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ORIGINAL

January 28, 2000

VIA OVERNIGHT DELIVERY

Ms. Blanca Bayo
Director
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, FL 32399-0850

000110-TP

Re: Touch 1 Communications, Inc. Transfer of Control to Z-Tel Technologies, Inc.

Dear Ms. Bayo:

Enclosed please find an original and 12 copies of the Notification of Transfer of Control from Touch 1 Communications, Inc. to Z-Tel Technologies, Inc. for filing with the Florida Public Service Commission.

Enclosed please also find a duplicate copy of this filing and a self-addressed, stamped envelope. Please date-stamp the duplicate upon receipt and return it in the envelope provided. Please do not hesitate to call me at (202) 955-9667 if you have any questions.

Respectfully submitted,

Melissa Smith

Melissa M. Smith

Enclosures

cc: Tom Williams

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January 28, 2000

BY FEDERAL EXPRESS

Ms. Blanca Bayo
Director
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, FL 32399-0850

Re: Touch 1 Communications, Inc.: Transfer of Control to Z-Tel Technologies, Inc.

Dear Ms. Bayo:

Touch 1 Communications, Inc. ("Touch 1") and Z-Tel Technologies, Inc. ("Z-Tel"), by their attorneys, hereby respectfully notify the Florida Public Service Commission ("Commission"), of their intent to transfer ownership and control of Touch 1 from Touch 1's current shareholders to Z-Tel through merger as described more fully below. Upon consummation of the merger, Touch 1 will become a wholly-owned subsidiary of Z-Tel; Touch 1 will continue to provide intrastate communications service on a resale basis in Florida under its existing authorization. Thus, this transaction does not involve the transfer of any certificate or authorization. It us our understanding that no formal approval by the Commission is required to complete this transaction.

The Parties. Touch 1 is a privately-held Alabama corporation headquarted at 100 Brookwood Road, P.O. Drawer 10751, Atmore, Alabama 36504-5751. Touch 1 is a reseller of 1+ long distance, 800 and calling card service. Touch 1 markets these services primarily to residential customers. Touch 1 is authorized to provide telecommunications services in the 48 contiguous United States and the District of Columbia, including Florida. Touch 1 received its authority to provide telecommunications services in Florida on December 23, 1994 in Docket No. 940938-TI. Touch 1 also is authorized by the Federal Communications Commission to provide interstate and international telecommunications services. Touch 1 currently serves more than 420,000 customers.

Z-Tel is a publicly-held Delaware corporation whose principal offices are located at Knight's Point, 601 South Harbour Island Boulevard, Suite 220, Tampa, Florida 33602. Z-Tel is publicly traded on the NASDAQ stock market under the symbol "ZTEL." Z-Tel, through its wholly-owned subsidiary, Z-Tel Communications, Inc., provides advanced, integrated telecommunications services primarily to residential and small business customers. Z-Tel Communications began offering telecommunications services to the public in September 1998, and offers both local and long distance telephone services in combination with Internet-based enhanced communications features. Z-Tel Communications is authorized to provide local exchange service in twenty-seven states including Florida, and is authorized to provide IXC service in forty-four states including Florida.[1] It also is authorized by the Federal Communications Commission to provide interstate and international telecommunications services. Z-Tel Communications currently provides nationwide interexchange service and provides enhanced local exchange service to customers in New York and Texas.

Transfer of Control. Touch 1 and Z-Tel have agreed in principle to a plan of merger ("Plan") whereby Z-Tel will acquire Touch 1. Specifically, the transfer of control will be accomplished through a triangular merger whereby a newly-formed subsidiary of Z-Tel will be merged with and into Touch 1. The stock of the subsidiary will be exchanged for the stock of Touch 1; Touch 1 will be the surviving entity and will be a wholly-owned subsidiary of Z-Tel. The outstanding Touch 1 shares of the current shareholders of Touch 1 will be converted into shares of Z-Tel stock.

After the consummation of the merger, Touch 1 will continue to operate under the same name and operating authority. Touch 1 also will continue to operate under the same rates, services, and tariff. Thus, the transfer of control will be transparent to customers and will not have any adverse impact on them. The Touch 1 contact for customer and Commission inquiries will remain Linda Farr, Manager of Regulatory Affairs, Touch 1 Communications, Inc., (334) 368-8600.

Z-Tel is financially and managerially qualified to assume control of Touch 1. In 1998, Z-Tel had revenues of approximately $140,000. Even though Z-Tel Communications only initiated service in September of 1998, by September 30, 1999, Z-Tel had revenues of approximately $2,170,000. A copy of Z-Tel's most recent financials prepared in connection with its recent

1 IXC service authorization was granted by Order No. PSC-98-1235-FOF-TI (Certificate No. 5695) issued September 21, 1998, Docket No. 980065-TI. Order No. PSC-99-0017-FOF-TI acknowledging name change was issued January 4, 1999, Docket No. 981823-TI. Z-Tel has local exchange authority under Certificate No. 5701. Z-Tel Communications, Inc. will continue to provide service under its existing authorization(s) after consummation of this transaction.

public offering is attached hereto as Exhibit A. In addition to the assets shown on the attached financial statements, Z-Tel has raised $110,000,000.00 through its recent public offering and currently has a market capitalization of approximately one billion dollars. Z-Tel is led by a highly-qualified team of management personnel, all of whom have extensive backgrounds in telecommunications. Z-Tel's qualifications are a matter of record before this Commission. Moreover, many members of Touch 1's management team will continue to serve with Touch 1 after the merger is consummated. Touch 1 will continue to operate in Florida under its present ownership pending consummation of the merger. The Commission will be notified when consummation occurs.

Public Interest Considerations. The proposed transfer of control of Touch 1 from its current shareholders to Z-Tel is in the public interest. The addition of Touch 1 to Z-Tel will enhance both Z-Tel's and Touch 1's ability to compete in the market for telecommunications services in Florida and elsewhere. The parties will benefit from increased economies of scale that will permit them to operate more efficiently and thus to compete more effectively. In addition, Touch 1 recently has reorganized in connection with its discharge from bankruptcy. Although now solvent, as a wholly-owned subsidiary of Z-Tel, Touch 1 will have access to the greater financial resources it needs to introduce new products and services and to respond to the competitive telecommunications environment in Florida and across the nation. Over time, consumers in Florida will benefit from a greater number of product and service options as well as lower prices.

Should our understanding be incorrect with respect to the need for approval of this transaction, we respectfully request that Commission staff immediately contact us.

Respectfully submitted,

Touch 1 Communications, Inc.

By: ____________________
Charles C. Hunter, Esq.
Hunter Communications Law Group, PC
1620 Eye Street, N.W.
Suite 701
Washington, D. C. 20006
Tel. (202) 293-2500
Fax. (202) 293-2571

Its Attorneys

Z-Tel Technologies, Inc.

By: ____________________
James J. Freeman
Melissa M. Smith
Kelley Drye & Warren LLP
1200 19th Street, N.W.
Suite 500
Washington, D. C. 20036
Tel. (202) 955-9600
Fax. (202) 955-9792

Its Attorneys

VERIFICATION

I am authorized to represent Z-Tel Technologies, Inc. and to make this verification on its behalf. The statements in the foregoing document relating to Z-Tel Technologies, Inc. and its subsidiaries are true of my own knowledge, except as otherwise specifically attributed, and as to matters that are stated therein on information and belief, I believe them to be true.

I declare under penalty of perjury that the foregoing is true and correct.

MARK H. JOHNSON
Secretary/Treasurer
Z-Tel Technologies, Inc.

STATE OF FLORIDA)
) SS
COUNTY OF HILLSBOROUGH)

Subscribed and sworn to before me this 25th day of January, 2000 by Mark H. Johnson, who is personally known to me.

Notary Public Dolorene M. Sackman

DOLORENE M. SACKMAN
MY COMMISSION # CC 716596
EXPIRES: February 12, 2002
Bonded Thru Notary Public Underwriters

My Commission expires: Feb. 12, 2002

VERIFICATION

I am authorized to represent Touch 1 Communications, Inc. and to make this verification on its behalf. The statements in the foregoing document relating to Touch 1 Communications, Inc. are true of my own knowledge, except as otherwise specifically attributed, and as to matters that are stated therein on information on belief, I believe them to be true.

I declare under penalty of perjury that the foregoing is true and correct.

JAMES F. CORMAN
President
Touch 1 Communications, Inc.

STATE OF FLORIDA)
)
COUNTY OF HILLSBOROUGH)

Subscribed and sworn to before me this 25th day of January, 2000, by James F. Corman, who has produced an Alabama driver's license as identification.

Dolorene M. Sackman
Notary Public

DOLORENE M. SACKMAN
MY COMMISSION # CC 718596
EXPIRES: February 12, 2002
Bonded Thru Notary Public Underwriters

My Commission expires: February 12, 2002

DC01/FREEJ/101924.1

EXHIBIT A
Financial Statements

Z-TEL TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

	December 31, 1998	September 30, 1999	September 30, 1999 (Pro Forma) (Unaudited) (Note 2)
Assets			
Current assets:			
Cash and cash equivalents	$ 7,973,000	$ 2,682,000	$ 1,518,000
Accounts receivable, net of allowance for doubtful accounts of approximately $54,000 at December 31, 1998 and $80,000 at September 30, 1999	15,000	607,000	607,000
Prepaid expenses and other current assets	423,000	773,000	773,000
Total current assets	8,411,000	4,062,000	2,898,000
Property and equipment, net	11,710,000	19,626,000	19,626,000
Other	153,000	1,270,000	1,270,000
Total assets	$20,274,000	$24,958,000	$23,794,000
Liabilities, Mandatorily Convertible Redeemable Preferred Stock and Stockholders' Equity (Deficit)			
Current liabilities:			
Accounts payable and accrued liabilities	$ 4,402,000	$ 9,166,000	$ 9,166,000
Current portion of long-term debt and capital lease obligations	681,000	2,992,000	2,992,000
Total current liabilities	5,083,000	12,158,000	12,158,000
Long-term debt and capital lease obligations	43,000	9,717,000	9,717,000
Total liabilities	5,126,000	21,875,000	21,875,000
Mandatorily convertible redeemable preferred stock (aggregate liquidation value of approximately $15,154,000 at December 31, 1998 and $26,128,000 at September 30, 1999)	15,154,000	26,128,000	—
Commitments and contingencies (Notes 6 and 7)			
Stockholders' equity (deficit):			
Common stock, $.01 par value; 30,000,000 shares authorized; 14,411,100 shares issued and outstanding; 21,813,878 shares issued and outstanding pro forma	144,000	144,000	218,000
Notes receivable for common stock	(3,329,000)	(3,011,000)	(3,011,000)
Deferred stock compensation	(192,000)	(203,000)	(203,000)
Additional paid-in capital	16,493,000	17,112,000	42,002,000
Accumulated deficit	(13,122,000)	(36,769,000)	(36,769,000)
Treasury stock, 279,675 shares, at cost	—	(318,000)	(318,000)
Total stockholders' equity (deficit)	(6,000)	(23,045,000)	1,919,000
Total liabilities, mandatorily convertible redeemable preferred stock and stockholders' equity (deficit)	$20,274,000	$24,958,000	$23,794,000

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

Z-TEL TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

	Period January 15, 1998 (date of inception) through December 31, 1998	Period January 15, 1998 (date of inception) through September 30, 1998 (Unaudited)	Nine Months Ended September 30, 1999
Revenue	$ 140,000	$ —	$ 2,170,000
Operating expenses:			
Network operations	382,000	43,000	4,588,000
Sales and marketing	2,201,000	489,000	3,620,000
Research and development	4,728,000	2,735,000	3,469,000
General and administrative	4,718,000	3,036,000	8,924,000
Depreciation and amortization	1,283,000	634,000	2,749,000
Total operating expenses	13,312,000	6,937,000	23,350,000
Operating loss	(13,172,000)	(6,937,000)	(21,180,000)
Nonoperating income (expense):			
Interest income	228,000	64,000	319,000
Interest expense	(178,000)	(298,000)	(2,786,000)
Total nonoperating income (expense)	50,000	(234,000)	(2,467,000)
Net loss	(13,122,000)	(7,171,000)	(23,647,000)
Less mandatorily convertible redeemable preferred stock dividends	(190,000)	—	(974,000)
Net loss attributable to common stockholders	$(13,312,000)	$(7,171,000)	$(24,621,000)
Weighted average common shares outstanding	6,554,699	3,753,191	14,383,338
Basic and diluted net earnings/(loss) per share	$ (2.03)	$ (1.91)	$ (1.71)
Shares used in pro forma basic and diluted net earnings/(loss) per share calculation (unaudited)	**10,992,102**		**21,786,116**
Pro forma basic and diluted net earnings/(loss) per share (unaudited)	$ (1.19)		$ (1.09)

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

Z-TEL TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Nature of Business

A) Description of Business

Z-Tel Technologies, Inc. and subsidiaries (Z-Tel or the Company) 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. The Company has six wholly owned subsidiaries: Z-Tel Communications, Inc., Z-Tel Business Networks, Inc., Z-Tel Holdings, Inc., Z-Tel Communications of Virginia, Inc., Z-Tel, Inc., and Z-Tel Network Services, Inc. Z-Tel Technologies, Inc. is the parent company, and has no other operations. Z-Tel Communications, Inc. is the operating entity. The remaining subsidiaries have no significant operations.

Z-Tel is an emerging integrated communications provider. The Company offers local and long distance telephone service and Internet access integrated with a full array of conventional and Internet-based enhanced communication services, primarily to consumers and small businesses.

The Company has incurred operating losses to date and, at September 30, 1999, had an accumulated deficit of $36.8 million. The Company's activities have been primarily financed through private placements of equity securities and debt instruments. The Company may need to raise additional capital through the issuance of debt or equity securities. Such financing may not be available on terms satisfactory to the Company, if at all. Accordingly, the Company has arranged for financing from a related party to be available as needed to ensure its continued operation through November 2000. This arrangement expires upon the successful completion of an initial public offering.

B) Recapitalization

The Board of Directors authorized an 11 for 10 stock split on November 19, 1999 which was effected in the form of a 10% stock dividend. All common share amounts have been adjusted retroactively to give effect to this split.

2. Summary of Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All material intercompany accounts and transactions have been eliminated.

Cash and Cash Equivalents

The Company considers all highly liquid investments with original maturity dates of three months or less to be cash equivalents.

Prepaid expenses and other current assets

Prepaid expenses and other current assets consist primarily of prepaid maintenance and support contracts and advances to suppliers.

2. Summary of Significant Accounting Policies (continued)

Property and Equipment

Property and equipment are recorded at historical cost. Maintenance and repairs are expensed as incurred, while renewals and betterments are capitalized. Upon the sale or other disposition of property, the cost and related accumulated depreciation are removed from the accounts and any gain or loss is recognized in operations. Depreciation is provided on the straight-line basis over the estimated useful lives of the property and equipment. Amortization of capitalized leases is provided on the straight-line basis over the lesser of the estimated useful lives or lease term.

The following summarizes the lives being used:

	Years
Switching equipment	5
Computer equipment	5
Software	3
Furniture and office equipment	5-10
Leasehold improvements	3

During 1998, the Company expensed costs related to software developed for internal use and capitalized software purchased from third parties. Effective January 1, 1999, the Company adopted Statement of Position (SOP) 98-1 "Accounting for the Cost of Computer Software Developed or Obtained for Internal Use." SOP 98-1 requires computer software costs related to internal software that are incurred in the preliminary project stage to be expensed as incurred. Once the capitalization criteria of SOP 98-1 have been met, costs of developing or obtaining internal-use computer software are capitalized. During the nine month period ended September 30, 1999, the Company capitalized approximately $2,196,000 of internally developed software. The adoption of SOP 98-1 did not impact the amount of development costs expensed in 1998 as the 1998 costs did not meet the criteria for capitalization as defined in SOP 98-1.

Income Taxes

The Company utilizes the asset and liability method of accounting for income taxes. Under this method, deferred income taxes are recorded to reflect the tax consequences on future years of differences between the tax basis of assets and liabilities and their financial reported amounts at each year-end based on enacted laws and statutory rates applicable to the periods in which differences are expected to affect taxable income. A valuation allowance is provided against the future benefits of deferred assets if it is determined that it is more likely than not that the future tax benefits associated with the deferred tax asset will not be realized.

Long-Lived Assets

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable.

2. Summary of Significant Accounting Policies (continued)

Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net undiscounted cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the discounted cash flows. No impairment losses have been recognized by the Company.

Stock-Based Compensation

The Company accounts for the issuance of stock options in accordance with the provisions of SFAS No. 123, "Accounting for Stock-Based Compensation." Under SFAS No. 123, entities recognize as expense, over the vesting period, the fair value of all stock-based awards on the date of the grant. For incentive stock options granted to employees, SFAS No. 123 allows entities to continue to apply the provisions of Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees," and provide pro forma net income and earnings per share disclosures for grants made as if the fair value method defined in SFAS No. 123 had been applied. The Corporation has elected to apply the provisions of APB Opinion No. 25 and consequently recognizes compensation expense over the vesting period for grants made to employees only if the market price of the underlying stock exceeds the exercise price. For stock options granted to non-employees, SFAS No. 123 requires entities to recognize as an expense, over the vesting period, the fair value of the options.

Revenue Recognition

Revenue related to long distance service charges are billed monthly in arrears and the associated revenues are recognized in the month of service. Revenue consists of fixed monthly fees and usage charges generally based on per minute rates. In late June 1999, the Company began offering local telephone and Internet access service (*Z-Line Home Edition*) to consumers and small businesses. Charges for this service are billed in advance on a monthly basis. The Company recognizes revenues for this service ratably over the service period, which management believes approximates the actual provision of services.

Advertising

Advertising costs are expensed as incurred. Included in sales and marketing expenses are advertising costs of approximately $1,164,000 and $592,000 for the nine-months ended September 30, 1999 and the period January 15, 1998 (date of inception) through December 31, 1998, respectively.

Costs of Start-Up Activities

The Company expenses the costs of start-up activities as incurred.

2. Summary of Significant Accounting Policies (continued)

Concentrations of Credit Risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash and cash equivalents and accounts receivable. The Company places its cash and cash equivalents in financial institutions considered by management to be high quality. The Company maintains cash balances at financial institutions in excess of the $100,000 insured by the Federal Deposit Insurance Corporation. The Company has not experienced any losses in these accounts and believes it is not exposed to any significant credit risk on cash balances. During the normal course of business, the Company extends credit to customers conducting business in the United States.

Segment Reporting

The Company operated during the nine-months ended September 30, 1999 and the period January 15, 1998 (date of inception) through December 31, 1998 in a single segment when applying the management approach defined in SFAS No. 131 "Disclosures about Segments of an Enterprise and Related Information."

Management's Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements. Estimates also affect the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Unaudited Interim Financial Data

The accompanying financial statements for the period from January 15, 1998 (date of inception) through September 30, 1998 are unaudited. In the opinion of management, these interim statements have been prepared on the same basis as the audited financial statements and include all adjustments, consisting only of normal recurring adjustments, necessary for the fair presentation of the results of the interim periods. The financial and other data disclosed in these notes to the financial statements for this period are unaudited. The results of operations for this interim period are not necessarily indicative of the results to be expected for any future periods.

Computation of Net Earnings/(Loss) Per Share

SFAS No. 128 "Earnings per Share" requires the presentation of basic and diluted earnings/(loss) per share. Basic earnings/(loss) per share is computed by dividing income (loss) available to common stockholders by the weighted average number of common shares

2. Summary of Significant Accounting Policies (continued)

outstanding for the period. Diluted earnings/(loss) per share is computed by giving effect to all dilutive potential common shares that were outstanding during the period.

Unaudited Pro Forma Data

The unaudited pro forma balance sheet as of September 30, 1999 reflects the payment of cumulative dividends of approximately $1,164,000 on mandatorily convertible redeemable preferred stock and the conversion of the Series A and Series B mandatorily convertible redeemable preferred stock into 7,402,778 shares of common stock (after the 11 for 10 recapitalization as described in Note 13(F).

Pro forma net earnings/(loss) per share has been computed as described above and also gives effect, under the Securities and Exchange Commission guidance, to the conversion of the mandatorily convertible redeemable preferred stock (using the as-if-converted method).

Reclassification

Certain amounts in the December 31, 1998 financial statements have been reclassified to conform with the September 30, 1999 presentation. These reclassifications have no effect on the total assets, shareholders' equity, net income or total cash flows previously reported by the Company.

3. Property and Equipment

At the respective dates, property and equipment approximates the following:

	December 31, 1998	September 30, 1999
Switching equipment	$ 6,672,000	$ 8,697,000
Computer equipment	2,898,000	6,759,000
Software	2,984,000	6,841,000
Furniture and office equipment	254,000	382,000
Leasehold improvements	185,000	979,000
	12,993,000	23,658,000
Less accumulated depreciation and amortization	1,283,000	4,032,000
	$11,710,000	$19,626,000

Depreciation expense and amortization expense related to property and equipment amounted to approximately $15,000 and $2,734,000, respectively, for the nine-months ended September 30, 1999 and approximately $686,000 and $597,000, respectively, for the period January 15, 1998 (date of inception) through December 31, 1998.

3. Property and Equipment (continued)

At the respective dates, assets acquired under capital leases, included in property and equipment, approximates the following:

	December 31, 1998	September 30, 1999
Switching equipment	$ —	$ 8,577,000
Computer equipment	—	4,868,000
Furniture and office equipment	95,000	298,000
	95,000	13,743,000
Less accumulated depreciation and amortization	8,000	2,385,000
	$87,000	$11,358,000

In March 1999, the Company entered into an agreement with CMB Capital, L.L.C. (a wholly owned entity of a shareholder of the Company) to sell and lease-back certain equipment. This agreement allows for a sale and lease-back of up to $35.2 million of certain equipment with revolving terms of 48 months and approximate effective interest rates ranging from 10.0% to 19.5%. Included in this agreement is a stock warrant to purchase 521,832 shares of common stock at $3.37 per share. The Company accounted for the warrant granted in accordance with SFAS No. 123, recognizing costs associated with the grant equal to the fair value of the warrant. The Company has recorded the fair value of the warrant as a commitment fee associated with the capital lease obligation and included it as part of minimum lease payments.

The agreement and warrant expire in March 2001 and March 2009, respectively. During the nine-month period ended September 30, 1999, the Company sold and leased-back certain equipment, receiving proceeds under this agreement of approximately $13.8 million. No gain or loss was recognized on the sale of these assets. At September 30, 1999, the Company has approximately $21.4 million available under this agreement for future sale and lease-back transactions. These leases are collateralized by the assets of the Company.

Included in the Company's accounts is amortization expense related to property and equipment held under capital leases of approximately $1,691,000 and $8,000, for the nine-months ended September 30, 1999 and for the period January 15, 1998 (date of inception) through December 31, 1998, respectively.

4. Other Assets

At the respective dates, other assets approximates the following:

	December 31, 1998	September 30, 1999
Certificate of deposit, restricted	$ —	$ 500,000
Interest receivable from stockholders	85,000	248,000
Deposits	68,000	342,000
Other	—	180,000
	$ 153,000	$1,270,000

The certificate of deposit is pledged as collateral on an outstanding letter of credit in the amount of $500,000 related to lease obligations on one of the Company's office spaces.

5. Accounts Payable and Accrued Liabilities

At the respective dates, accounts payable and accrued liabilities approximates the following:

	December 31, 1998	September 30, 1999
Trade accounts payable	$4,263,000	$7,349,000
Accrued payroll	106,000	170,000
Accrued other	33,000	1,647,000
	$4,402,000	$9,166,000

6. Long-Term Debt and Leases

Long-Term Debt

During 1998, the Company financed the purchase of certain assets with a note payable. At September 30, 1999 and December 31, 1998, the balance of this note was approximately $88,000 and $653,000, respectively. The note bears interest at approximately 10.0% and is payable through the year 1999. The note is collateralized by the assets purchased.

Operating Leases

The Company has entered into various non-cancelable operating leases for equipment and office space with monthly payments through the year 2009. Included in general and administrative expense is rental expense relating to operating leases of approximately $1,149,000 and $198,000 for the nine-months ended September 30, 1999 and the period January 15, 1998 (date of inception) through December 31, 1998, respectively.

6. Long-Term Debt and Leases (continued)

Capital Leases

The Company has entered into various capital lease obligations, effective interest rates ranging from 10.0% to 19.5%, with monthly payments through the year 2003.

Future minimum lease payments under non-cancelable operating and capital leases and long-term debt as of September 30, 1999 are approximately as follows:

Year Ending September 30,	Operating Leases	Capital Lease Obligations	Long-Term Debt
2000	$1,188,000	$ 5,110,000	$88,000
2001	1,359,000	5,101,000	—
2002	902,000	5,072,000	—
2003	897,000	2,569,000	—
2004	923,000	—	—
	5,269,000	17,852,000	88,000
Less amount representing estimated executory costs (taxes, etc.), including profit thereon, included in total minimum lease payments	—	1,094,000	—
Net minimum payments	$5,269,000	16,758,000	$88,000
Less amount representing interest on obligations under capital lease		4,137,000	
Present value of minimum lease payments (including approximately $2,904,000 due within one year)		$12,621,000	

7. Commitments and Contingencies

The Company has entered into agreements with various long distance carriers to provide transmission and termination services for the Company's long distance traffic. The agreements contain minimum value commitments. At September 30, 1999, the Company had met these minimum commitments, which approximated $331,000. These agreements expire at various times through November 2001.

The Company is involved in certain legal actions and claims arising in the ordinary course of its business. It is the opinion of management (based on advice of legal counsel) that such litigation and claims will be resolved without material adverse effect on the Company's financial position, results of operations, or cash flows. The Company is also aware of a threatened claim from a third party involving allegations of improper use of trade secrets. No legal action has commenced related to this alleged claim, which the Company believes is without merit. Should any legal action result, the Company intends to vigorously defend its position.

8. Income Taxes

For the nine-months ended September 30, 1999 and the period January 15, 1998 (date of inception) through December 31, 1998, no benefit for federal or state income taxes has been recorded due to the full valuation allowance recorded against the deferred tax asset.

As of September 30, 1999 and December 31, 1998, the Company had a net operating loss of approximately $36,000,000 and $12,700,000, respectively, available to reduce future federal income taxes. This net operating loss carryforward will begin to expire in 2018 and is subject to limitation in any given year in the event of certain changes in ownership, as set forth in the Internal Revenue Code Section 382 and related Treasury Regulations.

The tax effect of the temporary differences that gave rise to the deferred tax balances at the respective dates were approximately the following:

	December 31, 1998	September 30, 1999
Current deferred tax assets:		
Accounts receivable	$ 20,000	$ 29,000
Noncurrent deferred tax assets:		
Net operating loss	4,827,000	12,957,000
Fixed assets	70,000	94,000
Deferred compensation	34,000	72,000
Other	22,000	18,000
	4,953,000	13,141,000
Deferred tax assets	4,973,000	13,170,000
Valuation allowance	(4,973,000)	(13,170,000)
Net deferred tax asset	$ —	$ —

The Company provides a valuation allowance against net deferred tax assets if, based on the weight of available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized. The net deferred tax asset at September 30, 1999 and December 31, 1998 has been offset by the establishment of a valuation allowance for the full amount of the deferred tax asset.

8. Income Taxes (continued)

The following table summarizes, at the respective dates, the approximate differences between the actual tax provision and amounts obtained by applying the statutory U.S. federal income tax rate of 35% to the income (loss) before income taxes.

	December 31, 1998	September 30, 1999
Statutory provision/(benefit)	$(4,592 000)	$(7,566,000)
State taxes net of federal provision/(benefit)	(381,000)	(631,000)
	(4,973,000)	(8,197,000)
Change in valuation allowance	4,973,000	8,197,000
	$ —	$ —

9. Mandatorily Convertible Redeemable Preferred Stock

During 1998, the Company amended its articles of incorporation to authorize the issuance of up to 5,930,749 shares of Series A mandatorily convertible redeemable preferred stock (Series A Preferred) and 1,338,208 shares of Series B mandatorily convertible redeemable preferred stock (Series B Preferred), both with a $.01 par value.

In November 1998, the Company conducted a private placement of 2,695,795 shares of Series A Preferred and 1,338,208 shares of Series B Preferred, receiving aggregate net proceeds of approximately $15 million.

During 1999, the Company amended its articles of incorporation to reduce the authorized shares of its Series A from 5,930,749 to 2,695,795 and increase the authorized shares of its Series B from 1,338,208 to 4,034,003. In September 1999, the Company closed a private placement of 2,695,795 shares of Series B mandatorily convertible redeemable preferred stock. The Company received aggregate net proceeds of approximately $10 million from this placement.

Preferred stockholders have the option to convert their shares into shares of common stock at a one-for-one ratio. The conversion rate on a particular series of preferred stock is subject to adjustment in the event that any additional common stock, or other shares convertible into common stock, are issued for a per share price less than the particular series conversion price.

The preferred stock will automatically convert into shares of common stock upon the closing of an underwritten public offering pursuant to an effective registration statement under the Securities Act of 1933, covering the offer and sale of securities of the Company to the public with gross proceeds that equal or exceed $20 million at a per share price of at least $12, and whereby the aggregate value of the shares of common stock issuable on conversion is at least two times the conversion rate.

9. Mandatorily Convertible Redeemable Preferred Stock (continued)

Prior to conversion, preferred stockholders have the right to elect two members to the board of directors of the Company and are entitled to preferential rights to corporate assets in the event of liquidation. The preferred stock issues yield 8% cumulative dividends, which amounted to approximately $974,000 and $190,000 for the nine-months ended September 30, 1999 and the period January 15, 1998 (date of inception) through December 31, 1998, respectively, and are included in mandatorily convertible redeemable preferred stock at September 30, 1999 and December 31, 1998. No dividends on common stock have been declared by the board of directors since the Company's inception (January 15, 1998).

The Company entered into put agreements with the Series A and B Preferred stockholders, which require the Company to repurchase shares at the greater of fair market value or the original purchase price for certain violations of the private placement agreement. The put terminates upon the seventh anniversary date of the agreement or upon conversion of the preferred shares into common shares. The Company did not comply with certain provisions of the Series A Preferred private placement agreement relating to the issuance of financial statements to the stockholders within a certain time frame. The Company has obtained a waiver from the stockholders related to these provisions.

10. Related Party Transactions

During 1998, various executives of the Company issued full recourse promissory notes, totaling approximately $3.3 million to the Company in connection with the purchase of 2,929,575 shares of common stock. The principal balance of the notes and the related accrued interest (8% per annum) are due December 31, 2001. The notes are collateralized by the shares of common stock acquired with the notes, and those shares are held in escrow by the Company. In September 1999, the Company cancelled approximately $318,000 of these notes and reacquired 279,675 shares of common stock at $1.14 per share. At September 30, 1999, these shares are presented as treasury shares, at cost.

During 1998, an executive loaned the Company approximately $5.35 million with interest at a rate of 8% per year until paid. In August 1998, the Company issued 4,708,000 shares of common stock to the executive in exchange for the debt and accrued interest payable.

11. Stock-Based Compensation

Effective October 30, 1998, the Company adopted the 1998 Equity Participation Plan (the Plan) available for grant to eligible employees and eligible participants to purchase up to 1,261,000 shares of the Company's common stock. During September, the board of directors (the Board) increased the shares available for grant under the Plan to 6,000,000. The Plan is administered by a committee appointed by the Board, or by the Board. The Board or the appointed committee shall administer the Plan, select the eligible employees and eligible

11. Stock-Based Compensation (continued)

participants to whom options will be granted, the price to be paid, the exercise period and the number of shares subject to any such options and interpret, construe and implement the provisions of the Plan. During the nine-months ended September 30, 1999 and the period January 15, 1998 (date of inception) through December 31, 1998, respectively, the Company awarded options under the Plan totaling 2,078,941 and 201,850 shares of common stock, respectively, at a weighted average option price per share of $4.16 and $3.64. The vesting periods on these options range from immediately to four years and have a maximum contractual life of ten years.

Prior to the adoption of the Plan, the Board issued stock options (the Initial Plan) totaling 3,878,000 shares to various parties. The vesting periods on these options range from immediately to three years and range in price from $1.14 to $3.64. These options have a maximum contractual life of ten years.

A summary of the stock option activity for the nine-months ended September 30, 1999 and the period January 15, 1998 (date of inception) through December 31, 1998 is presented below:

	Initial Plan		1998 Equity Participation Plan		Total	
	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Outstanding, January 15, 1998 (date of inception)	—	$ —	—	$ —	—	$ —
Options granted	3,878,050	2.83	201,850	3.64	4,079,900	2.86
Forfeited	(58,850)	2.46	—	—	(58,850)	2.46
Outstanding, December 31, 1998	3,819,200	2.79	201,850	3.64	4,021,050	2.83
Options granted	—	—	2,418,232	4.06	2,418,232	4.06
Forfeited	(331,973)	3.43	(55,220)	3.64	(387,193)	3.46
Outstanding, September 30, 1999	3,487,227	$2.77	2,564,862	$3.75	6,052,089	$3.18

No options were exercised during the nine-months ended September 30, 1999 or the period January 15, 1998 (date of inception) through December 31, 1998.

11. Stock-Based Compensation (continued)

Had compensation cost for the Company's stock options granted been determined based on the fair value at the date of grant, consistent with the provisions of SFAS No. 123, the Company's net loss and loss per share of common stock for the nine-months ended September 30, 1999 and the period January 15, 1998 (date of inception) through December 31, 1998 would have been increased to the pro forma amounts shown below.

	Period January 15, 1998 (date of inception) through December 31, 1998	Nine Months Ended September 30, 1999
Net Loss		
As presented	$(13,122,000)	$(23,647,000)
As adjusted	(13,161,000)	(23,857,000)
Basic and Diluted Loss Per Common Share		
As presented	$ (2.03)	$ (1.71)
As adjusted	(2.04)	(1.71)

These adjusted amounts were determined using the minimum value method with the following key assumptions (a) a discount rate ranging from approximately 5% to 6%, (b) an average expected option life of 5 years; (c) there have been no options that have expired; and (d) no payment of dividends on common stock.

During the nine-months ended September 30, 1999 and the period January 15, 1998 (date of inception) through December 31, 1998, respectively, included in the options granted by the Company are 218,291 and 113,300 options to non-employees and recorded costs for the same periods, respectively, of approximately $621,000 and $89,000 related to these non-employee options. These non-employee stock options have been recorded in accordance with the provisions of SFAS No. 123 through the use of the Black-Scholes method. The Black-Scholes method utilizes the same assumptions as the minimum value method with the addition of a volatility factor of 64.3%.

The following table summarizes information about stock options and warrants outstanding at September 30, 1999:

Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (In Years)	Number Exercisable
$1.14	877,800	8.6	413,238
2.27	599,500	8.5	286,751
3.37	521,832	9.5	521,832
3.64	3,823,607	9.0	950,960
5.45	229,350	10.0	—
	6,052,089		2,172,781

12. Computation of Net Loss Per Share

Basic net earnings/(loss) per share is computed by dividing earnings/(loss) available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted net earnings/(loss) per share assumes the exercise of common stock equivalents for which market price exceeds exercise price, less shares assumed purchased by the Company with related proceeds. Incremental shares of common stock equivalents are not included in the calculation of net earnings/(loss) per share as the inclusion of such equivalents would be anti-dilutive.

Net earnings/(loss) per share is calculated as follows:

	Period January 15, 1998 (date of inception) through December 31, 1998	Period January 15, 1998 (date of inception) through September 30, 1998 (Unaudited)	Nine Months Ended September 30, 1999
Basic and diluted net earnings/(loss) per share:			
Income (loss) available to common stockholders:			
Net loss	$(13,122,000)	$(7,171,000)	$(23,647,000)
Less mandatorily convertible redeemable preferred stock dividends	(190,000)	—	(974,000)
Income (loss) available to common stockholders	$(13,312,000)	$(7,171,000)	$(24,621,000)
Weighted average common shares outstanding	6,554,699	3,753,191	14,383,338
Basis and diluted net earnings/(loss) per share	$ (2.03)	$ (1.91)	$ (1.71)

For each of the periods presented, basic and diluted net earnings/(loss) per share are the same. Unexercised options to purchase 5,712,797, 4,021,051 and 6,052,089 shares of common stock and unexercised mandatorily convertible redeemable preferred stock convertible into 0, 4,437,403 and 7,402,778 shares of common stock for the period January 15, 1998 (date of inception) through September 30, 1998 and through December 31,

12. Computation of Net Loss Per Share (continued)

1998 and the nine-month period ended September 30, 1999, respectively, which could potentially dilute basic earnings per share in the future were not included in the computation of diluted net earnings/(loss) per share for these periods because to do so would have been antidilutive in each case.

Unaudited pro forma net earnings/(loss) per share is calculated as follows:

	Period January 15, 1998 (date of inception) through December 31, 1998 (Unaudited)	Nine Months Ended September 30, 1999 (Unaudited)
Unaudited pro forma basic and diluted net earnings/(loss) per share:		
Income (loss) available to common stockholders:		
Net loss	$(13,122,000)	$(23,647,000)
Weighted average common shares outstanding	6,554,699	14,383,338
Effect of convertible securities:		
Mandatorily convertible redeemable preferred stock	4,437,403	7,402,778
Shares used in pro forma basic and diluted net earnings/(loss) per share calculation	10,992,102	21,786,116
Unaudited pro forma basic and diluted net earnings/(loss) per share	$ (1.19)	$ (1.09)

13. Subsequent Events

A) During October 1999, the Company purchased assets worth approximately $122,000 for approximately $75,000 cash and 11,000 shares of the Company's common stock.

B) Also in October 1999, the Company completed a private placement of 2,794,800 shares of its Series C mandatorily convertible redeemable preferred stock, par value $.01, for net proceeds of approximately $15 million.

C) Additionally, in October 1999, the Company's board of directors approved an amendment to increase the number of shares of $.01 par value common stock to 150,000,000 and to increase the aggregate number authorized shares for all classes of preferred stock to 50,000,000 shares. This approval is pending stockholder authorization.

D) Also during October 1999, the Company issued 55,000 shares of common stock to a third party software vendor for services.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(continued)

13. Subsequent Events (continued)

E) In October and November 1999, the Company granted 862,070 options to employees to purchase common stock at a weighted average exercise price of $6.18 per share.

Events (Unaudited) Subsequent to Date of Accountants' Report

In November 1999 the Company entered into an agreement with CMB Capital, LLC to restructure the terms of the leasing facility to allow for the early payment of the facility in the event of an initial public offering. The Company granted warrants for 115,500 shares of common stock at $7.27 per share.