Z TEL TECHNOLOGIES INC
Form 10-Q
November 14, 2003

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SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE PERIOD ENDED September 30, 2003

OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM TO

COMMISSION FILE NUMBER: 000-28467

Z-TEL TECHNOLOGIES, INC.

(Exact name of Registrant as specified in its charter)

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

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

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

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

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

Yes x No o

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

Yes o No x

The number of shares of the Registrant s Common Stock outstanding as of November 12, 2003 was approximately 35,596,195.

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Z-Tel Technologies, Inc. and Subsidiaries

Consolidated Balance Sheets
(In thousands, except share data)
(Unaudited)

	September 30, 2003	December 31, 2002
Assets		
Current assets:		
Cash and cash equivalents	$ 14,544	$ 16,037
Accounts receivable, net of allowance for doubtful accounts of $16,765 and $17,401	25,183	26,749
Prepaid expenses and other current assets	5,071	5,741
Total current assets	44,798	48,527
Property and equipment, net	40,769	48,320
Intangible assets, net	2,744	4,116
Other assets	4,940	5,748
Total assets	$ 93,251	$ 106,711
Liabilities, Mandatorily Redeemable Convertible Preferred Stock and Stockholders Deficit		
Current liabilities:		
Accounts payable and accrued liabilities	$ 53,682	$ 51,771
Deferred revenue	14,710	10,172
Current portion of long-term debt and capital lease obligations	6,553	5,964
Total current liabilities	74,945	67,907
Long-term deferred revenue	481	6,277
Long-term debt and capital lease obligations	562	4,180
Total liabilities	75,988	78,364
Mandatorily redeemable convertible preferred stock, $.01 par value; 50,000,000 shares authorized; 8,855,089 issued; 8,738,422 and 8,855,089 outstanding (aggregate liquidation value of $153,980 and $145,503)	138,559	127,631
Commitments and contingencies (Note 6)		
Stockholders deficit:		
Common stock, $.01 par value; 150,000,000 shares authorized; 35,837,412 and 35,609,803 shares issued; 35,495,862 and 35,268,253 outstanding	358	356
Notes receivable from stockholders	(1,121)	(1,589)
Additional paid-in capital	194,274	205,090
Accumulated deficit	(314,419)	(302,753)
Treasury stock, 341,550 shares at cost	(388)	(388)
Total stockholders deficit	(121,296)	(99,284)
Total liabilities, mandatorily redeemable convertible preferred stock and stockholders deficit	$ 93,251	$ 106,711

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

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Z-Tel Technologies, Inc. and Subsidiaries

Consolidated Statements of Operations
(In thousands, except share and per share data)
(Unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2003	**2002**	**2003**	**2002**
Revenues	$ 81,454	$ 58,715	$ 211,605	$ 178,208
Operating expenses:				
Network operations, exclusive of depreciation and amortization shown below	38,476	23,799	95,504	69,863
Sales and marketing	3,589	2,211	14,700	8,166
General and administrative	35,621	31,663	94,471	93,382
Asset impairment charge				1,129
Wholesale development costs				1,018
Restructuring charge				1,861
Depreciation and amortization	5,837	6,169	17,866	17,751
Total operating expenses	83,523	63,842	222,541	193,170
Operating loss	(2,069)	(5,127)	(10,936)	(14,962)
Nonoperating income (expense):				
Interest and other income	494	1,179	1,658	2,663
Interest and other expense	(978)	(1,014)	(2,388)	(3,011)
Total nonoperating income (expense)	(484)	165	(730)	(348)
Net loss	(2,553)	(4,962)	(11,666)	(15,310)
Less mandatorily redeemable convertible preferred stock dividends and accretion	(3,707)	(3,969)	(12,611)	(11,761)
Less deemed dividend related to beneficial conversion feature	(46)	(47)	(138)	(139)
Net loss attributable to common stockholders	$ (6,306)	$ (8,978)	$ (24,415)	$ (27,210)
Weighted average common shares outstanding	35,368,759	35,191,836	35,340,089	34,861,229
Basic and diluted net loss per share	$ (0.18)	$ (0.26)	$ (0.69)	$ (0.78)

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

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Z-Tel Technologies, Inc. and Subsidiaries

Consolidated Statements of Changes in Stockholders Deficit
(In thousands, except share data)
(Unaudited)

	Common Stock Shares	Common Stock Par Value	Notes Receivable from Stockholders	Additional Paid-In Capital	Accumulated Deficit	Treasury Stock	Total Stockholders' Deficit
Balance, December 31, 2002	35,268,253	$ 356	$ (1,589)	$ 205,090	$ (302,753)	$ (388)	$ (99,284)
Exercise of stock options	92,870	1		61			62
Exercise of warrants	25,714						
Accelerated vesting of stock options				123			123
Conversion of mandatorily redeemable convertible preferred stock to common	109,025	1		942			943
Repayment of notes receivable			468				468
Mandatorily redeemable convertible preferred stock dividends and accretion				(11,942)			(11,942)
Net loss					(11,666)		(11,666)
Balance, September 30, 2003	35,495,862	$ 358	$ (1,121)	$ 194,274	$ (314,419)	$ (388)	$ (121,296)

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

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Z-Tel Technologies, Inc. and Subsidiaries

Consolidated Statements of Cash Flows
(In thousands)
(Unaudited)

	Nine months ended September 30,	
	2003	**2002**
Cash flows from operating activities:		
Net loss	$(11,666)	$(15,310)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	17,866	17,751
Provision for bad debts	12,009	17,929
Asset impairment charge		1,129
Loss on disposal of equipment	44	
Expense charged for granting of stock options	123	184
Change in operating assets and liabilities:		
Increase in accounts receivable	(10,443)	(17,425)
(Increase) decrease in prepaid expenses	670	(765)
Decrease in other assets	781	343
Increase in accounts payable and accrued liabilities	1,912	9,257
Decrease in deferred revenue	(1,258)	(127)
Total adjustments	21,704	28,276
Net cash provided by operating activities	10,038	12,966
Cash flows from investing activities:		
Purchases of property and equipment	(7,731)	(13,706)
Principal repayments received on notes receivable	27	590
Issuance of note receivable		(997)
Net cash used in investing activities	(7,704)	(14,113)
Cash flows from financing activities:		
Payments on long-term debt and capital lease obligations	(4,285)	(4,283)
Payment of preferred stock dividends	(72)	
Principal repayments received on notes receivable issued for stock	468	
Proceeds from exercise of stock options and warrants	62	2
Net cash used in financing activities	(3,827)	(4,281)
Net decrease in cash and cash equivalents	(1,493)	(5,428)
Cash and cash equivalents, beginning of period	16,037	18,892
Cash and cash equivalents, end of period	$ 14,544	$ 13,464

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

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Z-TEL TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
(ALL TABLES ARE IN THOUSANDS, EXCEPT FOR SHARE AND PER SHARE DATA)

1. NATURE OF BUSINESS

DESCRIPTION OF BUSINESS

Z-Tel Technologies, Inc. and subsidiaries (we or us) is a telecommunications services provider incorporated in Delaware on January 15, 1998. We integrate access to local and long distance telephone networks with proprietary advanced features and operational support systems to provide innovative telecommunications services to consumers, businesses and other communications companies. We provide our services on both a retail and wholesale basis.

Our principal retail services are Z-LineHOME®, Z-LineBUSINESS® and Touch 1 long distance. Z-LineHOME and Z-LineBUSINESS are residential and business versions, respectively, of our flagship offering, the Z-Line®. The Z-Line is local telephone service, typically bundled with long distance and enhanced features, including a suite of our proprietary Internet-accessible and voice-activated functions. Z-Line s enhanced features include voicemail, Find Me call forwarding and our recently introduced Personal Voice Assistant , or PVA, which utilizes voice-recognition technology so that users can access a secure, online address book from any phone using simple voice commands in order to send voice emails, find contact information and dial numbers, among other things.

We offer our Z-LineHOME and Z-LineBUSINESS services in forty-seven states. Z-LineBUSINESS is particularly suited to businesses having multiple, geographically diverse locations. With us, these multi-location businesses can engage a single telephone company instead of several local phone companies for their communication needs. The majority of our Z-Line customers are concentrated in ten states.

Touch 1 long distance is a residential long distance telephone service. We gained nearly all these customers in our acquisition of Touch 1 Communications, Inc. in 2000. We offer Touch 1 long distance service nationwide, but we do not actively market this service.

At the wholesale level, we provide telephone and enhanced communications services and operational support services to other companies for their use in providing privately labeled telephone and enhanced communications services to their own end-user customers.

2. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared by us in accordance with accounting principles generally accepted in the United States of America for interim financial information and are in the form prescribed by the Securities and Exchange Commission in instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes for complete financial statements as required by accounting principles generally accepted in the United States of America. The interim unaudited financial statements should be read in conjunction with our audited financial statements as of and for the year ended December 31, 2002, included in our Annual Report on Form 10-K. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2003 are not necessarily indicative of the results that may be expected for the year ending December 31, 2003.

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RECLASSIFICATION

Certain amounts in the consolidated statements of operations for the three and nine months ended September 30, 2002 have been reclassified to conform to the presentation for the three and nine months ended September 30, 2003.

RECENT ACCOUNTING PRONOUNCEMENTS

In November 2002, the Emerging Issues Task Force (EITF) of the Financial Accounting Standards Board (FASB) reached a consensus on EITF No. 00-21, Accounting for Revenue Arrangements with Multiple Element Deliverables. EITF No. 00-21 addresses how to account for arrangements that may involve the delivery or performance of multiple products, services and/or rights to use assets. Revenue arrangements with multiple deliverables should be divided into separate units of accounting if the deliverables in the arrangement meet certain criteria. Arrangement consideration should be allocated among the separate units of accounting based on their relative fair values. EITF No. 00-21 also supersedes certain guidance set forth in Staff Accounting Bulletin No. 101 (SAB 101), Revenue Recognition in Financial Statements. The final consensus is applicable to agreements entered into in quarters beginning after June 15, 2003, with early adoption permitted. Additionally, companies are permitted to apply the consensus guidance to all existing arrangements as a cumulative effect of a change in accounting principle. We adopted this new pronouncement effective July 1, 2003, on a prospective basis. This adoption did not have a material impact on our consolidated financial statements.

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity. This statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. This statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective for our quarter beginning July 1, 2003. We reviewed this new pronouncement and concluded that none of the mandatorily redeemable convertible preferred stock recorded in the mezzanine section of our balance sheet is within the scope of SFAS No. 150. This conclusion is based on the facts that no unconditional obligation requiring the redemption of the securities exists because they are convertible into common at the option of the holder and the conversion option is substantial. We recognize that the FASB is in the process of possibly promulgating additional rules in the future related to securities similar to the ones that we have in the mezzanine section, but are unable to determine what any future rule s impact might have on our consolidated financial statements.

In June 2003, the FASB issued SFAS 149, An Amendment of Statement 133 on Derivative Instruments and Hedging Activities. This statement amends and clarifies financial accounting and reporting for hedging activities and derivative instruments, including certain derivative instruments embedded in other contracts. This Statement is effective for contracts entered into or modified after June 30, 2003. We adopted SFAS 149 in the third quarter of 2003. This adoption did not have any impact on our consolidated financial statements.

3. WHOLESALE SERVICES

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

We are deferring $1.0 million of revenues for pre-contract payments by recognizing this amount ratably over the life of the agreement. Additionally, we received a $1.0 million payment, of which we have returned $0.8 million to Sprint as a bill credit during the third quarter of 2003 for the achievement of reaching certain line-count thresholds. As of September 30, 2003, there was $0.2 million of the stimulus payment remaining which is recorded in short-term deferred revenue. We expect this amount to be returned to Sprint via bill credits in the fourth quarter of 2003.

As of September 30, 2003, under our contract with Sprint, we had approximately $5.8 million of deferred revenue, of which $0.4 million is recorded as long-term deferred revenue.

On August 7, 2003, we amended our contract with MCI to terminate the contract on December 31, 2003. On August 15, 2003, MCI provided us with notice that they were terminating the contract effective October 15, 2003. As a result of these events we accelerated the recognition of deferred revenue to the termination date of October 15, 2003. Prior to the early termination, we were recognizing the deferred revenue ratably over the life of the agreement with a termination date of December 31, 2005. During the third quarter of 2003, we recognized an additional $3.7 million of revenue as a result of the termination notice from MCI. As of September 30, 2003, we had $1.6 million of short-term deferred revenue attributable to MCI.

4. ACCOUNTS RECEIVABLE AGREEMENT

In July 2000, we entered into an accounts receivable agreement with RFC Capital Corporation, a division of Textron, Inc. (RFC), providing for the sale of certain of our accounts receivable to RFC. RFC has agreed to purchase up to $25.0 million of our accounts receivable. This agreement was extended for one year under substantially similar terms in July 2003. The current agreement expires in July 2004. The purchase of the receivables is at the option of RFC and they utilize selection criteria to determine which receivables will be purchased. We sold receivables to RFC at a 28% discount from inception of the agreement through March 2002. From March 2002 until the middle of September 2003, we sold our receivables at a discount rate of 19%. As of the end of September 2003, we were selling our receivables at a discount rate of 16%. This rate is negotiable and may change according to our actual collection experience. The collection percentage for receivables sold to RFC has been approximately 93% since the inception of the agreement. We receive an additional payment from RFC for servicing the assets in an amount equal to every dollar collected over the advance rate, less certain fees. The accounts receivable agreement does not have a minimum receivable sales requirement.

We sold approximately $94.9 and $108.5 million of receivables to RFC, for net proceeds of approximately $77.0 and $85.6 million, during the nine months ended September 30, 2003 and 2002, respectively. A net receivable servicing asset of approximately $12.9 million is included in our accounts receivable balance at September 30, 2003. We recorded costs, included in interest and other expenses, related to the agreement of approximately $0.3 million for both the three months ended September 30, 2003 and 2002, and $0.7 and $1.0 million for the nine months ended September 30, 2003 and 2002, respectively. Included in accounts payable and accrued liabilities are advances for unbilled receivables in the amount of $5.2 million at September 30, 2003. We are responsible for the continued servicing of the receivables sold, under any circumstance.

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5. INTANGIBLE ASSETS

The change in the carrying amount of our major class of intangible assets (as a result of our acquisition of Touch 1 in April of 2000) are as follows. We do not have any intangible assets that are not being amortized to a zero balance.

	September 30, 2003		
	Carrying Amount	**Accumulated Amortization**	**Net Intangible Assets**
Intangible assets subject to amortization:			
Customer related intangible assets	$6,860	$4,116	$2,744

The following table presents current and expected amortization expense of the existing intangible assets for the nine months ended September 30, 2003 and for each of the following periods:

Aggregate amortization expense:	
For the nine months ended September 30, 2003	$1,372
Expected amortization expense for the remainder of 2003	$ 457
Expected amortization expense for the years ending December 31,	
2004	$1,829
2005	$ 458

We did not record any asset impairment charge during the three or nine months ended September 30, 2003.

6. COMMITMENTS AND CONTINGENCIES

We have disputed billings, access and transport charges from certain inter-exchange carriers (IXCs) and incumbent local exchange carriers (ILECs). We contend that the invoicing and billings of these particular access charges were not in accordance with the interconnection, service level, or tariff agreements entered between us and certain parties. We have not paid the majority of these disputed amounts, as we generally only pay or record as expense amounts that in our judgment represent a liability to us. At September 30, 2003, we had total disputes of approximately $21.7 million, of which approximately $3.0 million have been recorded as an expense in our statement of operations.

We received a billing for $2.3 million from Verizon relating to the back-billing of dispatch charges believed to relate to the period from August 2000 to February 2002 and from March 2003 to September 2003. This amount is not included in the totals in the above paragraph and we do not know if this is the entire amount they will bill us. We have disputed these charges. We expect that if any of these charges are valid, a potion of these charges may be subject to being billed to our wholesale services customers for services that we provided under our contracts with them. We have not received any detail related to these charges from Verizon and therefore, are unable to determine their validity.

In October 2003, we received correspondence from WilTel Communications, Inc. (WilTel), stating that they believe we are not fulfilling our minutes-of-use commitment under our network agreement for long distance services signed with them on February 22, 2003. They have alleged that we owe them $3.1 million for our cumulative minutes-of-use commitment shortfall as of September 30, 2003. We have disputed this amount, which is included in the $21.7 of total disputes discussed in the first paragraph of this footnote, and believe that these charges are without merit and that WilTel was the cause for any shortfall in minutes-of-use, as they failed to provide the service under the agreement. Additionally, WilTel provided no notice of the alleged shortfalls as required under

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the contract. Finally, we believe that WilTel has over billed us for transport charges and owes us a credit for certain charges we incurred in order to utilize WilTel s network as agreed to in our contract. We are continuing to work with this carrier to resolve this issue and do not expect a material adverse impact on our financial statements.

For the customers of our wholesale clients provisioned using our company code, we are the ILEC s customer of record for billing. If one of our wholesale customers would default on amounts owed to us, become insolvent, or file bankruptcy, it is very likely that state utility regulators would require us to continue providing services to the end users of our wholesale client for at least a 90-day period. We attempt to mitigate this risk by requiring our wholesale customers to pay certain charges in advance to us.

7. RESTRUCTURING CHARGES

In April of 2002, we approved and implemented a restructuring to enhance our future cash flows and operating earnings. The restructuring included a reduction of force, coupled with the closure of our North Dakota call centers and our New York sales office. In accordance with EITF No. 94-3 Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity the restructuring costs were recognized as liabilities at the time management committed us to the plan. Management determined that these costs provided no future economic benefit to us.

The restructuring charge included employee termination expenses, lease abandonment expenses and lease settlement costs. In addition, we agreed to a settlement to exit the two leases for our call centers in North Dakota as of July 1, 2002. We have recorded a lease abandonment charge representing the future lease payments for our New York office as a liability and we are scheduled to make monthly cash payments through August 2005. All other expenses associated with this restructuring have been paid in full.

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

	Employee Termination Benefits	Lease Settlement Costs	Lease Abandonment Costs	Total
Balance at January 1, 2002	$	$	$	$
Plan Charges	913	325	623	1,861
Cash paid	(913)	(325)	(72)	(1,310)
Balance at December 31, 2002			551	551
Cash paid			(147)	(147)
Balance at September 30, 2003	$	$	$ 404	$ 404

8. STOCK-BASED COMPENSATION

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

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

	Three months ended September 30,		Nine months ended September 30,	
	2003	**2002**	**2003**	**2002**
Net loss attributable to common stockholders, as reported	$(6,306)	$ (8,978)	$(24,415)	$(27,210)
Add: Stock based compensation included in net loss	123	17	123	184
Deduct: Total stock based employee compensation determined under the fair value based method for all awards	(785)	(3,744)	(5,181)	(11,188)
Net loss attributable to common stockholders, pro forma	$(6,968)	$(12,705)	$(29,473)	$(38,214)
As reported	$ (0.18)	$ (0.26)	$ (0.69)	$ (0.78)
Pro forma	(0.20)	(0.36)	(0.83)	(1.10)

We calculated the fair value of each grant on the date of grant using the Black-Scholes option pricing model. The following assumptions were used for each respective period:

	Three months ended September 30,		Nine months ended September 30,	
	2003	**2002**	**2003**	**2002**
Discount Rate	3.5%	4.6%	3.1%	4.6%
Volatility	96.1%	92.6%	96.4%	92.6%
Average Option Expected Life	5 years	5 years	5 years	5 years

No options have expired, and no dividends have been paid on common stock since our inception.

9. COMPUTATION OF NET LOSS PER SHARE

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

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Net loss per share is calculated as follows:

	Three months ended September 30,		Nine months ended September 30,	
	2003	2002	2003	2002
Basic and diluted net loss per share:				
Net loss	$ (2,553)	$ (4,962)	$ (11,666)	$ (15,310)
Less mandatorily redeemable convertible preferred stock dividends and accretion	(3,707)	(3,969)	(12,611)	(11,761)
Less deemed dividend related to beneficial conversion feature	(46)	(47)	(138)	(139)
Net loss attributable to common stockholders	$ (6,306)	$ (8,978)	$ (24,415)	$ (27,210)
Weighted average common shares outstanding	35,368,759	35,191,836	35,340,089	34,861,229
Basic and diluted net loss per share	$ (0.18)	$ (0.26)	$ (0.69)	$ (0.78)

The following table outlines the shares of common stock equivalents that could potentially dilute basic earnings per share in the future but were not included in the computation of diluted net loss per share:

	September 30, 2003
Unexercised stock options	13,803,391
Unexercised warrants	10,580,985
Mandatorily redeemable preferred stock convertible into common shares	30,454,848
Total potentially dilutive shares of common stock equivalents	54,839,224

10. LEGAL AND REGULATORY PROCEEDINGS

During June and July 2001, three separate class action lawsuits were filed against us, certain of our current and former directors and officers (the D&Os) and firms engaged in the underwriting (the Underwriters) of our initial public offering of stock (the IPO). The lawsuits, along with approximately 310 other similar lawsuits filed against other issuers arising out of initial public offering allocations, have been assigned to a Judge in the United States District Court for the Southern District of New York for pretrial coordination. The lawsuits against us have been consolidated into a single action. A consolidated amended complaint was filed on April 20, 2002. A Second Corrected Amended Complaint (the Amended Complaint), which is the operative complaint, was filed on July 12, 2002.

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The Amended Complaint is based on the allegations that our registration statement on Form S-1, filed with the Securities and Exchange Commission (SEC) in connection with the IPO, contained untrue statements of material fact and omitted to state facts necessary to make the statements made not misleading by failing to disclose that the underwriters allegedly had received additional, excessive and undisclosed commissions from, and allegedly had entered into unlawful tie-in and other arrangements with, certain customers to whom they allocated shares in the IPO. The plaintiffs in the Amended Complaint assert claims against us and the D&Os pursuant to Section 11 of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated by the SEC thereunder. The plaintiffs in the Amended Complaint assert claims against the D&Os pursuant to Sections 11 and 15 of the Securities Act of 1933 and Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated by the SEC thereunder. The plaintiffs seek an undisclosed amount of damages, as well as pre-judgment and post-judgment interest, costs and expenses, including attorneys fees, experts fees and other costs and disbursements. Initial discovery has begun. We believe we are entitled to indemnification from our Underwriters.

A memorandum of understanding has been reached by lawyers for the plaintiffs, the issuers and insurers of the issuers. The memorandum sets forth the terms of a proposed settlement, the principal components of which are (i) a release of all claims against the issuers and their officers and directors, (ii) the assignment by the issuers to the plaintiffs of certain claims the issuers may have against the Underwriters and (iii) an undertaking by the insurers to ensure the plaintiffs receive not less than $1 billion in connection with claims against the Underwriters. Our board of directors has approved the memorandum of understanding. To be binding, the settlement must be approved by substantially all the issuers and thereafter submitted to and approved by the court. The settlement will not be binding upon any plaintiffs electing to opt-out of the settlement. We do not anticipate that this litigation will have an adverse material impact on us.

On September 20, 2002, one of our shareholders, Metropolitan Nashville Employee Benefit Board (Metro Nashville), filed suit against us, alleging that we wrongfully and improperly delayed providing them with a stock certificate and that during the time of such delay our stock price declined and they were unable to sell or to take steps to protect the value of their shares. Metro Nashville seeks compensatory damages in excess of $18 million, plus interest, and punitive damages of $18 million. Discovery has begun. We believe the lawsuit is without merit and are vigorously opposing the allegations. We cannot predict the outcome of this litigation with any certainty.

On August 6, 2002, we filed a complaint against Southwestern Bell Telephone Company (SWBT) before the Public Utility Commission of Texas (PUCT), requesting that the PUCT enjoin SWBT from disconnecting our access to customers in Texas on the basis of a billing dispute between the parties. The billing dispute centered on whether we owed SWBT certain amounts for alternatively billed service. On August 23, 2002, the PUCT issued, in part, the injunctive relief requested by us, making clear that service not be interrupted. On April 17, 2003, we entered into a settlement agreement with SWBT. The terms of the settlement are confidential.

On October 9, 2003, we filed a lawsuit against SBC Communications, Inc. and several of its subsidiaries (collectively, SBC) in federal court in Texas, where both SBC and we do business. The lawsuit alleges SBC s violation of the federal antitrust laws, the Racketeering Influenced Corrupt Organizations Act (RICO), the Lanham Act, and other federal and state laws. The complaint seeks damages and an injunction against SBC. We cannot predict the outcome of this litigation with any certainty.

On October 2, 2003, the Federal Communications Commission s decision in FCC CC Docket No. 01-338 (referred to as the Triennial Review) became effective. That decision establishes a new framework for identifying and ordering unbundled network element access to incumbent local telephone company networks. In particular, the Federal Communications Commission (FCC) made a national finding that companies like us were entitled to unbundled access to the constituent components of the Unbundled Network Element Platform (UNE-P) to serve analog customers (what the FCC calls the mass market). The FCC s regulatory framework does not require access to many unbundled network elements that had been previously ordered, particularly elements that

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would be utilized by entrants to provide broadband services, such as digital subscriber line (DSL). The FCC s Triennial Review framework provides for state commission review of many of these network elements (including loops, transport, and switching) in 9-month proceedings, which have begun in many of the states in which we operate, as well as continuing review. We expect that state commissions will in the coming months engage in a detailed and fact-intensive review of the availability of UNE-P for the services we currently provide. The results of these state commission proceedings are uncertain at this time and the results will certainly impact our business. In particular, any state commission action that restricts the availability of UNE-P or any of its constituent network elements could have a material adverse impact on our business. In addition, several parties, including us, have filed appeals of the FCC s Triennial Review Order, which have been consolidated in *United States Telecom Ass n. v. FCC*, Nos. 00-0012, 03-1310 and consolidated cases, now pending before the D.C. Circuit. We intend to appeal the FCC s standard for identifying unbundled network elements, the ostensible preemptive nature of the Order, and the FCC s failure to recognize fully that section 271 obligates Bell operating companies that have obtained authorization to provide interLATA services have an obligation to provide unbundled loops, switching, transport and signaling, regardless of section 251 requirements. Verizon, SBC, Qwest and USTA have filed for a stay of the FCC s rules related to UNE-P and other elements and have also requested that the D.C. Circuit issue an immediate writ of mandamus reversing the Triennial Review Order on these points. The impact of any such stay or grant of mandamus is uncertain at this time, but any such action that results in the vacating of any unbundling rules could have an immediate and adverse impact upon our business. BellSouth and other parties have filed petitions before the FCC for reconsideration of the Triennial Review Order on section 271 grounds and broadband unbundling rules; granting of any of those petitions in whole or in part similarly could impact our business.

In the ordinary course of business, we are involved in legal and regulatory proceedings, disputes and tax audits at the federal, state and local level that are generally incidental to our ongoing operations. In addition, from time to time, we are the subject of customer and vendor complaints filed with the state utility commissions of the states in which they operate or the Federal Communications Commission. Most complaints, are handled informally, and at this time, there are no formal proceedings pending. While there can be no assurance of the ultimate disposition of incidental legal proceedings or customer complaints, we do not believe their disposition will have a material adverse effect on our consolidated results of operations or financial position.

11. SEGMENT REPORTING

We have two reportable operating segments: retail services and wholesale services. Prior to April 2002 we had only one reportable segment, our retail services segment.

The retail services segment includes our Z-LineHOME and Z-LineBUSINESS services, which are bundled local and long-distance telephone services in combination with enhanced communication features accessible through the telephone, the Internet and certain personal digital assistants. We offer Z-LineHOME and Z-LineBUSINESS in 47 states. Our customers are concentrated primarily in metropolitan areas in 10 states for both our Z-LineHOME and Z-LineBUSINESS services. The retail segment also includes our Touch 1 residential long-distance offering that is available nationwide.

The wholesale services segment is the segment of our business whereby we facilitate other telephone companies offering telephone exchange and enhanced services to their own residential and small business customers using us as their primary platform for delivery. This service is currently available in 47 states. Sprint is currently our primary wholesale services customer.

We evaluate the performance of each operating segment based on operating income, exclusive of adjustments for special items. Special items are transactions or events that are included in our reported consolidated results but are excluded from segment results due to management s belief that they are nonrecurring or nonoperational in nature. It is also important to understand when viewing our segment results that we only record direct expenses in our wholesale services segment and, therefore, all employee benefits, occupancy, insurance, and other indirect or overhead related expenses are reflected in the retail services segment. We are in the process of reviewing and possibly adopting a methodology for internal reporting purposes that would allocate these indirect and overhead related expenses to the respective segment or possibly separating these expenses from the reported segments.

The following tables summarize the financial information concerning our reportable segments for the periods presented:

	Three months ended September 30, 2003			Three months ended September 30, 2002		
	Retail Services	Wholesale Services	Consolidated	Retail Services	Wholesale Services	Consolidated
Revenues	$52,793	$28,661	$81,454	$46,688	$12,027	$58,715
Segment results	$ (5,139)	$ 8,907	$ 3,768	$ (3,294)	$ 4,336	$ 1,042
Depreciation and amortization	$ 5,207	$ 630	$ 5,837	$ 5,596	$ 573	$ 6,169
Capital expenditures	$ 1,685	$ 263	$ 1,948	$ 1,609	$ 328	$ 1,937

	Nine months ended September 30, 2003			Nine months ended September 30, 2002		
	Retail Services	Wholesale Services	Consolidated	Retail Services	Wholesale Services	Consolidated
Revenues	$154,080	$57,525	$211,605	$159,527	$18,681	$178,208
Segment results	$ (12,235)	$19,165	$ 6,930	$ (7,310)	$ 5,189	$ (2,121)
Depreciation and amortization	$ 16,004	$ 1,862	$ 17,866	$ 16,840	$ 911	$ 17,751
Capital expenditures	$ 7,265	$ 466	$ 7,731	$ 5,799	$ 7,907	$ 13,706
Identifiable assets	$ 80,931	$12,320	$ 93,251	$ 96,376	$10,335	$106,711

All 2003 and 2002 consolidated segment results reconcile to the consolidated financial information above with the exception of the segment results reconciled below:

	Three months ended		Nine months ended	
	September 30, 2003	September 30, 2002	September 30, 2003	September 30, 2002
Reconciliation of segment results to net loss				
Consolidated segment operating income (loss)	$ 3,768	$ 1,042	$ 6,930	$ (2,121)
Retroactive reduction to network access rate				8,981
Asset impairment charge				(1,129)
Wholesale development costs				(1,081)
Restructuring charge				(1,861)
Depreciation and amortization	(5,837)	(6,169)	(17,866)	(17,751)
Interest and other income	494	1,179	1,658	2,663
Interest and other expense	(978)	(1,014)	(2,388)	(3,011)
Net loss	$(2,553)	$(4,962)	$(11,666)	$(15,310)

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

You should read the following discussion together with the consolidated financial statements and related notes and other sections of this Quarterly Report on Form 10-Q. This discussion contains forward-looking statements that involve risks and uncertainties. You can identify forward-looking statements by the fact that they do not relate strictly to historical or current facts. The words believe, anticipate, intend, expect, estimate, project and similar expressions are intended to identify forward-looking statements. Our actual results may differ materially from those projected in the forward-looking statements as a result of various factors. Factors that may affect our results of operations include, but are not limited to, our limited operating history and cumulative losses, uncertainty of customer demand, rapid expansion, potential software failures and errors, power failures, potential network and interconnection failure, dependence on local exchange carriers, dependence on third party vendors, dependence on key personnel, dependence on key wholesale customers, uncertainty of government regulation, legal and regulatory uncertainties, and competition. We disclaim any obligation to update information contained in any forward-looking statement. In addition to these factors, other factors that could affect our financial results are described in our Annual Report on Form 10-K, filed with the Securities and Exchange Commission on March 30, 2003.

OVERVIEW

We provide advanced, integrated telecommunications services targeted to residential and small business subscribers. We offer local and long distance telephone services in combination with enhanced communication features accessible through the telephone, the Internet and certain personal digital assistants.

We began providing our services on a wholesale basis to others during the first quarter of 2002. This service enables other companies to provide local, long-distance and enhanced telephone services to residential and small business customers by utilizing our telephone exchange services, enhanced services platform, infrastructure and back-office operations. The nature of our business is evolving, and we have a limited operating history.

CONSOLIDATED RESULTS OF OPERATIONS

The following is a discussion of significant changes in our results of operations, which occurred in the three and nine months ended September 30, 2003 compared to the same periods in the prior year. The following table summarizes the approximate changes in selected operating items and includes dollar changes, percentage changes and percentage of revenues to facilitate our discussions that follow.

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	For the three months ended September 30,		Amount Change	Percentage Change	Percentage of Revenues	
	2003	2002	Favorable (Unfavorable)	Favorable (Unfavorable)	2003	2002
		(In Millions)				
Results of Operations:						
Revenues	$81.5	$58.7	$ 22.8	38.8%	100.0%	100.0%
Operating expenses:						
Network operations	38.5	23.8	(14.7)	(61.8)%	47.3%	40.6%
Sales and marketing	3.6	2.2	(1.4)	(63.6)%	4.4%	3.7%
General and administrative	35.6	31.7	(3.9)	(12.3)%	43.7%	54.0%
Depreciation and amortization	5.8	6.2	0.4	6.5%	7.1%	10.6%
Total operating expenses	83.5	63.9	(19.6)	(30.7)%	102.5%	108.9%
Operating loss	(2.0)	(5.2)	3.2	61.5%	(2.5)%	(8.9)%
Nonoperating income (expense):						
Interest and other income	0.5	1.2	(0.7)	(58.3)%	0.6%	2.0%
Interest and other expense	(1.0)	(1.0)		%	(1.2)%	(1.7)%
Total nonoperating income (expense)	(0.5)	0.2	(0.7)	(350.0)%	(0.6)%	0.3%
Net loss	(2.5)	(5.0)	2.5	50.0%	(3.1)%	(8.5)%
Less mandatorily redeemable convertible preferred stock dividends and accretion	(3.7)	(3.9)	0.2	5.1%	(4.5)%	(6.6)%
Less deemed dividend related to beneficial conversion feature	(0.1)	(0.1)		%	(0.1)%	(0.2)%
Net loss attributable to common stockholders	$ (6.3)	$ (9.0)	$ 2.7	30.0%	(7.7)%	(15.3)%
Cash Flow Data:						
Net cash provided by operating activities	$ 3.9	$ 7.8	$ (3.9)	(50.0)%	*	*
Net cash used in investing activities	(1.9)	(1.9)		%	*	*
Net cash used in financing activities	(1.6)	(1.5)	(0.1)	(6.7)%	*	*
Net increase in cash and cash equivalents	$ 0.4	$ 4.4	$ (4.0)	(90.9)%	*	*

* Not meaningful

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	For the nine months ended September 30, 2003	For the nine months ended September 30, 2002	Amount Change Favorable (Unfavorable)	Percentage Change Favorable (Unfavorable)	Percentage of Revenues 2003	Percentage of Revenues 2002
		(In Millions)				
Results of Operations:						
Revenues	$211.6	$178.2	$ 33.4	18.7%	100.0%	100.0%
Operating expenses:						
Network operations	95.5	69.9	(25.6)	(36.6)%	45.1%	39.2%
Sales and marketing	14.7	8.2	(6.5)	(79.3)%	6.9%	4.6%
General and administrative	94.5	93.3	(1.2)	(1.3)%	44.6%	52.3%
Asset impairment charge		1.1	1.1	100.0%	%	0.6%
Wholesale development costs		1.0	1.0	100.0%	%	0.6%
Restructuring expense		1.9	1.9	100.0%	%	1.1%
Depreciation and amortization	17.9	17.8	(0.1)	(0.6)%	8.5%	10.0%
Total operating expenses	222.6	193.2	(29.4)	(15.2)%	105.1%	108.4%
Operating loss	(11.0)	(15.0)	4.0	26.7%	(5.1)%	(8.4)%
Nonoperating income (expense):						
Interest and other income	1.7	2.7	(1.0)	(37.0)%	0.8%	1.5%
Interest and other expense	(2.4)	(3.0)	0.6	20.0%	(1.1)%	(1.7)%
Total nonoperating expense	(0.7)	(0.3)	(0.4)	(133.3)%	(0.3)%	(0.2)%
Net loss	(11.7)	(15.3)	3.6	23.5%	(5.4)%	(8.6)%
Less mandatorily redeemable convertible preferred stock dividends and accretion	(12.6)	(11.8)	(0.8)	(6.8)%	(6.0)%	(6.6)%
Less deemed dividend related to beneficial conversion feature	(0.1)	(0.1)		%	(0.1)%	(0.1)%
Net loss attributable to common stockholders	$ (24.4)	$ (27.2)	$ 2.8	10.3%	(11.5)%	(15.3)%
Cash Flow Data:						
Net cash provided by operating activities	$ 10.0	$ 13.0	$ (3.0)	(23.1)%	*	*
Net cash used in investing activities	(7.7)	(14.1)	6.4	45.4%	*	*
Net cash used in financing activities	(3.8)	(4.3)	0.5	11.6%	*	*
Net decrease in cash and cash equivalents	$ (1.5)	$ (5.4)	$ 3.9	72.2%	*	*

* Not meaningful

Revenues. Revenues increased by $22.8 million to $81.5 million for the three months ended September 30, 2003, compared to $58.7 million the prior year period.

Revenues increased by $33.4 million to $211.6 million for the nine months ended September 30, 2003, compared to $178.2 million the prior year period.

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The following table, in millions, provides a summary of our revenues:

Type of Revenues	For the three months ended September 30, 2003	For the three months ended September 30, 2002	For the nine months ended September 30, 2003	For the nine months ended September 30, 2002
Bundled Service UNE-P	$50.4	$42.5	$146.1	$147.8
1+ Long Distance Services	2.4	4.2	8.0	11.7
Wholesale Services	28.7	12.0	57.5	18.7
Total	$81.5	$58.7	$211.6	$178.2

The increase in revenue was primarily a result of increases of $16.7 and $38.8 million in our wholesale services revenue for the three and nine months ended September 30, 2003, respectively. These increases were primarily a result of increased revenues from our new contract with Sprint, signed in February 2003, and were partially offset by the decreases in MCI s wholesale service revenues compared to the prior year periods. The revenue from our Z-LineHOME and Z-LineBUSINESS (Bundled Service UNE-P) lines increased by $7.9 million and decreased by $1.7 million for the three and nine months ended September 30, 2003, respectively, compared to the prior year periods. Additionally, the decrease in 1+ long distance (1+) lines in service, as a result of expected attrition in lines, contributed a decrease of $1.8 and $3.7 million for the three and nine months ended September 30, 2003, respectively, compared to the prior year periods.

Our Bundled Service UNE-P accounts made up 61.8% and 69.1% of our total revenues for the three and nine months ended September 30, 2003, respectively, compared to 72.4% and 82.9% for the same periods in the prior year. These service offerings are currently available in 47 states. We expect Bundled Service UNE-P revenue to continue to increase as a percentage of retail revenues, relative to our 1+, but decrease as an overall percentage of total revenues because we expect continued growth in our wholesale service business.

Network Operations. Our network operations expense primarily consists of fixed and variable transmission and unbundled network element platform expenses for interconnection with ILECs and transport and transmission services with IXCs.

Network operations expense increased by $14.7 million to $38.5 million for the three months ended September 30, 2003, compared to $23.8 million the prior year period.

Network operations expense increased by $25.6 million to $95.5 million for the nine months ended September 30, 2003, compared to $69.9 million the prior year period.

Our network operations expense as a percentage of revenues, increased to 47.3% and 45.1% for the three and nine months ended September 30, 2003, respectively, compared to 40.6% and 39.2% in the prior year periods. Included in the prior year is a $9.0 million retroactive rate reduction for access rates that occurred in the second quarter of 2002. Excluding that for the nine months ended September 30, 2002, the network costs, as a percentage of revenues, was 44.3%. The increase in network operation expenses is primarily the result of an increase in our wholesale business, resulting in increases of $7.5 and $17.4 million for the three and nine months ended September 30, 2003, while our retail business network operations expense decreased $1.8 and $0.8 million for the same periods. We recorded a reduction to network operations expense for certain retroactive rate reductions and billing errors in the amounts of $2.5 million for the nine months ended September 30, 2003, $1.2 during the first quarter and $1.3 million recorded in the second quarter of 2003. Additionally, during the third quarter of 2003 we settled various disputes with Ameritech resulting in a reduction to network operations expense in the amount of $0.9 million.

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Sales and Marketing. Our sales and marketing expense primarily consists of brand awareness advertising, independent sales contractors one-time bounty and residual commissions, direct mail and salaries and benefit expenses paid to employees engaged in sales and marketing activities.

Sales and marketing expense increased $1.4 million to $3.6 million for the three months ended September 30, 2003, compared to $2.2 million the prior year period.

Sales and marketing expense increased $6.5 million to $14.7 million for the nine months ended September 30, 2003, compared to $8.2 million the prior year period.

The increase in sales and marketing expense is directly attributable to increased payments of one-time and recurring commissions to independent sales contractors, which increased by $1.8 and $6.9 million for the three and nine months ended September 30, 2003 compared to the prior year periods.

We slowed our advertising levels and limited our independent sales contractor sales force during the third quarter of 2003, a significant change from the first two quarters of 2003, which saw an increase of sales and marketing efforts. During the third quarter of 2003, we changed the focus of our overall sales and marketing efforts toward Z-LineBUSINESS services, primarily through the addition of an in-house sales team dedicated to the effort and the recruitment of independent master sales contractors. This focus has provided us with the ability to leverage our national footprint by consolidating billing and providing local and long distance services to multi-location businesses while further diversifying our product offerings beyond residential and wholesale. Our business services have provided lower acquisition cost and we believe that the limited amount of sales and marketing dollars and resources were best spent focused on business rather than residential customer acquisition during the third quarter of 2003. During this time, we also changed our Z-LineHOME strategy to leverage the value of product differentiation through the use of the Personal Voice Assistant(TM) (PVA).

In the coming quarters, our use of PVA as the sales strategy focus and product differentiator for our residential offering will become more apparent. We believe that this approach will allow us to reduce our acquisition costs by creating opportunities to partner with organizations that can provide us with strong distribution economics. We are also planning on leveraging PVA not only to improve communications but as a distribution and delivery strategy that involves ourselves and current customers providing PVA to others as a free trial via e-mail. Customers and independent sales contractors will be able to provide PVA as an introduction to our service offerings via on-line sign-up and communications. We believe this new approach, coupled with our new PVA community and recruiting of member-based organizations, will provide increased retail customers at a lower acquisition cost than we have experienced through the independent contractor acquisition process. Additionally, we have introduced new bundle and pricing points in an effort to expand the marketability of our offerings to consumers including variations of our PVA on a stand-alone basis. During the fourth quarter of 2003, we expect to introduce the sale of PVA in electronic stores. We will continue to build the overall awareness of our Z brand and explore alliances and ventures with other companies. We expect sales and marketing expense to stay relatively flat during the fourth quarter of 2003 compared to the third quarter, and we will continue to manage sales and marketing expense as a discretionary item to assist with managing our overall cash position. We are expecting to invest in sales and marketing at a level necessary to maintain our current retail line count and continue to grow the number of our business lines steadily.

General and Administrative. General and administrative expense primarily consists of employee salaries and benefits, temporary services, bad debt expense, billing and collection costs, occupancy costs, and provisioning cost. Provisioning is the process of establishing us as the end-user s primary carrier.

General and administrative expense increased $3.9 million to $35.6 million for the three months ended September 30, 2003, compared to $31.7 million the prior year period. General and administrative expense improved by 10.3% to 43.7% of revenues for the three months ended September 30, 2003 compared to 54.0% the prior year period.

General and administrative expense increased $1.2 million to $94.5 million for the nine months ended September 30, 2003, compared to $93.3 million the prior year period. General and administrative expense improved by 7.7% to 44.6% of revenues for the nine months ended September 30, 2003 compared to 52.3% the prior year period.

The increase in our general and administrative expenses for the three months ended September 30, 2003 was primarily a result of the growth in wholesale lines from our agreement with Sprint and the increase in our retail lines in service compared to the prior year period.

The overall increase in general and administrative expense for the nine months ended September 30, 2003 was a result of an increase of $7.5 million associated with the growth of our wholesale services and was off set by improved incremental costs and reductions to bad debt, resulting in a reduction of retail general and administrative expense of $6.3 million compared to the prior year period.

Overall general and administrative expense as a percentage of revenue decreased for both the three and nine months ended September 30, 2003 compared to the prior year periods. The reduction of general and administrative expense as a percentage of revenue was the result of our ability to leverage our fixed costs across our growing wholesale and business offerings while reducing incremental costs by improving the overall quality of our residential customer base and lower cost-per-line to maintain a business line in comparison to a residential line. We anticipate general and administrative expenditures will continue to increase in the future to support our expanding service offerings, our expected increase in wholesale and business lines. We will continue to evaluate our operations for efficiencies and our employee staffing requirements as they relate to increased efficiencies or needs to expand or outsource. We expect to continue reductions to our general and administrative expense as a percentage of revenues and recognize that this reduction is necessary for our achievement of profitability and the generation of positive cash flow.

Asset Impairment Charge. Asset impairment charges were $1.1 million for the nine months ended September 30, 2002. In April 2002, we announced a restructuring plan that included a reduction in force and the closure of the North Dakota call centers resulting in an asset impairment charge totaling $1.1 million for property, plant, and equipment sold in conjunction with the settlement of the leases in these locations.

Wholesale development costs. Wholesale development costs were $1.0 million for the nine months ended September 30, 2002. We incurred these costs, related to the initiation of our wholesale services offerings, during the first quarter of 2002.

Restructuring Expense. Restructuring expenses were $1.9 million for the nine months ended September 30, 2002. In April 2002, we approved and implemented a restructuring to enhance our future cash flows and operating earnings. The restructuring included a reduction of force, coupled with the closure of our North Dakota call centers and our New York sales office. In accordance with Emerging Issues Task Force (EITF) 94-3, Liability Recognition for Certain Employee Termination Benefits and Other costs to Exit an Activity, the restructuring costs were recognized as liabilities at the time management committed us to the plan. Management determined that these costs provided no future economic benefit to us.

The restructuring charge includes termination benefits and lease abandonment costs. In addition, we agreed to a settlement to exit the two leases for our call centers in North Dakota as of July 1, 2002. All termination benefits and settlements to exit our lease in North Dakota were paid as of December 31, 2002. We have recorded a lease abandonment charge representing the future lease cash payments for our New York office as a liability and these payments are scheduled to continue monthly through August 2005. As of September 30, 2003 we had an accrual recorded in the amount of $0.4 million remaining for this restructuring charge.

Depreciation and Amortization. Depreciation and amortization expense decreased by $0.4 million to $5.8 million for the three months ended September 30, 2003, compared to $6.2 million the prior year period.

Depreciation and amortization expense increased $0.1 million to $17.9 million for the nine months ended September 30, 2003, compared to $17.8 million the prior year period.

The relatively small changes in depreciation and amortization expense for the three and nine months ended September 30, 2003 are primarily a result of fixed asset purchases remaining relatively flat during 2003. We anticipate a flat to slightly increased depreciation and amortization expense for the remainder of 2003 depending on our requirements to purchase additional computer equipment, switching equipment, furniture and leasehold improvements as a result of our retail line growth, the line growth of our wholesale services clients and the introduction of new services.

Interest and Other Income. Interest and other income decreased $0.7 million to $0.5 million for the three months ended September 30, 2003, compared to $1.2 million the prior year period.

Interest and other income decreased $1.0 million to $1.7 million for the nine months ended September 30, 2003, compared to $2.7 million the prior year period.

Interest and other income consists of interest charged to our Bundled Service UNE-P customers for not paying their bills on time and income from interest earned from our cash balance. The decrease for 2003 was primarily due to our having fewer average customers in service compared to the prior year periods and our improved subscriber management activities.

Interest and Other Expense. Interest and other expense was $1.0 million for both the three months ended September 30, 2003 and 2002.

Interest and other expense decreased $0.6 million to $2.4 million for the nine months ended September 30, 2003, compared to $3.0 million the prior year period.

Our interest expense is a result of late fees for vendor payments, charges related to our RFC Capital Corporation (RFC) accounts receivable agreement, capital leases and our debt obligations. The overall decrease for the nine months in interest and other expense is a result of our overall increased liquidity in 2003 compared to the prior year period that allowed us to make more timely payments of our operating expenses while simultaneously reducing our reliance on our RFC accounts receivable agreement during the year. We also have less outstanding term debt obligations, which has contributed to lower interest payments. We anticipate that interest expense will decrease in the near future as we continue to reduce our debt obligations and improve our cash flow from operating activities. This decrease may be offset to the extent that we are able to borrow money to support growth through new funding sources and to finance any significant capital expenditures necessary to grow our business in the future. We expect the continued utilization of our RFC accounts receivable agreement, at least through July 2004, the current maturity date of the existing agreement.

Income Tax Benefit. No provision for federal or state income taxes has been recorded due to the full valuation allowance recorded against the deferred tax asset for the three and nine months ended September 30, 2003 and 2002.

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Net Loss. Our net loss improved by $2.5 million to a loss of $2.5 million for the three months ended September 30, 2003, compared to net loss of $5.0 million the prior year period.

Our net loss improved $3.6 million to a loss of $11.7 million for the nine months ended September 30, 2003, compared to a net loss of $15.3 million the prior year period.

Net Loss Attributable to Common Stockholders. Our net loss attributable to common stockholders improved $2.7 million to a loss of $6.3 million for the three months ended September 30, 2003, compared to a loss of $9.0 million the prior year period.

Our net loss attributable to common stockholders improved $2.8 million to a loss of $24.4 million for the nine months ended September 30, 2003, compared to a loss $27.2 million the prior year period.

This primary reasons for this decrease are discussed above, however, the change in the accumulation of dividends and accretion of the preferred stock further improved our net loss attributable to common stockholders by $0.2 million for the three months ended September 30, 2003 and an offset the improvement by $0.8 million for the nine months ended September 30, 2003.

RESULTS OF OPERATIONS BY SEGMENT

Management evaluates the performance of each segment based on operating income, excluding depreciation and amortization and adjustments for special items. Special items are transactions or events that are included in our reported consolidated results but are excluded from segment results due to their nonrecurring or nonoperational nature. We have detailed these special items in footnote 13 Segment Reporting and any other excluded items to reconcile to net loss as reported in our consolidated statement of operations. In addition, when changes in our business affect the comparability of current versus historical results, we will adjust historical operating information to reflect the current business structure.

The following tables present, in millions, our reportable segments. It is important to understand that we only record direct expenses in our wholesale services segment, therefore, all employee benefits, occupancy, insurance, and other indirect or overhead related expenses are reflected in the retail services segment. We are in the process of reviewing and possibly adopting a methodology for internal reporting purposes that would allocate these indirect and overhead related expenses to the respective units or possibly separating these expenses from our future segment analysis.

	Three months ended September 30, 2003			Three months ended September 30, 2002		
	Retail Services	Wholesale Services	Consolidated Results	Retail Services	Wholesale Services	Consolidated Results
Revenues	$52.8	$28.7	$ 81.5	$46.7	$12.0	$ 58.7
Operating expenses:						
Network operations	26.1	12.4	38.5	18.9	4.9	23.8
Sales and marketing	3.6		3.6	2.2		2.2
General and administrative	28.2	7.4	35.6	28.9	2.8	31.7
Total operating expenses	57.9	19.8	77.7	50.0	7.7	57.7
Segment results	$ (5.1)	$ 8.9	$ 3.8	$ (3.3)	$ 4.3	$ 1.0

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	Nine months ended September 30, 2003			Nine months ended September 30, 2002		
	Retail Services	Wholesale Services	Consolidated Results	Retail Services	Wholesale Services (1)	Consolidated Results
Revenues	$154.1	$57.5	$211.6	$159.5	$ 18.7	$178.2
Operating expenses:						
Network operations	71.6	23.9	95.5	72.4	6.5	78.9