

FULLNET COMMUNICATIONS INC

Form 10-Q

May 15, 2009

**Table of Contents**

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q**

**(Mark One)**

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

**For the quarterly period ended March 31, 2009**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number: 000-27031**

**FULLNET COMMUNICATIONS, INC.**

**(Exact name of registrant as specified in its charter)**

**OKLAHOMA**

**(State or other jurisdiction of incorporation or organization)**

**73-1473361**

**(I.R.S. Employer Identification No.)**

**201 Robert S. Kerr Avenue, Suite 210**

**Oklahoma City, Oklahoma 73102**

**(Address of principal executive offices)**

**(405) 236-8200**

**(Registrant's telephone number)**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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

As of May 12, 2009, 7,425,565 shares of the registrant's common stock, \$0.00001 par value, were outstanding.

**FORM 10-Q  
TABLE OF CONTENTS**

	Page
<b>PART I. FINANCIAL INFORMATION</b>	
Item 1. Financial Statements	
<u>Condensed Consolidated Balance Sheets – March 31, 2009 (Unaudited) and December 31, 2008 (Derived from Audited Statements)</u>	3
<u>Condensed Consolidated Statements of Operations – Three months ended March 31, 2009 and 2008 (Unaudited)</u>	4
<u>Condensed Consolidated Statement of Stockholders – Deficit – Three months ended March 31, 2009 (Unaudited)</u>	5
<u>Condensed Consolidated Statements of Cash Flows – Three months ended March 31, 2009 and 2008 (Unaudited)</u>	6
<u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u>	7
<u>Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	14
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	20
<u>Item 4. Controls and Procedures</u>	20
<u>Item 4T. Controls and Procedures</u>	21
<b><u>PART II. OTHER INFORMATION</u></b>	
<u>Item 1. Legal Proceedings</u>	22
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	22
<u>Item 3. Defaults Upon Senior Securities</u>	22
<u>Item 4. Submission of Matters to a Vote of Security Holders</u>	22
<u>Item 5. Other Information</u>	22
<u>Item 6. Exhibits</u>	22
<u>Signatures</u>	27
<u>Exhibit 31.1</u>	
<u>Exhibit 31.2</u>	

Exhibit 32.1

Exhibit 32.2

- 2 -

---

**Table of Contents**

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

	<b>MARCH 31, 2009</b>	<b>DECEMBER 31, 2008</b>
	<b>(Unaudited)</b>	<b>(Derived from Audited Statements)</b>
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash	\$ 8,276	\$ 11,753
Accounts receivable, net	13,836	11,318
Prepaid expenses and other current assets	32,549	36,785
Total current assets	54,661	59,856
PROPERTY AND EQUIPMENT, net	269,225	324,227
INTANGIBLE ASSETS, net	5,577	8,782
OTHER ASSETS	5,250	5,250
TOTAL	\$ 334,713	\$ 398,115
 <b>LIABILITIES AND STOCKHOLDERS DEFICIT</b>		
<b>CURRENT LIABILITIES</b>		
Accounts payable, current portion	\$ 195,739	\$ 210,211
Accrued and other current liabilities, current portion	1,271,729	1,216,687
Notes payable, current portion	565,736	557,036
Deferred revenue	122,920	128,548
Total current liabilities	2,156,124	2,112,482
ACCOUNTS PAYABLE, less current portion	250,681	252,178
ACCRUED AND OTHER LIABILITIES, less current portion	172,782	174,155
NOTES PAYABLE, less current portion	238,800	247,500
Total liabilities	2,818,387	2,786,315
<b>STOCKHOLDERS DEFICIT</b>		
Common stock \$.00001 par value; authorized, 10,000,000 shares; issued and outstanding, 7,355,308 and 6,670,878 shares in 2009 and 2008,	74	74

respectively

Common stock issuable, 70,257 shares in 2009 and 2008	57,596	57,596
Additional paid-in capital	8,381,912	8,378,467
Accumulated deficit	(10,923,256)	(10,824,337)
Total stockholders' deficit	(2,483,674)	(2,388,200)
TOTAL	\$ 334,713	\$ 398,115

See accompanying notes to condensed consolidated financial statements.

Table of Contents

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

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2009</b>	<b>March 31, 2008</b>
REVENUES		
Access service revenues	\$ 121,057	\$ 143,347
Co-location and other revenues	346,670	343,837
Total revenues	467,727	487,184
OPERATING COSTS AND EXPENSES		
Cost of access service revenues	54,687	56,519
Cost of co-location and other revenues	98,784	81,524
Selling, general and administrative expenses	335,528	366,134
Depreciation and amortization	58,207	68,494
Total operating costs and expenses	547,206	572,671
LOSS FROM OPERATIONS	(79,479)	(85,487)
INTEREST EXPENSE	(19,440)	(23,464)
NET LOSS	\$ (98,919)	\$ (108,951)
Net loss per share basic	\$ (.01)	\$ (.02)
Net loss per share assuming dilution	\$ (.01)	\$ (.02)
Weighted average shares outstanding basic	7,425,565	6,878,021
Weighted average shares outstanding assuming dilution	7,425,565	6,878,021

See accompanying notes to condensed consolidated financial statements.

**Table of Contents**

**FullNet Communications, Inc. and Subsidiaries**  
**CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS DEFICIT (UNAUDITED)**  
**Three Months Ended March 31, 2009**

	<b>Common stock</b>			<b>Common</b>	<b>Additional</b>	<b>Accumulated</b>	
	<b>Shares</b>	<b>Amount</b>		<b>Stock</b>	<b>Paid In</b>	<b>Deficit</b>	<b>Total</b>
				<b>Issuable</b>	<b>Capital</b>		
Balance at January 1, 2009	7,355,308	\$ 74		\$ 57,596	\$ 8,378,467	\$ (10,824,337)	\$ (2,388,200)
Warrant extension granted in settlement of liabilities					3,445		3,445
Net loss						(98,919)	(98,919)
Balance at March 31, 2009	7,355,308	\$ 74		\$ 57,596	\$ 8,381,912	\$ (10,923,256)	\$ (2,483,674)

See accompanying notes to the condensed consolidated financial statements.



**Table of Contents**

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

	<b>Three Months Ended</b>	
	<b>March 31,</b>	<b>March 31, 2008</b>
	<b>2009</b>	
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net loss	\$ (98,919)	\$ (108,951)
Adjustments to reconcile net loss to net cash provided by operating Activities		
Depreciation and amortization	58,207	68,494
Stock compensation		44
Provision for uncollectible accounts receivable	244	949
Net (increase) decrease in		
Accounts receivable	(2,762)	8,731
Prepaid expenses and other current assets	4,236	29,210
Net increase (decrease) in		
Accounts payable trade	(12,524)	35,329
Accrued and other liabilities	53,669	(24,726)
Deferred revenue	(5,628)	1,615
Net cash (used in) provided by operating activities	(3,477)	10,695
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchases of property and equipment		(28,853)
Acquisition of assets		
Net cash used in investing activities		(28,853)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Principal payments on borrowings under notes payable		(11,600)
Proceeds from exercise of options		28,049
Net cash provided by financing activities		16,449
<b>NET DECREASE IN CASH</b>	(3,477)	(1,709)
Cash at beginning of period	11,753	15,369
Cash at end of period	\$ 8,276	\$ 13,660

**SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION**

Cash paid for interest	\$	\$	11,600
Warrant extension granted in settlement of liabilities		3,445	

See accompanying notes to the condensed consolidated financial statements.

**Table of Contents**

**FullNet Communications, Inc. and Subsidiaries**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**1. UNAUDITED INTERIM FINANCIAL STATEMENTS**

The unaudited condensed consolidated financial statements and related notes have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been omitted pursuant to such rules and regulations. The accompanying unaudited condensed consolidated financial statements and related notes should be read in conjunction with the audited consolidated financial statements of the Company and notes thereto for the year ended December 31, 2008.

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, 2009. Certain reclassifications have been made to prior period balances to conform with the presentation for the current period. These reclassifications did not impact the net loss.

**2. MANAGEMENT S PLANS**

At March 31, 2009, current liabilities exceed current assets by \$2,101,463. The Company does not have a line of credit or credit facility to serve as an additional source of liquidity. Historically the Company has relied on shareholder loans as an additional source of funds. The Company is in default on various loans (see Note 9. Notes Payable). These factors raise substantial doubts about the Company's ability to continue as a going concern.

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

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

**Table of Contents**

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

**3. USE OF ESTIMATES**

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

**4. LOSS PER SHARE**

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

	Three Months Ended	
	March 31, 2009	March 31, 2008
Numerator:		
Net loss	\$ (98,919)	\$ (108,951)
Denominator:		
Weighted average shares outstanding - basic	7,425,565	6,878,021
Effect of dilutive stock options		
Effect of dilutive warrants		
Weighted average shares outstanding - assuming dilution	7,425,565	6,878,021
Net loss per share - basic	\$ (.01)	\$ (.02)
Net loss per share - assuming dilution	\$ (.01)	\$ (.02)

Basic and diluted loss per share were the same for the three months ended March 31, 2009 and 2008 because there was a net loss for each period.

**5. ACCOUNTS RECEIVABLE**

Accounts receivable consist of the following:

	March 31, 2009	December 31, 2008
Accounts receivable	\$ 201,720	\$ 198,958
Less allowance for doubtful accounts	(187,884)	(187,640)
	\$ 13,836	\$ 11,318



**Table of Contents****6. PROPERTY AND EQUIPMENT**

Property and equipment consist of the following:

	March 31, 2009	December 31, 2008
Computers and equipment	\$ 1,470,952	\$ 1,470,952
Leasehold improvements	966,915	966,915
Software	57,337	57,337
Furniture and fixtures	28,521	28,521
	2,523,725	2,523,725
Less accumulated depreciation	(2,254,500)	(2,199,498)
	\$ 269,225	\$ 324,227

Depreciation expense for the three months ended March 31, 2009 and 2008 was \$55,002 and \$63,713, respectively.

**7. INTANGIBLE ASSETS**

Intangible assets consist primarily of acquired customer bases and covenants not to compete and are carried net of accumulated amortization. Upon initial application of Statement of Financial Accounting Standard ( SFAS ) No. 142, *Goodwill and Intangible Assets*, 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 March 31, 2009 and 2008 relating to intangible assets was \$3,205 and \$4,781, respectively.

**8. ACCRUED AND OTHER CURRENT LIABILITIES**

Accrued and other current liabilities consist of the following:

	March 31, 2009	December 31, 2008
Accrued interest	\$ 475,816	\$ 456,737
Accrued deferred compensation	593,316	567,305
Accrued other liabilities	202,597	192,645
	\$ 1,271,729	\$ 1,216,687

**9. NOTES PAYABLE**

Notes payable consist of the following:

	March 31, 2009	December 31, 2008
	\$ 293,900	\$ 293,900

Interim loan from a shareholder, interest at 10%, requires payments equal to 50% of the net proceeds received by the Company from its private placement of convertible promissory notes, matured December 2001; unsecured (1)

Convertible promissory notes; interest at 12.5% of face amount, payable quarterly; these notes are unsecured and matured at December 31, 2006 (convertible into approximately 1,003,659 shares at March 31, 2009 and December 31, 2008) (2)	510,636	510,636
	804,536	804,536
Less current portion	565,736	557,036
	\$ 238,800	\$ 247,500

(1) In September 2007, the lender agreed to accept monthly payments of \$5,800 beginning December 1, 2007 to be allocated 50% to principal and 50% to interest. At March 31, 2009, the outstanding principal and interest of the interim loan was \$521,782. The Company has been unable to make all of the required payments pursuant to the terms of the September 2007 agreement. The lender has not made any formal demands for

payment or  
instituted  
collection action;  
however we are  
in discussions  
with the lender to  
restructure this  
liability.



**Table of Contents**

(2) During 2000 and 2001, the Company issued 11% convertible promissory notes or converted other notes payable or accounts payable to convertible promissory notes in an amount totaling \$2,257,624. The terms of the Notes are 36 months with limited prepayment provisions. Each of the Notes may be converted by the holder at any time at \$1.00 per common stock share and by the Company upon registration and when the closing price of the Company's common stock has been at or above \$3.00 per share for three consecutive trading days. Additionally, the Notes are accompanied by warrants exercisable for the purchase of the number of shares of

Company common stock equal to the number obtained by dividing 25% of the face amount of the Notes purchased by \$1.00. These warrants are exercisable at any time during the five years following issuance at an exercise price of \$.01 per share. Under the terms of the Notes, the Company was required to register the common stock underlying both the Notes and the detached warrants by filing a registration statement with the Securities and Exchange Commission within 45 days following the Final Expiration Date of the Offering (March 31, 2001). On May 31, 2001, the Company exchanged 2,064,528 shares of its common stock and warrants (exercisable for the purchase of 436,748 shares

of common stock at \$2.00 per share) for convertible promissory notes in the principal amount of \$1,746,988 (recorded at \$1,283,893) plus accrued interest of \$123,414. The warrants expired on May 31, 2006. This exchange was accounted for as an induced debt conversion and a debt conversion expense of \$370,308 was recorded.

Pursuant to the provisions of the convertible promissory notes, the conversion price was reduced from \$1.00 per share on January 15, 2001 to \$.49 per share on December 31, 2003 for failure to register under the Securities Act of 1933, as amended, the common stock underlying the convertible promissory notes and underlying

warrants on February 15, 2001. Reductions in conversion price are recognized at the date of reduction by an increase to additional paid-in capital and an increase in the discount on the convertible promissory notes. Furthermore, the interest rate was increased to 12.5% per annum from 11% per annum because the registration statement was not filed before March 1, 2001. At March 31, 2009, the outstanding principal and interest of the convertible promissory notes was \$931,352.

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

promissory  
notes.

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

#### 10. COMMON STOCK OPTIONS AND WARRANTS

The following table summarizes the Company's employee stock option activity for the three months ended March 31, 2009:

	Three Months Ended March 31, 2009	Weighted Average Exercise Price
Options outstanding, beginning and end of the period	2,447,704	\$ .53

On January 1, 2006, the Company adopted SFAS No. 123(R), *Share-Based Payment*. SFAS 123(R) replaced SFAS No. 123, *Accounting for Stock-Based Compensation*, and supersedes *Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees*, using the modified prospective method as described in the standard. Under this modified prospective method, the Company is required to record compensation cost for new and modified awards over the related vesting period of such awards prospectively and record compensation cost prospectively for the unvested portion at time of adoption, of previously issued and outstanding awards over the remaining vesting period of such awards. Adoption of SFAS123(R) had no impact on the Company's consolidated financial statements or consolidated results of operations.

The following table summarizes the Company's common stock purchase warrant and non-employee stock option activity for the three months ended March 31, 2009:

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

	Three Months Ended March 31, 2009	Weighted Average Exercise Price
Warrants and non-employee stock options outstanding, beginning and end of the period	591,000	\$ .49

#### 11. RECENTLY ISSUED ACCOUNTING STANDARDS

In April 2008, the FASB issued FASB Staff Position ( FSP ) No. 142-3, *Determination of the Useful Life of Intangible Assets* ( FSP 142-3 ). FSP 142-3 amends the factors an entity should consider in developing renewal or extension assumptions used in determining the useful life of recognized intangible assets under FASB Statement No. 142, *Goodwill and Other Intangible Assets*. This new guidance applies prospectively to intangible assets that are acquired individually or with a group of other assets in business combinations and asset acquisitions. FSP 142-3 became effective for the Company on January 1, 2009. The Company has determined that FASB Statement No. 142-3 has no material effect on the consolidated financial statements.

**Table of Contents**

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* ( SFAS 141R ) and SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51* ( SFAS 160 ). SFAS 141R changes the accounting for business combinations, including the measurement of acquirer shares issued in consideration for a business combination, the recognition of contingent consideration, the accounting for pre-acquisition gain and loss contingencies, the recognition of capitalized in-process research and development, the accounting for acquisition-related restructuring cost accruals, the treatment of acquisition related transaction costs, and the recognition of changes in the acquirer's income tax valuation allowance. SFAS 160 changed the accounting and reporting for minority interests, reporting them as equity separate from the parent entity's equity, as well as requiring expanded disclosures. The provisions of SFAS 141R and SFAS 160 became effective for the Company on January 1, 2009. The Company has determined that FASB Statement No. 141 has no material effect on the consolidated financial statements.

Effective December 30, 2007, the Company adopted the provisions of SFAS No. 157, *Fair Value Measurements* ( SFAS 157 ), which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements required under other accounting pronouncements. Issued in February 2008, FSP 157-1 *Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13*, removed leasing transactions accounted for under Statement 13 and related guidance from the scope of SFAS 157. FSP 157-2 *Partial Deferral of the Effective Date of Statement 157* ( FSP 157-2 ), deferred the effective date of SFAS 157 for all nonfinancial assets and nonfinancial liabilities to fiscal years beginning after November 15, 2008.

SFAS 157 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. SFAS 157 also requires that a fair value measurement reflect the assumptions market participants would use in pricing an asset or liability based on the best information available. Assumptions include the risks inherent in a particular valuation technique (such as a pricing model) and/or the risks inherent in the inputs to the model. The adoption of SFAS 157 did not have a significant impact on the Company's financial statements.

SFAS 157 establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under SFAS No. 157 are described below:

- Level 1 Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;
- Level 2 Quoted prices in markets that are not active or financial instruments for which all significant inputs are observable, either directly or indirectly; and
- Level 3 Prices or valuations that require inputs that are both significant to the fair value measurement and unobservable.

**Table of Contents**

In October 2008, the FASB issued FSP 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* ( FSP 157-3 ). The FSP clarifies the application of SFAS 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. The FSP is effective October 10, 2008, and for prior periods for which financial statements have not been issued. The Company adopted the provisions of FSP 157-3 in its financial statements for the year ended December 31, 2008. The adoption did not have a material impact on the Company's consolidated results of operations or financial position.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* ( SFAS 159 ). This statement permits companies to choose to measure many financial assets and liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The Company adopted the provisions of SFAS 159 on January 1, 2008.

**12. CERTAIN RELATIONSHIPS**

The Company has an operating lease for certain equipment that is leased from one of its shareholders who also holds a \$293,900 interim loan (see Note 9 Notes Payable). The original lease was dated November 21, 2001 and the terms were \$6,088 per month for 12 months with a fair market purchase option at the end of the lease. Upon default on the lease, the Company was allowed to continue leasing the equipment on a month-to-month basis at the same monthly rate as the original lease. The Company has been unable to make the month-to-month payments. In January and November 2006, the Company agreed to extend the expiration date on 425,000 and 140,000, respectively, of common stock purchase warrants for the lessor in return for a credit of \$17,960 and \$3,940, respectively, on the operating lease. In September 2007, the lessor agreed to cease the monthly lease payments effective January 1, 2007 which generated a total of \$54,795 of forgiveness of debt income. The lessor also agreed to accept payments of \$499 per month on the balance owed. In January 2009, the Company agreed to extend the expiration date on 425,000 of common stock purchase warrants for the lessor in return for a credit of \$3,445 on the operating lease. At March 31, 2009 the Company had recorded \$256,717 in unpaid lease payments. The loss of this equipment would have a material adverse effect on the Company's business, financial condition and results of operations. The Company has been unable to make all of the required payments pursuant to the terms of the September 2007 agreement. The lessor has not made any formal demands for payment or instituted collection action; however the Company is in discussions with the lessor to restructure this liability.

**13. CONTINGENCIES**

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

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



**Table of Contents**

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

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

On February 24, 2009, the Enforcement Bureau of the Federal Communications Commission issued an Omnibus Notice of Apparent Liability for Forfeiture ( NAL ) to the Company in the amount of \$20,000 for failure to timely file a certification report concerning so-called Customer Proprietary Network Information ( CPNI ). There were approximately 690 other telecommunications companies included in the NAL. Each company has the opportunity to submit further evidence and arguments in response to the NAL to show that no forfeiture should be imposed or that some lesser amount should be assessed. The Company is in the process of preparing its response.

**Table of Contents**

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

*The following discussion is qualified in its entirety by the more detailed information in our Form 10-K and the financial statements contained therein, including the notes thereto, and our other periodic reports filed with the Securities and Exchange Commission since December 31, 2008 (collectively referred to as the Disclosure Documents). Certain forward-looking statements contained in this Report and in the Disclosure Documents regarding our business and prospects are based upon numerous assumptions about future conditions which may ultimately prove to be inaccurate and actual events and results may materially differ from anticipated results described in such statements. Our ability to achieve these results is subject to certain risks and uncertainties, including those inherent risks and uncertainties generally in the Internet service provider and competitive local exchange carrier industries, the impact of competition and pricing, changing market conditions, and other risks. Any forward-looking statements contained in this Report represent our judgment as of the date of this Report. We disclaim, however, any intent or obligation to update these forward-looking statements. As a result, the reader is cautioned not to place undue reliance on these forward-looking statements. References to us in this report include our subsidiaries: FullNet, Inc. ( FullNet ), FullTel, Inc. ( FullTel ) and FullWeb, Inc. ( FullWeb ).*

**Overview**

We are an integrated communications provider offering integrated communications and Internet connectivity to individuals, businesses, organizations, educational institutions and government agencies. Through our subsidiaries, we provide high quality, reliable and scalable Internet access, web hosting, equipment co-location and traditional telephone services. Our overall strategy is to become 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 Internet sites on the World Wide Web ( WWW ) at [www.fullnet.net](http://www.fullnet.net) and [www.fulltel.com](http://www.fulltel.com). Information contained on our Web sites is not and should not be deemed to be a part of this Report.

**Company History**

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

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

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

Through FullTel, our wholly owned subsidiary, we are a fully licensed competitive local exchange carrier or CLEC in Oklahoma. FullTel activates local access telephone numbers for the cities in which we will market, sell and operate our retail FullNet Internet service provider brand, wholesale dial-up Internet service; our business-to-business network design, connectivity, domain and Web hosting businesses; and traditional telephone services. At March 31, 2009 FullTel provided us with local telephone access in approximately 232 cities.

**Table of Contents**

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

**Results of Operations**

The following table sets forth certain statement of operations data as a percentage of revenues for the three months ended March 31, 2009 and 2008:

	<b>Three Months Ended</b>			
	<b>March 31, 2009</b>		<b>March 31, 2008</b>	
	<b>Amount</b>	<b>Percent</b>	<b>Amount</b>	<b>Percent</b>
<b>Revenues:</b>				
Access service revenues	\$ 121,057	25.9%	\$ 143,347	29.4%
Co-location and other revenues	346,670	74.1	343,837	70.6
<b>Total revenues</b>	<b>467,727</b>	<b>100.0</b>	<b>487,184</b>	<b>100.0</b>
Cost of access service revenues	54,687	11.7	56,519	11.6
Cost of co-location and other revenues	98,784	21.1	81,524	16.7
Selling, general and administrative expenses	335,528	71.7	366,134	75.2
Depreciation and amortization	58,207	12.4	68,494	14.1
<b>Total operating costs and expenses</b>	<b>547,206</b>	<b>116.9</b>	<b>572,671</b>	<b>117.6</b>
Loss from operations	(79,479)	(16.9)	(85,487)	(17.6)
Interest expense	(19,440)	(4.2)	(23,464)	(4.8)
Net loss	\$ (98,919)	(21.1)%	\$ (108,951)	(22.4)%

**Three Months Ended March 31, 2009 Compared to Three Months Ended March 31, 2008***Revenues*

Access service revenues decreased \$22,290 or 15.6% to \$121,057 for the 2009 1st Quarter from \$143,347 for the same period in 2008 primarily due to a decline in the number of customers.

Co-location and other revenues increased \$2,833 or 0.8% to \$346,670 for the 2009 1st Quarter from \$343,837 for the same period in 2008. This increase was primarily attributable to the net addition of new customers.

*Operating Costs and Expenses*

Cost of access service revenues decreased \$1,832 or 3.2% to \$54,687 for the 2009 1<sup>st</sup> Quarter from \$56,519 for the same period in 2008. Cost of access service revenues as a percentage of access service revenues increased to 45.2% during the 2009 1st Quarter, compared to 39.4% during the same period in 2008.

Cost of co-location and other revenues increased \$17,260 or 21.2% to \$98,784 for the 2009 1st Quarter from \$81,524 for the same period in 2008 primarily attributable to recurring costs related to increased customers on traditional phone services. Cost of co-location and other revenues as a percentage of co-location and other revenues increased to 28.5% during the 2009 1st Quarter, compared to 23.7% during the same period in 2008.



**Table of Contents**

Selling, general and administrative expenses decreased \$30,606 or 8.4% to \$335,528 for the 2009 1st Quarter compared to \$366,134 for the same period in 2008 primarily attributable to decreases in employee related costs, supplies, and bad debt expenses of \$21,124, \$5,010 and \$5,170, respectively. Selling, general and administrative expenses as a percentage of total revenues decreased to 71.7% during the 2009 1st Quarter from 75.2% during the same period in 2008.

Depreciation and amortization expense decreased \$10,287 or 15.0% to \$58,207 for the 2009 1st Quarter compared to \$68,494 for the same period in 2008 primarily related to several assets reaching full depreciation.

*Interest Expense*

Interest expense decreased \$4,024 or 17.2% to \$19,440 for the 2009 1st Quarter compared to \$23,464 for the same period in 2008. This decrease was primarily attributable to the lower note balances from the payment of principal on the notes.

**Liquidity and Capital Resources**

As of March 31, 2009, we had \$8,276 in cash and \$2,156,124 in current liabilities, including \$122,920 of deferred revenues that will not require settlement in cash.

At March 31, 2009, we had a working capital deficit of \$2,101,463, while at December 31, 2008 we had a working capital deficit of \$2,052,626. 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 March 31, 2009, \$173,592 of the \$189,703 we owed to our trade creditors was past due. We have no formal agreements regarding payment of these amounts. At March 31, 2009, \$256,717 payable under a matured lease obligation was outstanding and we had outstanding principal and interest owed on matured notes totaling \$1,453,134. We have not made payment or negotiated an extension of the notes and the lenders have not made any payment demands. We are currently developing a plan to satisfy these notes on terms acceptable to the note holders.

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

Cash flow for the periods ending March 31, 2009 and 2008 consist of the following.

	For the Periods Ended March 31,	
	2009	2008
Net cash flows (used in) provided by operations	\$ (3,477)	\$ 10,695
Net cash flows used in investing activities		(28,853)
Net cash flows provided by financing activities		16,449

Cash used for the purchases of equipment was \$28,853 for the three months ended March 31, 2008.

Cash used for principal payments on notes payable was \$11,600 for the three months ended March 31, 2008.

Cash provided by the exercise of options was \$28,049 for the three months ended March 31, 2008.

**Table of Contents**

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

mergers and acquisitions and

further development of operations support systems and other automated back office systems

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

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

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

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

**Financing Activities**

On January 5, 2001, we obtained a \$250,000 interim loan. This loan bears interest at 10% per annum and requires payments equal to 50% of the net proceeds received by us from our private placement of convertible notes payable. Subsequently, the principal balance of the loan was increased to \$320,000 and the due date was extended to December 31, 2001. Through August 2007 we had made aggregate payments of principal and interest of \$35,834 on this loan. In September 2007, the lender agreed to accept monthly payments of \$5,800 beginning December 1, 2007 to be allocated 50% to principal and 50% to interest. At March 31, 2009, the outstanding principal and interest of the interim loan was \$521,782. The Company has been unable to make all of the required payments pursuant to the terms of the September 2007 agreement. The lender has not made any formal demands for payment or instituted collection action; however we are in discussions with the lender to restructure this liability.

**Table of Contents**

We have an operating lease for certain equipment that is leased from one of our shareholders who also holds a \$293,900 interim loan (see Note 9 Notes Payable). The original lease was dated November 21, 2001 and the terms were \$6,088 per month for 12 months with a fair market purchase option at the end of the lease. Upon default on the lease, we were allowed to continue leasing the equipment on a month-to-month basis at the same monthly rate as the original lease. We have been unable to make the month-to-month payments. In January and November 2006, we agreed to extend the expiration date on 425,000 and 140,000, respectively, of common stock purchase warrants for the lessor in return for a credit of \$17,960 and \$3,940, respectively, on the operating lease. In September 2007, the lessor agreed to cease the monthly lease payments effective January 1, 2007 which generated a total of \$54,795 of forgiveness of debt income. The lessor also agreed to accept payments of \$499 per month on the balance owed. In January 2009, we agreed to extend the expiration date on 425,000 of common stock purchase warrants for the lessor in return for a credit of \$3,445 on the operating lease. At March 31, 2009 we had recorded \$256,717 in unpaid lease payments. The loss of this equipment would have a material adverse effect on our business, financial condition and results of operations. We have been unable to make all of the required payments pursuant to the terms of the September 2007 agreement. The lessor has not made any formal demands for payment or instituted collection action; however we are in discussions with the lessor to restructure this liability.

Pursuant to the provisions of the convertible promissory notes (see Note 9 Notes Payable), the conversion price was reduced from \$1.00 per share on January 15, 2001 to \$.49 per share on December 31, 2003 for failure to register under the Securities Act of 1933, as amended, the common stock underlying the convertible promissory notes and underlying warrants on February 15, 2001. Reductions in conversion price were recognized at the date of reduction by an increase to additional paid-in capital and an increase in the discount on the notes payable. Furthermore, the interest rate was increased to 12.5% per annum from 11% per annum because the registration statement was not filed before March 1, 2001. In November and December 2003 and March 2004, \$455,000, \$50,000 and \$5,636, respectively, of these convertible promissory notes matured. We have not made payment or negotiated an extension of these notes, and the lenders have not made any demands. At March 31, 2009, the outstanding principal and interest of the convertible promissory notes was \$931,352.

**Recently Issued Accounting Standards**

In April 2008, the FASB issued FASB Staff Position ( FSP ) No. 142-3, *Determination of the Useful Life of Intangible Assets* ( FSP 142-3 ). FSP 142-3 amends the factors an entity should consider in developing renewal or extension assumptions used in determining the useful life of recognized intangible assets under FASB Statement No. 142, *Goodwill and Other Intangible Assets*. This new guidance applies prospectively to intangible assets that are acquired individually or with a group of other assets in business combinations and asset acquisitions. FSP 142-3 became effective for us on beginning January 1, 2009. We have determined that FASB Statement No. 142-3 has no material effect on the consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* ( SFAS 141R ) and SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51* ( SFAS 160 ). SFAS 141R changes the accounting for business combinations, including the measurement of acquirer shares issued in consideration for a business combination, the recognition of contingent consideration, the accounting for pre-acquisition gain and loss contingencies, the recognition of capitalized in-process research and development, the accounting for acquisition-related restructuring cost accruals, the treatment of acquisition related transaction costs, and the recognition of changes in the acquirer's income tax valuation allowance. SFAS 160 changed the accounting and reporting for minority interests, reporting them as equity separate from the parent entity's equity, as well as requiring expanded disclosures. The provisions of SFAS 141R and SFAS 160 became effective for us on January 1, 2009. We have determined that FASB Statement No. 141 has no material effect on the consolidated financial statements.

**Table of Contents**

Effective December 30, 2007, we adopted the provisions of SFAS No. 157, *Fair Value Measurements* ( SFAS 157 ), which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements required under other accounting pronouncements. Issued in February 2008, FSP 157-1 *Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13*, removed leasing transactions accounted for under Statement 13 and related guidance from the scope of SFAS 157. FSP 157-2 *Partial Deferral of the Effective Date of Statement 157* ( FSP 157-2 ), deferred the effective date of SFAS 157 for all nonfinancial assets and nonfinancial liabilities to fiscal years beginning after November 15, 2008.

SFAS 157 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. SFAS 157 also requires that a fair value measurement reflect the assumptions market participants would use in pricing an asset or liability based on the best information available. Assumptions include the risks inherent in a particular valuation technique (such as a pricing model) and/or the risks inherent in the inputs to the model. The adoption of SFAS 157 did not have a significant impact on our financial statements.

SFAS 157 establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under SFAS No. 157 are described below:

- Level 1 Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;
- Level 2 Quoted prices in markets that are not active or financial instruments for which all significant inputs are observable, either directly or indirectly; and
- Level 3 Prices or valuations that require inputs that are both significant to the fair value measurement and unobservable.

In October 2008, the FASB issued FSP 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* ( FSP 157-3 ). The FSP clarifies the application of SFAS 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. The FSP is effective October 10, 2008, and for prior periods for which financial statements have not been issued. We adopted the provisions of FSP 157-3 in our financial statements for the year ended December 31, 2008. The adoption did not have a material impact on our consolidated results of operations or financial position.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* ( SFAS 159 ). This statement permits companies to choose to measure many financial assets and liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007. We adopted the provisions of SFAS 159 on January 1, 2008.

**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.



**Table of Contents**

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

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. Quantitative and Qualitative Disclosures About Market Risk**

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

**Item 4. Controls and Procedures**

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

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

- pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets;

- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors; and

- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on our financial statements.

**Table of Contents**

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

**Item 4(T). Controls and Procedures.**

This report does not include an attestation report of our registered public accounting firm regarding internal control over financial reporting. Management’s report was not subject to attestation by our registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit us to provide only management’s report in this report.

**Table of Contents****PART II OTHER INFORMATION****Item 1. Legal Proceedings**

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

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

None.

**Item 3. Defaults Upon Senior Securities**

We are in default on convertible promissory notes that matured in November 2003, December 2003 and March 2004. These notes bear interest at 12.5% per annum and are convertible into approximately 1,003,659 shares of our common stock. We were unable to pay these notes at maturity and are currently developing a plan to satisfy these notes on terms acceptable to the note holders. At March 31, 2009, the aggregate outstanding principal and accrued interest of the convertible promissory notes was \$931,352. We have not made payment or negotiated an extension of these notes, and the lenders have not made any demands.

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

No matters were submitted to a vote of security holders during the first quarter of 2009.

**Item 5. Other Information**

During the three months ended March 31, 2009 all events reportable on Form 8-K were reported.

**Item 6. Exhibits**

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

<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).	#

**Table of Contents**

<i>Exhibit Number</i>	<i>Exhibit</i>	
4.2	Certificate of Correction to the Amended Certificate of Incorporation and the Ninth Section of the Certificate of Incorporation (filed as Exhibit 2.1 to Registrant's Registration Statement on form 10-SB, file number 000-27031 and incorporated by reference).	#
4.3	Certificate of Correction to Articles II and V of Registrant's Bylaws (filed as Exhibit 2.1 to Registrant's Registration Statement on Form 10-SB, file number 000-27031 and incorporated herein by reference).	#
4.4	Form of Warrant Agreement for Interim Financing in the amount of \$505,000 (filed as Exhibit 4.1 to Registrant's Quarterly Report on Form 10-QSB for the Quarter ended March 31, 2000 and incorporated herein by reference).	#
4.5	Form of Warrant Certificate for Florida Investors for Interim Financing in the amount of \$505,000 (filed as Exhibit 4.2 to Registrant's Quarterly Report on Form 10-QSB for the Quarter ended March 31, 2000 and incorporated herein by reference).	#
4.6	Form of Promissory Note for Florida Investors for Interim Financing in the amount of \$505,000 (filed as Exhibit 4.3 to Registrant's Quarterly Report on Form 10-QSB for the Quarter ended March 31, 2000 and incorporated herein by reference).	#
4.7	Form of Warrant Certificate for Georgia Investors for Interim Financing in the amount of \$505,000 (filed as Exhibit 4.4 to Registrant's Quarterly Report on Form 10-QSB for the Quarter ended March 31, 2000 and incorporated herein by reference).	#
4.8	Form of Promissory Note for Georgia Investors for Interim Financing in the amount of \$505,000 (filed as Exhibit 4.5 to Registrant's Quarterly Report on Form 10-QSB for the Quarter ended March 31, 2000 and incorporated herein by reference).	#
4.9	Form of Warrant Certificate for Illinois Investors for Interim Financing in the amount of \$505,000 (filed as Exhibit 4.6 to Registrant's Quarterly Report on Form 10-QSB for the Quarter ended March 31, 2000 and incorporated herein by reference).	#
4.10	Form of Promissory Note for Illinois Investors for Interim Financing in the amount of \$505,000 (filed as Exhibit 4.7 to Registrant's Quarterly Report on Form 10-QSB for the Quarter ended March 31, 2000 and incorporated herein by reference).	#
4.11	Form of Warrant Agreement for Interim Financing in the amount of \$500,000 (filed as Exhibit 4.8 to Registrant's Quarterly Report on Form 10-QSB for the Quarter ended March 31, 2000 and incorporated herein by reference).	#
4.12	Form of Warrant Certificate for Interim Financing in the amount of \$500,000 (filed as Exhibit 4.9 to Registrant's Quarterly Report on Form 10-QSB for the Quarter ended March 31, 2000 and incorporated herein by reference).	#
4.13		#

Edgar Filing: FULLNET COMMUNICATIONS INC - Form 10-Q

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).

- |      |   |   |
|------|---|---|
| 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)  | # |

**Table of Contents**

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

Edgar Filing: FULLNET COMMUNICATIONS INC - Form 10-Q

February 18, 2000 and incorporated herein by reference).

- |       |   |   |
|-------|---|---|
| 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).   | # |

**Table of Contents**

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



Edgar Filing: FULLNET COMMUNICATIONS INC - Form 10-Q

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).

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	#

**Table of Contents**

<i>Exhibit Number</i>	<i>Exhibit</i>	
10.36	Promissory Note dated June 15, 2001, issued to higganbotham.com L.L.C.	#
10.37	Promissory Note dated November 19, 2001, issued to Northeast Rural Services	#
10.38	Promissory Note dated November 19, 2001, issued to Northeast Rural Services	#
10.39	Form of Convertible Promissory Note dated September 6, 2002	#
10.40	Employment Agreement with Timothy J. Kilkenny dated July 31, 2002	#
10.41	Employment Agreement with Roger P. Baresel dated July 31, 2002	#
10.42	Letter from Grant Thornton LLP to the Securities and Exchange Commission dated January 30, 2003	#
10.43	Form 8-K dated January 30, 2003 reporting the change in certifying accountant	#
10.44	Form 8-K dated September 20, 2005 reporting the change in certifying accountant	#
22.1	Subsidiaries of the Registrant	#
31.1	Certification pursuant to Rules 13a-14(a) and 15d-14(a) of Timothy J. Kilkenny	*
31.2	Certification pursuant to Rules 13a-14(a) and 15d-14(a) of Roger P. Baresel	*
32.1	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 by Timothy J. Kilkenny	*
32.2	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 by Roger P. Baresel	*
#	Incorporated by reference.	
*	Filed herewith.	

**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: May 15, 2009

By: /s/ TIMOTHY J. KILKENNY

Timothy J. Kilkenny  
Chief Executive Officer

Date: May 15, 2009

By: /s/ ROGER P. BARESEL

Roger P. Baresel  
President and Chief Financial and  
Accounting Officer

- 27 -

---

**Table of Contents**

**EXHIBIT INDEX**

Exhibit No.	Description
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