Z TEL TECHNOLOGIES INC
Form 10-Q
August 12, 2004

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SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(MARK ONE)
[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE SIX MONTHS ENDED JUNE 30, 2004

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE TRANSITION PERIOD FROM TO

COMMISSION FILE NUMBER: 000-28467

Z-TEL TECHNOLOGIES, INC.

(Exact name of Registrant as specified in its charter)

DELAWARE	59-3501119
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

601 SOUTH HARBOUR ISLAND BOULEVARD, SUITE 220
TAMPA, FLORIDA 33602
(813) 273-6261
(Address, including zip code, and
telephone number including area code, of
Registrant s principal executive offices)

SECURITIES REGISTERED PURSUANT TO SECTION 12(B) OF THE ACT: NONE

SECURITIES REGISTERED PURSUANT TO SECTION 12(G) OF THE ACT: COMMON STOCK, PAR VALUE $.01 PER SHARE, PREFERRED STOCK PURCHASE RIGHTS

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes [X] No [ ]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12B-2 of the Exchange Act)

Yes [ ] No [X]

The number of shares of the Registrant s Common Stock outstanding as of August 9, 2004 was approximately 37,488,207.

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Z-TEL TECHNOLOGIES, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(UNAUDITED)
(IN THOUSANDS, EXCEPT PER SHARE DATA)

	June 30, 2004	December 31, 2003
Assets		
Current assets:		
Cash and cash equivalents	$ 8,196	$ 12,013
Accounts receivable, net of allowance for doubtful accounts of $9,206 and $13,804	28,672	24,600
Prepaid expenses and other current assets	4,804	7,664
Total current assets	41,672	44,277
Property and equipment, net	34,298	39,069
Intangible assets, net	1,372	2,287
Other assets	3,227	3,820
Total assets	$ 80,569	$ 89,453
Liabilities, Mandatorily Redeemable Convertible Preferred Stock and Stockholders Deficit		
Current liabilities:		
Accounts payable and accrued liabilities	$ 63,745	$ 59,230
Deferred revenue	8,357	11,068
Current portion of long-term debt and capital lease obligations	2,078	5,017
Asset based loan	12,619	
Total current liabilities	86,799	75,315
Long-term deferred revenue	221	361
Long-term debt and capital lease obligations	205	514
Total liabilities	87,225	76,190
Mandatorily redeemable convertible preferred stock, $.01 par value; 50,000,000 shares authorized; 8,855,089 issued; 8,736,337 and 8,738,422 outstanding (aggregate liquidation value of $164,998 and $158,779)	152,366	144,282

Commitments and contingencies (Notes 9 and 11)		
Stockholders deficit:		
Common stock, $.01 par value; 150,000,000 shares authorized; 37,321,257 and 36,186,686 shares issued; 36,979,707 and 35,845,136 outstanding	373	362
Notes receivable from stockholders	(930)	(1,121)
Unearned stock compensation	(984)	
Additional paid-in capital	183,281	189,008
Accumulated deficit	(340,374)	(318,880)
Treasury stock, 341,550 shares at cost	(388)	(388)
Total stockholders deficit	(159,022)	(131,019)
Total liabilities, mandatorily redeemable convertible preferred stock and stockholders deficit	$ 80,569	$ 89,453

The accompanying notes are an integral part of these consolidated financial statements.

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Z-TEL TECHNOLOGIES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)
(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2004	**2003**	**2004**	**2003**
Revenues	$ 63,797	$ 71,046	$ 132,264	$ 131,975
Operating expenses:				
Network operations, exclusive of depreciation and amortization shown below	31,237	32,070	65,271	58,852
Sales and marketing	4,450	6,617	8,971	11,111
General and administrative	31,658	31,944	66,229	58,850
Restructuring charge	807		807	
Depreciation and amortization	5,109	6,002	10,420	12,029
Total operating expenses	73,261	76,633	151,698	140,842
Operating loss	(9,464)	(5,587)	(19,434)	(8,867)
Nonoperating income (expense):				
Interest and other income	491	239	1,352	1,164
Interest and other expense	(2,138)	(660)	(3,412)	(1,410)
Total nonoperating expense	(1,647)	(421)	(2,060)	(246)
Net loss	(11,111)	(6,008)	(21,494)	(9,113)
Less mandatorily redeemable convertible preferred stock dividends and accretion	(3,626)	(4,667)	(7,991)	(8,904)
Less deemed dividend related to beneficial conversion feature	(47)	(46)	(93)	(92)
Net loss attributable to common stockholders	$ (14,784)	$ (10,721)	$ (29,578)	$ (18,109)

Weighted average common shares outstanding	36,608,703	35,305,448	36,337,804	35,286,953
Basic and diluted net loss per share	$ (0.40)	$ (0.30)	$ (0.81)	$ (0.51)

The accompanying notes are an integral part of these consolidated financial statements.

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Z-TEL TECHNOLOGIES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY (DEFICIT)
AND COMPREHENSIVE INCOME
(UNAUDITED)
(IN THOUSANDS, EXCEPT SHARE DATE)

	Common Stock		Notes Receivable from	Unearned Stock	Additional Paid-In	Accumulated	Treasury	Total Stockholders'
	Shares	Par Value	Stockholders	Compensation	Capital	Deficit	Stock	Deficit
Balance, December 31, 2003	35,845,136	$362	$(1,121)	$	$189,008	$(318,880)	$(388)	$(131,019)
Exercise of stock options	372,480	3			486			$ 489
Exercise of warrants	37,714	3						$ 3
Issuance of common stock for settlement	585,723	5			743			$ 748
Issue common restricted stock				(984)	1,128			$ 144
Conversion of mandatorily redeemable								$
convertible preferred stock to common	138,654							$
Repayment of notes receivable			191					$ 191
Mandatorily redeemable convertible preferred								$
stock dividends and accretion					(8,084)			$ (8,084)
Net loss						(21,494)		$ (21,494)
Balance, June 30, 2004	36,979,707	$373	$ (930)	$(984)	$183,281	$(340,374)	$(388)	$(159,022)

The accompanying notes are an integral part of these consolidated financial statements

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Z-TEL TECHNOLOGIES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)
(In thousands)

	Six Months Ended June 30,	
	2004	**2003**
Cash flows from operating activities:		
Net loss	$(21,494)	$ (9,113)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	10,418	12,029
Provision for bad debts	3,017	6,268
Expense charged for granting of restricted stock	888	
Change in operating assets and liabilities:		
(Increase) decrease in accounts receivable	(7,089)	(13,465)
(Increase) decrease in prepaid expenses	2,860	930
(Increase) decrease in other assets	553	(29)
Increase (decrease) in accounts payable and accrued liabilities	4,515	(1,284)
Increase (decrease) in deferred revenue	(2,851)	10,813
Total adjustments	12,311	15,262
Net cash (used in) provided by operating activities	(9,183)	6,149
Cash flows from investing activities:		
Purchases of property and equipment	(4,732)	(5,783)
Principal repayments received on notes receivable	40	27
Net cash used in investing activities	(4,692)	(5,756)
Cash flows from financing activities:		
Payments on long-term debt and capital lease obligations	(3,248)	(2,755)
Payment of preferred stock dividends	(3)	
Principal repayments received on notes receivable issued for stock	191	469
Proceeds from asset based loan	12,619	
Proceeds from exercise of stock options and warrants	499	60

Net cash provided by (used in) financing activities	10,058	(2,226)
Net decrease in cash and cash equivalents	(3,817)	(1,833)
Cash and cash equivalents, beginning of period	12,013	16,037
Cash and cash equivalents, end of period	$ 8,196	$ 14,204

The accompanying notes are an integral part of these consolidated financial statements

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Z-TEL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)
(ALL TABLES ARE IN THOUSANDS, EXCEPT FOR SHARE AND PER SHARE DATA)

1. NATURE OF BUSINESS

DESCRIPTION OF BUSINESS

Z-Tel Technologies, Inc. and subsidiaries (Z-Tel or we or us) incorporated in Delaware on January 15, 1998 as Olympus Telecommunications Group, Inc. In March 1998, Olympus Telecommunications Group, Inc. changed its name to Z-Tel Technologies, Inc.

We are a provider of advanced, integrated telecommunications services targeted to consumer (residential) and business subscribers. We offer local and long distance telephone services in combination with enhanced communications features accessible through the telephone, the Internet and certain personal digital assistants. We offer our Z-LineHOME and Z-LineBUSINESS services in forty-nine states. Our customers are primarily concentrated in ten states. We also provide long-distance telecommunications services to customers nationally.

We introduced our wholesale services during the first quarter of 2002. This service provides other companies with the opportunity to provide local, long-distance and enhanced telephone service to their own residential and business end user customers on a private label basis by utilizing our telephone exchange services, enhanced services platform, infrastructure and back-office operations.

Historically we have utilized the unbundled network elements platform (UNE-P) as the basis of delivering our primary services to our retail end users and end users of our wholesale customers. Under UNE-P we utilize various unbundled elements of the incumbent

local exchange carriers to facilitate the delivery of our services to our own end users and the end users that are acquired and owned by our wholesale services customers. To date, UNE-P has been the primary access method that we have utilized in delivering our services.

We introduced our voice over Internet protocol (VoIP) service offerings during the second quarter of 2004. This service offering provides us an alternative method to UNE-P in delivering our services to consumer and business customers. We have tested this delivery method in two markets and have developed a beta customer base in each market. We intend, upon the successful completion of this initial test phase, to pursue aggressively VoIP as the eventual preferred method whereby we will deliver our services to our end users. We also intend to offer this new access method to our existing and future wholesale services partners. While this is a more capital intensive approach, this method of delivery mitigates our reliance on the incumbent local exchange carriers.

LIQUIDITY AND CAPITAL RESOURCES

We have a limited operating history and our operations are subject to certain risks and uncertainties, particularly related to the evolution of the regulatory environment, which impacts our access to and cost of the network elements that we utilize to provide services to our customers, access to adequate financing, and competition within the industry.

We have incurred significant losses since our inception, resulting in an accumulated deficit at June 30, 2004 of approximately $340.4 million. We also had total liabilities recorded at June 30, 2004 of approximately $87.2 million. We experienced positive cash flows from operations for the first time for the year ended December 31, 2002 and again during 2003. We also had positive cash flows from operations for the three months ended March 31, 2004, but experienced negative cash flows from operations for the three and six months ended June 30, 2004. Prior to 2002 we had historically been dependent on financing from investors to sustain our operating activities.

The company s reported cash position declined on a net basis for the three months and six months ended June 30, 2004. The net cash declines for the three and six months ended June 30, 2004 were $3.6 and $3.8 million respectively.

At June 30, 2004, we had cash on hand of approximately $8.2 million. In addition, we have an asset based loan agreement, which provides us with up to $25 million to fund operations, of which we were utilizing $12.6 million as of June 30, 2004, which was approximately the maximum then available to us under the loan availability calculation. We did not meet the fixed charge coverage ratio for the quarter ended June 30, 2004. All other covenants have been met per our agreement with Textron. Per the agreement, Textron can cancel the loan arrangement with us; however, we believe that it is unlikely that Textron would take such measures. We are working to resolve this issue without triggering a cancellation of the agreement (see Footnote 5 to our financial statements in this report).

We anticipate that we may not generate adequate cash flow over the foreseeable future to meet all of our operating, investing and financing requirements. We are actively exploring potential financing arrangements to help improve our liquidity position and to give us more flexibility in pursuing our business plan over the foreseeable future.

On June 16, 2004, the D.C. Circuit decision to USTA II became effective and the FCC s unbundling rules that were the subject of the appeal were vacated. If the FCC does not write adequate interim and final UNB rules, or if the USTA II decision is not stayed or reversed, or if state commissions do not take action under state law, there could be an immediate, significant, adverse and material impact upon our business. ILECs might utilize the reversal of the unbundling rules to deny us access to their local networks or sharply increase the price of that access. We believe that in the event the vacated unbundling rules are not replaced by either the FCC or the state commissions, we have interconnection agreements with our principal ILEC suppliers (including Verizon, SBC, BellSouth and Qwest) that will permit us to obtain access to local network elements during the interviewing time period. (see Footnote 11 to our financial statements in this report).

On July 26, 2004, Sprint indicated to us that they plan on committing less resources to the existing wholesale services arrangement under which we currently operate. Although Sprint is not canceling the agreement, they have indicated to us that we can expect lower sales volumes as early as August 2004 (see Footnote 13 to our financial statements in this report).

By letter dated July 28, 2004, the Nasdaq Stock Market Inc. notified us that for 10 consecutive days the market value of our listed securities was below $35 million as required for continued inclusion by Nasdaq Marketplace Rule 4310(c)(2)(B)(ii). Nasdaq has given us 30 calendar days or until August 27, 2004 to regain compliance (see Footnote 13 to our financial statements in this report).

If actual results differ materially from our current plan or if expected financing is not available, we may have the ability to curtail growth initiatives and spending, including the reduction of certain discretionary capital and operating costs. These plans may include, but are not be limited to, the implementation of a workforce reduction. There can be no assurance, however, that we will be able to implement our strategies or obtain additional financing under favorable terms, if at all.

2. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared by us in accordance with accounting principles generally accepted in the United States of America for interim financial information and are in the form prescribed by the Securities and Exchange Commission s (SEC) instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes for complete financial statements as required by accounting principles generally accepted in the United States of America. The interim unaudited financial statements should be read in conjunction with our audited financial statements as of and for the year ended December 31, 2003, included in our Annual Report on Form 10-K filed with the SEC on March 30, 2004. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. Operating results for the six months ended June 30, 2004 are not necessarily indicative of the results that may be expected for the year ending December 31, 2004.

RECLASSIFICATION

Certain amounts in the consolidated statements of operations for the six months ended June 30, 2003 have been reclassified to conform to the presentation for the six months ended June 30, 2004.

3. Significant Accounting Policies and Recent Accounting Pronouncements

SIGNIFICANT ACCOUNTING POLICIES

Our significant accounting policies are included in the Notes to Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2003.

STOCK-BASED COMPENSATION

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We account for our stock option plans in accordance with the provisions of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations and comply with the disclosure provisions of SFAS No. 123, Accounting for Stock-Based Compensation and SFAS No. 148. As such, we record compensation expense on the date of grant only if the current market price of the underlying stock exceeds the exercise price. Additionally, if a modification is made to an existing grant, any related compensation expense is calculated on the date both parties accept the modification and recorded on the date the modification becomes effective.

The following table illustrates, in accordance with the provisions of SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, an Amendment of SFAS 123, Accounting for Stock-Based Compensation, the effect on net loss and earnings per share if we had applied the fair value recognition provisions of SFAS No. 123, to stock-based employee compensation (encompassing the impacts of both stock option and restricted stock grants).

	For the three months ended June 30,		For the six months ended June 30,	
	2004	**2003**	**2004**	**2003**
Net loss attributable to common stockholders, as reported	$(14,784)	$(10,721)	$(29,578)	$(18,109)
Add: Stock based compensation included in net loss	145		145	
Deduct: Total stock based employee compensation determined under the fair value based method for all awards	(1,043)	(1,247)	(1,799)	(4,429)
Net loss attributable to common stockholders, pro forma	$(15,682)	$(11,968)	$(31,232)	$(22,538)
Basic and Diluted Net Loss Per Common Share				
As reported	$ (0.40)	$ (0.30)	$ (0.81)	$ (0.51)
Pro forma	(0.43)	(0.34)	(0.86)	(0.64)

We calculated the fair value of each grant on the date of grant using the Black-Scholes option pricing model. In addition to there being no payments of dividends on our common stock, the following assumptions were used for each respective period:

	For the three months ended June 30,		For the six months ended June 30,	
	2004	**2003**	**2004**	**2003**
Discount Rate	3.4%	2.5%	3.1%	2.6%
Volatility	98.4%	97.3%	100.1%	97.0%

Average Option Expected Life	5 years	5 years	5 years	5 years

Incremental shares of common stock equivalents are not included in the calculation of net loss per share as the inclusion of such equivalents would be anti-dilutive.

RECENT ACCOUNTING PRONOUNCEMENTS

In March 2004, the Emerging Issues Task Force (EITF) reached a consensus on EITF Issue No. 03-6, Participating Securities and the Two-Class Method under Financial Accounting Standards Board (FASB) Statement No. 128, Earnings per Share. EITF 03-6 clarifies what constitutes a participating security and provides further guidance in applying the two-class method of calculating earnings per share (EPS). The consensus reached by the Task Force in this Issue is effective for reporting periods beginning after March 31, 2004. We adopted EITF Issue No. 03-06 in the quarter ended June 30, 2004. There was no impact of the adoption on the computation of EPS during the three months and six months ended June 30, 2004, as the effect is anti-dilutive. In periods of net income, we will utilize the two-class method of computing EPS.

4. WHOLESALE SERVICES

In February 2003, we executed an agreement providing for the resale of our local wireline telecommunications services and for the provisioning of ancillary services with Sprint. Under this agreement, we provide Sprint access to our Web-integrated, enhanced communications platform and operational support systems. We are the primary obligor for certain underlying expenses that are incorporated into our pricing in connection with the agreement and therefore, are recording revenues using a gross presentation. This accounting method results in revenue being recorded for certain per-line, per-minute, and direct costs and the corresponding expenses are recorded in the appropriate operating expense line. As a result of this accounting treatment, increases or decreases in pricing or volume that impact certain direct costs that are incurred in connection with this agreement would have little or no impact on net income, as the amount is recorded in an equivalent amount in both revenue and expense. Our wholesale services agreement with Sprint is non-exclusive in nature.

We are deferring $1.0 million of revenues for pre-contract payments by recognizing this amount ratably over the life of the agreement.

As of June 30, 2004, under our contract with Sprint, we had approximately $2.2 million of deferred revenue recorded, of which

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$0.2 million is recorded as long-term deferred revenue.

Sprint revenues were 32.3% of total revenues for the three months ended June 30, 2004, as compared to 14.9% for the prior year period. Sprint revenues were 33.1% of total revenues for the six months ended June 30, 2004, as compared to 9.3% for the prior year period.

On July 26, 2004 Sprint indicated to us that they plan on committing less resources to the existing wholesale services arrangement under which we currently operate. Although Sprint is not canceling the agreement, they have indicated to us that we can expect lower sales volumes as early as August 2004 (see Footnote 13 to our financial statements in this report).

5. ACCOUNTS RECEIVABLE AGREEMENT

In April 2004 we signed a three-year asset based loan agreement with Textron Financial Corporation (Textron). This agreement eliminated our RFC accounts receivable factoring agreement, and provides us with an availability to borrow up to $25 million at a 6% interest rate. Our overall availability is based on the eligibility of our accounts receivables, subject to certain limitations and advance rates. The new asset based loan agreement is expected to provide us with additional liquidity because it includes residential, business and wholesale accounts receivable while our prior arrangement with RFC only included certain portions of our accounts receivable. We believe that this new agreement may provide us with additional working capital financing flexibility to help facilitate the growth of our business, to the extent growth materializes in our business.

This agreement has three primary financial covenants: a fixed charge coverage ratio, accounts receivable turnover requirement and an unfunded capital expenditures cap. The fixed charge coverage ratio requirement is measured each quarter as of June 30, 2004. The ratio requirements begin low and increase each quarter through December 31, 2004 and then remain constant. We did not meet the fixed charge coverage ratio for the quarter ended June 30, 2004. All other covenants have been met per our agreement with Textron. Per the agreement, Textron can cancel the loan arrangement with us; however, we believe that it is unlikely that Textron would take such measures. We are working to resolve this issue without triggering a cancellation of the agreement. At current collection rates, we will collect the total amount outstanding under this facility in less than a month. We believe that Textron is adequately secured under this facility. In addition, we have already disclosed to Textron the cost saving measures recently implemented to make improvements that would allow us to meet the fixed charge coverage ratio required in future quarters.

There are also disposition of asset limitations, limits on change of control, certain notification requirements, change in management limitations and certain other restrictions. There are also certain limitations on our ability to access subordinated debt within the confines of the agreement; however, we believe the agreement will provide us with flexibility for future debt financing alternatives. Under the amended asset based loan structure with Textron, we had an outstanding loan balance to Textron of approximately $12.6 million at June 30, 2004.

6. INTANGIBLE ASSETS

In accordance with Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets, we reassessed the expected useful lives of existing intangible assets. This reassessment resulted in no changes to the expected useful lives of our intangible assets. We only have one intangible asset as of June 30, 2004.

Summarized below is our only recorded intangible asset that will continue to be amortized under SFAS No. 142. It is a customer list that was acquired in April of 2000 in connection with our acquisition of Touch 1.

	June 30, 2004		
	Carrying Amount	Accumulated Amortization	Net Intangible Assets
Intangible assets subject to amortization:			
Customer list standalone 1+	$9,145	$ 7,773	$ 1,372

The following table presents current and expected amortization expense of the existing intangible assets as of June 30, 2004 for each of the following periods:

Aggregate amortization expense:

For the six months ended June 30, 2004	$915
Expected amortization expense for the remainder of 2004	$914
Expected amortization expense for the year ending December 31, 2005	$458

7. RESTRUCTURING CHARGES

In April 2002, we approved and implemented a restructuring to improve our future cash flows and operating earnings. The restructuring included a reduction in force coupled with the closure of our North Dakota call centers and our New York sales office. In

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accordance with Emerging Issues Task Force (EITF) 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity, the restructuring costs were recognized as liabilities at the time management committed to the plan. Management determined that these costs provided no future economic benefit to us.

The restructuring charge included termination benefits in connection with the termination of 167 employees and lease abandonment costs. In addition, we agreed to a settlement to exit the two leases for our call centers in North Dakota as of July 1, 2002. On May 17, 2004 a termination agreement was signed for our New York office lease on which we had previously recorded a lease abandonment charge in connection with the restructure. The settlement included a $90,000 payment in lieu of the remaining balance of $299,545 previously recorded as a lease abandonment charge. The settlement payment consisted of a one-time payment of $30,000, paid at the time of agreement, and three promissory notes of $20,000 payable on November 1, 2004, May 1, 2005 and August 30, 2005, respectively. All other expenses associated with this restructuring have been paid in full.

In June 2004, we approved and implemented another restructuring to improve our future cash flows and operating earnings. The restructuring included a reduction in force. In accordance with Financial Accounting Standards Board (FASB) SFAS No. 146 Accounting for Costs Associated with Exit or Disposal Activities the restructuring costs were considered a One-Time Termination Benefit and as such we recognized the restructuring costs as a liability at the communication date of June 8, 2004. The restructuring charge included termination benefits in connection with the reduction in force of 102 employees. The total charge taken in the second quarter of 2004 was $806,875 of which $40,832 was paid in the second quarter. The majority of the remainder of termination benefits will be paid in full by the end of August 2004.

SFAS No. 146 replaces the Emerging Issues Task Force (EITF) 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity, used with the 2002 restructuring plan.

The following table shows the restructuring charges and related accruals recognized under the plans and the effect on our consolidated financial position:

	Employee Termination Benefits	Lease Settlement Costs	Lease Abandonment Costs	Total
Balance at January 1, 2002	$	$	$	$
Plan Charges	913	325	623	1,861
Cash paid	(913)	(325)	(72)	(1,310)
Balance at December 31, 2002			551	551
Cash paid			(200)	(200)
Balance at December 31, 2003			351	351
Plan Charges	807			807
Lease Termination Settlement			(210)	(210)
Cash paid	(41)		(81)	(122)

Balance at June 30, 2004	$ 766	$	$ 60	$ 826

8. STOCK BASED COMPENSATION

STOCK OPTIONS

For employee stock options, the Financial Accounting Standards Board (FASB) issued SFAS No. 123, Accounting for Stock-Based Compensation, requiring entities to recognize as an expense, over the vesting period, the fair value of the options or utilize the accounting for employee stock options used under Accounting Principles Board (APB) Opinion No. 25. We apply the provisions of APB Opinion No. 25 and consequently recognize compensation expense over the vesting period for grants made to employees and directors only if, on the measurement date, the market price of the underlying stock exceeds the exercise price. We do provide the pro forma net loss and earnings per share disclosures as required under SFAS No. 123 for grants made as if the fair value method defined in SFAS No. 123 had been applied. We recognize expense over the vesting period of the grants made to non-employees based on utilizing the Black-Scholes stock valuation model to calculate the value of the option on the measurement date.

RESTRICTED STOCK

In March and April 2004, our compensation committee approved the granting of 403,000 shares of restricted stock with a then approximate value of $1.1 million to certain executive officers and key employees. Consideration paid for this stock is par value of $0.01 and continued employment. We apply the provisions of APB Opinion No. 25 and consequently recognize compensation expense over the vesting period for grants made to employees because the exercise prices are less than the market price on the date of grant. We recorded compensation expense of $0.1 million for the three and six months ended June 30, 2004.

9. COMMITMENTS AND CONTINGENCIES

We have disputed billings and access charges from certain inter-exchange carriers (IXCs) and incumbent local exchange carriers (ILECs). We contend that these billings are not in accordance with the interconnection, service level, or tariff agreements between

us and certain IXCs and ILECs. We have not paid these disputed amounts and, while we can make no guarantee, management believes that we will prevail or mostly prevail in these disputes. At June 30, 2004, the total disputed amounts were approximately $19.7 million.

We currently have agreements with two long-distance carriers to provide transmission and termination services for all of our long distance traffic. These agreements generally provide for the resale of long distance services on a per-minute basis and contain minimum volume commitments. As a result of a settlement of a billing dispute associated with minimum volume commitments required in one of these contracts we have agreed to pay an increased per minute charge for minutes until the achievement of certain minimum minute requirements. All other terms of the original agreement continue in full force. We believe that we will be in full compliance with all minimum volume commitments during 2004. We have accrued $0.2 million representing the incremental increased fees we expect to pay in 2004, so that the expense recorded per minute is consistent throughout the agreement.

In connection with certain of our wholesale services agreements, all or a portion of customer lines are provisioned using a unique code for our company. Therefore, we are the customer of record for all Regional Bell Operating Companies billings, including a portion actually attributable to our wholesale services customers. It is very likely that the state commissions would require us to continue providing services to the end user customer for at least a 90-day period, regardless of whether our wholesale relationships continue or whether our wholesale services customers provide payment to us.

We have agreed to certain service level agreements (SLAs) for providing service under our wholesale service agreements. If we were to not fulfill the SLAs after the phase-in period there are certain remedies including but not limited to financial compensation. We have not paid any financial compensation to date as a result of our not meeting any SLAs.

10. COMPUTATION OF NET LOSS PER SHARE

Basic net loss per share is computed by dividing net loss attributable to common stockholders by the weighted average number of common shares outstanding during the period. Incremental shares of common stock equivalents are not included in the calculation of net loss per share as the inclusion of such equivalents would be anti-dilutive.

Net loss per share is calculated as follows: