

FULLNET COMMUNICATIONS INC

Form 10QSB

August 11, 2006

**Table of Contents**

**U.S. SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-QSB**

**(Mark One)**

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

**For the quarterly period ended June 30, 2006**

**TRANSITION REPORT UNDER 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 small business issuer as specified in its charter)

**Oklahoma**

**73 1473361**

(State or other jurisdiction of

(I.R.S. Employer Identification

No.)

incorporation or organization)

201 Robert S. Kerr Avenue, Suite 210, Oklahoma City, Oklahoma 73102

(Address of principal executive offices)

(405) 236-8200

(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  No**

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

The number of shares outstanding of the Issuer's Common Stock, \$.00001 par value, as of August 10, 2006 was 6,741,135.

Transitional Small Business Disclosure Format (Check one): **Yes  No**

**FORM 10 QSB  
TABLE OF CONTENTS**

	Page
<b>PART I. FINANCIAL INFORMATION</b>	
<b>Item 1. Financial Statements</b>	
<u>Condensed Consolidated Balance Sheets (Unaudited) June 30, 2006 and December 31, 2005</u>	3
<u>Condensed Consolidated Statements of Operations Three and six months ended June 30, 2006 and 2005 (Unaudited)</u>	4
<u>Condensed Consolidated Statement of Stockholders Deficit Six months ended June 30, 2006 (Unaudited)</u>	5
<u>Condensed Consolidated Statements of Cash Flows Six months ended June 30, 2006 and 2005 (Unaudited)</u>	6
<u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u>	7
<u>Item 2. Management's Discussion and Analysis or Plan of Operation</u>	14
<u>Item 3. Controls and Procedures</u>	22
<b><u>PART II. OTHER INFORMATION</u></b>	
<u>Item 1. Legal Proceedings</u>	24
<u>Item 2. Unregistered Sale of Equity Securities and Use of Proceeds</u>	24
<u>Item 3. Defaults Upon Senior Securities</u>	24
<u>Item 4. Submission of Matters to a Vote of Security Holders</u>	24
<u>Item 5. Other Information</u>	24
<u>Item 6. Exhibits and Reports on Form 8-K</u>	24
<u>Signatures</u>	29
<u>Certification Pursuant to Rules 13a-14(a)/15d-14(a)</u>	
<u>Certification Pursuant to Rules 13a-14(a)/15d-14(a)</u>	
<u>Certification Pursuant to 18 U.S.C. Section 1350</u>	
<u>Certification Pursuant to 18 U.S.C. Section 1350</u>	

**Table of Contents**

**FullNet Communications, Inc. and Subsidiaries**  
**CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)**

	<b>JUNE 30, 2006</b>	<b>DECEMBER 31, 2005</b>
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash	\$ 13,278	\$ 14,974
Accounts receivable, net	109,998	122,616
Prepaid expenses and other current assets	61,591	108,631
Total current assets	184,867	246,221
PROPERTY AND EQUIPMENT, net	774,472	888,957
INTANGIBLE ASSETS, net	56,643	75,874
OTHER ASSETS	18,282	18,282
<b>TOTAL</b>	<b>\$ 1,034,264</b>	<b>\$ 1,229,334</b>
 <b>LIABILITIES AND STOCKHOLDERS DEFICIT</b>		
<b>CURRENT LIABILITIES</b>		
Accounts payable trade	\$ 181,068	\$ 160,998
Accounts payable related party	237,552	218,982
Accrued and other current liabilities	777,004	709,999
Accrued interest related party	168,066	152,197
Notes payable, current portion	598,607	594,804
Notes payable related party	320,000	320,000
Deferred revenue	134,376	120,784
Total current liabilities	2,416,673	2,277,764
NOTES PAYABLE, less current portion	41,346	90,912
OTHER LIABILITIES	76,395	80,827
<b>STOCKHOLDERS DEFICIT</b>		
Common stock \$.00001 par value; authorized, 10,000,000 shares; issued and outstanding, 6,670,878 and 6,652,878 shares in 2006 and 2005, respectively	68	66
Common stock issuable, 70,257 shares in 2006 and 2005	57,596	57,596
Additional paid-in capital	8,346,142	8,328,004

Edgar Filing: FULLNET COMMUNICATIONS INC - Form 10QSB

Accumulated deficit	(9,903,956)	(9,605,835)
Total stockholders deficit	(1,500,150)	(1,220,169)
TOTAL	\$ 1,034,264	\$ 1,229,334

See accompanying notes to condensed consolidated financial statements.

- 3 -

---

**Table of Contents**

**FullNet Communications, Inc. and Subsidiaries**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)**

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>	<b>June 30,</b>	<b>June 30,</b>	<b>June 30,</b>
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
<b>REVENUES</b>				
Access service revenues	\$ 188,880	\$ 215,541	\$ 383,612	\$ 452,647
Co-location and other revenues	229,881	392,323	465,337	750,009
Total revenues	418,761	607,864	848,949	1,202,656
 <b>OPERATING COSTS AND EXPENSES</b>				
Cost of access service revenues	63,851	72,279	121,402	138,412
Cost of co-location and other revenues	58,328	50,193	114,984	87,358
Selling, general and administrative expenses	341,227	337,472	697,086	648,024
Depreciation and amortization	74,833	104,798	159,840	210,884
Total operating costs and expenses	538,239	564,742	1,093,312	1,084,678
INCOME (LOSS) FROM OPERATIONS	(119,478)	43,122	(244,363)	117,978
GAIN ON BAD DEBT RECOVERY, net		17,500		17,500
INTEREST EXPENSE	(26,780)	(30,988)	(53,758)	(64,238)
INCOME (LOSS) before income taxes	(146,258)	29,634	(298,121)	71,240
Income tax expense (benefit)				
NET INCOME (LOSS)	\$ (146,258)	\$ 29,634	\$ (298,121)	\$ 71,240
Net income (loss) per share basic	\$ (.02)	\$ NIL	\$ (.04)	\$ .01
Net income (loss) per share assuming dilution	\$ (.02)	\$ NIL	\$ (.04)	\$ .01
Weighted average shares outstanding basic	6,741,135	6,723,135	6,740,833	6,723,135
Weighted average shares outstanding assuming dilution	6,741,135	8,509,533	6,740,833	8,402,262



**Table of Contents**

**FullNet Communications, Inc. and Subsidiaries**  
**CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS DEFICIT (UNAUDITED)**  
**Six Months Ended June 30, 2006**

	Common stock		Common Stock	Additional paid-in capital	Accumulated	Total
	Shares	Amount	Issuable		Deficit	
Balance at January 1, 2006	6,652,878	\$ 66	\$ 57,596	\$ 8,328,004	\$ (9,605,835)	\$ (1,220,169)
Warrant exercise	18,000	2		178		180
Warrant extension granted in settlement of liabilities				17,960		17,960
Net loss					(298,121)	(298,121)
Balance at June 30, 2006	6,670,878	\$ 68	\$ 57,596	\$ 8,346,142	\$ (9,903,956)	\$ (1,500,150)

See accompanying notes to the condensed consolidated financial statements.

- 5 -

---



**Table of Contents**

**FullNet Communications, Inc. and Subsidiaries**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)**

	<b>Six Months Ended</b>	
	<b>June 30, 2006</b>	<b>June 30, 2005</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income (loss)	\$ (298,121)	\$ 71,240
Adjustments to reconcile net income (loss) to net cash provided by operating Activities		
Depreciation and amortization	159,840	210,884
Gain on bad debt recovery		(17,500)
Provision for uncollectible accounts receivable	19,503	17,511
Net (increase) decrease in Accounts receivable	(6,885)	196
Prepaid expenses and other current assets	47,040	(53,522)
Net increase (decrease) in Accounts payable trade	20,070	9,471
Accounts payable related party	36,530	36,530
Accrued and other liabilities	62,573	28,574
Accrued interest related party	15,869	15,869
Deferred revenue	13,592	(42,460)
Net cash provided by operating activities	70,011	276,793
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchases of property and equipment	(18,088)	(80,038)
Acquisition of assets	(8,036)	(31,396)
Net cash used in investing activities	(26,124)	(111,434)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Principal payments on borrowings under notes payable	(45,763)	(117,654)
Principal payments on note payable to related party		(16,289)
Principal payments on capital lease obligations		(31,586)
Proceeds from exercise of warrants	180	
Net cash used in financing activities	(45,583)	(165,529)
NET DECREASE IN CASH	(1,696)	(170)
Cash at beginning of period	14,974	12,226
Cash at end of period	\$ 13,278	\$ 12,056

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION

Cash paid for interest	\$ 10,320	\$ 22,951
Warrant extension granted in settlement of liabilities	17,960	

See accompanying notes to the condensed consolidated financial statements.

- 6 -

---

**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, 2005.

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, 2006. Certain reclassifications have been made to prior period balances to conform with the presentation for the current period.

**2. MANAGEMENT S PLANS**

At June 30, 2006, current liabilities exceed current assets by \$2,231,806. 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 and lease agreements (see Note 9. Notes Payable and Note 14. Related Party Transactions). These factors raise substantial doubts about 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.

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 raise additional capital on satisfactory terms or at all.

**Table of Contents****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. INCOME (LOSS) PER SHARE**

Income (loss) per share basic is calculated by dividing net income (loss) by the weighted average number of shares of stock outstanding during the period, including shares issuable without additional consideration. Income (loss) per share assuming dilution is calculated by dividing net income (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		Six Months Ended	
	June 30, 2006	June 30, 2005	June 30, 2006	June 30, 2005
Numerator:				
Net income (loss)	\$ (146,258)	\$ 29,634	\$ (298,121)	\$ 71,240
Denominator:				
Weighted average shares outstanding basic	6,741,135	6,723,135	6,740,833	6,723,135
Effect of dilutive stock options		859,865		763,922
Effect of dilutive warrants		926,533		915,205
Weighted average shares outstanding assuming dilution	6,741,135	8,509,533	6,740,833	8,402,262
Net income (loss) per share basic	\$ (.02)	\$ NIL	\$ (.04)	\$ .01
Net income (loss) per share assuming dilution	\$ (.02)	\$ NIL	\$ (.04)	\$ .01

Basic and diluted losses per share were the same for the three and six months ended June 30, 2006 because there was a net loss for each period.

Stock options exercisable for the purchase of 1,199,921 common stock shares at exercise prices ranging from \$0.08 to \$3.00 per share were outstanding for the three and six months ended June 30, 2005, but were not included in the calculation of income (loss) per share assuming dilution because the options were not dilutive.

Warrants exercisable for the purchase of 1,023,248 common stock shares at exercise prices ranging from \$0.08 to \$2.00 per share were outstanding for the three and six months ended June 30, 2005, but were not included in the calculation of income (loss) per share assuming dilution because the warrants were not dilutive.

Convertible promissory notes convertible into 1,003,659 common stock shares at a conversion price of \$1.00 per share were outstanding for the three and six months ended June 30, 2005, but were not included in the calculation of income (loss) per share assuming dilution because the convertible notes were not dilutive.

**5. ACCOUNTS RECEIVABLE**

Accounts receivable consist of the following:

**Table of Contents**

	June 30, 2006	December 31, 2005
Accounts receivable	\$ 238,670	\$ 231,785
Less allowance for doubtful accounts	(128,672)	(109,169)
	\$ 109,998	\$ 122,616

**6. PROPERTY AND EQUIPMENT**

Property and equipment consist of the following:

	June 30, 2006	December 31, 2005
Computers and equipment	\$ 1,313,115	\$ 1,296,856
Leasehold improvements	941,861	940,032
Software	56,512	56,512
Furniture and fixtures	19,153	19,153
	2,330,641	2,312,553
Less accumulated depreciation	(1,556,169)	(1,423,596)
	\$ 774,472	\$ 888,957

Depreciation expense for the three months ended June 30, 2006 and 2005 was \$66,192 and \$66,662, respectively. Depreciation expense for the six months ended June 30, 2006 and 2005 was \$132,573 and \$134,303, respectively.

**7. INTANGIBLE ASSETS**

Intangible assets consist primarily of acquired customer bases and covenants not to compete and are carried net of accumulated amortization. Upon initial application of SFAS 142 as of January 1, 2002, the Company reassessed useful lives and began amortizing 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 June 30, 2006 and 2005 relating to intangible assets was \$8,641 and \$38,136, respectively. Amortization expense for the six months ended June 30, 2006 and 2005 relating to intangible assets was \$27,267 and \$76,581, respectively.

**8. ACCRUED AND OTHER CURRENT LIABILITIES**

Accrued and other current liabilities consist of the following:

	June 30, 2006	December 31, 2005
Accrued interest	\$ 266,122	\$ 237,165
Accrued deferred compensation	396,912	353,917
Accrued other liabilities	113,970	118,917
	\$ 777,004	\$ 709,999

**Table of Contents****9. NOTES PAYABLE**

Notes payable consist of the following:

	June 30, 2006	December 31, 2005
Note payable to a bank, payable in monthly installments of \$8,768, including interest of 9.5%, maturing September 2008; collateralized by property and equipment, accounts receivable and Company common stock owned by the founder and CEO of the Company; guaranteed by the founder and CEO of the Company; partially guaranteed by the Small Business Administration	\$ 124,317	\$ 170,080
Interim loan, from a related party, interest at 10%, requires payments equal to 50% of the net proceeds received by the Company from its private placement of convertible promissory notes, matured December 2001; unsecured (1)	320,000	320,000
Convertible promissory notes; interest at 12.5% of face amount, payable quarterly; these notes are unsecured and are matured at June 30, 2006 (convertible into approximately 1,003,659 shares at June 30, 2006 and December 31, 2005) (2)	510,636	510,636
Other notes payable	5,000	5,000
	959,953	1,005,716
Less current portion	918,607	914,804
	\$ 41,346	\$ 90,912

(1) This loan and accrued interest of \$168,066 was past due on June 30, 2006; the Company has not made payment or negotiated an extension of the loan and the lender has not made any demands.

(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

- 10 -

---

**Table of Contents**

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 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 June 30, 2006, the outstanding principal and interest of the convertible promissory notes was \$774,530.

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.

**10. COMMON STOCK OPTIONS AND WARRANTS**

The following table summarizes the Company's employee stock option activity for the three and six months ended June 30, 2006:

	Three Months Ended June 30, 2006	Weighted Average Exercise Price	Six Months Ended June 30, 2006	Weighted Average Exercise Price
Options outstanding, beginning and end of the period	3,083,034	\$ .43	3,083,034	\$ .43

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment*. SFAS 123(R) replaces SFAS No. 123, *Accounting for Stock-Based Compensation*, and supersedes *Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees*. The Company adopted SFAS 123(R) on January 1, 2006 using the modified prospective method as described in the standard. Under the modified prospective method, the Company is required to record compensation cost for new and modified awards over the related vesting period of such awards prospectively and record compensation cost prospectively for the unvested portion at time of adoption, of previously issued and outstanding awards over the remaining vesting period of such awards. As of January 1, 2006, the Company had no unvested outstanding awards and as a result, the adoption of SFAS 123(R) had no impact on the Company's consolidated financial statements or consolidated results of operations.

The Company used the modified prospective method at the date of adoption and therefore results for the three and six months ended June 30, 2005 have not been restated. Had compensation expense for employee stock options granted under our stock option plans been determined based on fair value at the grant date consistent with SFAS No. 123, our net income and earnings per share for the three and six months ended June 30, 2005 would have been the pro forma amounts indicated below and were estimated using the Black-Scholes option pricing model with the following weighted average assumptions:

Risk free interest rate	4.5%
Expected volatility	122.5%
Dividend yield	0.0%
Weighted average expected life	5 years

**Table of Contents**

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net income (loss)		
As reported	\$ 29,634	\$ 71,240
Pro forma	\$ 13,465	\$ 55,071
Basic income (loss) per share		
As reported	\$ NIL	\$ .01
Pro forma	\$ NIL	\$ .01
Diluted income (loss) per share		
As reported	\$ NIL	\$ .01
Pro forma	\$ NIL	\$ .01

The following table summarizes the Company's common stock purchase warrant and non-employee stock option activity for the three and six months ended June 30, 2006:

	Three Months Ended June 30, 2006	Weighted Average Exercise Price	Six Months Ended June 30, 2006	Weighted Average Exercise Price
Warrants and non-employee stock options outstanding, beginning of the period	1,369,727	\$ .86	1,479,306	\$ .82
Warrants and non-employee stock options exercised during the period			(18,000)	.01
Warrants and non-employee stock options expired during the period	(595,727)	1.47	(687,306)	1.33
Warrants and non-employee stock options outstanding, end of the period	774,000	\$ .39	774,000	\$ .39

**11. RECENTLY ISSUED ACCOUNTING STANDARDS**

SFAS No. 151, *Inventory Costs* - an amendment of APB No. 4 and SFAS No. 152, *Accounting for Real Estate Time-Sharing Transactions* - an amendment of FASB Statements No. 66 and 67, SFAS No. 153, *Exchange of Non-monetary Assets* - an amendment of APB No. 29, SFAS No. 154, *Accounting Changes and Error Corrections* - a replacement of APB No. 20 and SFAS 3, SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments* - an amendment of FASB Statements No. 133 and No. 140, and SFAS No. 156, *Accounting for Servicing of Financial Assets* - an amendment of FASB Statement No. 140 were recently issued. SFAS No. 151, 152, 153, 154, 155, and 156 have no current applicability to the Company and have no effect on the consolidated financial statements.

**12. SIGNIFICANT CUSTOMER**

During the six months ended June 30, 2005, the Company had one customer that comprised approximately 28% of total revenues. The customer's service contract expired on December 31, 2005 without renewal or extension. Consequently, the Company experienced a loss of this revenue commencing in 2006 without a corresponding

reduction in expenses.

- 12 -

---

**Table of Contents**

**13. RELATED PARTY TRANSACTIONS**

The Company is in default on an operating lease for certain equipment which is leased from one of its significant shareholders who also holds a \$320,000 interim loan that is also in default (see Note 9. Notes Payable, above). The original lease was dated November 21, 2001 and required 12 monthly rental payments of \$6,088 with a fair market purchase option at the end of the 12-month lease. Upon default on the lease, the Company has continued leasing the equipment on a month-to-month basis at the same monthly rate as the original lease. The Company has been unable to make the month-to-month payments. In January 2006, the Company agreed to extend the expiration date on 425,000 common stock purchase warrants for the lessor in return for a credit of \$17,960 on the operating lease. At June 30, 2006 the unpaid lease payments totaled \$237,552. The lessor has not made any demands for payment or threatened to terminate the month-to-month lease arrangement.

**14. CONTINGENCIES**

During September 2005, the Company received a back billing from AT&T (formerly SBC) of approximately \$230,000. Since then, the Company has received a number of additional back billings from AT&T that total in excess of \$4,800,000. The Company believes AT&T has no basis for these charges, is currently reviewing these billings with its attorneys and plans to vigorously dispute the charges. Therefore, the Company has not recorded any expense or liability related to these billings.

As a telecommunications company, 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 ). For example, the Company along with many other telecommunications companies in Oklahoma is currently a party to one or more proceedings before the OCC relating to the terms of its interconnection agreement with AT&T (formerly SBC Communications) and an anticipated successor to this interconnection agreement. These proceedings were initiated due to the unreasonable changes that AT&T was proposing be incorporated in the successor interconnection agreement. During April 2006 the OCC ruled in favor of the Company. However, AT&T has asked for an appeal of this ruling. Therefore, the regulatory proceeding concerning the terms of the interconnection agreement with AT&T, which is based upon their standard interconnection agreement, and the anticipated successor thereto is ongoing and is expected to conclude during 2006. The Company is unable to accurately predict the outcome of this regulatory proceeding at this time but an unfavorable outcome could have a material adverse effect on the Company's business, financial condition or results of operations.

- 13 -

---

**Table of Contents**

**Item 2. Management's Discussion and Analysis or Plan of Operation**

*The following discussion is qualified in its entirety by the more detailed information in our Form 10-KSB 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, 2004 (collectively referred to as the Disclosure Documents ). Certain forward-looking statements contained herein and in such 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, such as those inherent 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 the dominant 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 an Internet site on the World Wide Web ( WWW ) at [www.fullnet.net](http://www.fullnet.net). Information contained on our Web site 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, and shifted our focus from offering dial-up services to providing wholesale and private label network connectivity and related services to other Internet service providers. During 1995 and 1996, we furnished wholesale and private label network connectivity services to Internet service providers.

In 1997 we continued our focus on serving as a backbone provider by upgrading and acquiring more equipment. We also started offering our own Internet service provider brand access and services to our wholesale customers. As of June 30, 2006, there was one Internet service provider in Oklahoma that used the FullNet brand name for whom we provide the backbone to the Internet. There was one Internet service provider that used a private label brand name, for whom we are its access backbone and provide on an outsource basis technical support, systems management and operations. Additionally, we provide high-speed broadband connectivity, traditional telephone services, website hosting, network management and consulting solutions to over 100 businesses in Oklahoma.

In 1998 our gross revenues exceeded \$1,000,000 and we made the Metro Oklahoma City Top 50 Fastest Growing Companies list. In 1998 we commenced the process of organizing a competitive local

**Table of Contents**

exchange carrier ( CLEC ) through FullTel, and acquired Animus Communications, Inc. ( Animus ), a wholesale Web-service company, which enabled us to become a total solutions provider to individuals and companies seeking a one-stop shop in Oklahoma. Animus was renamed FullWeb in January 2000.

With the incorporation of FullTel and the acquisition of FullWeb, our current business strategy is to become the dominant integrated communications provider in Oklahoma, focusing on rural areas. We expect to grow through the acquisition of additional customers for our carrier-neutral co-location space and traditional telephone services, the acquisition of Internet service providers, as well as through a FullNet brand marketing campaign.

During February 2000, our common stock began trading 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.

We completed our network operations center during the first quarter of 2001. 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, 24-hour onsite support with both battery and generator backup.

Through FullTel, our wholly owned subsidiary, we are a fully licensed competitive local exchange carrier or CLEC in Oklahoma. The FullTel data center telephone switching equipment was installed in March 2003. At which time, FullTel began the process of activating local access telephone numbers for the cities in which we will 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 June 30, 2006 FullTel provided us with local telephone access in approximately 232 cities.

**Table of Contents****Results of Operations**

The following table sets forth certain statement of operations data as a percentage of revenues for the three and six months ended June 30, 2006 and 2005:

	Three Months Ended				Six Months Ended			
	June 30, 2006		June 30, 2005		June 30, 2006		June 30, 2005	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Revenues:								
Access service revenues	\$ 188,880	45.1%	\$ 215,541	35.5%	\$ 383,612	45.2%	\$ 452,647	37.6%
Co-location and other revenues	229,881	54.9	392,323	64.5	465,337	54.8	750,009	62.4
Total revenues	418,761	100.0	607,864	100.0	848,949	100.0	1,202,656	100.0
Cost of access service revenues	63,851	15.2	72,279	11.9	121,402	14.3	138,412	11.5
Cost of co-location and other revenues	58,328	13.9	50,193	8.3	114,984	13.6	87,358	7.3
Selling, general and administrative expenses	341,227	81.5	337,472	55.5	697,086	82.1	648,024	53.9
Depreciation and amortization	74,833	17.9	104,798	17.2	159,840	18.8	210,884	17.5
Total operating costs and expenses	538,239	128.5	564,742	92.9	1,093,312	128.8	1,084,678	90.2
Income (loss) from operations	(119,478)	(28.5)	43,122	7.1	(244,363)	(28.8)	117,978	9.8
Gain on bad debt recovery, net			17,500	2.9			17,500	1.5
Interest expense	(26,780)	(6.4)	(30,988)	(5.1)	(53,758)	(6.3)	(64,238)	(5.4)
Net income (loss) before income taxes	(146,258)	(34.9)	29,634	4.9	(298,121)	(35.1)	71,240	5.9
Income tax expense (benefit)								
Net income (loss)	\$ (146,258)	(34.9)%	\$ 29,634	4.9%	\$ (298,121)	(35.1)%	\$ 71,240	5.9%

**Three Months Ended June 30, 2006 Compared to Three Months Ended June 30, 2005***Revenues*



## Edgar Filing: FULLNET COMMUNICATIONS INC - Form 10QSB

Access service revenues decreased \$26,661 or 12.4% to \$188,880 for the 2006 2<sup>nd</sup> Quarter from \$215,541 for the same period in 2005 primarily due to a decline in the number of customers.

Co-location and other revenues decreased \$162,442 or 41.4% to \$229,881 for the 2006 2<sup>nd</sup> Quarter from \$392,323 for the same period in 2005. This decrease was primarily attributable to the loss of one significant customer and reciprocal compensation that was partially offset by the sale of additional services to existing customers and addition of new customers. During the 2005 2<sup>nd</sup> Quarter, we had one customer that comprised \$164,516, approximately 27%, of total revenues. This customer's service contract expired on December 31, 2005 without renewal or extension. Consequently, we experienced a loss of this revenue commencing in 2006. During the 2006 2<sup>nd</sup> Quarter we did not record reciprocal compensation revenue (fees for terminating AT&T (formerly SBC) customers' local calls onto our network). During the same period in 2005 we recorded approximately \$42,400 of reciprocal compensation revenue that included approximately \$31,200 arising from a change in estimate for the period March 2003 through March 2005. We began billing AT&T during 2004, and have billed for the periods of March 2003 through June 2006. AT&T failed to pay and is disputing approximately \$166,700. We are pursuing AT&T for all balances due, however there is significant uncertainty as to whether or not we will be successful. Upon the ultimate resolution of AT&T's challenge, we will recognize the associated revenue, if any. On a going-forward basis

- 16 -

---

**Table of Contents**

it is uncertain at what rate or if any reciprocal compensation will be allowed in our successor interconnection agreement with AT&T.

*Operating Costs and Expenses*

Cost of access service revenues decreased \$8,428 or 11.7% to \$63,851 for the 2006 2<sup>nd</sup> Quarter compared to \$72,279 for the same period in 2005. This decrease was primarily due to non-recurring expenditures during the 2005 2<sup>nd</sup> Quarter to expand and support our network. Cost of access service revenues as a percentage of access service revenues increased to 33.8% during the 2006 2<sup>nd</sup> Quarter, compared to 33.5% during the same period in 2005.

Cost of co-location and other revenues increased \$8,135 or 16.2% to \$58,328 for the 2006 2<sup>nd</sup> Quarter compared to \$50,193 for the same period in 2005. This increase was primarily due to recurring costs associated with increased capabilities related to traditional phone services. Cost of co-location and other revenues as a percentage of co-location and other revenues increased to 25.4% during the 2006 2<sup>nd</sup> Quarter compared to 12.8% during the same period in 2005.

Selling, general and administrative expenses for the 2<sup>nd</sup> Quarter 2006 remained relatively stable compared to the same period in 2005. Selling, general and administrative expenses as a percentage of total revenues increased to 81.5% during the 2006 2<sup>nd</sup> Quarter from 55.5% during the same period in 2005 primarily due to the decrease in revenues.

Depreciation and amortization expense decreased \$29,965 or 28.6% to \$74,833 for the 2006 2<sup>nd</sup> Quarter from \$104,798 for the same period in 2005 primarily due to several of our intangible assets becoming fully amortized. In January 2002, upon initially applying Statement of Financial Account Standards 142, *Goodwill and Intangible Assets* ( SFAS 142 ), we reassessed useful lives and we began amortizing our intangible assets over their estimated useful lives and in direct relation to any decreases in the acquired customer bases to which they relate. Amortization expense for the 2<sup>nd</sup> Quarter 2006 and 2005 relating to intangible assets was \$8,641 and \$38,136, respectively.

*Gain on Bad Debt Recovery*

During the 2005 2<sup>nd</sup> Quarter, we negotiated and settled a customer's account receivable that had previously been written off as bad debt expense. This settlement was recorded net of our legal expenses as a \$17,500 gain on bad debt recovery.

*Interest Expense*

Interest expense decreased \$4,208 or 13.6% to \$26,780 for the 2006 2<sup>nd</sup> Quarter from \$30,988 for the same period in 2005. This decrease was primarily attributable to the retirement of several high interest rate notes, leases and credit cards with interest rates ranging from 29.5% to 6.3%.

**Six Months Ended June 30, 2006 Compared to Six Months Ended June 30, 2005**

*Revenues*

Access service revenues decreased \$69,035 or 15.3% to \$383,612 for the 2006 six-month period from \$452,647 for the same period in 2005 primarily due to a decline in the number of customers.

**Table of Contents**

Co-location and other revenues decreased \$284,672 or 38% to \$465,337 for the 2006 six-month period from \$750,009 for the same period in 2005. This decrease was primarily attributable to the loss of one significant customer and reciprocal compensation that was partially offset by the sale of additional services to existing customers and addition of new customers. During the 2005 six-month period, we had one customer that comprised \$333,408, approximately 28%, of total revenues. This customer's service contract expired on December 31, 2005 without renewal or extension. Consequently, we experienced a loss of this revenue commencing in 2006. During the 2006 six-month period we recorded approximately \$7,800 of reciprocal compensation revenue (fees for terminating AT&T (formerly SBC) customers' local calls onto our network). During the same period in 2005 we recorded approximately \$75,100 of reciprocal compensation revenue that included approximately \$51,200 arising from a change in estimate for the period March 2003 through December 2004. We began billing AT&T during 2004, and have billed for the periods of March 2003 through June 2006. AT&T failed to pay and is disputing approximately \$166,700. We are pursuing AT&T for all balances due, however there is significant uncertainty as to whether or not we will be successful. Upon the ultimate resolution of AT&T's challenge, we will recognize the associated revenue, if any. On a going-forward basis it is uncertain at what rate or if any reciprocal compensation will be allowed in our successor interconnection agreement with AT&T.

*Operating Costs and Expenses*

Cost of access service revenues decreased \$17,010 or 12.3% to \$121,402 for the 2006 six-month period from \$138,412 for the same period in 2005. This decrease was primarily due to increased expenditures to expand and support our network. Cost of access service revenues as a percentage of access service revenues increased to 31.7% during the 2006 six-month period, compared to 30.6% during the same period in 2005.

Cost of co-location and other revenues increased \$27,626 or 31.6% to \$114,984 for the 2006 six-month period, compared to \$87,358 for the same period in 2005. This increase was primarily due to recurring costs associated with increased capabilities related to traditional phone services. Cost of co-location and other revenues as a percentage of co-location and other revenues increased to 24.7% during the 2006 six-month period, compared to 11.6% during the same period in 2005.

Selling, general and administrative expenses increased \$49,062 or 7.6% to \$697,086 for the 2006 six-month period from \$648,024 for the same period in 2005. This increase was primarily attributable to increases in employee costs and professional fees of \$35,660 and \$22,788, respectively. Employee costs for the 2006 six-month period were \$457,640, compared to \$421,980 during the same period in 2005. This increase was primarily due to annual wage increases and the filling of the vacancy in a sales position from December 2004 through September 2005. Selling, general and administrative expenses as a percentage of total revenues increased to 82.1% during the 2006 six-month period from 53.9% during the same period in 2005 primarily due to the decrease in revenues.

Depreciation and amortization expense decreased \$51,044 or 24.2% to \$159,840 for the 2006 six-month period from \$210,884 for the same period in 2005 primarily due to several of our intangible assets becoming fully amortized. In January 2002, upon initially applying Statement of Financial Account Standards 142, *Goodwill and Intangible Assets* (SFAS 142), we reassessed useful lives and we began amortizing our intangible assets over their estimated useful lives and in direct relation to any decreases in the acquired customer bases to which they relate. Amortization expense for the 2006 and 2005 six-month period relating to intangible assets was \$27,267 and \$76,581, respectively.

**Table of Contents***Gain on Bad Debt Recovery*

During the 2005 six-month period, we negotiated and settled a customer's account receivable that had previously been written off as bad debt expense. This settlement was recorded net of our legal expenses as a \$17,500 gain on bad debt recovery.

*Interest Expense*

Interest expense decreased \$10,480 or 16.3% to \$53,758 for the 2006 six-month period from \$64,238 for the same period in 2005. This decrease was primarily attributable to the retirement of several high interest rate notes, leases and credit cards with interest rates ranging from 29.5% to 6.3%.

**Liquidity and Capital Resources**

As of June 30, 2006, we had \$13,278 in cash and \$2,416,673 in current liabilities, including \$134,376 of deferred revenues that will not require settlement in cash.

At June 30, 2006, we had a deficit working capital of \$2,231,806, while at December 31, 2005 we had a deficit working capital of \$2,031,543. 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 June 30, 2006, \$164,167 of the \$181,068 we owed to our trade creditors and \$231,463 of the \$237,552 payable to a related party was past due. We have no formal agreements regarding payment of these amounts. At June 30, 2006, we had outstanding principal and interest owed on matured notes totaling \$1,262,596. We have neither made payment nor 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 six months ended June 30, 2005, we had one customer that accounted for approximately 28% of total revenues. The contract pursuant to which we provided services to this customer expired on December 31, 2005. This customer did not renew its contract. Therefore commencing in 2006 we experienced a loss of this revenue without a corresponding reduction in expense.

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 \$4,800,000. We believe AT&T has no basis for these charges, are currently reviewing these billings with our attorneys and plan to vigorously dispute the charges. Therefore, we have not recorded any expense or liability related to these billings.

	For the Periods Ended June 30,	
	2006	2005
Net cash flows provided by operations	\$ 70,011	\$ 276,793
Net cash flows used in investing activities	(26,124)	(111,434)
Net cash flows used in financing activities	(45,583)	(165,529)

Cash used for the purchases of equipment was \$18,088 and \$80,038, respectively, for the six months ended June 30, 2006 and 2005. Cash used for the acquisition of assets was \$8,036 and \$31,396, respectively, for the six months ended June 30, 2006 and 2005.

**Table of Contents**

Cash used for principal payments on notes payable and capital lease obligations was \$45,763 and \$165,529, respectively, for the six months ended June 30, 2006 and 2005.

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:

- o mergers and acquisitions and
  
- o 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.

In the event that we are unable to obtain additional capital or to obtain it on acceptable terms or in sufficient amounts, we will be required to delay the further development of our network or take other actions. This could have a material adverse effect on our business, operating results and financial condition and our ability to achieve sufficient cash flows to service debt requirements.

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 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**

On January 5, 2001, we obtained a \$250,000 interim loan. This loan bears interest at 10% per annum and requires payments equal to 50% of the net proceeds received by us from our private placement of convertible notes payable. Subsequently, the principal balance of the loan was increased to \$320,000 and the due date was extended to December 31, 2001. Through June 30, 2006 we had made aggregate payments of principal and interest of \$35,834 on this loan. Pursuant to the terms of this loan the balance was due on December 31, 2001 and we have not made payment or negotiated an extension of the loan and

**Table of Contents**

the lender has not made any demands. At June 30, 2006, the outstanding principal and interest of the loan was \$488,066.

We are in default on an operating lease for certain equipment that is leased from one of our significant shareholders who also holds a \$320,000 interim loan that is also in default (see Note 9. Notes Payable of the financial statements above). The original lease was dated November 21, 2001 and required 12 monthly rental payments of \$6,088 with a fair market purchase option at the end of the 12-month lease term. Upon default on the lease, we have continued to lease the equipment on a month-to-month basis at the same monthly rental rate; however, we have been unable to make these monthly rental payments. In January 2006, we agreed to extend the expiration date on 425,000 common stock purchase warrants for the lessor in return for a credit of \$17,960 on this lease obligation. At June 30, 2006 the unpaid lease payments totaled \$237,552. The lessor has not made any demands for payment or threatened to terminate the month-to-month lease arrangement. The loss of this equipment would have a material adverse effect on the Company's business, financial condition and results of operations.

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 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 June 30, 2006, the outstanding principal and interest of the convertible promissory notes was \$774,530.

**Recently Issued Accounting Standards**

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment*. SFAS 123(R) replaces SFAS No. 123, *Accounting for Stock-Based Compensation*, and supersedes *Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees*. We adopted SFAS 123(R) on January 1, 2006 using the modified prospective method as described in the standard. Under the modified prospective method, we are required to record compensation cost for new and modified awards over the related vesting period of such awards prospectively and record compensation cost prospectively for the unvested portion at time of adoption, of previously issued and outstanding awards over the remaining vesting period of such awards. As of January 1, 2006, we had no unvested outstanding awards and as a result, the adoption of SFAS123(R) had no impact on our consolidated financial statements or consolidated results of operations.

SFAS No. 151, *Inventory Costs* - an amendment of APB No. 4 and SFAS No. 152, *Accounting for Real Estate Time-Sharing Transactions* - an amendment of FASB Statements No. 66 and 67, SFAS No. 153, *Exchange of Non-monetary Assets* - an amendment of APB No. 29, SFAS No. 154, *Accounting Changes and Error Corrections* - a replacement of APB No. 20 and SFAS 3, SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments* - an amendment of FASB Statements No. 133 and No. 140, and SFAS No. 156, *Accounting for Servicing of Financial Assets* - an amendment of FASB Statement No. 140 were recently issued. SFAS No. 151, 152, 153, 154, 155, and 156 have no current applicability to us and have no effect 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.

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.

**Item 3. 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 (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets; (ii) 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 (iii) 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 Chief Executive Officer and Chief Financial Officer, 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, 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

**Table of Contents**

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.

- 23 -

---



**Table of Contents**

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

As a telecommunications company, 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 ). For example, we along with many other telecommunications companies in Oklahoma are currently a party to one or more proceedings before the OCC relating to the terms of our interconnection agreement with AT&T (formerly SBC Communications) and an anticipated successor to this interconnection agreement. These proceedings were initiated due to the unreasonable changes that AT&T was proposing be incorporated in the successor interconnection agreement. During April 2006 the OCC ruled in our favor. However, AT&T has asked for an appeal of this ruling. Therefore, the regulatory proceeding concerning the terms of the interconnection agreement with AT&T, which is based upon their standard interconnection agreement, and the anticipated successor thereto is ongoing and is expected to conclude during 2006. We are unable to accurately predict the outcome of this regulatory proceeding 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 an interim loan that matured December 31, 2001. This loan bears interest at 10% per annum and requires payments equal to 50% of the net proceeds received by us from our private placement of convertible notes payable. Through June 30, 2006, we had made aggregate payments of principal and interest of \$35,834 on this loan. At June 30, 2006, the outstanding principal and accrued interest of the loan was \$488,066. We have not made payment or negotiated an extension of the loan and the lender has not made any demands.

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 June 30, 2006, the aggregate outstanding principal and accrued interest of the notes was \$774,530. We have not made payment or negotiated an extension of these notes, and the lenders have not made any demands.

**Item 4. Submission of Matters to a Vote of Security Holders**

None.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

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

- 24 -

---

**Table of Contents**

<i>Exhibit Number</i>	<i>Exhibit</i>	
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).	#
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).    | # |

- 25 -

---

**Table of Contents**

<i>Exhibit Number</i>	<i>Exhibit</i>	<i>#</i>
4.14	Form of Convertible Promissory Note for September 29, 2000, private placement (filed as Exhibit 4.13 to Registrant's Form 10-KSB for the fiscal year ended December 31, 2000 and incorporated herein by reference).	#
4.15	Form of Warrant Agreement for September 29, 2000, private placement (filed as Exhibit 4.13 to Registrant's Form 10-KSB for the fiscal year ended December 31, 2000 and incorporated herein by reference).	#
4.16	Form of 2001 Exchange Warrant Agreement (filed as Exhibit 4.16 to Registrant's Form 10-QSB for the quarter ended June 30, 2001 and incorporated herein by reference)	#
4.17	Form of 2001 Exchange Warrant Certificate (filed as Exhibit 4.17 to Registrant's Form 10-QSB for the quarter ended June 30, 2001 and incorporated herein by reference)	#
10.1	Financial Advisory Services Agreement between the Company and National Securities Corporation, dated September 17, 1999 (filed as Exhibit 10.1 to Registrant's Form 10-KSB for the fiscal year ended December 31, 1999, and incorporated herein by reference).	#
10.2	Lease Agreement between the Company and BOK Plaza Associates, LLC, dated December 2, 1999 (filed as Exhibit 10.2 to Registrant's Form 10-KSB for the fiscal year ended December 31, 1999, and incorporated herein by reference).	#
10.3	Interconnection agreement between Registrant and Southwestern Bell dated March 19, 1999 (filed as Exhibit 6.1 to Registrant's Registration Statement on Form 10-SB, file number 000-27031 and incorporated herein by reference).	#
10.4	Stock Purchase Agreement between the Company and Animus Communications, Inc. (filed as Exhibit 6.2 to Registrant's Registration Statement on Form 10-SB, file number 000-27031 and incorporated herein by reference).	#
10.5	Registrar Accreditation Agreement effective February 8, 2000, by and between Internet Corporation for Assigned Names and Numbers and FullWeb, Inc. d/b/a FullNic f/k/a Animus Communications, Inc. (filed as Exhibit 10.1 to Registrant's Quarterly Report on Form 10-QSB for the Quarter ended March 31, 2000 and incorporated herein by reference).	#
10.6	Master License Agreement For KMC Telecom V, Inc., dated June 20, 2000, by and between FullNet Communications, Inc. and KMC Telecom V, Inc. (filed as Exhibit 10.1 to the Registrant's Quarterly Report on Form 10-QSB for the Quarter ended June 30, 2000 and incorporated herein by reference).	#
10.7	Domain Registrar Project Completion Agreement, dated May 10, 2000, by and between FullNet Communications, Inc., FullWeb, Inc. d/b/a FullNic and Think Capital (filed as Exhibit 10.2 to Registrant's Quarterly Report on Form 10-QSB for the Quarter ended June 30, 2000 and incorporated herein by reference).	#

Edgar Filing: FULLNET COMMUNICATIONS INC - Form 10QSB

- 10.8      Amendment to Financial Advisory Services Agreement between Registrant and National Securities Corporation, dated April 21, 2000 (filed as Exhibit 10.3 to Registrant's Quarterly Report on Form 10-QSB for the Quarter ended June 30, 2000 and incorporated herein by reference).      #
- 10.9      Asset Purchase Agreement dated June 2, 2000, by and between FullNet of Nowata and FullNet Communications, Inc. (filed as Exhibit 99.1 to Registrant's Form 8-K filed on June 20, 2000 and incorporated herein by reference).      #
- 10.10     Asset Purchase Agreement dated February 4, 2000, by and between FullNet of Bartlesville and FullNet Communications, Inc. (filed as Exhibit 2.1 to Registrant's Form 8-K filed on February 18, 2000 and incorporated herein by reference).      #

- 26 -

---

**Table of Contents**

<i>Exhibit Number</i>	<i>Exhibit</i>	<i>#</i>
10.11	Agreement and Plan of Merger Among FullNet Communications, Inc., FullNet, Inc. and Harvest Communications, Inc. dated February 29, 2000 (filed as Exhibit 2.1 to Registrant's Form 8-K filed on March 10, 2000 and incorporated herein by reference).	#
10.12	Asset Purchase Agreement dated January 25, 2000, by and between FullNet of Tahlequah, and FullNet Communications, Inc. (filed as Exhibit 2.1 to Registrant's Form 8-K filed on February 9, 2000 and incorporated herein by reference).	#
10.13	Promissory Note dated August 2, 2000, issued to Timothy J. Kilkenny (filed as Exhibit 10.13 to Registrant's Form 10-KSB for the fiscal year ended December 31, 2000).	#
10.14	Warrant Agreement dated August 2, 2000, issued to Timothy J. Kilkenny (filed as Exhibit 10.14 to Registrant's Form 10-KSB for the fiscal year ended December 31, 2000).	#
10.15	Warrant Certificate dated August 2, 2000 issued to Timothy J. Kilkenny (filed as Exhibit 10.15 to Registrant's Form 10-KSB for the fiscal year ended December 31, 2000).	#
10.16	Stock Option Agreement dated December 8, 2000, issued to Timothy J. Kilkenny (filed as Exhibit 10.16 to Registrant's Form 10-KSB for the fiscal year ended December 31, 2000).	#
10.17	Warrant Agreement dated November 9, 2000, issued to Roger P. Baresel (filed as Exhibit 10.17 to Registrant's Form 10-KSB for the fiscal year ended December 31, 2000).	#
10.18	Warrant Agreement dated December 29, 2000, issued to Roger P. Baresel (filed as Exhibit 10.18 to Registrant's Form 10-KSB for the fiscal year ended December 31, 2000).	#
10.19	Stock Option Agreement dated February 29, 2000, issued to Wallace L. Walcher (filed as Exhibit 10.19 to Registrant's Form 10-KSB for the fiscal year ended December 31, 2000).	#
10.20	Stock Option Agreement dated February 17, 1999, issued to Timothy J. Kilkenny (filed as Exhibit 3.1 to Registrant's Registration Statement on Form 10-SB, file number 000-27031 and incorporated herein by reference).	#
10.21	Stock Option Agreement dated October 19, 1999, issued to Wesdon C. Peacock (filed as Exhibit 10.21 to Registrant's Form 10-KSB for the fiscal year ended December 31, 2000).	#
10.22	Stock Option Agreement dated April 14, 2000, issued to Jason C. Ayers (filed as Exhibit 10.22 to Registrant's Form 10-KSB for the fiscal year ended December 31, 2000).	#
10.23	Stock Option Agreement dated May 1, 2000, issued to B. Don Turner (filed as Exhibit 10.23 to Registrant's Form 10-KSB for the fiscal year ended December 31, 2000).	#
10.24	Form of Stock Option Agreement dated December 8, 2000, issued to Jason C. Ayers, Wesdon C. Peacock, B. Don Turner and Wallace L. Walcher (filed as Exhibit 10.24 to Registrant's Form 10-KSB for the fiscal year ended December 31, 2000).	#

Edgar Filing: FULLNET COMMUNICATIONS INC - Form 10QSB

10.25	Warrant Certificate Dated November 9, 2000, issued to Roger P. Baresel (filed as Exhibit 10.25 to Registrant's Form 10-KSB for the fiscal year ended December 31, 2000).	#
10.26	Warrant Certificate Dated November 9, 2000, issued to Roger P. Baresel (filed as Exhibit 10.26 to Registrant's Form 10-KSB for the fiscal year ended December 31, 2000).	#
10.27	Warrant Certificate Dated December 29, 2000, issued to Roger P. Baresel (filed as Exhibit 10.27 to Registrant's Form 10-KSB for the fiscal year ended December 31, 2000).	#
10.28	Stock Option Agreement dated October 13, 2000, issued to Roger P. Baresel (filed as Exhibit 10.28 to Registrant's Form 10-KSB for the fiscal year ended December 31, 2000).	#
10.29	Stock Option Agreement dated October 12, 1999, issued to Travis Lane (filed as Exhibit 10.29 to Registrant's Form 10-KSB for the fiscal year ended December 31, 2000).	#

- 27 -

---

**Table of Contents**

<i>Exhibit Number</i>	<i>Exhibit</i>	
10.30	Promissory Note dated January 5, 2001, issued to Generation Capital Associates (filed as Exhibit 10.30 to Registrant's Form 10-KSB for the fiscal year ended December 31, 2000).	#
10.31	Placement Agency Agreement dated November 8, 2000 between FullNet Communications, Inc. and National Securities Corporation (filed as Exhibit 10.31 to Registrant's Form 10-KSB for the fiscal year ended December 31, 2000).	#
10.32	Promissory Note dated January 25, 2000, issued to Fullnet of Tahlequah, Inc.	#
10.33	Promissory Note dated February 7, 2000, issued to David Looper	#
10.34	Promissory Note dated February 29, 2000, issued to Wallace L. Walcher	#
10.35	Promissory Note dated June 2, 2000, issued to Lary Smith	#
10.36	Promissory Note dated June 15, 2001, issued to higganbotham.com L.L.C.	#
10.37	Promissory Note dated November 19, 2001, issued to Northeast Rural Services	#
10.38	Promissory Note dated November 19, 2001, issued to Northeast Rural Services	#
10.39	Form of Convertible Promissory Note dated September 6, 2002	#
10.40	Employment Agreement with Timothy J. Kilkenny dated July 31, 2002	#
10.41	Employment Agreement with Roger P. Baresel dated July 31, 2002	#
10.42	Letter from Grant Thornton LLP to the Securities and Exchange Commission dated January 30, 2003	#
10.43	Form 8-K dated January 30, 2003 reporting the change in certifying accountant	#
10.44	Form 8-K dated September 20, 2005 reporting the change in certifying accountant	#
22.1	Subsidiaries of the Registrant	#
31.1	Certification pursuant to Rules 13a-14(a) and 15d-14(a) of Timothy J. Kilkenny	*
31.2	Certification pursuant to Rules 13a-14(a) and 15d-14(a) of Roger P. Baresel	*
32.1	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 by Timothy J. Kilkenny	*
32.2	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 by Roger P. Baresel	*



# Incorporated by  
reference.

\* Filed herewith.

- 28 -

---

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of the Exchange Act, the Registrant caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

**REGISTRANT:  
FULLNET COMMUNICATIONS, INC.**

Date: August 11, 2006

By: /s/ TIMOTHY J. KILKENNY  
Timothy J. Kilkenny  
Chief Executive Officer

Date: August 11, 2006

By: /s/ ROGER P. BARESEL  
Roger P. Baresel  
President and Chief Financial and Accounting  
Officer

- 29 -