

FULLNET COMMUNICATIONS INC

Form 10QSB

August 15, 2005

**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, 2005**

**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  
incorporation or organization)

(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

(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**

The number of shares outstanding of the Issuer's Common Stock, \$.00001 par value, as of August 10, 2005 was 6,723,135.

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

---

**FORM 10 QSB  
TABLE OF CONTENTS**

	Page
<b>PART I. FINANCIAL INFORMATION</b>	
Item 1. Financial Statements	
<u>Consolidated Balance Sheets (Unaudited) June 30, 2005 and December 31, 2004</u>	3
<u>Consolidated Statements of Operations Three and six months ended June 30, 2005 and 2004 (Unaudited)</u>	4

Edgar Filing: FULLNET COMMUNICATIONS INC - Form 10QSB

<u>Consolidated Statement of Stockholders Deficit Six months ended June 30, 2005 (Unaudited)</u>	5
<u>Consolidated Statements of Cash Flows Six months ended June 30, 2005 and 2004 (Unaudited)</u>	6
<u>Notes to 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 Rule 13a-14(a) and 15d-14(a) - Timothy J. Kilkenny</u>	
<u>Certification Pursuant to Rule 13a-14(a) and 15d-14(a) - Roger P. Baresel</u>	
<u>Certification Pursuant to Section 906 - Timothy J. Kilkenny</u>	
<u>Certification Pursuant to Section 906 - Roger P. Baresel</u>	

**Table of Contents**

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

	<b>JUNE 30,</b>	<b>DECEMBER</b>
	<b>2005</b>	<b>31,</b>
		<b>2004</b>
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash	\$ 12,056	\$ 12,226
Accounts receivable, net	59,004	59,212
Prepaid expenses and other current assets	135,331	81,809
Total current assets	206,391	153,247
PROPERTY AND EQUIPMENT, net	936,598	990,863
INTANGIBLE ASSETS, net	114,825	160,010
OTHER ASSETS	5,250	5,250
<b>TOTAL</b>	<b>\$ 1,263,064</b>	<b>\$ 1,309,370</b>
<b>LIABILITIES AND STOCKHOLDERS DEFICIT</b>		
<b>CURRENT LIABILITIES</b>		
Accounts payable trade	\$ 180,928	\$ 171,457
Accounts payable related party	182,451	145,921
Accrued and other current liabilities	771,583	725,190
Notes payable, current portion	920,903	968,825
Capital lease obligations, current portion		12,761
Deferred revenue	144,734	187,194
Total current liabilities	2,200,599	2,211,348
NOTES PAYABLE, less current portion	119,049	205,070
CAPITAL LEASE OBLIGATIONS, less current portion		18,825
OTHER	166,673	168,624
<b>STOCKHOLDERS DEFICIT</b>		
Common stock \$.00001 par value; authorized, 10,000,000 shares; issued and outstanding, 6,652,878 shares in 2005 and 2004	66	66
Common stock issuable, 70,257 shares in 2005 and 2004	57,596	57,596
Additional paid-in capital	8,328,004	8,328,004

Edgar Filing: FULLNET COMMUNICATIONS INC - Form 10QSB

Accumulated deficit	(9,608,923)	(9,680,163)
Total stockholders' deficit	(1,223,257)	(1,294,497)
TOTAL	\$ 1,263,064	\$ 1,309,370

See accompanying notes to financial statements.

- 3 -

---

**Table of Contents**

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

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30, 2005</b>	<b>June 30, 2004</b>	<b>June 30, 2005</b>	<b>June 30, 2004</b>
<b>REVENUES</b>				
Access service revenues	\$ 215,541	\$ 186,202	\$ 452,647	\$ 395,359
Co-location and other revenues	392,323	390,224	750,009	691,684
Total revenues	607,864	576,426	1,202,656	1,087,043
 <b>OPERATING COSTS AND EXPENSES</b>				
Cost of access service revenues	72,279	52,751	138,412	103,344
Cost of co-location and other revenues	50,193	38,188	87,358	94,456
Selling, general and administrative expenses	337,472	309,864	648,024	617,936
Depreciation and amortization	104,798	99,537	210,884	196,156
Total operating costs and expenses	564,742	500,340	1,084,678	1,011,892
INCOME FROM OPERATIONS	43,122	76,086	117,978	75,151
GAIN ON DEBT FORGIVENESS		46,383		46,383
GAIN ON BAD DEBT RECOVERY, net	17,500		17,500	
INTEREST EXPENSE	(30,988)	(41,809)	(64,238)	(97,604)
INCOME (LOSS) before income taxes	29,634	80,660	71,240	23,930
Income tax expense (benefit)				
NET INCOME (LOSS)	\$ 29,634	\$ 80,660	\$ 71,240	\$ 23,930
Net income (loss) per share -basic	\$ NIL	\$ .01	\$ .01	\$ NIL
Net income (loss) per share assuming dilution	\$ NIL	\$ .01	\$ .01	\$ NIL
Weighted average shares outstanding basic	6,723,135	6,713,135	6,723,135	6,713,135
	8,509,533	7,720,639	8,402,262	7,807,338

Weighted average shares outstanding  
assuming dilution

See accompanying notes to financial statements.

Table of Contents

**FullNet Communications, Inc. and Subsidiaries**  
**CONSOLIDATED STATEMENT OF STOCKHOLDERS DEFICIT (UNAUDITED)**  
**Six Months Ended June 30, 2005**

	Common stock Shares	Amount	Common Stock Issuable	Additional paid-in capital	Accumulated Deficit	Total
Balance at January 1, 2005	6,652,878	\$66	\$57,596	\$8,328,004	\$(9,680,163)	\$(1,294,497)
Net income					71,240	71,240
Balance at June 30, 2005	6,652,878	\$66	\$57,596	\$8,328,004	\$(9,608,923)	\$(1,223,257)

See accompanying notes to financial statements.



**Table of Contents**

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

	<b>Six Months Ended</b>	
	<b>June 30, 2005</b>	<b>June 30, 2004</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income (loss)	\$ 71,240	\$ 23,930
Adjustments to reconcile net loss to net cash provided by operating Activities		
Depreciation and amortization	210,884	196,156
Amortization of discount and costs relating to financing		1,757
Gain on debt forgiveness		(46,383)
Gain on bad debt recovery	(17,500)	
Loss on sale of assets		7,024
Provision for uncollectible accounts receivable	17,511	46,440
Net (increase) decrease in		
Accounts receivable	196	(110,129)
Prepaid expenses and other current assets	(53,522)	(24,267)
Other assets		(699)
Net increase (decrease) in		
Accounts payable trade	46,001	(20,288)
Accrued and other liabilities	44,443	138,504
Deposits		23,938
Deferred revenue	(42,460)	5,548
 Net cash provided by operating activities	 276,793	 241,531
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchases of property and equipment	(80,038)	(45,074)
(Acquisition) sale of assets	(31,396)	5,900
 Net cash used in investing activities	 (111,434)	 (39,174)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Principal payments on borrowings under notes payable	(117,654)	(160,034)
Principal payments on note payable to related party	(16,289)	(5,153)
Principal payments on capital lease obligations	(31,586)	(32,870)
 Net cash used in financing activities	 (165,529)	 (198,057)
 NET (DECREASE) INCREASE IN CASH	 (170)	 4,300
Cash at beginning of period	12,226	11,480
 Cash at end of period	 \$ 12,056	 \$ 15,780

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION

Cash paid for interest	\$ 22,951	\$ 42,693
Assets acquired through issuance of capital lease		54,992
See accompanying notes to financial statements.		

- 6 -

---

**Table of Contents**

**FullNet Communications, Inc. and Subsidiaries**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**1. UNAUDITED INTERIM FINANCIAL STATEMENTS**

The unaudited 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 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, 2004.

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, 2005. Certain reclassifications have been made to prior period balances to conform with the presentation for the current period.

**2. 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.

**3. 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.

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30, 2005</b>	<b>June 30, 2004</b>	<b>June 30, 2005</b>	<b>June 30, 2004</b>
Numerator:				
Net income	\$ 29,634	\$ 80,660	\$ 71,240	\$ 23,930
Denominator:				
Weighted average shares outstanding basic	6,723,135	6,713,135	6,723,135	6,713,135
Effect of dilutive stock options	859,865	180,392	763,922	253,490
Effect of dilutive warrants	926,533	827,112	915,205	840,713
Weighted average shares outstanding assuming dilution	8,509,533	7,720,639	8,402,262	7,807,338
Net income (loss) per share basic	\$ NIL	\$ .01	\$ .01	\$ NIL
Net income (loss) per share assuming dilution	\$ NIL	\$ .01	\$ .01	\$ NIL

Stock options exercisable for the purchase of 1,199,921 common stock shares at exercise prices ranging from \$.08 to \$3.00 per share were outstanding for the three and six months ended June 30,

- 7 -

---

**Table of Contents**

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 \$.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.

Stock options to purchase 1,453,588 shares of common stock at exercise prices ranging from \$.05 to \$3.00 per share were outstanding for the three and six months ended June 30, 2004, but were not included in the calculation of income (loss) per share assuming dilution because the options were not dilutive.

Warrants to purchase 1,135,623 shares of common stock at exercise prices ranging from \$.05 to \$2.77 per share were outstanding for the three and six months ended June 30, 2004, but were not included in the calculation of income (loss) per share assuming dilution because the warrants were not dilutive.

Convertible promissory notes to purchase 1,003,659 shares of common stock at an exercise price of \$1.00 per share were outstanding for the three and six months ended June 30, 2004, but were not included in the calculation of income (loss) per share assuming dilution because the convertible notes were not dilutive.

**4. 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, 2005 and 2004 relating to intangible assets was \$38,136 and \$37,913, respectively. Amortization expense for the six months ended June 30, 2005 and 2004 relating to intangible assets was \$76,581 and \$74,359, respectively.

**Table of Contents****5. NOTES PAYABLE**

Notes payable consist of the following:

	June 30, 2005	December 31, 2004
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 (1)	\$ 204,316	\$ 291,390
Interim loan, 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 (2)	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, 2005; convertible into approximately 1,003,659 shares at June 30, 2005 and December 31, 2004 (3)	510,636	510,636
Note payable to an individual, payable in monthly installments of \$1,277 until paid in full, including interest at a variable rate (prime plus 2.25%; 7.5% at June 30, 2005), matures September 2014; collateralized by substantially all assets acquired in conjunction with the acquisition of Harvest Communications, Inc.		9,580
Note payable to the Company's founder and CEO, payable in monthly installments of \$1,034 including interest at 8.5%, maturing May 2006; unsecured		16,289
Other notes payable	5,000	26,000
	1,039,952	1,173,895
Less current portion	920,903	968,825
	\$ 119,049	\$ 205,070

(1) December 31, 2004 includes three notes payable to a bank, payable in monthly installments aggregating \$10,010, including interest ranging from 9.5% to 11.5%, 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. Two of these notes were paid off during the quarter ending June 30, 2005.

(2)

This loan and accrued interest of \$136,066 was past due on June 30, 2005; the Company has not made payment or negotiated an extension of the loan and the lender has not made any demands.

- (3) 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

**Table of Contents**

\$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 expire 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 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, 2005, the outstanding principal and interest of the convertible promissory notes was \$719,289.

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.

**6. COMMON STOCK OPTIONS AND WARRANTS**

The Company's employee stock options are accounted for under APB Opinion No. 25 and related interpretations. Had compensation cost for the Company's stock options been determined based on the fair value at the grant dates consistent with the method of Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*, the Company's net income (loss) and income (loss) per share for the three months and six months ended June 30, 2005 and 2004 would have changed to the pro forma amounts indicated below:

	Three Months Ended June 30, 2005	Three Months Ended June 30, 2004	Six Months Ended June 30, 2005	Six Months Ended June 30, 2004
Net income (loss)				
As reported	\$ 29,634	\$ 80,660	\$ 71,240	\$ 23,930
Pro forma	\$ 13,465	\$ 65,240	\$ 55,071	\$ 8,510
Basic income (loss) per share				
As reported	\$ NIL	\$ .01	\$ .01	\$ NIL
Pro forma	\$ NIL	\$ .01	\$ .01	\$ NIL



Edgar Filing: FULLNET COMMUNICATIONS INC - Form 10QSB

Diluted income (loss) per share				
As reported	\$ NIL	\$ .01	\$ .01	\$ NIL
Pro forma	\$ NIL	\$ .01	\$ .01	\$ NIL

- 10 -

---

**Table of Contents**

The fair value of each option grant prior to February 2000 was estimated on the date of grant using the minimum value method because there was no public trading market for the Company's securities. During February 2000, the Company's common stock began trading on the OTC Bulletin Board under the symbol FULO. The fair values of the options granted subsequent to February 2000 have been estimated at the date of grant using the Black-Scholes option pricing model.

The following table summarizes the Company's employee stock option activity for the three and six months ended June 30, 2005:

	Three Months Ended June 30, 2005	Weighted Average Exercise Price	Six Months Ended June 30, 2005	Weighted Average Exercise Price
Options outstanding, beginning of the period	3,014,700	\$ .43	3,014,700	\$ .43
Options issued during the period	6,000	.09	6,000	.09
Options cancelled during the period	(6,666)	(.04)	(6,666)	(.04)
Options outstanding, end of the period	3,014,034	\$ .43	3,014,034	\$ .43

The following table summarizes the Company's common stock purchase warrant and certain stock option activity for the three and six months ended June 30, 2005:

	Three Months Ended June 30, 2005	Weighted Average Exercise Price	Six Months Ended June 30, 2005	Weighted Average Exercise Price
Warrants and certain stock options outstanding, beginning of the period	2,096,806	\$ .62	2,119,306	\$ .62
Warrants and certain stock options expired during the period			(22,500)	(1.14)
Warrants and certain stock options outstanding, end of the period	2,096,806	\$ .62	2,096,806	\$ .62

**7. RECENTLY ISSUED ACCOUNTING STANDARDS**

In December 2004, the Financial Accounting Standards Board (the FASB) issued Statement of Financial Accounting Standard (SFAS) No. 123R *Share-Based Payment*. The standard amends SFAS No. 123 *Accounting for Stock Based Compensation* and supersedes APB No. 25 *Accounting for Stock Issued to Employees*. SFAS No. 123R requires entities to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. That cost will be recognized over the period during which an employee is required to provide service in exchange for the award. FAS No. 123R eliminates the

alternative to use APB Opinion No. 25's intrinsic value method of accounting that was provided in Statement 123 as originally issued. FAS No. 123R will be effective for the Company for the first interim or annual reporting period beginning after December 31, 2005. As permitted by SFAS No. 123, the Company currently accounts for share-based payments to employees using the APB No. 25 intrinsic value method and recognizes no compensation cost for employee stock options. Accordingly, the provisions of FAS No. 123R will reduce earnings upon adoption. The Company will adopt FAS

- 11 -

---

**Table of Contents**

No. 123R within the prescribed time and is currently reviewing the provisions to determine its impact on the financial statements.

**8. MANAGEMENT S PLANS**

At June 30, 2005, current liabilities exceed current assets by \$1,994,208. The Company does not have a line of credit or credit facility to serve as an additional source of liquidity.

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 and co-location 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.

**9. ACQUISITION**

On July 30, 2004, the Company purchased approximately 1,300 of the dial-up Internet access customers of CWIS Internet Services, Inc. (CWIS), an Oklahoma corporation. In addition to paying \$25,000 at closing, the Company will pay CWIS an amount based upon the future collected revenues received from all active CWIS customers transferred at the time of closing for eighteen months following the closing. As of June 30, 2005 an additional \$62,316 had been paid based on collected revenues.

**10. SIGNIFICANT CUSTOMER**

During the six months ended June 30, 2005 and 2004, the Company had one customer that comprised approximately 28% and 31%, respectively, of total revenues. The contract pursuant to which the Company provides services to this customer expires on December 31, 2005. The customer has informally notified the Company that it will not renew this contract; therefore the Company will experience a loss of this revenue without a corresponding reduction in expense.

**11. CONTINGENCIES**

As a telecommunications company, we are effected 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

**Table of Contents**

party to one or more proceeding before the OCC relating to the terms of our interconnection agreement with SBC Communications and an anticipated successor to this interconnection agreement. These proceedings were initiated due to the unreasonable changes that SBC was proposing be incorporated in the successor interconnection agreement. The regulatory proceeding concerning the terms of our interconnection agreement with SBC Communication, which is based upon their standard interconnection agreement, and the anticipated successor thereto is ongoing and is expected to conclude in the second or third quarter of this year. We cannot anticipate the outcome of this regulatory proceeding at this time but a negative outcome with any of these regulatory proceedings could have a material adverse effect on our 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, and equipment co-location. 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 being 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, 2005, 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 also 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, 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, the acquisition of Internet service providers, as well as through a FullNet brand marketing campaign. During 2000 and 2001, we completed eight separate acquisitions of Internet service provider companies. We completed one acquisition of an Internet service provider during 2004.

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.

In June 2000, we began providing co-location services to KMC Telecom V, Inc. ( KMC ), a facilities-based competitive local exchange carrier pursuant to an agreement that will terminate on December 31, 2005. Under the terms of this agreement, we receive \$42,275 per month to provide co-location and support services for KMC s telecommunications equipment at our network operations center in Oklahoma City, Oklahoma. We completed our network operations center during the first quarter of 2001. KMC moved into our network operations center and began making payments during the third quarter of 2000. We plan to market additional 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 network operations center telephone switching equipment was installed in March 2003. At which time, FullTel began the process of activating local access telephone numbers for every city in which we will market, sell and operate our retail FullNet Internet service provider brand, wholesale dial-up Internet service and our business-to-business network design, connectivity, domain and Web hosting businesses. At June 30, 2005 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, 2005 and 2004:

	Three Months Ended				Six Months Ended			
	June 30, 2005		June 30, 2004		June 30, 2005		June 30, 2004	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Revenues:								
Access service revenues	\$215,541	35.5%	\$186,202	32.3%	\$ 452,647	37.6%	\$ 395,359	36.4%
Co-location and other revenues	392,323	64.5	390,224	67.7	750,009	62.4	691,684	63.6
Total revenues	607,864	100.0	576,426	100.0	1,202,656	100.0	1,087,043	100.0
Cost of access service revenues	72,279	11.9	52,751	9.2	138,412	11.5	103,344	9.5
Cost of co-location and other revenues	50,193	8.3	38,188	6.6	87,358	7.3	94,456	8.7
Selling, general and administrative expenses	337,472	55.5	309,864	53.7	648,024	53.9	617,936	56.8
Depreciation and amortization	104,798	17.2	99,537	17.3	210,884	17.5	196,156	18.1
Total operating costs and expenses	564,742	92.9	500,340	86.8	1,084,678	90.2	1,011,892	93.1
Income (loss) from operations	43,122	7.1	76,086	13.2	117,978	9.8	75,151	6.9
Gain on debt forgiveness			46,383	8.1			46,383	4.3
Gain on bad debt recovery, net	17,500	2.9			17,500	1.5		
Interest expense	(30,988)	(5.1)	(41,809)	(7.3)	(64,238)	(5.4)	(97,604)	(9.0)
Net income (loss) before income taxes	29,634	4.9	80,660	14.0	71,240	5.9	23,930	2.2
Income tax expense (benefit)								
Net income (loss)	\$ 29,634	4.9%	\$ 80,660	14.0%	\$ 71,240	5.9%	\$ 23,930	2.2%

**Three Months Ended June 30, 2005 Compared to Three Months Ended June 30, 2004***Revenues*

Access service revenues increased \$29,339 or 15.8% to \$215,541 for the three-month period ended June 30, 2005 from \$186,202 for the same period in 2004. This increase was primarily due to a net increase in the number of customers attributable to the purchase of a customer base of approximately 1,300 customers on July 30, 2004.

Co-location and other revenues increased \$2,099 or 0.5% to \$392,323 for the three-month period ended June 30, 2005 from \$390,224 for the same period in 2004. Co-location and other revenues increased by \$20,886 primarily due to the addition of new customers. This increase was offset by a decrease in reciprocal compensation revenue (fees for terminating SBC customers local calls onto our network). For the three-month period ended June 30, 2005 we recorded \$42,396 of reciprocal compensation revenue which included \$31,210 arising from a change in estimate for the period of March 2003 through March 2005. In May 2005, we billed SBC approximately \$86,000 for reciprocal compensation. This bill covered the period June 2004 through April 2005. SBC failed to pay and is disputing approximately \$33,000 of this billing. Consequently, we have established a reserve of approximately \$33,000 and have not recorded any revenue associated with the reserve. For the three-month period ended June 30, 2004 we



recorded \$61,183

- 16 -

---

**Table of Contents**

of reciprocal compensation revenue that included \$40,556 for the period of March 2003 through December 2003. In June 2004, we billed SBC approximately \$97,000 for reciprocal compensation. This was the first reciprocal compensation billing that we presented to SBC and covered the period March 2003 through May 2004. SBC failed to pay and is disputing approximately \$36,000 of our billing. Consequently, we have established a reserve of \$36,000 and have not recorded any revenue associated with the reserve. We are pursuing SBC for all balances due, however there is significant uncertainty as to whether or not we will be successful. Upon the ultimate resolution of SBC'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 the successor interconnection agreement.

*Operating Costs and Expenses*

Cost of access service revenues increased \$19,528 or 37.0% to \$72,279 for the three months ended June 30, 2005 from \$52,751 for the same period in 2004. This increase was primarily due to increased expenditures to expand and support our network and an equipment sale to an existing customer and the related cost. Cost of access service revenues as a percentage of access service revenues increased to 33.5% during the three months ended June 30, 2005, compared to 28.3% during the same period in 2004.

Cost of co-location and other revenues increased \$12,005 or 31.4% to \$50,193 for the three months ended June 30, 2005 compared to \$38,188 for the same period in 2004. This increase was primarily due to increased expenditures to expand and support our services. Cost of co-location and other revenues as a percentage of co-location and other revenues increased to 12.8% during the three months ended June 30, 2005, compared to 9.8% during the same period in 2004.

Selling, general and administrative expenses increased \$27,608 or 8.9% to \$337,472 for the three months ended June 30, 2005 from \$309,864 for the same period in 2004. This increase was primarily due to an increase in employee costs that included a one-time bonus to our Chief Executive Officer of \$21,500. Selling, general and administrative expenses as a percentage of total revenues increased to 55.5% during the 2005 three-month period from 53.7% during the 2004 three-month period.

Depreciation and amortization expense increased \$5,261 or 5.3% to \$104,798 for the three months ended June 30, 2005 from \$99,537 for the same period in 2004 primarily due to the installation of approximately \$80,000 of equipment during the six months ended June 30, 2005 and \$205,000 of equipment during the year 2004. In January 2002, upon initially applying Statement of Financial Accounting Standards 142, *Goodwill and Intangible Assets* (SFAS 142), we reassessed the useful lives of our intangible assets and we began amortizing these assets over their estimated useful lives and in direct relation to any decreases in the acquired customer bases to which these assets relate. Amortization expense for the three months ended June 30, 2005 and 2004 relating to intangible assets was \$38,136 and \$37,913, respectively.

*Gain on Debt Forgiveness*

During the three months ended June 30, 2004, we negotiated and settled \$68,018 of notes payable including accrued interest and \$6,878 of accounts payable. These settlements generated a total of \$46,383 of forgiveness of debt income of which \$41,979 was related to notes payable and \$4,404 was related to accounts payable.

**Table of Contents**

*Gain on Bad Debt Recovery*

During the three months ended June 30, 2005, we negotiated and settled a customer's account receivable that had previously been written off to 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 \$10,821 or 25.9% to \$30,988 for the three months ended June 30, 2005 from \$41,809 for the same period in 2004. 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 7.3%.

**Six Months Ended June 30, 2005 Compared to Six Months Ended June 30, 2004**

*Revenues*

Access service revenues increased \$57,288 or 14.5% to \$452,647 for the six months ended June 30, 2005 from \$395,359 for the same period in 2004. This increase was primarily due to a net increase in the number of customers attributable to the purchase of a customer base of approximately 1,300 customers on July 30, 2004.

Co-location and other revenues increased \$58,325 or 8.4% to \$750,009 for the six months ended June 30, 2005 from \$691,684 for the same period in 2004. Of this increase \$44,370 was primarily due to the addition of new customers. In addition, for the six months ended June 30, 2005 we recorded \$75,138 of reciprocal compensation revenue (fees for terminating SBC customers' local calls onto our network), which included \$51,206 arising from a change in estimate for the period of March 2003 through December 2004. In May 2005, we billed SBC approximately \$86,000 for reciprocal compensation. This bill covered the period June 2004 through April 2005. SBC failed to pay and is disputing approximately \$33,000 of this billing. Consequently, we have established a reserve of approximately \$33,000 and have not recorded the associated revenue. For the six-month period ended June 30, 2004 we recorded \$61,183 of reciprocal compensation revenue which included \$40,556 for the period of March 2003 through December 2003. In June 2004, we billed SBC approximately \$97,000 for reciprocal compensation. This was the first reciprocal compensation billing that we presented to SBC and covered the period March 2003 through May 2004. SBC failed to pay and is disputing approximately \$36,000 of our billing. Consequently, we have established a reserve of \$36,000 and have not recorded the associated revenue. We are pursuing SBC for all balances due, however there is significant uncertainty as to whether or not we will be successful. Upon the ultimate resolution of SBC'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 the successor interconnection agreement.

*Operating Costs and Expenses*

Cost of access service revenues increased \$35,068 or 33.9% to \$138,412 for the six months ended June 30, 2005 from \$103,344 for the same period in 2004. This increase was primarily due to increased expenditures to expand and support the company's network. Cost of access service revenues as a percentage of access service revenues increased to 30.6% during the six months ended June 30, 2005, compared to 26.1% during the same period in 2004.

Cost of co-location and other revenues decreased \$7,098 or 7.5% to \$87,358 for the six months ended June 30, 2005, compared to \$94,456 for the same period in 2004. This decrease was primarily due to approximately \$21,000 of taxes and other telecommunications fees mandated by certain governmental agencies on certain revenues received in 2003, that we had originally concluded were not subject to these

**Table of Contents**

taxes and other telecommunications fees. However after consultation with legal counsel, we concluded that the revenues were subject to these taxes and other telecommunications fees and recorded the liability along with approximately \$10,000 of associated penalties and interest in the first quarter of 2004. This decrease was offset by increased expenditures to expand and support our services. Cost of co-location and other revenues as a percentage of co-location and other revenues decreased to 11.6% during the six months ended June 30, 2005, compared to 13.7% during the same period in 2004.

Selling, general and administrative expenses increased \$30,088 or 4.9% to \$648,024 for the six months ended June 30, 2005 from \$617,936 for the same period in 2004. This increase was primarily due an increase in employee costs which included a one-time bonus to our Chief Executive Officer of \$21,500. Selling, general and administrative expenses as a percentage of total revenues decreased to 53.9% during the 2005 six-month period from 56.8% during the 2004 six-month period.

Depreciation and amortization expense increased \$14,728 or 7.5% to \$210,884 for the six months ended June 30, 2005 from \$196,156 for the same period in 2004. This increase was primarily due to the installation of approximately \$80,000 of equipment during the six months ended June 30, 2005 and \$205,000 of equipment during the year 2004. In January 2002, upon initially applying Statement of Financial Account Standards 142, *Goodwill and Intangible Assets* ( SFAS 142 ), we reassessed useful lives of our intangible assets and we began amortizing these 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 six months ended June 30, 2005 and 2004 relating to intangible assets was \$76,581 and \$74,359, respectively.

*Gain on Debt Forgiveness*

During the six months ended June 30, 2004, we negotiated and settled \$68,018 of notes payable including accrued interest and \$6,878 of accounts payable. These settlements generated a total of \$46,383 of forgiveness of debt income of which \$41,979 was related to notes payable and \$4,404 was related to accounts payable.

*Gain on Bad Debt Recovery*

During the six months ended June 30, 2005, we negotiated and settled a customer s account receivable that had previously been written off to 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 \$33,366 or 34.2% to \$64,238 for the six months ended June 30, 2005 from \$97,604 for the same period in 2004. 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 7.3%.

**Liquidity and Capital Resources**

As of June 30, 2005, we had \$12,056 in cash and \$2,200,599 in current liabilities, including \$144,734 of deferred revenues that will not require settlement in cash.

**Table of Contents**

At June 30, 2005, we had a deficit working capital of \$1,994,208, while at December 31, 2004 we had a deficit working capital of \$2,058,101. 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, 2005, \$180,358 of the \$180,958 we owed to our trade creditors and \$176,363 of the \$182,451 payable to a related party was past due. We have no formal agreements regarding payment of these amounts. At June 30, 2005, we had outstanding principal and interest owed on matured notes totaling \$1,175,355. 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 and 2004, we had one customer that comprised approximately 28% and 31%, respectively, of total revenues. The contract pursuant to which we provide services to this customer expires on December 31, 2005. The customer has informally notified us that it will not renew the contract. Therefore we will experience a loss of this revenue source without a corresponding reduction in expense.

	For the Periods Ended June 30,	
	2005	2004
Net cash flows provided by operations	\$ 276,793	\$ 241,531
Net cash flows used in investing activities	(111,434)	(39,174)
Net cash flows used in financing activities	(165,529)	(198,057)

Cash used for the purchases of equipment was \$80,038 and \$45,074, respectively, for the six months ended June 30, 2005 and 2004. Cash used for the CWIS asset purchase was \$31,396 for the six months ended June 30, 2005. Cash provided by the sale of assets was \$5,900 for the six months ended June 30, 2004.

Cash used for principal payments on notes payable and capital lease obligations was \$165,529 and \$198,057, respectively, for the six months ended June 30, 2005 and 2004.

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.

**Table of Contents**

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 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, 2005 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 the lender has not made any demands. At June 30, 2005, the outstanding principal and interest of the loan was \$456,066.

We are in default on an operating lease for certain equipment that is leased from one of our significant shareholders who also holds the \$320,000 interim loan that is in default. The original lease was dated November 21, 2001 and the terms required rental payments of \$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 have been unable to make the month-to-month payments and at June 30, 2005 had recorded \$182,451 in unpaid lease payments. The lessor has not made any demands.

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. The Company has neither made payment nor negotiated an extension of these notes, and the lenders have

**Table of Contents**

not made any payment demands. At June 30, 2005, the outstanding principal and interest of the convertible promissory notes was \$719,289.

**Recently Issued Accounting Standards**

In December 2004, the Financial Accounting Standards Board (the FASB ) issued Statement of Financial Accounting Standard ( SFAS ) No. 123R *Share-Based Payment*. The standard amends SFAS No. 123 *Accounting for Stock Based Compensation* and supersedes APB No. 25 *Accounting for Stock Issued to Employees*. SFAS No. 123R requires entities to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. That cost will be recognized over the period during which an employee is required to provide service in exchange for the award. FAS No. 123R eliminates the alternative to use APB Opinion No. 25 's intrinsic value method of accounting that was provided in Statement 123 as originally issued. FAS No. 123R will be effective for us for the first interim or annual reporting period beginning after December 31, 2005. As permitted by SFAS No. 123, we currently account for share-based payments to employees using the APB No. 25 intrinsic value method and recognize no compensation cost for employee stock options. Accordingly, the provisions of FAS No. 123R will reduce earnings upon adoption. We will adopt FAS No. 123R within the prescribed time and are currently reviewing the provisions to determine its impact on the financial statements.

**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.

**Table of Contents**

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 no change in our disclosure controls and procedures and internal control over financial reporting occurred during the period covered by this report that would 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 telecommunications company, we are effected 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 proceeding before the OCC relating to the terms of our interconnection agreement with SBC Communications and an anticipated successor to this interconnection agreement. These proceedings were initiated due to the unreasonable changes that SBC was proposing be incorporated in the successor interconnection agreement. The regulatory proceeding concerning the terms of our interconnection agreement with SBC Communication, which is based upon their standard interconnection agreement, and the anticipated successor thereto is ongoing and is expected to conclude in the second or third quarter of this year. We cannot anticipate the outcome of this regulatory proceeding at this time but a negative outcome with any of these regulatory proceedings 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, 2005, we had made aggregate payments of principal and interest of \$35,834 on this loan. At June 30, 2005, the outstanding principal and accrued interest of the loan was \$456,066. We have neither made payment nor negotiated an extension of the loan and the lender has not made any payment 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, 2005, the outstanding principal and accrued interest of the notes was \$719,289. We have neither made payment nor negotiated an extension of these notes, and the lenders have not made any payment 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 filed as part of 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	#

Edgar Filing: FULLNET COMMUNICATIONS INC - Form 10QSB

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>	
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>	
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,	#

Edgar Filing: FULLNET COMMUNICATIONS INC - Form 10QSB

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).	#
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	#
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 15, 2005

By: /s/ TIMOTHY J. KILKENNY

Timothy J. Kilkenny  
Chief Executive Officer

Date: August 15, 2005

By: /s/ ROGER P. BARESEL

Roger P. Baresel  
President and Chief Financial and Accounting  
Officer

- 29 -