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Redacted

KPMG

UNIDIAL INCORPORATED

Financial Statements

December 31, 1997, 1996 and 1995

With Independent Auditors' Report Thereon

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UNIDIAL INCORPORATED

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December 31, 1997, 1996 and 1995

KPMG Peat Marwick LLP

Suite 2600
400 West Market Street
Louisville, KY 40202

Independent Auditors' Report

The Board of Directors
UniDial Incorporated:

We have audited the accompanying balance sheets of UniDial Incorporated (the Company) as of December 31, 1997 and 1996, and the related statements of operations, shareholders' deficit, and cash flows for each of the years in the three-year period ended December 31, 1997. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of UniDial Incorporated as of December 31, 1997 and 1996, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 1997 in conformity with generally accepted accounting principles.

KPMG Peat Marwick LLP

Louisville, Kentucky
March 12, 1998, except as to notes 6
and 14, which are as of May 18, 1998
and April 24, 1998, respectively

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Balance Sheets

December 31, 1997 and 1996

Assets (notes 6 and 7)		1997	1996
Current assets:			
Cash and cash equivalents	$	[redacted]	[redacted]
Accounts receivable (net of allowance of $3,037,917 and $1,432,142, respectively)		[redacted]	[redacted]
Notes receivable from agents (net of allowance of $322,048 and $339,498, respectively)		[redacted]	[redacted]
Receivable from affiliated companies (note 5)			
Prepaid and other current assets			
Total current assets		[redacted]	[redacted]
Property and equipment (note 4)		[redacted]	[redacted]
Notes receivable from agents maturing after one year			
Investment in and advances to affiliated companies (note 5)			
Other assets (less accumulated amortization of $264,635 and $199,009, respectively)		[redacted]	[redacted]
	$	[redacted]	[redacted]

Liabilities and Shareholders' Deficit		1997	1996
Current liabilities:			
Accounts payable	$	[redacted]	[redacted]
Current portion of long-term debt (notes 6 and 7)			
Accrued agent commissions			
Other accrued liabilities (note 5)			
Deferred agent fees (note 2)			
Total current liabilities		[redacted]	[redacted]
Long-term debt (notes 6 and 7)		[redacted]	[redacted]
Deferred agent fees-noncurrent (note 2)			
Total liabilities		[redacted]	[redacted]
Shareholders' deficit (note 10):			
Preferred stock. Authorized 500 shares; 10 shares designated as Series A and 60 shares designated as Series B; issued 9.1 shares of Series A and 60 shares of Series B (note 9)		[redacted]	[redacted]
Common stock, no par value. Authorized 2,000 shares in 1997 and 1,000 shares in 1996; issued and outstanding 880 and 820 shares, respectively		[redacted]	[redacted]
Accumulated shareholders' deficit			
Total shareholders' deficit		[redacted]	[redacted]
Commitments and contingencies (notes 1, 5, 6, 7, 10, 11 and 12)			
	$	[redacted]	[redacted]

See accompanying notes to financial statements.

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Statements of Operations

Years ended December 31, 1997, 1996 and 1995

		1997	1996	1995
Revenues:				
Telecommunications services	$	[redacted]	[redacted]	[redacted]
Cost of revenues:				
Telecommunications services		[redacted]	[redacted]	[redacted]
Gross profit		[redacted]	[redacted]	[redacted]
Commission expense		[redacted]	[redacted]	[redacted]
Other selling, general and administrative expenses		[redacted]	[redacted]	[redacted]
Provision for doubtful accounts and notes receivable		[redacted]	[redacted]	[redacted]
Loss from operations		[redacted]	[redacted]	[redacted]
Other income (expense):				
Interest income		[redacted]	[redacted]	[redacted]
Interest expense				
Equity in net loss of affiliated companies (note 5)		[redacted]	[redacted]	[redacted]
Loss before income taxes		[redacted]	[redacted]	[redacted]
Income taxes (note 8)		[redacted]	[redacted]	[redacted]
Net loss	$	[redacted]	[redacted]	[redacted]
Basic loss per common share	$	[redacted]	[redacted]	[redacted]

See accompanying notes to financial statements.

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UNIDIAL INCORPORATED

Statements of Shareholders' Deficit

Years ended December 31, 1997, 1996 and 1995

	Common Stock		Preferred Stock		Accumulated Shareholders' Deficit	Total Shareholders' Deficit
	Shares	Amount	Shares	Amount		
Balance at December 31, 1994	[redacted]	$ [redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Common stock issued on conversion of convertible subordinated debentures	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Net loss	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Balance at December 31, 1995	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Net loss	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Balance at December 31, 1996	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Common stock issued	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Series A preferred stock issued	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Series B preferred stock issued	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Net loss	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Balance at December 31, 1997	[redacted]	$ [redacted]	[redacted]	[redacted]	[redacted]	[redacted]

See accompanying notes to financial statements.

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Statements of Cash Flows

Years ended December 31, 1997, 1996 and 1995

		1997	1996	1995
Cash flows from operating activities:				
Net loss	$	[redacted]	[redacted]	[redacted]
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:				
Depreciation and amortization		[redacted]	[redacted]	[redacted]
Amortization of deferred agent fees		[redacted]	[redacted]	[redacted]
Non-cash compensation expense		[redacted]	[redacted]	[redacted]
Loss on investment in affiliated companies		[redacted]	[redacted]	[redacted]
Issuance of common stock for services		[redacted]	[redacted]	[redacted]
(Increase) in accounts receivable		[redacted]	[redacted]	[redacted]
(Increase) decrease in notes receivable from agents		[redacted]	[redacted]	[redacted]
Increase in receivable from affiliated companies		[redacted]	[redacted]	[redacted]
(Increase) decrease in prepaid expenses		[redacted]	[redacted]	[redacted]
Increase in accounts payable		[redacted]	[redacted]	[redacted]
Increase in accrued agent commissions		[redacted]	[redacted]	[redacted]
Increase in other accrued liabilities		[redacted]	[redacted]	[redacted]
Increase (decrease) in deferred agent fees		[redacted]	[redacted]	[redacted]
Net cash provided by (used in) operating activities		[redacted]	[redacted]	[redacted]
Cash flows from investing activities:				
Increase in receivable from affiliated companies		[redacted]	[redacted]	[redacted]
Purchases of property and equipment		[redacted]	[redacted]	[redacted]
Investment in and advances to affiliated companies		[redacted]	[redacted]	[redacted]
Proceeds from sale of notes receivable from agents		[redacted]	[redacted]	[redacted]
(Increase) decrease in other assets		[redacted]	[redacted]	[redacted]
Net cash used in investing activities		[redacted]	[redacted]	[redacted]
Cash flows from financing activities:				
Increase (decrease) in short-term debt		[redacted]	[redacted]	[redacted]
Repayment of long-term debt		[redacted]	[redacted]	[redacted]
Borrowings under revolving line of credit		[redacted]	[redacted]	[redacted]
Repayments on revolving line of credit		[redacted]	[redacted]	[redacted]
Issuance of common stock		[redacted]	[redacted]	[redacted]
Net cash provided by financing activities		[redacted]	[redacted]	[redacted]
Net increase (decrease) in cash and cash equivalents		[redacted]	[redacted]	[redacted]
Cash and cash equivalents - beginning		[redacted]	[redacted]	[redacted]
Cash and cash equivalents - ending	$	[redacted]	[redacted]	[redacted]

See accompanying notes to financial statements.

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Notes to Financial Statements

December 31, 1997, 1996 and 1995

(1) Company Organization and Basis of Presentation

UniDial Incorporated (the Company) was incorporated on February 23, 1993 and commenced operations in August 1993 in Louisville, Kentucky. The Company provides telecommunications services throughout the United States through a distribution network of authorized independent agents. The Company is a non-facilities based provider and is therefore able to quickly and efficiently enter new markets while maximizing redundancy, without incurring the cost apparent in constructing and managing network hardware. In addition to long distance service, the Company currently offers a wide array of telecommunications services including Internet/Intranet, Calling Cards, Advanced Data, Wireless and Conference Calling.

The telecommunications industry is highly competitive with intense competition in providing both retail and wholesale long distance telecommunications services. The Company competes, both directly at the wholesale level and through UniDial Agents at the retail level. The Company is subject to regulatory requirements imposed by federal (Federal Communications Commission - "FCC"), state and local governmental agencies. Regulations by the FCC as well as state agencies include limitations on types of services and service areas offered to the public.

In December of 1996, the Board of Directors approved a change in the Company's fiscal year end from March 31 to December 31 effective the calendar year beginning January 1, 1996. The statements of operations, shareholders' deficit and cash flows are presented for the years ended December 31, 1997, 1996 and 1995, respectively.

To date, the Company has funded its operations with external financing. The primary source of funds is a bank revolving line of credit from its primary bank. During the year ended December 31, 1997, the Company raised additional funds through the issuance of preferred stock in exchange for senior debentures and the cancellation of debt. The debentures were in the amount of $[redacted] and the cancellation of debt was for $[redacted] (see note 9). As a result of the above described transactions, the Company has kept its debt service obligations relatively constant over the last year. [redacted]

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(1) Company Organization and Basis of Presentation (Continued)

[redacted] The Company's continued development, expansion, operation and the further development of additional services, including local services, will require substantial capital expenditures. Funding these expenditures is dependent upon the Company's ability to raise additional financing. [redacted] While there can be no assurance the Company will be able to obtain the additional financing necessary to satisfy its cash requirements or to successfully implement its growth strategy, management believes that the Company's current cash resources will be sufficient to fund the Company's continuing cash flow and required capital expenditures during 1998.

(2) Summary of Significant Accounting Policies

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 the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expense during the reporting period. Actual results could differ from those estimates.

Certain prior year amounts have been reclassified to conform to 1997 presentations.

Revenue Recognition

Telecommunications services income is recognized on the accrual basis as services are provided. The Company provides administrative and support services to its agents and pays commissions based on revenues from the agents' accounts. Prior to March 31, 1996, agents were authorized to market the Company's services for a fee of [redacted] which in certain instances were financed by the Company. A portion of the agent fee representing the Company's cost of providing initial services was recognized as income in the initial year of the contract as such costs were incurred. The remaining amount was deferred and amortized over the term of the contract (generally five years) on a straight-line basis.

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(2) Summary of Significant Accounting Policies (Continued)

Revenue Recognition (Continued)

Commencing April 1, 1996, new agents have the ability to terminate the contractual relationship with the Company at any time during the first 6 months of the agreement. The Company has elected to not record agent notes receivable or any related earned or deferred revenues for these agents until the 6 month period has elapsed. If the agent has not withdrawn from the program after 6 months, the agent note is recorded and the portion of the agent fee representing the Company's cost of providing initial services is recognized as income in the seventh month of the contract. The remaining revenue is deferred and amortized over the remaining term of the contract (generally fifty-four months) on a straight-line basis.

During the second quarter of 1997, the Company began to allow agents to enter the program for a fee of [redacted] Agents entering the program at this fee are not entitled to any bonus commissions as mentioned below. The 6 month termination clause mentioned above is also present in these agency agreements. If the agency agreement is not terminated prior to the end of the 6 month period, the agent note is recorded and the portion of the agent fee representing the Company's cost of providing initial services is recognized as income in the seventh month of the contract. The remaining revenue is deferred and amortized over the remaining term of the contract (generally fifty-four months) on a straight-line basis.

Notes receivable from agents are comprised of financing arrangements for the agents fees and certain other loans made to agents. These loans are normally interest-bearing and contain repayment schedules from 12 to 36 months.

During 1997, the Company changed its accounting policy of revenue recognition for agent fees financed with notes receivable on a retroactive basis, whereby, the recognition of such agent fees and interest income on the related notes receivable is further limited to amounts recognizable under the cost-recovery method on an individual agent basis. This change in accounting policy resulted in [redacted]

Agent fees, which are included in telecommunications services revenues, amounted to [redacted] in 1997, 1996 and 1995, respectively.

(2) Summary of Significant Accounting Policies (Continued)

Revenue Recognition (Continued)

In the event of the sale of one or more of the agent's accounts, or a sale of [redacted]r more of the voting common stock of the Company, certain agents are entitled to a bonus commission equivalent to [redacted] of the consideration received from the sale.

In addition, the Company has the right to offset commissions earned with uncollectible accounts receivable attributed to a specific agent or with past due notes receivable payments, up to certain specified percentages of such uncollectible accounts receivable and up to 100% of past due notes receivable payments.

Management believes its allowance for doubtful accounts receivable, combined with its ability to offset agents' commissions, is adequate to provide for uncollectible accounts receivable. Management believes its allowance for doubtful notes receivable, combined with its ability to offset agents' commissions, is adequate to provide for uncollectible agents' notes receivable.

Property and Equipment

Property and equipment is carried at cost, less accumulated depreciation. Depreciation of property and equipment is computed using the straight-line method over the estimated lives of the assets. Improvements to leased assets or fixtures are amortized over their estimated useful lives or lease period, whichever is shorter. Leased property meeting certain criteria is capitalized and the present value of the related lease payments is recorded as a liability. Amortization of capitalized leased assets is computed on the straight-line method over the term of the lease.

Income Taxes

The Company accounts for income taxes using the asset and liability method. Under the asset and liability method, deferred tax assets and liabilities are established for temporary differences between the financial statement and tax basis of the Company's assets, including carryforwards, and liabilities at enacted tax rates which are expected to be in effect when such amounts are realized or settled. A valuation allowance is established to reduce deferred tax assets to an amount that will more likely than not be realized.

(2) Summary of Significant Accounting Policies (Continued)

Other Assets

Other assets consist of organization expenses, which are amortized on a straight-line method over a five year period, deferred loan fees, which are amortized on a straight-line method over the life of the related loans, and a trademark, which is amortized on a straight-line method over a five-year period.

Stock Options

Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* ("SFAS 123") permits entities to either i) recognize as expense over the vesting period the fair value on the date of grant of all stock-based awards, or ii) apply Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* ("APB 25"), and related interpretations, providing disclosures of pro forma net income (loss) and earnings (loss) per share for stock options granted in 1995 and future years as if the fair-value-based method defined in SFAS 123 had been applied. The Company has elected to continue to apply the provisions of APB 25 and to provide the SFAS 123 pro forma disclosures. As such, compensation expense is recognized on the date of grant only if the market price of the underlying stock on the grant date exceeds the exercise price.

Basic Loss Per Common Share

During 1997, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 128, *Earnings Per Share*, ("SFAS 128"), which requires the computation and disclosure of basic and diluted income (loss) per common share. Basic income (loss) per common share is determined by dividing income (loss) by the weighted average number of shares of common stock outstanding. Diluted income (loss) per common share is determined by dividing income (loss) by the weighted average number of shares of common stock outstanding plus the weighted average number of shares that would be issued upon exercise of dilutive stock options assuming proceeds are used to repurchase shares pursuant to the treasury stock method, and the conversion of preferred stock described in note 9. Diluted loss per common share is not presented as this calculation would be antidilutive.

(2) Summary of Significant Accounting Policies (Continued)

Basic Loss Per Common Share (Continued)

The following illustrates the computation of basic loss per common share:

	1997	1996	1995
Net loss	$ [redacted]	[redacted]	[redacted]
Add: Preferred stock dividends	[redacted]	[redacted]	[redacted]
Net loss available to common shareholders	$ [redacted]	[redacted]	[redacted]
Weighted average shares	[redacted]	[redacted]	[redacted]
Basic loss per common share	$ [redacted]	[redacted]	[redacted]

(3) Statement of Cash Flows

For purposes of the statement of cash flows, the Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

The following summarizes supplemental cash flow data for the years ended December 31, 1997, 1996 and 1995:

	1997	1996	1995
Cash paid for interest	$ [redacted]	[redacted]	[redacted]
Cash paid for income taxes	[redacted]	[redacted]	[redacted]

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Notes to Financial Statements

(3) Statement of Cash Flows (Continued)

Non-cash investing and financing transactions are summarized as follows:

	1997	1996	1995
Uncollectible accounts receivable offset to accrued agent commissions	$ [redacted]	[redacted]	[redacted]
Payment of notes and accrued interest receivable by offset to accrued agent commissions	[redacted]	[redacted]	[redacted]
Issuance of debentures to pay accounts payable	[redacted]	[redacted]	[redacted]
Deferred agent fees financed by issuance of notes receivable	[redacted]	[redacted]	[redacted]
Common stock issued for conversion of debentures	[redacted]	[redacted]	[redacted]
Preferred stock issued for cancellation of debentures and payables	[redacted]	[redacted]	[redacted]
Capital lease obligation incurred for purchase of equipment	[redacted]	[redacted]	[redacted]
Long-term debt incurred for purchase of other asset	[redacted]	[redacted]	[redacted]

(4) Property and Equipment

Property and equipment is summarized as follows:

	1997	1996
Furniture and fixtures	$ [redacted]	[redacted]
Equipment and computer software	[redacted]	[redacted]
	[redacted]	[redacted]
Less accumulated depreciation and amortization	[redacted]	[redacted]
Property and equipment, net	$ [redacted]	[redacted]

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(4) Property and Equipment (Continued)

Property and equipment include capitalized leases with a cost and accumulated amortization of [redacted]and [redacted]n 1997 and [redacted] and [redacted]in 1996.

(5) Investment in and Advances to Affiliated Companies

NTR.Net Corporation (NTR.Net), a related party, provides internet services to the Company on a wholesale basis which are resold to customers of the Company. At December 31, 1997 and 1996, the investment in NTR.Net was [redacted] and [redacted], respectively, and is included in [redacted] Pursuant to this service relationship, the Company paid to NTR.Net approximately [redacted] [redacted]and [redacted]r the years ended December 31, 1997, 1996 and 1995, respectively. Certain officers, directors and shareholders of the Company are also shareholders of NTR.Net. One of the principal shareholders of NTR.Net is also a related party to a principal shareholder of the Company. The Company uses the equity method of accounting for its investment in NTR.Net. The Company's share of NTR.Net's net [redacted] was [redacted], [redacted] and [redacted] for the years ended December 31, 1997, 1996 and 1995, respectively. At December 31, 1997, 1996 and 1995, the Company's ownership percentage of the outstanding stock of NTR.Net was[redacted]%, [redacted]% and [redacted]%, respectively.

Summarized unaudited financial information applicable to NTR.Net as of and for the years ended December 31, 1997 and 1996 follows:

		1997	1996
Current assets	$	[redacted]	[redacted]
Current liabilities		[redacted]	[redacted]
Working capital deficit		[redacted]	[redacted]
Fixed assets		[redacted]	[redacted]
Other assets		[redacted]	[redacted]
Long-term debt		[redacted]	[redacted]
Stockholders' deficit	$	[redacted]	[redacted]
Total revenues	$	[redacted]	[redacted]
Net loss	$	[redacted]	[redacted]

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(5) Investment in and Advances to Affiliated Companies (Continued)

The Company guaranteed certain lease obligations of NTR.Net in an aggregate amount of [redacted] and [redacted] at December 31, 1997 and 1996, respectively.

During the fourth quarter of 1997, the Company entered into an agreement with IXC International, Inc. ("IXC") to form UniDial Communications Services, LLC ("UniDial Direct") to assemble a direct sales force for UniDial Incorporated products. The formation of the new entity is the Company's initial effort to increase its distribution channels and attract mid to large size business customers.

The Company has committed [redacted] to the initial capital funding while IXC is responsible for the remaining funding of [redacted]. The Company has [redacted] ownership of the new entity with IXC possessing the remaining [redacted]. However, because of significant minority participating rights, the Company will account for UniDial Direct on the equity method of accounting. An initial capital contribution of [redacted] was made by the Company during the fourth quarter of 1997. At December 31, 1997, the Company's investment in and receivable from UniDial Direct was [redacted] and [redacted] respectively. The Company's share of UniDial Direct's net loss for 1997 was [redacted]

Summarized unaudited financial information applicable to UniDial Direct as of and for the period from inception through December 31, 1997 follows:

Current assets	$	[redacted]
Current liabilities		[redacted]
Working capital		[redacted]
Fixed assets		[redacted]
Other assets		[redacted]
Long-term debt		[redacted]
Stockholders' equity	$	[redacted]
Total revenues	$	[redacted]
Net loss	$	[redacted]

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Notes to Financial Statements

(6) Financing Arrangements

Long-term debt consists of the following at December 31, 1997 and 1996:

		1997	1996
8% Senior Subordinated Convertible Debentures; due December 1, 2005	$	[redacted]	[redacted]
Revolving line of credit; originally due May 31, 1997; renewed until May 31, 2000; interest at 1% to 2% above the prime rate; payable monthly		[redacted]	[redacted]
Unsecured note payable; due June 1, 1999; interest at 9%; principal and interest payable annually		[redacted]	[redacted]
Capital lease obligations		[redacted]	[redacted]
Total debentures, lines of credit, note payable and capital lease obligations		[redacted]	[redacted]
Less current maturities		[redacted]	[redacted]
Total long-term debt	$	[redacted]	[redacted]

Maturities of long-term debt are as follows:

Fiscal Year Ending December 31,		
1998	$	[redacted]
1999		
2000		
	$	[redacted]

8% Senior Subordinated Convertible Debentures

The 8% Senior Subordinated Convertible Debentures (the Senior Debentures) were issued pursuant to a Payment Agreement with WorldCom, Inc. (WorldCom, formerly Wiltel, Inc.) discussed in note 7. WorldCom canceled the Senior Debentures for 9.1 shares of Series A preferred stock during November 1997. See note 9 for further information.

(6) Financing Arrangements (Continued)

Convertible Subordinated Debentures

The Company was authorized to issue up to nineteen 8% Convertible Subordinated Debentures (the Subordinated Debentures) in face amounts of $[redacted]. The Subordinated Debentures were convertible into the Company's common stock by the holders beginning November 1, 1995 and for thirty days thereafter, at the rate of one debenture for ten shares of the Company's common stock, subject to adjustment as described in the debenture agreement. On November 1, 1995 debenture holders also had the right to demand that the Company purchase the Subordinated Debentures at a premium of ten percent. During November 1995, eleven of the twelve debenture holders exercised their right to convert their subordinated debentures into common stock of the Company. The remaining debenture holder exercised the demand feature referred to above and was paid in full during 1996.

Revolving Line of Credit

The Company maintains a revolving credit facility (the Financing Agreement) with Star Bank, N.A. (the Lender). Under the terms of the Financing Agreement governing the facility, loans can be borrowed and reborrowed from time to time in an amount as of any date, not exceeding the loan availability then in effect. At December 31, 1997 and 1996, the maximum loan availability to the Company was $[redacted] and $[redacted] respectively. The loan availability is defined as the lesser of the Company's borrowing base, which is an amount equal to (i) the lesser of 120% of the Company's net eligible receivables or 1.75 times the Company's average monthly revenues for the most recent three months, less a reserve amount determined at the discretion of the Lender; or (ii) the maximum loan availability less certain lease obligations.

Interest is accrued at the Lender's prime rate as in effect from day to day, plus the Applicable Percentage (as defined), which shall be 1.0%, 1.5% or 2.0% based upon the average daily balances of loans outstanding for the calendar month and is payable monthly. The Financing Agreement also provides for an additional 2.0% above the applicable rates of interest upon and during an event of default, as defined. The rates at December 31, 1997 and 1996 were [redacted]% and [redacted]%, respectively.

(6) Financing Arrangements (Continued)

Revolving Line of Credit (Continued)

The Financing Agreement requires payment of a monthly facility fee equal to the difference between the loan availability and the average daily principal balance outstanding times the result obtained by multiplying the Facility Fee Percentage (as defined) times a fraction based upon the relationship of the number of days such loans were outstanding to 360 days. The Facility Fee Percentage was 0.25% through May 31, 1996 and increased in increments of one-eighth of one percent annually to a maximum of 0.5% effective after May 31, 1997.

The Financing Agreement provides for a development fee of up to $950,000 upon the earliest to occur of (i) the termination of the Financing Agreement, (ii) the consummation of an initial public offering of the Company's common stock or (iii) the consummation of a sale of the Company's common stock such that certain persons set forth in the Financing Agreement no longer own fifty or more percent of the Company's common stock. During March 1996, the sale of the Company's common stock as described in (iii) above occurred, however, a one-time waiver of the development fee was granted by the Lender.

All obligations under the Financing Agreement are collateralized by a security interest in substantially all of the Company's business assets as defined in the Security Agreement, and are guaranteed by the principal shareholders of the Company.

The Financing Agreement includes covenants limiting additional indebtedness, changes in debenture documents, merger activities, certain investments, stock redemptions, capital expenditures and sales of assets, among other things, as set forth in the Financing Agreement. The Financing Agreement also contains financial covenants specifying minimum amounts for earnings before interest, income taxes, depreciation and amortization (EBITDA), tangible net worth and cash flows. At December 31, 1997 and 1996, the Company was in violation of certain of these convenants, for which appropriate waivers were obtained.

(6) Financing Arrangements (Continued)

Revolving Line of Credit (Continued)

The Financing Agreement was amended on June 14, 1997, October 6, 1997 and May 18, 1998 to $[redacted]xtend the maturity date to May 31, 2000 and to waive violation of certain financial covenants. The Company may terminate the Financing Agreement by giving notice of its intent to do so and paying a termination fee as described in the Financing Agreement. No termination fee is payable if the development fee, discussed above, is paid.

(7) Telecommunications Services and Payment Agreements

Telecommunications Services Agreement - WorldCom

The Company entered into a telecommunications services agreement with WorldCom on March 1, 1994, as amended on November 30, 1997 (the "WorldCom Agreement"), for switched services and other associated services. The WorldCom Agreement expires May 31, 2003. Under the WorldCom Agreement the Company has committed to purchase a certain amount of services on a monthly basis (the "Monthly Minimum Commitment"). If the Company fails to meet the Monthly Minimum Commitment on a quarterly basis, the term of the WorldCom Agreement will be extended in accordance with a formula set forth in the agreement.

The WorldCom Agreement also commits the Company to purchase a certain percentage of its telecommunications services from WorldCom on a monthly basis up to a certain amount (the "Minimum Telecommunications Amount"). Once the Minimum Telecommunications Amount has been reached, the percentage and the Minimum Telecommunications Amount decrease. If the Company fails to meet the Minimum Telecommunications Amount, WorldCom has the ability to reduce the discounts that it gives to the Company on gross charges for switched services. For purposes of determining if the Company has met its Minimum Telecommunications Amount, telecommunication services exclude services not provided by WorldCom or services provided by IXC under its agreement with UniDial Direct. The Company is currently satisfying the Minimum Telecommunications Amount.

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(7) <u>Telecommunications Services and Payment Agreements (Continued)</u>

<u>Telecommunications Services Agreement - WorldCom (Continued)</u>

The WorldCom Agreement provides the Company with various discounts, applied in arrears, on the Company's charges. The discounts are based upon the monthly revenue relevant to the preceding month, provided the Company has paid all undisputed charges on a current basis and has not otherwise been subject to a suspension notice under the WorldCom Agreement. In addition, WorldCom has agreed to give the Company any rate reductions that WorldCom generally makes available to its other wholesale customers. Payments due under the WorldCom Agreement are to be made within 45 days of the invoice date and are secured by an interest in substantially all of the Company's business assets. WorldCom's security interest is subordinate to the security interest of the Company's primary lender.

The WorldCom Agreement may not be terminated by WorldCom but may be terminated by the Company once the Company uses an aggregate amount of WorldCom's telecommunication services.

Under a separate agreement (the "Private Line Agreement"), WorldCom also provides digital services for frame relay and dedicated service for the Company. Under the Private Line Agreement, the Company is also committed to purchase up to [redacted]er month in private line and frame relay services (the "Private Line Commitment") beginning in June 1998. If the Company fails to meet the Private Line Commitment, the Company is required to pay the difference between the actual usage and the Private Line Commitment. The Company believes that it will meet the Private Line Commitment.

In connection with the Services Agreement, effective March 1, 1994, the Company and its principal stockholders entered into a Payment Agreement with WorldCom, wherein the Company was authorized to issue up to [redacted] of 8% Senior Debentures due December 1, 2005 in satisfaction of a portion of the payments owed by the Company to WorldCom pursuant to the Services Agreement. The Senior Debentures were issuable by the Company, at its option, for every $10,000 of debt incurred by the Company.

(7) Telecommunications Services and Payment Agreements (Continued)

Telecommunications Services Agreement - WorldCom (Continued)

The Senior Debentures were senior to the Company's 8% Convertible Debentures due November 1, 2003 described in note 6. Interest was payable annually on December 1 of each year. In connection with the execution of the Financing Agreement discussed in note 6, WorldCom subordinated its interest in the security discussed above to the Lender and all WorldCom covenants were modified and amended in their entirety to be identical to the Lender's covenants.

On November 30, 1997, the Company entered into a preferred stock purchase agreement with WorldCom. See note 9 for further information.

Telecommunications Services Agreement - Sprint

On February 27, 1996, the Company entered into a carrier transport switched service agreement, as subsequently amended on October 31, 1997 (the "Sprint Agreement") with Sprint Communications Company L.P. ("Sprint") that expires May 31, 2000. The discounted rates under the Sprint Agreement are contingent upon the Company achieving certain (i) quarterly revenue targets (the "Quarterly Targets") and (ii) monthly revenue sub-targets (the "Monthly Sub-Targets"). If the Company fails to meet the Quarterly Targets for any two consecutive quarters, the rates charged under the Sprint Agreement will be increased to rates commensurate with the actual volume accumulated during the second of the two quarters. The rate increase will remain in effect until the beginning of the next quarter after the Company meets its Quarterly Target. If the Company fails to meet the Monthly Sub-Target, the Company may lose discounts up to [redacted] per month on intrastate pricing in certain states.

Telecommunications Services Agreement - IXC

On April 22, 1997, the Company entered into a four-year telecommunications services agreement with IXC, as subsequently amended on January 1, 1998 (the "IXC Agreement"). The IXC Agreement provides that the Company will receive certain discounts if the Company attains a certain target in monthly billings (the "Monthly Target"). If the Company fails to achieve the Monthly Target, IXC may increase the Company's rates for services. The Company is currently meeting the Monthly Target.

(7) Telecommunications Services and Payment Agreements (Continued)

Telecommunications Services Agreement - IXC (Continued)

If any repricing for failure to meet the Monthly Target is unsatisfactory to the Company, the Company may terminate the IXC Agreement with respect to services repriced upon six months written notice to IXC. IXC may terminate the agreement upon six months written notice if a "Change in Control" of the Company occurs. A "Change in Control" is defined as meaning any person or entity, other than stockholders of the Company as of the date of the IXC Agreement, owning or acquiring more than 51% of the capital stock and voting power of the Company, or the Company selling or otherwise transferring all or substantially all of the assets of the Company to any other person or entity.

(8) Income Taxes

A reconciliation of the income tax benefit at the statutory rate to the Company's effective rate is as follows:

	1997	1996	1995
Tax benefit computed at the statutory rate State income tax benefit, net of Federal taxes	[redacted]	[redacted]	[redacted]
Change in the beginning-of-the-year balance of the valuation for deferred tax assets allocated to income tax expense	[redacted]	[redacted]	[redacted]
Other	[redacted]	[redacted]	[redacted]
	[redacted]	[redacted]	[redacted]

The significant components of deferred income tax expense are as follows:

	1997	1996	1995
Deferred tax benefit (exclusive of the effects of other component below)	$ [redacted]	[redacted]	[redacted]
Increase in beginning-of-the-year balance of the valuation allowance for deferred tax assets	$ [redacted]	[redacted]	[redacted]

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(8) Income Taxes (Continued)

The principal basis differences between assets and liabilities for financial reporting and tax return purposes which give rise to deferred taxes relate to the following:

	1997	1996
Deferred tax assets:		
Net operating loss carryforward	$ [redacted]	[redacted]
Deferred agent fees	[redacted]	[redacted]
Accounts receivable	[redacted]	[redacted]
Investment in affiliated companies	[redacted]	[redacted]
Other	[redacted]	[redacted]
	[redacted]	[redacted]
Valuation allowance	[redacted]	[redacted]
Net deferred tax asset	$ [redacted]	[redacted]

The valuation allowance for deferred tax assets as of January 1, 1997 and 1996 was $[redacted] and $[redacted], respectively. The net change in the total valuation allowance for the years ended December 31, 1997 and 1996 was [redacted] $[redacted] and $[redacted] respectively.

Under the asset and liability method, the likelihood of realizing tax benefits related to potential deferred tax assets is evaluated by management and a valuation allowance is recognized to reduce the deferred tax asset if it is more likely than not that the deferred asset will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Management believes it is more likely than not the Company will realize the benefits of these deductible differences, net of the valuation allowance, for such temporary differences.

The Company has available at December 31, 1997 approximately $[redacted] of unused net operating loss carryforwards that may be applied against future taxable income and that expire from 2007 to 2012. The Company's utilization of $[redacted] of its net operating loss carryforwards is limited to $[redacted] annually due to a greater than 50% change in ownership that occurred during the year ended December 31, 1996. Additionally, utilization of net operating loss carryforwards may be further limited in the event there is another change in control.

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(9) Preferred Stock

In November 1997, the Company entered into a Preferred Stock Purchase Agreement (the Agreement) whereby the Company sold to WorldCom 9.1 shares of Series A and 60 shares of Series B convertible preferred stock of the Company for [redacted] share. In exchange for all the Series A and Series B shares the [redacted] convertible debentures held by WorldCom and [redacted] payable to WorldCom, respectively, were canceled. Management believes the fair value of the preferred shares approximates the fair value of the liabilities canceled.

These shares carry the right to cumulative annual dividends in the amount of [redacted]er share. In the event of liquidation of the Company, the holders of these shares will receive an amount equal to the sum of [redacted]r share and any accrued but unpaid dividends before any amount is paid to holders of common stock of the Company.

Each Series A and Series B share is convertible into [redacted]es and [redacted]hares, respectively, of common stock of the Company at January 1, 1998. This conversion right extends until the earlier to occur of (i) June 30, 1998 or (ii) an underwritten public offering pursuant to an effective registration statement under the Securities Act of 1933, as amended, covering the offer and sale of common stock for the account of the Company to the public with an aggregate offering price to the public of not less than [redacted]

In the event of an initial public offering with an aggregate offering price of not less than [redacted] a similar event of the Company, if the value of the common stock into which the Series B convertible preferred stock is either convertible or has already been converted is worth less than the then applicable Series B conversion price, then the Company shall pay to the shareholder the difference between the value and the Series B conversion price.

(10) Employee Benefits

Effective April 1, 1996, the Company established a profit sharing plan qualified under Section 401(k) of the Internal Revenue Code. Under the profit sharing plan, the Company provides funds to match 25% of the contribution made by the participating employee up to a maximum of 4% of the employee's compensation. The Company may also make additional contributions at the discretion of management. Contributions to the profit sharing plan were approximately [redacted] and [redacted] 1997 and 1996, respectively.

(10) Employee Benefits (Continued)

The Company had a Phantom Stock Plan (the Plan) in effect for certain key employees who contributed to the Company's success. The Plan provided for the granting of a maximum of 50 bonus units to participants designated by the Board of Directors. Bonus units were granted at an exercise price of $100 each, were exercisable during a ten year period beginning on the grant date, and were fully vested upon the grant date. On December 31 of each year, the Company agreed to pay the participants cash bonuses equal to the dividends, if any, they would have received on bonus units equivalent to the shares the participants would have owned if such bonus units were shares of the Company's common stock. Upon exercise of vested bonus units, the Company would pay the participant the cash equivalent equal to the difference between the fair value (as defined in the Plan) of the Company's then outstanding common stock minus the grant price. At December 31, 1996, twenty-two bonus units were outstanding. No bonus units were exercised during 1996. During the first quarter of 1997, the Plan was terminated, and all amounts accrued under the Plan were distributed to the participants thereunder. Expenses of the Plan amounted to [redacted] [redacted] or 1997, 1996 and 1995, respectively.

In 1997, the Board of Directors approved a non-qualified stock option plan which permits the issuance of options to purchase shares of common stock to be granted to certain key employees of the Company at not less than 85% of fair market value at the date of grant. The number of shares allowed to be purchased with options combined with the current amount of shares outstanding shall not exceed the total number of shares authorized, which is 2,000 at December 31, 1997. Options granted under the plan have 10-year terms. Certain options vest on the date of grant while others vest ratably over two and three year periods.

(10) Employee Benefits (Continued)

The Company applies Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations in accounting for its plan. Accordingly, no compensation expense has been recognized for the stock option plan. Had compensation cost for the Company's stock options granted in 1997 been determined under the fair value approach described in Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*, the Company's net loss and basic loss per common share would have increased to the pro forma amounts indicated below:

	December 31, 1997 As reported	December 31, 1997 Pro Forma
Net loss available to common shareholders	$ [redacted]	$ [redacted]
Basic loss per common share		

The fair value of the option grants are estimated as of the date of the grant by calculating the present value of the exercise price using a risk free interest rate of 5.75% and an expected life of 5 years.

A summary of the status of the Company's stock option plan as of December 31, 1997 is presented below:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Life
Outstanding at January 1, 1997	-	N/A	N/A
Granted	69.5	$ 16,000	10 years
Forfeited	(3.6)	16,000	N/A
Exercised	(49.0)	16,000	N/A
Outstanding at December 31, 1997	16.9	$ 16,000	9.04 years
Exercisable at December 31, 1997	0.0	N/A	N/A

The weighted average fair value of options granted in 1997 was $[redacted]

(Continued)

(11) Commitments and Contingencies

The Company leases its corporate headquarters under operating leases expiring in 1999 and 2002. Rental expense for all operating leases during the years ended December 31, 1997, 1996 and 1995 amounted to approximately [redacted] $[redacted] and [redacted]espectively.

Future minimum payments under noncancelable leases as of December 31, 1997 are as follows:

Year ending December 31,	Capital Leases	Operating Leases
1998	$ [redacted]	[redacted]
1999	[redacted]	[redacted]
2000	[redacted]	[redacted]
2001	[redacted]	[redacted]
2002	[redacted]	[redacted]
Net minimum lease payments under capital leases	[redacted]	
Less amount representing interest	[redacted]	
Present value of minimum lease payments under capital leases	$ [redacted]	

The Company's financial statements do not reflect various commitments and contingent liabilities which arise in the normal course of business. These include informal lines of credit extended to agents with an available balance of approximately $0 and $142,000 at December 31, 1997 and 1996, respectively. The amount of collateral obtained, if deemed necessary, is based upon management's credit evaluation of the agent.

The Company's contractual relationship with its agents is governed by the agent agreements described in note 2. The structure of the Company's relationship with its agents may, under certain circumstances, be deemed to create a franchisor/franchisee relationship. The Company believes it has taken appropriate steps to assure that its agent relationships comply with applicable state and federal laws. However, there can be no assurance that state and federal regulatory authorities or individual agents will not raise material issues with regard to the Company's prior compliance with applicable state and federal laws and that such matters will not have a material adverse effect on the Company's financial position or results of operations.

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(11) Commitments and Contingencies (Continued)

During 1997, the Florida Public Service Commission (the "Commission") initiated an investigation alleging the Company of "slamming". Slamming is charging a person's long distance carrier without permission. The Company made a settlement offer in the amount of $150,000 and if not accepted by the Commission, the Company intends to defend this matter vigorously. Management believes that any claims asserted as a result of this matter will not have a material adverse effect on the financial position or results of operations of the Company.

As of December 31, 1997, there were other pending legal actions and proceedings against the Company which arise in the normal course of business and in which claims for damages are asserted. Management believes that the ultimate result of these legal actions and proceedings will not have a material adverse effect on the financial position or results of operations of the Company.

The Company entered into a Notes Purchase Agreement (the Agreement) on January 1, 1997 with Agent Financial Services, LLC (AFS), a company managed and owned by certain shareholders of the Company, to exchange approximately [redacted] of its notes receivable (the Notes) for cash in the same amount. Under the [redacted] AFS will administer the Notes and intends to provide additional credit (the New Notes) to certain UniDial agents as determined by established credit standards. In connection with the Agreement, the Company guarantees the collection of the Notes and New Notes up to a maximum of [redacted] the aggregate plus accrued interest and any costs incurred during the collection process. The Company's guaranty of collection continues as long as there are notes and advances outstanding as defined in the Agreement. The Company also guarantees a [redacted] of credit granted to AFS on February 25, 1997. The line of credit is used by AFS to fund the New Notes. As of December 31, 1997, outstanding Notes and New Notes issued by AFS amounted to [redacted] and borrowings under the line of credit amounted to [redacted] The Company does not believe any loss has occurred in connection with the Notes, New Notes or the line of credit which would have a material impact on the financial condition or results of operations of the Company.

(11) Commitments and Contingencies (Continued)

In 1997, the Company issued stock options to AFS and an employee of AFS in connection with the Agreement. The option issued to AFS is for ten shares of common stock of the Company, exercisable immediately up to five years from the grant date at a price of [redacted] This option may not be partially exercised and is outstanding at December 31, 1997. The option issued to the employee of AFS is for 2.5 shares of common stock of the Company, exercisable in whole or in part immediately up to ten years from the grant date at a price of $16,000 per share. During 1997, the option issued to the employee of AFS was partially exercised to purchase one share of common stock.

(12) Year 2000 Risks

The Company is aware of the issues associated with the programming code in existing computer systems as the Year 2000 approaches. The Year 2000 problem arises when computer programs use two digits rather than four to define the applicable year. Some systems may treat the Year 2000 as the Year 1900. This could result in a major system failure or miscalculations. The Company developed its primary billing and customer service systems internally over the past four years and believes that they are Year 2000 compliant. Other networking and interfacing programs which are affected by the Year 2000 are utilized by the Company to operate its day-to-day business. Most of these systems use software developed by and licensed from third party software vendors. The Company is utilizing both internal and external resources to identify, correct, and test the Company's systems for Year 2000 compliance. The Company is actively managing all of its third party software vendors to determine that software corrections and warranty commitments are obtained. The Company relies on information from its carriers and other vendors and believes the primary carriers and vendors are currently on schedule to meet the Company's Year 2000 timetable. The Company believes that mission critical applications are Year 2000 compliant. Most of the systems testing will be completed in 1998, with the remainder scheduled to be completed during the second quarter of 1999. The Company believes that the costs associated with Year 2000 compliance will be absorbed in routine annual software maintenance contracts and are not likely to be incremental costs to the Company.

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Notes to Financial Statements

(13) New Accounting Pronouncements

In June 1997, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 130, *Reporting Comprehensive Income* ("SFAS 130") and Statement of Financial Accounting Standards No. 131, *Disclosures about Segments of an Enterprise and Related Information* ("SFAS 131"). SFAS 130 defines comprehensive income as the change in equity (net assets) of a business enterprise during a period from transactions and other events and circumstances from non-owner sources. The Statement requires comprehensive income to be reported in financial statements that is displayed with the same prominence as other financial statements. This Statement is effective for fiscal years beginning after December 15, 1997. The Company does not expect the implementation of this Statement to have a material effect on the financial statements.

SFAS 131 changes the way public companies report information about segments of their business in their annual financial statements and requires them to report selected segment information in their quarterly report to shareholders. SFAS 131 requires that companies disclose segment data based on how management makes decisions about allocating resources to segments and measuring their performance. SFAS 131 is effective in 1998. In the initial year of application, SFAS 131 is not required to be applied to interim periods. The Company does not expect the implementation of SFAS 131 to have a material effect on the financial statements.

(14) Subsequent Event

On April 24, 1998, the Company entered into an Agreement and Plan of Merger to acquire all of the outstanding stock of MetraCom Corporation in exchange for $4.5 million in cash and shares of common stock of the Company with a value of $4.5 million. MetraCom is a non-facilities-based reseller of local and long distance phone services that currently resells Bell Atlantic's local service and Sprint's long distance service in various northeastern states. The closing of the acquisition is subject to the completion of several conditions, and is expected to occur in the third quarter of 1998.