

MPHASE TECHNOLOGIES INC  
Form S-1  
August 09, 2005

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As filed with the Securities and Exchange Commission on August 8, 2005

Registration No. 333-

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

## FORM S-1

REGISTRATION STATEMENT  
UNDER THE SECURITIES ACT OF 1933

mPHASE TECHNOLOGIES, INC.

(Exact name of registrant as specified in its charter)

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

**7385**  
(Primary Standard Industrial  
Classification Code Number)  
587 Connecticut Avenue  
Norwalk, Connecticut 06854-1711  
Telephone: (203) 838-2741

**22-2287503**  
(I.R.S. Employer  
Identification Number)

(Address, including zip code, and telephone number, including area code, of registrant's principal executive offices)

Martin S. Smiley  
Chief Financial Officer  
mPHASE TECHNOLOGIES, INC.  
587 Connecticut Avenue  
Norwalk, Connecticut 06854-1711  
Telephone: (203) 831-2242  
Telecopy: (203) 853-3304

(Name, address, including zip code, and telephone number, including area code, of agent for service)

Approximate date of commencement of proposed sale to the public: As soon as practicable after the effective date of this Registration Statement.

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the

Securities Act of 1933, check the following box.

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If this form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering.

If this form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering.

If this form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering.

If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box.

**CALCULATION OF REGISTRATION FEE**

Title of each class of securities to be registered	Amount to be Registered	Proposed maximum offering price per share(1)	Proposed maximum aggregate offering price(1)	Amount of Registration fee
<b>Stock, \$.01 par value</b>	<b>38,230,800</b>	<b>\$.25</b>	<b>\$9,557,700</b>	<b>\$1,180</b>

(1) Estimated solely for the purpose of calculating the registration fee pursuant to Rule 457(c) under the Securities Act of 1933, as amended, on the basis of the average of the bid and ask prices per share of our common stock, as reported on the OTC Bulletin Board, on August 4, 2005.

THE REGISTRANT HEREBY AMENDS THIS REGISTRATION STATEMENT ON SUCH DATE OR DATES AS MAY BE NECESSARY TO DELAY ITS EFFECTIVE DATE UNTIL THE REGISTRANT SHALL FILE A FURTHER AMENDMENT WHICH SPECIFICALLY STATES THAT THIS REGISTRATION STATEMENT SHALL THEREAFTER BECOME EFFECTIVE IN ACCORDANCE WITH SECTION 8(A) OF THE SECURITIES ACT OF 1933, AS AMENDED, OR UNTIL THIS REGISTRATION STATEMENT SHALL BECOME EFFECTIVE ON SUCH DATE AS THE COMMISSION, ACTING PURSUANT TO SUCH SECTION 8(A), MAY DETERMINE.

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August 8, 2005

PROSPECTUS  
mPHASE TECHNOLOGIES, INC.

38,230,800 Shares of Common Stock

This prospectus relates to the resale of up to 38,230,800 shares of common stock, of which 22,029,300 shares are issued and outstanding and up to 16,201,500 shares may be issued upon the exercise of warrants and options held by the selling stockholders. The selling stockholders listed on pages 55 - 58 may sell the shares from time to time.

Our common stock is listed on the Over-the-Counter Bulletin Board under the symbol "XDSL.OB" The last reported sales price of our common stock on August 4, 2005 was \$.25 per share.

THESE SECURITIES ARE SPECULATIVE AND INVOLVE A HIGH DEGREE OF RISK. PLEASE REFER TO "RISK FACTORS" BEGINNING ON PAGE 8.

Our principal executive offices are located at 587 Connecticut Avenue, Norwalk, Connecticut 06854-1711. Our phone number is (203) 838-2741.

NEITHER THE SECURITIES AND EXCHANGE COMMISSION NOR ANY OTHER REGULATORY BODY HAS APPROVED OR DISAPPROVED ANY OF THESE SECURITIES OR PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

The date of this prospectus is August 8, 2005

TABLE OF CONTENTS

	<b>Page</b>
<b>Prospectus Summary</b>	<b>1</b>
<b>The Offering</b>	<b>4</b>
<b>Forward-Looking Statements</b>	<b>4</b>
<b>Summary Financial Data</b>	<b>6</b>
<b>Risk Factors</b>	<b>8</b>
<b>Use of Proceeds</b>	<b>11</b>
<b>Price Range of Common Stock</b>	<b>12</b>
<b>Selected Financial Data</b>	<b>13</b>
<b>Selected Quarterly Financial Data</b>	<b>14</b>
<b>Company Operations</b>	<b>17</b>
<b>Business</b>	<b>36</b>
<b>Legal Proceedings</b>	<b>52</b>
<b>Our Management</b>	<b>52</b>
<b>Stock Options</b>	<b>55</b>
<b>Security Ownership of Certain Beneficial Owners and Management</b>	<b>58</b>
<b>Certain Relationships and Related Transactions</b>	<b>60</b>
<b>Selling Stockholders</b>	<b>66</b>
<b>Plan of Distribution</b>	<b>72</b>
<b>Description of Securities</b>	<b>74</b>
<b>Legal Matters</b>	<b>75</b>
<b>Experts</b>	<b>76</b>
<b>Where You Can Find Additional Information</b>	<b>76</b>

YOU SHOULD RELY ONLY ON THE INFORMATION CONTAINED IN THIS DOCUMENT OR THOSE DOCUMENTS TO WHICH WE HAVE REFERRED YOU. WE HAVE NOT AUTHORIZED ANYONE TO PROVIDE YOU WITH INFORMATION THAT IS DIFFERENT. THIS DOCUMENT MAY ONLY BE USED

WHERE IT IS LEGAL TO SELL THESE SECURITIES.

THE DELIVERY OF THIS PROSPECTUS OR ANY ACCOMPANYING SALE DOES NOT IMPLY THAT: (1) THERE HAVE BEEN NO CHANGES IN OUR AFFAIRS AFTER THE DATE OF THIS PROSPECTUS; OR (2) THE INFORMATION CONTAINED IN THIS PROSPECTUS IS CORRECT AFTER THE DATE OF THIS PROSPECTUS.

#### PROSPECTUS SUMMARY

You should read this Prospectus Summary together with the more detailed information contained in this prospectus, including the risk factors and financial statements and the notes to the financial statements. This prospectus contains forward-looking statements that involve risks and uncertainties. Our actual results may differ materially from those discussed in the forward-looking statements. Factors that might cause such a difference include those discussed in the Risk Factors section and elsewhere in this prospectus.

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From inception (October 2, 1996), through March 31, 2004 the Company had incurred (unaudited) development stage losses and has an accumulated deficit of approximately \$125,259,323 million and a stockholders' deficit of approximately \$2,537,180 respectively. Cumulatively, through June 30, 2004 and March 31, 2005, (unaudited) the Company had negative cash flows from operations of approximately \$47.8 million and \$54.1 million respectively. The auditors report for the fiscal year ended June 30, 2004 is qualified as to the Company's ability to continue as a going concern. Management estimates the Company needs to raise between \$5 million and \$10 million during the next 12 months to sustain its current level of operations.

#### mPHASE TECHNOLOGIES, INC.

mPhase Technologies, Inc. (mPhase, the Company, we or us), a New Jersey corporation, founded in 1996 is a publicly-held company with approximately 14,830 shareholders and approximately 141 million shares of common stock outstanding as of July 26, 2005. The Company's common stock is traded on the NASDAQ Over the Counter Bulletin Board under the ticker symbol XDSL. We are headquartered in Norwalk, Connecticut with offices in Little Falls, New Jersey and New York, N.Y. mPhase shares common office space and common management with Microphase Corporation, a privately-held company. Microphase sells radio frequency and filtering technologies to the defense and telecommunications industry. Microphase has been in operation for 50 years and supports mPhase with engineering, administrative and financial resources, as needed.

mPhase is a developer of broadband communications products, specifically, middleware, set top boxes and systems integration solutions for the delivery of broadcast quality television, video on demand, high speed internet and voice utilizing internet protocol. (IPTV) mPhase's believes that Release 3.0 of its TV+ solution, scheduled for September of 2005 is the most cost-effective, standards based, scalable solution with carrier class quality and security available for telecommunications service providers around the world. mPhase believes that telecommunication service providers in countries outside of the United States that generally lack extensive fiber to the home infrastructure will find the Company's TV+ solution as an attractive way to retain traditional telephone customers by offering a full package of services. The TV+ solution is designed to enable telecommunication service providers to solve the "last mile" from a central office location to a customer over any existing infrastructure including copper, fiber or coax. Version 3.0 of the TV+ solution is a culmination of years of development of a world class television delivery solution for telecommunication service providers. The Company also develops and sells DSL products including "intelligent" POTS Splitter DSL loop diagnostic systems and Plain Old Telephone Service (POTS) Splitters necessary to split a telephone signal into a high frequency digital and low digital data component and low frequency analog voice component necessary for a telephone service provider to provide high-speed internet services over copper from its central office to its customer's premises. Since our inception in 1996 we have been a development-stage company.

In February of 2004, the Company entered into the field of Nanotechnology research and development of micro power cell batteries of various voltages. The initial goal is to develop batteries for military applications having significantly longer shelf life prior to activation, instant on capabilities due to their extremely small internal size, and power management capabilities to significantly extend their duty cycle periods than are currently available in the market. The Company believes that such development is consistent with its strategy of being a pioneer in areas of high growth technology and potentially diversifies its mix of products. On March 11, 2005 the Company announced that it had expanded its nanotechnology research and efforts to develop extremely sensitive uncooled magnetic sensors, commonly known as a magnetometer, as a new product line.

#### **IPTV Solution**

Our primary activities currently consist of designing, manufacturing and testing Release 3.0 of our TV+ middleware solution and next generation set top box designed as the key ingredients for the deliver of IP (Internet Protocol) based broadcast television over a telephone service providers existing infrastructure including copper, fiber and coaxial networks or combinations thereof. We have not, as yet, derived significant sales revenue from our TV+ solution. Our solutions facilitate telephone companies becoming full service communications providers by enabling the

simultaneous delivery of digital broadcast television, stored video from network based servers, high -speed data and voice services over the existing infrastructure and topology. mPhase has developed Release 3.0 of its TV+ solution primarily for telephone companies in parts of the world where access to multi-channel television is limited. We have engaged the Bell Labs division of Lucent Technologies Inc. to develop portions of our TV+ solution as well as to perform exploratory research with respect to our nanotechnology product development.

mPhase is a pioneer in the field of development of solutions for the delivery of television, high speed internet and voice by telecommunications service providers from such provider's central offices to its customers. This has been commonly referred to as the "last mile to the home solution" for delivery of a full menu of services to a customer that the Company believes is compelling where the existing infrastructure of a service provider is composed of copper wires rather than fiber in the "last mile to the house. Such infrastructure is found primarily outside of the United States, since (except for rural areas) most areas of significant population in the United States contains significant fiber to the home infrastructure. mPhase introduced its first TV over DSL platform, the Traverser Digital Video and Data Delivery System (DVDDS) in 1998. The DVDDS, is a patented end-to-end system that enables a telecommunications service provider to deliver up to several hundred channels of motion picture experts group two (MPEG-2) standard broadcast digital television, high speed internet and plain old telephone service (POTS) over copper telephone lines between a central office facility (CO) of the provider and a customer's premise. mPhase has not, derived any material revenues from sales of the DVDDS and has replaced the product with the newer TV+ solution. The DVDDS is a proprietary technology developed in conjunction with Georgia Tech Research Corporation (GTRC) that allows for the delivery of any television channel to all users at any given time without a dilution in quality. The system is the only system that utilizes non-internet protocol for the delivery of broadcast television over Asymmetric DSL (ADSL). The DVDDS was installed for serving over 80 customers at Hart Telephone Company in Hartwell, Georgia, as a limited user beta system was operational. A DVDDS system is also installed at the BMW manufacturing plant in Spartanburg, South Carolina for use as a telebroadcast system in a commercial setting.

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The new mPhase TV+ solution replaced the legacy Traverser DVDDS system and is developed in conjunction with Bell Laboratories division of Lucent Technologies, Inc. The TV+ solution marks a change in the Company's product emphasis from a proprietary end to end solution designed to deliver television over DSL as a solution for telephone companies that had copper from their central offices to their customer premises. The TV+ system was developed as an outgrowth of mPhase's engagement of Bell Labs in fiscal year 2003 to cost reduce mPhase's set top box that operated with the legacy DVDDS system developed by GTRC. The TV+ system replaces the DVDDS system with an open industry standards-based platform. Releases 1 and 2 (containing an enhanced programming guide) of the mPhaseTV+ system are complete and ready for commercial deployment and Release 3.0 is due to be released during September of 2005. Releases 1.0 and 2.0 of the TV+ system each deliver 255 broadcast television channels over ADSL and utilizes an industry-leading, standards-based Lucent Technologies, Inc.'s Stinger DSL Access Concentrator (DSLAM) for transport of digital television plus high speed internet and voice. The mPhase TV+ system consists of a powerful software platform and a cost reduced set top box located in a telephone customer's premises plus the Lucent

Stinger located at the Central Office of a telecommunications service provider or in the loop servicing the customer.

Release 1.0 and 2.0 of the TV+ solution provides comprehensive end to end management of delivery of digital broadcast television by interfacing with the Stinger and a video headend built by a telephone service provider to downlink broadcast television programming from satellites. mPhase software manages the broadcast television compressed data prior to the distribution to a customer by the Stinger and supports administrative tasks associated with subscriber management. The use of the Lucent Stinger for transport in the TV+ system results in a highly reliable architecture for the delivery of broadcast television. This is accomplished by internally multicasting each television channel for delivery from the central office of a telecommunications service provider to a larger number of end users. Release 2.0 of the TV+ system is capable of distributing 255 channels of broadcast television simultaneously to 455 customers by one Lucent Stinger DSLAM concentrator. We believe that the TV+ platform is a reliable standards-based solution for delivery of broadcast television using ADSL. For mPhase the alliance with Lucent marks a change in strategy from selling a complete proprietary platform to providing an industry-standards solution.

As noted above, the Company believes that the demand for the TV+ system will be greatest in markets primarily outside of the United States that do not have a hybrid fiber coaxial cable ("HFC") infrastructure necessary for cable TV or fiber to the curb necessary for very fast DSL (VDSL).

In December of 2004, the Company announced that Lucent Russia selected the mPhase TV+ solution to deploy to 1000 customers of one of seven regional telecommunications operators in Russia that are part of a Russian Holding Company with over 15 million customers. Installation of the broadcast television switch (the "BTS") software as well as mPhase's set top box is expected to begin in September of 2005 and be completed by the end of December of 2005. In December of 2004, the Company also announced that it had reached agreement with Beyaz Holding Company, an owner of Turkey's leading television news and entertainment station to provide technology for the introduction of an array of new digital television services throughout Turkey.

Release 3.0 of the TV+ solution marks the culmination of mPhase's 7 year effort to develop a world class solution for telecommunication service providers seeking to provide carrier class, highly scaleable and cost effective delivery of feature rich broadcast television over its existing infrastructure. Release 3.0 of the TV+ solution consist of a state of the art middleware system that enables a telecommunication service provider seeking to delivery feature rich broadcast television over ANY infrastructure including fiber, copper, coaxial solution or any combination of the foregoing to its customers. The Company is also developing a next generation set top box designed to further enhance its overall product solution. It is important to note, however that the middleware that is the key solutions ingredient is designed to work with the DSLAM or other transportation technologies plus any set top box as a completely OPEN STANDARDS BASED solution. Our middleware is transport agnostic and operates with any IP based network including any DSL, ethernet or fiber infrastructure or combination thereof and may be deployed IP Multicast Router or DSLAM transportation method used for the delivery of digital television and high-speed data.

Furthermore Release 3.0 of the TV+ solution utilizes a communications framework based upon Internet Protocol (IP) instead of Asynchronous Transfer Mode (ATM) that is utilized by Releases 1.0 and 2.1. ATM is an industry standard for transportation of data based upon a packaging of information into a fixed-size cell format for transportation across networks. Many telecommunications service providers currently deploy equipment that handles this protocol because it can support voice, video, data and multimedia applications simultaneously with a high degree of reliability. IP is another transport protocol that maintains network information and routes packets across networks. IP packets are larger and can hold more data than ATM cells. Historically, there have been concerns that service providers would be unable to provide the same quality of service with IP because it is not optimized for time-sensitive signals such as broadcast television and voice. Nevertheless, there is a greater demand by telecommunication service providers for IP systems for delivery of television, voice and high-speed data because such systems are significantly more cost effective to deploy based upon greater scalability.

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Release 3.0 of the TV+ system consists primarily of highly scalable system management software/middleware designed to deliver IP television, video on demand, high speed internet and voice over both fiber and copper infrastructures of a telephone service provider. As noted above it will operate with both the Lucent Stinger as well as the DSLAM's of other major vendors. Release 3.0 of the TV+ solution will also be able to send multiple TV channels down a single DSL line using ADSL2. The Company believes that the current TV+ solution offers the premiere solution in IPTV that telecommunications service providers are seeking for the delivery of converged services to preserve and enhance their traditional telephone voice delivery capabilities and compete against cable and satellite technologies for delivery of converged services to their traditional customers.

In those television markets in the United States that are not served by HFC, we believe that the availability of programming content is essential to facilitate potential sales of our systems enabling delivery of broadcast television over ADSL. In March of 2000, we established mPhase Television net., Inc. (mPhase TV), a joint venture between mPhase and Alphastar International, Inc in which mPhase owns approximately 57% of. Through such joint venture mPhase TV has compiled significant experienced in negotiation contracts with broadcast television programming providers for U.S. markets. Such experience should prove useful in assisting a U.S. telecommunications service provider to arrange contact packages with various content providers of broadcast television.

#### NanoTechnology Products

Effective February 3, 2004, mPhase entered into a 12 month research and development agreement with the Bell Labs division of Lucent Technologies, Inc. to develop micro power cell battery arrays employing nantextured superhydrophobic materials for \$1.2 million. In March of 2005, the Company has extended the contract with Lucent for another 12 months at approximately the same cost to continue development of such product, with additional agreements to extend our relationship with Lucent Bell Labs on an ongoing basis past this period. Under the terms of the contract, the Company will share in royalties from any licensing of the products developed with Lucent.

mPhase believes that the initial market for the product will be military applications. A first generation laboratory feasibility prototype of the product was completed during the second quarter in fiscal year 2005.

On March 11, 2005, the Company announced that it had entered into a new 12 month research and development agreement with the Bell Labs division of Lucent Technologies Inc at a cost of approximately \$1.2 million to co-develop and commercialize uncooled magnetic ultra-sensitive sensors for a host of defense and civilian applications. The sensors, technically referred to as magnetometers, are based upon Micro Electro Mechanical Systems (MEMS), and are being designed to create a new generation of uncooled ultra sensitive magnetic field sensors.

#### mPhase DSL Component Products

Although the Company has changed significantly with respect to its telecommunications solutions from a hardware to a software provider, mPhase continues to design and markets a line of DSL component products ranging from items such as Plain Old Telephone Service (POTS) splitters to innovative loop management products. From our inception in 1996 to date virtually all of mPhase's revenue has been derived from sales of our DSL products such as POTS splitters and low pass filters.

Our newest innovation in our suite of DSL component products is our

*i*POTS or Intelligent POTS splitter product. This product enables telephone service providers comprehensive remote and automated test access to all elements of a DSL network. The *i*POTS, and *i*POTS3 allow a telephone service provider to bypass POTS splitters on a DSL network and avoid having to manually intervene and disrupt line usage so a test signal can pass through a DSL network. This product marks an advancement in automating DSL loop management. As DSL deployments increase, it is becoming more important for telecommunications service providers to streamline the process for rolling-out and troubleshooting DSL services. Additionally, as competition for high speed Internet expands, the market is witnessing a reduction in the price for such service. Therefore, it has become imperative that telecommunications service providers

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lower the operational costs involved with deploying and supporting DSL services. Currently our *POTS* is designed for use with the Lucent Stinger, whereas, the *POTS3* (recently renamed the Broadband Loop Watch product) is compatible with digital subscriber line access multiplexers (data transport devices or DSLAM's) manufactured by other vendors.

In November of 2004, the Company announced that Lucent Technologies Saudi Arabia's telecommunications deployment selected the Company's Broadband Loop Watch product. The broadband loop management system is designed to reduce operating and maintenance expenses associated with DSL deployments by telecommunications service providers. The first delivery of such product is expected during the beginning of the second quarter of fiscal year 2006.

For the year ending June 30, 2004 sales from our POTS Splitter Shelves were \$4,641,346 with a Net Loss of \$7,758,586 as compared to POTS Splitter Shelf sales of \$351,027 and a Net Loss of \$6,650,211 for the fiscal year ended June 30, 2003. For the nine months ending March 31, 2005 (unaudited), sales from POTS Splitter Shelves and our TV + platform totaled \$1,039,003 with a Net Loss of \$9,484,240 compared to sales (exclusively of POTS SPLITTERS) of \$4,335,476 and a Net Loss of \$4,889,771 for the same period ending March 31, 2004. (See Financial Statements which commence on page F-1.)

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## THE OFFERING

Common stock offered: Up to 38,230,800 shares of common stock, of which 22,029,300 shares are issued and outstanding and up to 16,201,500 shares may be issued pursuant to convertible notes and upon exercise of warrants and options held by the selling stockholders.

Common Stock to be outstanding after this offering: Approximately 178 million shares of common stock. This does not include an aggregate of approximately 110 million shares that are reserved for issuance pursuant to convertible notes, outstanding employee stock options, non-employee stock options and warrants.

Use of proceeds: We will not receive any proceeds from the sale and issuance of the common stock included in this offering. However, we will receive approximately \$4,075,375 upon the exercise of all of the warrants and options by the selling stockholders, which would be used for general working capital.

Risk Factors: An investment in our common stock is subject to significant risks. You should carefully consider the information set forth in the "Risk Factors" section of this prospectus as well as other information set forth in this prospectus, including our financial statements and related notes.

Dividend policy: We do not expect to pay dividends on our common stock in the foreseeable future. We anticipate that all future earnings, if any, generated from operations will be retained to develop and expand our business.

Plan of Distribution: The shares of common stock (OTC Bulletin Board symbol: XDSDL.OB) offered for resale may be sold by the selling stockholders pursuant to this prospectus in the manner described under "Plan of Distribution."

We have applied for trademarks on certain marks which relate to our products. This prospectus also contains product names, trade names and trademarks of ours as well as those of other organizations. All other brand names and trademarks appearing in this prospectus are the property of their respective holders.

## FORWARD-LOOKING STATEMENTS

In addition to the other information contained in this prospectus, investors should carefully consider the risk factors disclosed in this prospectus, including those beginning on page 12, in evaluating an investment in our common stock. This prospectus includes "forward-looking statements". All statements other than statements of historical fact are "forward-looking statements" for purposes of these provisions, including any projections of earnings, revenues or other financial items, any statements of the plans and objectives of management for future operations, any statements concerning proposed new products or services, any statements regarding future economic conditions or performance, and any statement of assumptions underlying any of the foregoing. In some cases, forward-looking statements can be identified by the use of terminology such as "may", "will", "expects", "plans", "anticipates", "estimates", "potential", or "continue" or the negative thereof or other comparable terminology.

Although we believe that the expectations reflected in the forward-looking statements contained herein and in such incorporated documents are reasonable, there can be no assurance that such expectations or any of the forward-looking statements will prove to be correct, and actual results could differ materially from those projected or assumed in the forward-looking statements. Our future financial condition and results of operations, as well as any forward-looking statements, are subject to inherent risks and uncertainties, including but not limited to the risk factors set forth above and for the reasons described elsewhere in this prospectus. All forward-looking statements and reasons why results may differ included in this prospectus are made as of the date hereof, and we assume no obligation to update any such forward-looking statement or reason why actual results might differ.

## SUMMARY FINANCIAL DATA

The summary financial data set forth below should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the historical consolidated financial statements and notes included in this prospectus. The statements of operations data from October 2, 1996 (date of inception) to June 30, 1998 are derived from financial statements that have been audited by (i) Schuhalter, Coughlin & Suozzo, PC, independent auditors from inception to June 30, 1998, and (ii) by Arthur Andersen for the years ended 1999, 2000 and 2001 included in this prospectus. The statement of operations data for the year ended June 30, 2002, June 30, 2003 and June 30, 2004 are derived from the financial statements that have been audited by Rosenberg, Rich, Baker, Berman & Company in this prospectus.

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Year Ended June 30,  
(in thousands except per share data)

STATEMENT OF	2000	2001	2002	2003	2004	Cumulative from inception October 2, 1996 to June 30, 2004
<b>OPERATIONS DATA:</b>						
Total revenues	\$ 279	\$ 10,524	\$ 2,582	\$ 1,582	\$ 4,641	\$ 19,609
Costs and Expenses:						
Cost of sales	132	5,805	2,415	1,493	4,270	14,115
Research and development	10,157	10,780	3,820	3,538	3,928	38,275
General and administrative	27,859	17,322	7,039	2,684	4,118	78,995
Depreciation and amortization	471	660	670	515	123	2,889
Operating loss	(38,340)	(24,043)	(11,361)	(6,649)	(7,798)	(114,666)
Other income (expense), net	20	-	142	50	150	(1,104)
Interest income (expense)	158	43	(26)	(51)	(111)	5
Net loss	\$ (38,162)	\$ (24,000)	\$ (11,245)	\$ (6,650)	\$ (7,759)	\$ (115,775)
Basic and diluted net loss per share	\$ (1.41)	\$ (.72)	\$ (.23)	\$ (.10)	\$ (.10)	
Shares used in basic and diluted net loss per share	26,974,997	33,436,641	49,617,280	65,217,088	77,677,120	

\* Does not include any common stock equivalents since their effect would be anti-dilutive.

Year ended June 30  
(in thousand)

	2000	2001	2002	2003	2004
<b>BALANCE SHEET DATA:</b>					
Cash and cash equivalents	\$ 6,432	\$ 31	\$ 47	\$ 397	\$ 90
Working capital (deficit)	3,557	(1,458)	(94)	(1,405)	(2,112)
Total assets	11,184	8,997	6,942	3,782	2,591
Long-term obligations, net of current portion	-	90	2,891	2,608	1,038
Total stockholders' equity (deficit)	\$ 7,329	\$ 1,865	\$ (42)	\$ (3,229)	\$ (2,918)

As of  
March  
31, 2005  
(Unaudited)  
(in thousands)

**BALANCE SHEET DATA:**

Cash and cash equivalents	\$238
Working capital (deficit)	\$(2,332)

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Total assets	\$2,319
Long-term obligations, net of current portion	\$561
Total stockholders' equity (deficit)	\$(2,537)

The balance sheet data as of June 30, 2003 and 2004 is derived from the financial statements that have been audited by Rosenberg, Rich, Baker, Berman & Company in this prospectus and the balance sheet data for March 31, 2005, and include all adjustments (consisting of normal recurring items) that management considers necessary for a fair presentation of the financial statements have been derived from the unaudited financial statements reviewed by Rosenberg, Rich, Baker, Berman & Company included in this prospectus.

The statement of operations data for the nine months ended March 31, 2005 and March 31, 2004 have been derived from the unaudited financial statements reviewed by Rosenberg, Rich Baker Berman & Company included in this prospectus and include all adjustments (consisting of normal recurring items) that management considers necessary for a fair presentation of the financial statements. The (unaudited) results for the nine month period ended March 31, 2005 are not necessarily indicative of the operating results to be expected in the future.

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	2004	Nine Months Ended March 31, 2005	Cumulative Totals From Inception (October 2, 1996) to March 31, 2005
	(Unaudited)	(Unaudited)	(Unaudited)
Total revenues	\$4,335	\$1,039	20,649
Expenses:			
Cost of sales	3,878	823	14,736
Research and development	2,859	3,820	42,237
General and administrative	2,196	5,416	84,471
Depreciation and amortization	101	194	3,084
Operating loss	(4,698)	(9,214)	(123,880)
Other income (expense), net	(201)	(270)	(1,379)
Interest income (expense)	(72)	(132)	(137)
Net loss	\$(4,900)	(9,484)	(125,259)
Basic and diluted net loss per share*	\$(0.07)	\$(0.09)	
Shares used in basic and diluted net loss per share*	75,312,435	101,062,839	

\*Does not include any common stock equivalents since their effect would be anti-dilutive.

## RISK FACTORS

An investment in the common stock offered by this prospectus involves a high degree of risk. In addition to the other information in this prospectus and any supplements to this prospectus, you should carefully consider the following risks before making an investment decision.

### Risks Related to Financial Aspects of Our Business

In fiscal year 2004, the Company entered into the new and emerging business of developing products using the science of Nanotechnology which entails significant exploratory development and commercial risk.

The Company has expended a total of \$1.2 million pursuant to a contract with Lucent Technologies, Inc. to initially develop longer life battery cells for military applications. The Company expects to continue exploratory research with Lucent Technologies, Inc. and has extended its current Development Agreement with Lucent for an additional 12 months at a cost of \$100,000 per month. Even though a feasibility prototype product has been successfully developed, pure research involves a high degree of risk with significant uncertainty as to whether a commercially viable product will result. On March 10, 2005 the Company undertook an additional capital commitment of \$1.2 million to Lucent Technologies Inc for new research and development of uncooled magnetic ultra sensors using the science of Nanotechnology. The Company does not expect significant revenues from either product for at least 3 years.

mPhase's stock price has suffered significant declines during the past five years and remains volatile

The market price of our common stock closed at \$7.88 on July 26, 2000 and closed at \$.247 on July 26, 2005. During such period the number of shares outstanding of the Company increased from approximately 30 million shares to 141 million shares (undiluted) and approximately 245 million shares (full diluted). Such increase was the result of periodic private placements by the Company in order to finance company operations. Stocks in telecommunications equipment

providers of DSL products have been very volatile during such period. Our common stock is a highly speculative investment and is suitable only for such investors with financial resources that enable them to sustain the loss of their entire investment in such stock. Because the price of our common stock is less than \$5.00 per share and is not traded on the NASDAQ National or NASDAQ Small Cap exchanges, it is considered to be a "penny stock" limiting the type of customers that broker/dealers can sell to. Such customers consist only of "established customers" and "Accredited Investors" (within the meaning of Rule 501 of Regulation D of the Securities Act of 1933, as amended-generally individuals and entities of substantial net worth) thereby limiting the liquidity of our common stock.

We have reported net losses for each of our fiscal years from our inception in 1996 and for the nine months (unaudited) ended March 31, 2005 and March 31, 2004 respectively and may not be able to operate profitably in the future.

We have had substantial operating losses since our inception in 1996 (including \$7,758,586 and \$6,650,211 for the fiscal year ended June 30, 2004 and fiscal year ended June 30, 2003, respectively and (unaudited) \$9,484,240 and \$4,889,771 for the nine month period ending March 31, 2005 and March 31, 2004 respectively) and cannot be certain when or if we will ever be profitable. We expect to continue to have net losses for the foreseeable future and have a need to raise not less than \$5-10 million in additional cash in the next 12 months through further offerings to continue operations. We have never been profitable from our inception in October, 1996 through March 31, 2005 (unaudited) and we have incurred (a) accumulated losses of \$125,259,323 and a stockholder's deficit of \$2,537,180 and (b) cumulative negative cash flow of \$54,120,374. As of March 31, 2005 (unaudited) we have a negative net worth of \$2,537,180 and negative working capital of \$2,332,278.

Our independent auditor's report express doubt about our ability to continue as a going concern

The reports of the Company's outside auditors' Rosenberg, Rich, Baker, Berman & Company with respect to its latest audited 10K for

the fiscal years ended June 30, 2004, June 30, 2003 and June 30, 2002 stated that "there is substantial doubt of the Company's ability to continue as a going concern." Such opinion from our outside auditors makes it significantly more difficult and expensive for the Company to raise additional capital necessary to continue our operations.

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**Our common stock is subject to significant dilution upon issuance of shares we have reserved issuance.**

As of July 26, 2005, we have warrants, options and convertible notes outstanding convertible into approximately 100 million total shares of mPhase common stock which, upon conversion, may adversely affect the future price of our common stock. As of July 26, 2005 we have warrants and options convertible into approximately 77 million shares of our common stock at \$.35 per share or less that, upon exercise, will result in significant dilution to many of our current shareholders and may adversely affect the future price of our common stock. As of July 26, 2005, the Company has approximately 1,440,000 shares of common stock reserved for the issuance upon the conversion of a 12% convertible notes to a related party at an average exercise price \$.25 per share which may adversely affect the future price of our common stock. We may be forced to raise additional cash for operations by selling additional shares of our common stock at depressed prices causing further dilution to our shareholders.

#### Risk Factors Related to Our Operations

We have been a development-stage company since our inception in 1996 and have not to date had a significant deployment of any of our solutions for the delivery of broadcast television, high-speed internet and voice by a major telephone service provider.

We have had to date no material revenues derived from sales of either our legacy Traverser Digital Video Data Delivery System (DVDDS) or our TV+ solution or our new Broadband Loop Watch product. There have been to date only one sale of our software and Set Top Boxes for 1000 customers of a telecommunications service provider in Russia that is just commencing deployment of a small group of customers as a trial and no major deployments of Release 2.0 of our TV+ Solution by telephone service providers globally of our products and there currently is uncertainty as to the extent, if at all, that deployments will occur in the future.

We depend upon outsourcing of our research and product development of our television platform and Nanotechnology products to Lucent Technologies Inc.

We depend upon Lucent Technologies Inc. for the successful development of our TV+ product, certain design and software used in our Broadband Loop Watch product and our Nanotechnology products and our business would be materially adversely affected if Lucent Technologies Inc. were to terminate our relationship.

The loss of key personnel could adversely affect our business.

Management and employment contracts with all of our officers have expired and no assurances can be given that such executives will remain with the Company or that the Company will be able to successfully enter into agreements with such key executives. All of our officers and other key employees have been granted stock options that are intended to represent a key component of their compensation. Such options may not provide the intended incentives to such persons if our stock price declines or experiences significant volatility.

Economic support from affiliated companies has been significant.

During the downturn in the telecommunications industry that has continued over the past 4 years, both Microphase Corporation, and Janifast Ltd. had provided significant financial support to mPhase in the form of either cash infusions or conversions of related party debt. Such companies, which share common management with mPhase, are under no legal obligation to and may not be able to sustain such economic support of mPhase in the future should such support be necessary.

Sales and margins from our component DSL products have varied dramatically during the past four years and remains volatile.

Sales and gross margins from our POTS Splitter and other DSL products have experienced a general decline and significant volatility during the period from June 30, 2001 through March 31, 2005 as a result of the significant downturn in capital spending by telecommunications service providers. Sales have declined during each quarter of the fiscal year ended June 30, 2004 and continued to decline during the first quarter of fiscal year 2005. Such decline has continued throughout fiscal year 2005 and the outlook for continuing growth in sales remains uncertain. Failure to achieve significant sales with adequate gross margins with respect to our component DSL products will negatively affect the cash available to the Company prior to commencement of sales of our TV+solution thereby having a negative effect upon the overall financial condition of the Company and the price of our common stock.

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We rely on single sources for supply of a certain component for our POTS splitter product that has been the source of all of our revenues to date.

We purchase the core torroid that is a key component in our POTS Splitter Product from VAC corporation. We purchase such component on a purchase order basis and have no long term contract for the supply of such component. The loss of this current source of supply could result in us having to redesign our product at additional cost and result in lost revenues from our main source of sales to date.

We may incur substantial expenditures in the future in order to protect our intellectual property.

Although our legacy Traverser DVDDS television platform is patent-protected and not the subject of any infringement allegations we do not have currently patents or patents pending for our TV+ solution. The telecommunications industry, in general, is characterized by a large number of patents and frequent patent litigation based upon claims of patent infringement when compared to other industries.

#### Risk Factors Related to Our Targeted Markets

Historically the sale of infrastructure products to telecommunication providers in the international markets has a long lead time and a multiplicity of risks.

We expect the majority of our future revenues from our TV+ solution to be derived from international emerging markets and our success depends upon our ability to sell our flagship television platform outside of the United States where political, currency and regulatory risks are significantly greater. As a result of their distance from the United States, different time zones, culture, management and language differences, these operations pose greater risk than selling in the United States. Our sales cycle for our TV + solution is lengthy (since it involves a major strategic decision by an international telecommunications service provider) and we may incur significant marketing expenses with no guarantee of future sales. A significant market for our legacy Traverser DVDDS never developed and may never develop for our TV +solution if international telephone service providers fail to successfully deploy broadband services including high speed data and television Telephone service providers worldwide have significantly decreased capital expenditures for broadband and other deployment as a result of the current economic downturn in the industry. Future market demand that will cause telephone service providers to aggressively roll out IPTV, in general, is highly unpredictable especially in markets outside of the United States. Certain telephone companies (especially in developing international economies) may have copper wire infrastructure that is not of sufficient quality to accommodate the mPhaseTV+ solution. Changes in foreign taxes and import duties and economic and political instability in international markets pose a greater risk to our operations than U.S. markets.

Our television platform may not achieve compliance with regulatory requirements in foreign countries.

Our mPhaseTV+ solution may fail to meet foreign regulatory standards. Since our targeted markets for our television platform involves countries outside of the United States, such product is subject to greater regulatory risks since it must comply with different standards of different countries than can vary widely in the telecommunications industry. The failure to meet such regulatory standards would result in potential customers in countries outside of the United States not deploying of our TV+ solution.

The telecommunications industry is subject to intense competition characterized by swift changes in technology.

The telecommunications equipment industry is subject to swift and continuing innovation and technological changes that could render our TV+ solution obsolete and intense competition in the industry could prevent our ever becoming profitable. Our competitors that sell IP TV solutions that compete with and mPhase TV+ set top box and middleware include much larger and better known and capitalized companies with significantly greater selling and marketing experience and financial resources. Such competitors include for middleware a joint venture between Microsoft and

Alchaetel, as well as Minverva, Orca Interactive, Siemens, VBrick Systems and Video Furnance. For set top boxes the Company is in competition with Advanced Digital Broadcast, Amino Communications, Kreatel, Pace Micro Technology, Samsung Telsey Telecommunications and VBrick Systems. End to end solutions competitors for IPTV include UTStarcom, mxWare and Industria. Telephone service providers that are our targeted customers face competition from cable-based technologies, fixed wireless technologies and satellite technologies that may cause them not to deploy our TV+ product.

Deployment of our television platform requires certain additional investments by telecommunications service providers.

Our Customers may need to build a digital head-end to download television content from satellites involving a significant additional capital expenditure to utilize the digital Television capabilities of our TV+ solution. For customers desiring feature rich solutions such as video on demand, the installation of additional routers and servers may be required to upgrade the internet backbone capabilities of such customer. Such additional capital costs may cause a number of potential customers not to deploy our TV+ solution.

We may not be able to evolve our technology, products and services or develop new technology, products and services that are acceptable to our customers

The market for our broadcast digital television platforms over DSL is characterized by:

Rapid technology change;

New and improved product introductions;

Changing customer demands; and

Evolving industry standards and product obsolescence.

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Our future success will depend upon our ability to continually enhance our TV+ solution to deliver feature rich, open standards, carrier class television on the most scaleable cost efficient platform custom tailored to the rigorous and varied demands of telecommunications service providers. The development of enhanced and new technology, products and services is a complex and uncertain process requiring high levels of innovation, highly-skilled engineering and development personnel, and the accurate anticipation of technological and market trends. We may not be able to identify, develop, market or support new or enhanced technology, products, or services on a timely basis, if at all owing to our size and limited financial resources.

Telecommunications service providers outside of the United States must be able to access sources for broadcast television content in order to deploy our TV+ Solution.

In order to have an incentive to deploy the TV+ solution, an international telecommunications service provider must have access, to multiple channels of Television programming from content providers at prices that enable such provider to earn a profit from the deployment of television programming. In certain of our key target markets, such as Brazil, only cable companies are permitted under current law to provide such content and therefore a local service provider must establish a working relationship with such a cable provider to have an incentive to utilize our products.

### USE OF PROCEEDS

The selling stockholders will receive the proceeds from the resale of the shares of common stock. We will not receive any proceeds from the resale of the shares of common stock by the selling stockholders. However, we will receive approximately \$4,075,375 if all of the warrants and options are converted to purchase shares of common stock registered under this prospectus, which would be used for general working capital.

### PRICE RANGE OF COMMON STOCK

The primary market for our common stock is the OTC Bulletin Board, where it trades under the symbol "XDSL.OB". The following table sets forth the high and low closing bid prices for the shares for the periods indicated as provided by the National Quotation Bureau, Inc. The quotations shown reflect inter-dealer prices, without retail mark-up, mark-down, or commission and may not represent actual transactions.

Year/Quarter	High	Low
<b>Fiscal year ended June 30, 1999</b>		
First Quarter	\$4.25	\$0.75
Second Quarter	3.65625	1.5625
Third Quarter	5.625	1.875
Fourth Quarter	8.75	2.90625
<b>Fiscal year ended June 30, 2000</b>		
First Quarter	\$9.25	\$2.96875
Second Quarter	6.1875	2.50
Third Quarter	19.125	6.50
Fourth Quarter	14.125	6.00
<b>Fiscal year ended June 30, 2001</b>		
First Quarter	\$9.25	\$3.00
Second Quarter	5.9375	1.4688
Third Quarter	3.38	1.22
Fourth Quarter	2.61	1.03
<b>Fiscal year ended June 30, 2002</b>		
First Quarter	\$1.67	\$0.31
Second Quarter	.86	.31
Third Quarter	.62	.27
Fourth Quarter	.50	.23
<b>Fiscal year ended June 30, 2003</b>		
First Quarter	\$.32	\$.15

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<b>Second Quarter</b>	<b>.31</b>	<b>.15</b>
<b>Third Quarter</b>	<b>.36</b>	<b>.19</b>
<b>Fourth Quarter</b>	<b>.42</b>	<b>.28</b>
<b>Fiscal Year ended June 30, 2004</b>		
<b>First Quarter</b>	<b>\$.42</b>	<b>\$.29</b>
<b>Second Quarter</b>	<b>\$.61</b>	<b>\$.26</b>
<b>Third Quarter</b>	<b>\$.69</b>	<b>\$.41</b>
<b>Fourth Quarter</b>	<b>\$.46</b>	<b>\$.29</b>
<b>Fiscal Year ended June 30, 2005</b>		
<b>First Quarter</b>	<b>\$.31</b>	<b>\$.21</b>
<b>Second Quarter</b>	<b>\$.35</b>	<b>\$.23</b>
<b>Third Quarter</b>	<b>\$.59</b>	<b>\$.30</b>
<b>Fourth Quarter</b>	<b>\$.41</b>	<b>\$.24</b>

As of July 26, 2005 (unaudited), we had 140,965,957 shares of common stock outstanding and approximately 14,839 stockholders. The last reported sales price of our common stock on July 26, 2005 was \$.247 per share.

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## DIVIDEND POLICY

We have never declared or paid any cash dividends on our common stock and do not anticipate paying any cash dividends in the foreseeable future. We currently intend to retain future earnings, if any, to finance operations and the expansion of our business. Any future determination to pay cash dividends will be at the discretion of the board of directors and will be based upon our financial condition, operating results, capital requirements, plans for expansion, restrictions imposed by any financing arrangements and any other factors that the board of directors deems are relevant.

## SELECTED FINANCIAL DATA

The selected financial data set forth below should be read in conjunction with "Company Operations" and the historical financial statements and notes included in this prospectus. The statement of operations data for the years ended June 30, 1999, 2000 and 2001, are derived from financial statements that have been audited by Arthur Andersen LLP, and the statement of operations data for the years ended June 30, 2002, 2003 and 2004 are derived from financial statements that have been audited by Rosenberg, Rich, Baker, Berman & Company, independent auditors, and are included in this prospectus. The operations data for the quarterly periods ended September 30, 1999 and each quarter thereafter to and including the quarter ended December 31, 2001 are derived from unaudited financial statements reviewed by Arthur Andersen LLP and the operations data for the quarterly periods from March 31, 2002 and each quarter thereafter through and including the quarter ended March 31, 2005, have been derived from unaudited financial statements reviewed by Rosenberg, Rich, Baker, Berman & Company, which include all adjustments (consisting of normal recurring items) that management considers necessary for a fair presentation. The results for the fiscal year ended June 30, 2004 and the results for the nine months ended March 31, 2005 are not necessarily indicative of the operating results to be expected in the future.

	For The Year Ended June 30,					For the Nine Months Ended March 31, (Unaudited)	
	2000	2001	2002	2003	2004	2004	2005
<b>STATEMENT OF OPERATIONS DATA:</b>							
Total revenues	\$279,476	\$10,524,134	\$2,582,446	\$1,581,639	\$4,641,346	\$4,335,476	\$1,039,003
Costs and Expenses:							
Cost of sales	131,756	5,804,673	2,415,129	1,493,394	4,068,255	3,878,389	823,217
Research and development	10,156,936	10,779,570	3,819,583	3,538,305	4,069,721	2,858,715	3,820,128
General & administrative	27,859,330	17,321,614	7,038,923	2,683,534	4,177,961	2,196,052	5,416,357
Depreciation & amortization	471,101	660,372	670,183	515,417	122,878	100,833	193,650
Operating loss	(38,339,647)	(24,042,095)	(11,361,372)	(6,649,011)	(7,797,469)	(4,698,483)	(9,214,349)
Other income (expense), net	20,000	-	142,236	49,968	38,833	(128,991)	(137,751)
Interest income (expense)	158,105	43,361	(26,225)	(51,168)	(111,175)	(72,367)	(132,140)
Net Loss	\$(38,161,542)	\$(23,998,734)	\$(11,245,361)	\$(6,650,211)	\$(7,758,586)	(4,899,771)	(9,484,240)
Basic and diluted net loss per share	\$(1.41)	\$(0.72)	\$(0.23)	\$(0.10)	\$(.10)	\$(.07)	\$(.09)
Shares used in basic and diluted net loss per							

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share(1)                      26,974,997      33,436,641      49,617,280      65,217,088      77,677,120      75,312,435      101,062,839

(1) Does not include shares on a pro forma basis for all periods presented for shares which may be issued pursuant to warrants issued in private placements, options or conversion rights for certain notes; of which the underlying shares of the Company's common stock for such common equivalent shares are subject to registration by this prospectus, since their effect is anti-dilutive. Common equivalent shares for such shares other than the options, warrants and convertible rights subject to registration herein, have also been excluded from the computation of diluted earnings per share since their effect is anti-dilutive.

The balance sheet data as of June 30, 1999, 2000, 2001 are derived from financial statements that have been audited by Arthur Andersen LLP and June 30, 2002, 2003 and 2004 are derived from financial statements that have been audited by Rosenberg, Rich, Baker, Berman & Company and the balance sheet data as of March 31, 2005, have been derived from unaudited financial statements reviewed by Rosenberg, Rich, Baker, Berman & Company, and include all adjustments (consisting of normal recurring items) that management considers necessary for a fair presentation.

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Balance Sheet Data as of:

	2000	2001	June 30, 2002	2003	2004
Cash and cash equivalents	\$6,432,417	\$31,005	\$47,065	\$396,860	\$90,045
Working capital (deficit)	3,556,587	(1,458,227)	(94)	(1,405,331)	(2,111,452)
Total assets	11,184,246	8,997,182	6,942,515	3,781,649	2,590,718
Total Long-term obligations, net of current portion	0	90,000	2,890,535	2,607,552	1,038,050
Total stockholders' equity (deficit)	\$7,328,504	\$1,864,642	\$(42,849)	\$(3,228,886)	\$(2,917,962)

March 31, 2005

Cash and cash equivalents	\$237,828
Working capital (deficit)	(2,332,278)
Total assets	2,318,504
Total Long-term obligations, net of current portion	560,500
Total stockholders' equity (deficit)	\$(2,537,180)

SELECTED QUARTERLY FINANCIAL DATA

The statement of operations data as of the periods indicated below are derived from unaudited financial statements, of which the quarterly periods ended September 30, 1999 and each quarter thereafter to and including the quarter ended December 31, 2001 are derived from unaudited financial statements reviewed by Arthur Andersen LLP. The operations data for the quarterly periods ended March 31, 2002 and each quarter thereafter through and including the quarter ended March 31, 2005, have been derived from unaudited financial statements reviewed by Rosenberg, Rich, Baker, Berman & Company. The foregoing includes all adjustments (consisting of normal recurring items) that management considers necessary for a fair presentation of the financial statements.

Three Months Ended  
March 31,  
(in thousands, except share amounts)

FISCAL 2005 QUARTERLY

STATEMENT OF OPERATIONS DATA:

Total revenues	\$564
Costs and Expenses:	
Cost of sales	448
Research and development	1,664
General and administrative	2,636
Depreciation and amortization	65
Operating loss	(4,249)
Interest expense, Net	(37)
Gain (Loss) on Debt extinguishments	(59)

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Net Loss	\$(4,346)
Basic and diluted net loss per share	\$(.04)
Shares used in basic and diluted net loss per share(1)	120,015,504

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## Three Months Ended

September 30,

December 31

(in thousands, except share amounts)

## FISCAL 2005 QUARTERLY

## STATEMENT OF OPERATIONS DATA:

Total revenues	\$179	\$295
Costs and Expenses:		
Cost of sales	130	245
Research and development	1,101	1,055
General and administrative	709	2,071
Depreciation and amortization	1	127
Operating loss	(1,762)	(3,203)
Interest expense, Net	(29)	(66)
Gain (Loss) on Debt extinguishment	(41)	(37)
Net Loss	\$(1,832)	(3,306)
Basic and diluted net loss per share	\$(.02)	(.04)
Shares used in basic and diluted net loss per share(1)	89,719,962	93,388,584

## Three Months Ended

September 30

December 31

March 31

June 30

(in thousands, except share amounts)

## FISCAL 2004 QUARTERLY

## STATEMENT OF

## OPERATIONS DATA:

Total revenues	\$2,489	\$1,291	\$555	\$294
Costs and Expenses:				
Cost of sales	2,099	1,191	484	294
Research and development	611	843	1,404	1,212
General and administrative	605	914	803	1,856
Depreciation and amortization	46	28	27	22
Operating loss	(872)	(1,685)	(2,162)	(3,078)
Interest expense, Net	(16)	(16)	(20)	(59)
Gain (Loss) on debt extinguishment	23	-	(152)	278
Net Loss	\$(865)	\$(1,701)	\$(2,334)	\$(2,859)
Basic and diluted net loss per share	\$(.01)	\$(.02)	\$(.03)	\$(.03)
Shares used in basic and dilute net loss per share	71,725,318	72,814,272	81,564,405	84,885,017

## Three Months Ended

September 30

December 31

March 31

June 30

(in thousands, except share amounts)

## FISCAL 2003 QUARTERLY

## STATEMENT OF

## OPERATIONS DATA:

Total revenues	\$210	\$562	\$210	\$600
Costs and Expenses:				
Cost of sales	197	547	205	544
Research and development	803	753	906	1,077
General and administrative	893	731	544	516
Depreciation and amortization	131	129	129	127
Operating loss	(1,814)	(1,598)	(1,574)	(1,664)
Interest expense, Net	(18)	(15)	(11)	(6)
Gain on debt extinguishments	41	-	9	11

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Gain (Loss) on investments	-	(16)	(12)	17
Net Loss	\$(1,791)	\$(1,629)	\$(1,588)	\$(1,642)
Basic and diluted net loss per share	\$(.03)	\$(.07)	\$(.02)	\$(.02)
Shares used in basic and diluted net loss per share(1)	60,881,131	65,914,466	65,956,810	68,164,160

	Three Months Ended			
	September 30	December 31	March 31	June 30
	(in thousands, except share amounts)			

**FISCAL 2002 QUARTERLY  
STATEMENT OF  
OPERATIONS DATA:**

Total revenues	\$537	\$545	\$866	\$634
Costs and Expenses:				
Cost of Sales	457	530	724	704
Research and development	1,111	1,257	539	912
General and administrative	2,862	1,641	1,355	1,182
Depreciation and amortization	193	209	136	132
Operating loss	(4,086)	(3,092)	(1,888)	(2,296)
Interest expense, Net	(10)	(1)	(5)	(10)
Gain (Loss) on debt extinguishments	33	5	85	19
Net Loss	\$(4,063)	\$(3,088)	\$(1,808)	\$(2,287)
Basic and diluted net loss per share	\$(.10)	\$(.07)	\$(.03)	\$(.04)
Shares used in basic and diluted net loss per share(1)	42,037,506	44,645,458	55,606,168	56,459,167

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	Three Months Ended			
	September 30	December 31	March 31	June 30
	(in thousands, except share amounts)			
<b>FISCAL 2001 QUARTERLY</b>				
<b>STATEMENT OF</b>				
<b>OPERATIONS DATA:</b>				
Total revenues	\$1,865	\$5,231	\$2,959	\$469
Costs and Expenses:				
Cost of Sales	872	2,779	1,689	465
Research and development	3,162	3,318	2,220	2,080
General and administrative	3,485	3,314	3,105	7,406
Depreciation and amortization	123	136	200	201
Operating loss	(5,779)	(4,316)	(4,255)	(9,683)
Interest income\$ Net	28	8	4	3
Net loss	\$(5,751)	\$(4,308)	\$(4,251)	\$(9,680)
Basic and diluted net loss per share	\$(.18)	\$(.13)	\$(.12)	\$(.27)
Shares used in basic and diluted net loss per share(1)	31,562,727	32,324,964	34,205,000	35,702,797

	Three Months Ended			
	September 30	December 31	March 31	June 30
	(in thousands, except share amounts)			
<b>FISCAL 2000 QUARTERLY</b>				
<b>STATEMENT OF</b>				
<b>OPERATIONS DATA:</b>				
Total revenues	\$-	\$-	\$40	\$240
Costs and Expenses:				
Cost of sales	-	-	19	113
Research and development	1,491	1,904	2,858	3,904
General and administrative	1,210	1,226	12,776	12,648
Depreciation and amortization	114	116	118	123
Operating loss	(2,815)	(3,246)	(15,731)	(16,548)
Other income, net	-	-	-	20
Interest income, Net	18	41	57	42
Net Loss	\$(2,797)	\$(3,205)	\$(15,674)	\$(16,486)
Basic and diluted net loss per share	\$(.11)	\$(.12)	\$(.56)	\$(.55)
Shares used in basic and diluted net loss per share(1)	24,942,965	25,907,602	27,743,996	29,729,060

(1) The quarterly earnings per share data above are computed independently for each of the quarters presented. As such, the sum of the quarterly per common share information may not equal the full year amounts due to rounding differences resulting from changes in the weighted-average number of common shares outstanding.

**(1) SELECTED BALANCE SHEET DATA**

The summary financial data set forth below should be read in conjunction with "Company's Operations" and the historical consolidated financial statements and notes included in this prospectus. The balance sheet data including the effects of Changes in the Statement of Stockholders from October 2, 1996 (date of inception) to June 30, 1998 are derived from financial statements that have been audited by (i) Schuhalter, Coughlin & Suozzo, PC, independent auditors from inception to June 30, 1998 (ii) from financial statements that have been audited by Arthur Andersen for the years ended 1999, 2000 and 2001 and the balance sheet data as of June 30, 2002, 2003, and 2004 which are included in this prospectus, are derived from financial statements that have been audited by Rosenberg, Rich, Baker, Berman & Company.

Year

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	<b>2000</b>	<b>2001</b>	<b>Ended June 30, 2002</b>	<b>2003</b>	<b>2004</b>
<b>BALANCE SHEET DATA:</b>					
Cash and cash equivalents	\$6,432	\$31	\$47	\$397	\$90
Working capital (deficit)	3,557	(1,458)	(94)	(1,405)	(2,111)
Total assets	11,184	8,997	6,943	3,781	2,591
Long-term obligations, net of current portion	-	90	2,890	2,608	1,038
Total stockholders' equity (deficit)	\$7,329	\$1,865	\$(43)	\$(3,229)	\$(2,918)

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## COMPANY OPERATIONS

The following is management's discussion and analysis of the operations of mPhase, since its inception in 1996 which should be read in conjunction with the accompanying financial statements, financial data, and the related notes.

### CAUTIONARY STATEMENT PURSUANT TO SAFE HARBOR PROVISIONS OF THE PRIVATE LITIGATION REFORM ACT OF 1995:

Some of the statements contained in or incorporated by reference in this Prospectus discuss the Company's plans and strategies for its business or state other forward-looking statements, as this term is defined in the Private Securities Litigation Reform Act of 1995. The words "anticipate," "believe," "estimate," "expect," "plan," "intend," "should," "seek," "will," and similar expressions are intended to identify these forward-looking statements, but are not the exclusive means of identifying them. These forward-looking statements include, among others, statements concerning the Company's expectations regarding its working capital requirements, gross margins, results of operations, business, growth prospects, competition and other statements of expectations, beliefs, future plans and strategies, anticipated events or trends, and similar expressions concerning matters that are not historical facts. Any forward-looking statements contained in this Prospectus are subject to risks and uncertainties that could cause actual results to differ materially from those results expressed in or implied by the statements contained herein.

## OVERVIEW

mPhase Technologies, Inc. (mPhase, the Company, we or us), a New Jersey corporation, founded in 1996 is a publicly-held company with approximately 14,830 shareholders and approximately 141 million shares of common stock outstanding. The Company's common stock is traded on the NASDAQ Over the Counter Bulletin Board under the ticker symbol XDSL.

mPhase is a developer of broadband communications products, specifically, IP TV plus a digital subscriber line (DSL) products for telecommunications service providers around the world. In February of 2004 mPhase has entered into the new and emerging area of NanoTechnology. Since our inception in 1996 we have been a development-stage company and operating activities have related primarily to research and development, establishing third-party manufacturing relationships and developing product brand recognition among telecommunications service providers.

We are headquartered in Norwalk, Connecticut with offices in Little Falls, New Jersey and New York, New York. mPhase shares common office space and common management with Microphase Corporation, a privately-held company. Microphase is a seller of radio frequency and filtering technologies to the defense industry. Microphase has been in operation for almost 50 years and supports mPhase with engineering, administrative and financial resources, as needed.

### Description of Operations

Since our inception in 1996 our primary activities through fiscal year 2003 consisted of designing, manufacturing and testing our flagship products designed to enable telephone service providers to deliver digital broadcast television over DSL. Fiscal years 2004 and 2005 marked a significant shift of the Company's focus, in response to technology advancements with respect to the delivery of video data using internet protocol. The Company has shifted its telecommunications solution focus from technology for the delivery of broadcast television high speed internet and voice over DSL to the development of middleware/software for carrier class delivery of IP TV over copper, fiber, coax or any infrastructure representing a combination of the foregoing that is used by a telecommunications service provider. This shift has taken place over the past two years and has culminated in our flagship product namely Release 3.0 of our TV+ solution. This product is scheduled for final testing in September of 2005 as part of an initial deployment of 1000 ports with a major telecommunications service provider in Russia. We have not, as yet, derived any significant revenue from our TV+ solution, which is the culmination of several earlier versions that have been

changed to accommodate the latest in technological innovation and market demand for IPTV. The Company's recent entry into the field of nanotechnology is focused upon exploratory development of batteries with significantly longer shelf lives and enhanced capabilities and magnetometer sensor devices with potentially wide applicability for both military and commercial security applications. The Company believes that such development is consistent with its strategy of being a pioneer of high growth technology products and potentially diversifies its product mix.

mPhase introduced its first TV over DSL platform, the Traverser&#153 Digital Video and Data Delivery System ("DVDDS"), in 1998. The DVDDS is a patented end to end system that enables a telecommunications service provider to deliver up to several hundred channels of motion picture experts group two ("MPEG-2") standard broadcast digital television, high speed internet and voice over copper telephone lines between a central office facility of the provider and a customer's premise. mPhase has not, as yet, derived any material revenues from sales of the DVDDS. The DVDDS is a proprietary technology developed in conjunction with Georgia Tech Research Corporation (GTRC) and is one of the first systems of its kind developed. The system is the only system on the market that utilizes non- Internet Protocol ("IP") transmission over ADSL. The DVDDS is installed at Hart Telephone Company in Hartwell, Georgia, where a limited user system of approximately 80 customers was tested. A DVDDS&#153 system is also installed at the BMW manufacturing plant in Spartanburg, South Carolina for use as a television broadcast system in a commercial setting.

The new mPhase TV+ system, developed in conjunction with Bell Laboratories division of Lucent Technologies, Inc., is also designed to allow for the simultaneous delivery of voice, high speed data, and broadcast TV over copper telephone lines between a telephone service provider's central office (CO) and the customer premises. The TV+ system was developed in conjunction with Bell

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Laboratories as an outgrowth of mPhase's engagement of Bell Labs in fiscal year 2003 to cost reduce mPhase's set top box that operates with the legacy DVDDS system developed by Georgia Tech Research Corporation (GTRC). The TV+ system has replaced the legacy DVDDS system with an open industry standards-based platform. Release 1 and 2.0 of the mPhaseTV+ system is complete and ready for commercial deployment. The TV+ system delivers 255 broadcast television channels over ADSL and utilizes an industry-leading, standards-based Lucent Technologies, Inc.'s Stinger<sup>®</sup> DSL Access Concentrator for transport of digital television plus high speed internet and voice. The mPhase TV+ system consists of a powerful software platform and a cost reduced set top box located in a telephone customer's premises plus the Lucent Stinger located at the CO or in the loop servicing the customer. For mPhase the alliance with Lucent marks a change in strategy from selling a complete proprietary platform to providing an industry-standards solution. The Company believes that the demand for the TV+ system will be greatest in markets primarily outside of the United States that do not have a hybrid fiber coaxial cable ("HFC") infrastructure necessary for cable TV or fiber to the curb necessary for very fast DSL (VDSL).

In December of 2004, the Company announced that a major telecommunications service provider in Russia had chosen to deploy to 1,000 of its customers mPhase's TV+ platform. The Russian service provider has over 1 million customers and is part of a holding company with 15 million customers.

Release 3.0 of the TV+ solution, utilizes a communications framework based upon Internet Protocol (IP) instead of Asynchronous Transfer Mode (ATM) that is utilized by Releases 1.0 and 2.1. ATM is an industry standard for transportation of data based upon a packaging of information into a fixed-size cell format for transportation across networks. Many telecommunications service providers currently deploy equipment that handles this protocol because it can support voice, video, data and multimedia applications simultaneously with a high degree of reliability. IP is another transport protocol that maintains network information and routes packets across networks. IP packets are larger and can hold more data than ATM cells. Historically, there have been concerns that service providers would be unable to provide the same quality of service with IP because it is not optimized for time-sensitive signals such as broadcast television and voice. Nevertheless, there is a greater demand by telecommunication service providers for IP systems for delivery of television, voice and high-speed data because such systems are significantly more cost effective to deploy based upon greater scalability.

Release 3.0 of the TV+ solution is a system management software/middleware product that will operate with both the Lucent Stinger as well as the DSLAM's of other major vendors. Release 3.0 of the TV system will also be able to send multiple TV channels over both fiber, coax as well as down a single DSL line over copper using ADSL2 supported DSLAM's and be capable of delivery of Video on Demand. Our TV+ solution is an open standards-based, carrier class technology with tremendous scalability and enables a telecommunications service provider to custom tailor the deployment of feature rich IP television, high speed internet and voice. Such solution enables a telecommunications service provider to significantly enhance revenue, margins with a very high rate of return as compared to the traditional economics for delivery of telephone voice services only. In addition, Telecom's around the world are under increased pressure to delivery multiple converged services in order to retain their traditional telephone voice customers. The TV+ solution may be used in combination with any vendors set top box designed for the delivery of IP TV and the DSLAM's of all major vendors. The solution allows a service provider to start small and test its take rate among customers with a maximum of flexibility of design, features and cost allowing it to enter the market for converged services to its customers on an optimal basis.

mPhase has transformed itself from a developer of closed end proprietary technology for the delivery of TV over DSL to a Company that has developed a carrier class middleware/software solution for the delivery of IP TV using a standards-based platform designed to provide telecommunications with maximum flexibility in system configuration with components from all major vendors. mPhase is continuing in the development of a next generation set top box designed to further enhance its IP TV+ solution and to be used as a stand alone product. mPhase's current IPTV solution is designed to be used over fiber, coax and copper or any combination thereof currently deployed by a telecommunications service provider. In addition mPhase's IP TV solution may be used with any DSLAM's of all major vendors. In addition our IPTV solution may be used with other telecommunications transport technology such

as Multicast Routers instead of DSLAM's for the delivery of voice, data and IPTV.

#### mPhase DSL Component Products

. mPhase continues to design and market a line of DSL component products ranging from commodity items such as POTS splitters to innovative loop management products. Most notable in the suite of DSL component products is the recently introduced iPOTS3 (recently renamed the "Broadband Loop Watch") or Intelligent POTS Splitter product. The newly developed version of the Broadband Loop Watch product is compatible with the Lucent Stinger as well as DSLAM's manufactured by other vendors. This product marks a significant advancement in automating loop management. The Broadband Loop Watch allows service providers to perform full loop testing for DSL deployment and maintenance from a central office without having to deploy a more costly deployment of personnel to the field. This is accomplished by allowing service providers to temporarily bypass the POTS Splitter and have a comprehensive view of their DSL networks. Prior to the introduction of this product in order to perform full testing, service providers would have to manually intervene so that so that test signals could be passed through the network. In November of 2004, the Company announced that it had been selected to provide its automated Broadband Watch product for Saudi Arabia Telecom under an initial purchase order in excess of \$1 million. As DSL deployments scale, it is becoming increasingly more important for telecommunications service providers to streamline the process for provisioning and troubleshooting DSL services. Additionally, as competition for high speed Internet expands, the market is witnessing a reduction in price. Therefore, it has become imperative that telecommunications service providers lower the operational costs involved with supporting DSL services.

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## Nanotechnology

Effective February 3, 2004, mPhase has entered into a Development Agreement with Lucent Technologies, Inc. to commercialize the use of nano power cell technology. The initial agreement was for a 12 month period of exploratory development at the cost of \$100,000 per month of a new form of power cell having a shelf life far in excess of conventional battery technology. In March of 2005 the Company extended such Agreement for another 12 months at the cost of \$100,000 per month to continue development of the nano power cell product. We believe that this arrangement with the Bell Labs division of Lucent will give mPhase the opportunity to develop and offer breakthrough battery technology and other potential applications, initially to the government market for defense and homeland security and ultimately to the commercial market. It is anticipated that the initial applications for nano power cells will address the need to supply emergency and reserve power to a broad range of products for the defense department.

The Company believes that its entry into this new field of high technology growth will provide product diversification without negatively affecting its focus upon its traditional products aimed at delivery of Television over DSL. The Company developed a lab prototype of its first nano power cell product that was completed in the second quarter of fiscal year 2005. The Company is unable, at this time, to predict when significant commercialization and material revenues will be derived from its entry into the NanoTechnology business.

On March 10, 2005 the Company announced an agreement with the Bell Labs research and development arm of Lucent Technologies, Inc. to co develop using the science of nanotechnology and commercialize uncooled magnetic ultra-sensitive sensors for a host of defense and civilian applications. The sensors, technically referred to as magnetometers, are based upon Micro Electro Mechanical Systems (MEMS) using designs based upon fundamental breakthroughs made in the past few years at Bell Labs as part of the New Jersey Nanotechnology Consortium. Initial tests of these MEMS magnetometers indicate sensitivities 1000 times those achieved in presently available uncooled magnetometers. Such devices are designed to create a new generation of ultra sensitive magnetic field sensors that will enable military combatants to detect with greater accuracy and range hostile military forces. Commercial applications may include inexpensive navigational components for mobile phones to sensing devices for identification used in homeland security products, as well as sensors used in diagnostic systems for detection of metal fatigue for numerous industrial applications.

## Nano Battery

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mPhase Technologies along with its partner Lucent/Bell Labs, has been jointly conducting research since February 2004 that demonstrates control and manipulation of fluids on superhydrophobic surfaces to create power cells by controlling wetting behavior of electrolyte on nanostructured electrode surfaces. The scientific research conducted this year has set the groundwork for continued exploration in the development of intelligent nanotechnology power cells (nano-batteries), and forms a path to commercialization of the technology for a broad range of market opportunities. During the first half of 2005 the battery team has been testing modifications and enhancements to the internal design of the battery to optimize its power and energy density characteristics, as well as making engineering improvements that will assist in making the battery easier to manufacture when the project reaches that level of maturity.

In June of 2005 the battery project was expanded to include a joint technical development effort through December 2005 between mPhase and Rutgers University to potentially incorporate a Lithium based design. This work program has initially started as a modest technology effort to help characterize and test the nano battery design using Lithium chemistry and determine if the current design is capable of supporting the lithium based chemistry. Based on the results of the testing with Rutgers University, mPhase may decide to accelerate the work effort.

## Magnetomete

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In February 2005 mPhase and Lucent Technologies' Bell Laboratories entered into a joint effort to develop an extremely sensitive magnetometer. Magnetometers can be used in a wide range of applications that include military surveillance, securing the retail environment, automotive sensors and actuators, industrial processing, medical imaging, scientific measurements, detection of mineral deposits and even air and space exploration. In sensor networks ultra-sensitive magnetometers can be used, for example, to detect and accurately pinpoint battlefield objects or they might also be used to study the workings of the human brain.

Magnetometers work by sensing changes in magnetic fields due to the motion of magnetic objects or changes in electrical currents generated by those objects. The magnetometer detects these objects by measuring time-varying magnetic signals that are superimposed on the combination of earth's background field (used to orient compasses) and static magnetic fields due to nearby magnetic objects.

#### Highly Sensitive Magnetometers

- The enhanced sensitivity of these devices results from two scientific advances recently made researchers at Lucent Bell Labs. Presently, the highest sensitivity magnetometers commercially available require cooling to cryogenic temperatures. Called SQUIDs (for Superconducting Quantum Interference Devices) these devices only work at the temperature where liquid helium boils, -455 degrees below zero Fahrenheit, making such magnetometers expensive and bulky and therefore ill-suited for remote-sensing applications. Room temperature magnetometers, on the other hand, are less sensitive, and use technology that was developed in World War II for detecting submarines.

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The new technology being developed by Bell Labs and mPhase employs a number of different designs based on Micro-Mechanical Systems (MEMS). These designs use the very high "Quality Factor (Q)" of the mechanical resonance in single crystals of silicon. A resonance is similar to the fundamental frequency of a tuning fork. When tapped, a tuning fork will vibrate for a length of time inversely proportional to the internal friction of vibration within the metal of the tuning fork. A comparable tuning fork made from single crystal silicon, which has less internal friction than the hardest metal, will vibrate almost a thousand times longer. Based on this principal, a device employing a high Q resonator will have enhanced amplitude of vibration at the resonance frequency, and hence will display a greater sensitivity to external perturbations that affect its resonance frequency. By coupling the mechanical motion of a bar or a paddle constructed from silicon to the ambient magnetic field, this high mechanical sensitivity can be converted to high magnetic field sensitivity. The technical approach that the team is developing can be achieved either statically with an integrated magnetic film, or dynamically through motion of the silicon bar or paddle.

#### The Benefits of MEMS

- Commercial magnetometers using purely electronic detection, such as Hall, magneto-resistance or flux-gate devices, have sensitivities limited by their *electronic* Q-factor. This Q-factor depends on the natural electrical resistance, or electronic friction, of the metal in the circuit. For room-temperature operations it is therefore difficult to reduce the electrical Q-factor. Mechanical resonators made from semiconductor-grade silicon, on the other hand, exhibit mechanical Q-factors, approaching 100,000 at room temperature. In all, these new, smaller and less costly magnetometers should be 100-1000 times more sensitive than existing commercial devices, thus enabling a new class of sensor systems that mPhase plans on commercializing.

The mPhase and Lucent magnetometer team has successfully reached an early milestone and have produced a number MEM based sensor samples from the clean room facilities and are working on integrating them into the surrounding electronic circuitry so that measurement, characterization and sensitivity testing can be conducted.

#### Revenues

. To date, all material revenues have been generated from sales of the POTS Splitter Shelves and other DSL component products to a small number of telecommunications companies. mPhase believes that future revenues are difficult to predict because of "the length and variability of the commercial roll-out of the IPTV to various telecommunications service providers and (ii) the Company's recent entry into the NanoTechnology business. Since the Company believes that there may be a significant international market for its TV+ IPTV solution involving many different countries, with different regulations, certifications and commercial practices than the United States, future revenues are highly subject to the changing variables and uncertainties. Additionally, the recent instability of the telecommunications market evidenced by reduction in capital spending across the whole in the telecom sector contributes to our difficulty in accurately predicting future revenues.

#### Cost of revenues

. The costs necessary to generate revenues from the sale of POTS Splitter Shelves and other related DSL component products include direct material, labor and manufacturing. mPhase paid these costs to Janifast Ltd., which has facilities in the People's Republic of China and is owned by and managed by certain senior executives of the Company. The cost of revenues also includes certain royalties paid to Microphase Corporation, a privately held corporation organized in 1955, which shares certain common management with the Company and is majority-owned by a director of mPhase. Costs for future production of the TV + Platform will consist primarily of payments to manufacturers to acquire the necessary components and assemble the product including Lucent Technologies Inc., Espiral Group and Magpie Telecom Insiders, Inc.

#### Research and development

. Research and development expenses consist principally of the payments made to Microphase and Lucent, respectively, for development of the Broadband Loop Watch, the TV+ IPTV solution and nanotechnology products respectively. The IPTV+ solution consists primarily of middleware/software designed for the delivery of feature rich, carrier class, broadcast TV, high speed internet and voice by telecommunications service providers open using standards based equipment and transport configurations. All research and development costs are expensed as incurred.

#### General and administrative

. Selling, general and administrative expenses consist primarily of salaries and related expenses for personnel engaged in direct marketing of the TV+ solution for IPTV, POTS Splitter Shelves, the Broadband Loop Watch "intelligent pots splitter" diagnostic product and other DSL component products, as well as support functions including executive, legal and accounting personnel. Certain administrative activities are outsourced on a monthly fee basis to Microphase and mPhase leases its principal office in Norwalk, Connecticut from Microphase.

#### Non-Cash compensation charges

. The Company makes extensive use of stock options and warrants as a form of compensation to employees, directors and outside consultants. We incurred non-cash compensation charges totaling \$67,932,341 from inception (October 2, 1996) through June 30, 2004, of which \$2,117,769 was included in research and development expenses and \$47,133,142 was included in general and administrative expenses.

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TWELVE MONTHS ENDED JUNE 30, 2004 VS. JUNE 30, 2003

Revenues. Total revenues for the year ended June 30, 2004 increased to \$4,641,346 from \$1,581,639 for the year ended June 30, 2003. The increase was primarily attributable to increased sales of the Company's POTS Splitter product line especially during the first quarter of fiscal year ended June 30, 2004, caused by an upturn in July and August of 2004 of orders from one customer that orders component products from the Company. The Company continues to believe that its line of POTS Splitter products is positioned to be competitively priced with high reliability and connectivity, and as such has the potential to be significant part of DSL deployment. The Company cannot predict when the demand for telecommunication equipment will resume, however we do not expect significant sales in the first two quarters of fiscal 2005.

Cost of revenues. Cost of sales was \$4,068,255 for the year ended June 30, 2004 as compared to \$1,493,394 in the year ended 30, 2003. Cost of revenues increased for the twelve months ended June 30, 2004 compared to the prior period ending June 30, 2003 primarily because of increased sales. Gross margins for the period ended June 30, 2004 were 12%. The gross margins have varied dramatically as spending among telecommunication providers has contracted, coupled with downward pressures related to the supply and demand of telecommunications products. The single most significant reason the margins decreased dramatically was due to the reduced selling price of our POTS Splitter product. Discounts, consisting of a 2% discount from the amount invoiced if paid within 10 days were offered during fiscal year 2004. Such discounts amounted to \$71,425 for the period ended June 30, 2004, and were offered to Covad Communication our leading telecommunications service provider customer. Discounts were offered in fiscal 2003 to an existing customer to accelerate collections in connection with an order of our POTS Splitter product and was treated as a purchase discount to each our customers, and the reduction to net sales lowered the gross margins in the period.

Research and Development. Research and development expenses were \$4,069,721 for the year ended June 30, 2004 as compared to \$3,538,305 in the year ended June 30, 2003, an increase of \$531,416. Such expenditures included \$2,328,602 incurred with Lucent Technologies, Inc. for the year ended June 30, 2004 as compared to \$1,112,500 during the comparable period in 2003. In addition we incurred \$99,494 with Microphase and other strategic vendors for the year ended June 30, 2004 as compared to \$528,434 during the comparable period in 2003.

The significant increase in research and development expenses with Lucent Technologies, Inc. is due to the continued and accelerated development of the TV+ product together with the entry into a \$1.2 million 12 month Development Agreement for battery and power pack product development utilizing Nanotechnology. Such expenditures are expected to increase in fiscal year 2005 since the Company's strategy is to further enhance the features and cost reduce its TV+ and expand its product line in the Nanotechnology area.

The elimination in research expenditures incurred with GTRC is due to the Company's refocus in development from its legacy Traverser DVDDS television delivery platform to its TV+ product.

Research expenditures incurred with Microphase were related to the continuing development of the Company's DSL component products, including the Company's line of POTS Splitters and Microfilters and the Company's newest products, the iPOTS&#153.

General and Administrative Expenses. Selling, general and administrative expenses were \$4,177,961 for the year ended June 30, 2004 up from \$2,683,534 for the comparable period in 2003, an increase of \$1,494,427. The increase in the selling, general and administrative costs was primarily the result of the addition of a number of new employees critical to the Company's needs in developing, marketing and selling the TV+ and NanoTechnology product lines with Lucent.

Included is an increase of non-cash charges relating to the issuance of common stock and options to consultants, which totaled \$1,010,895 for the year ended June 30, 2004 as compared to \$477,836 during the comparable period in

2003. Other components of the increase in selling, general and administrative expenses were increases in payroll of approximately \$461,226 to \$953,602, increase in the use of outside consultants of approximately \$251,103 to \$987,720, marketing expenses such as trade shows of \$30,148 to \$40,347, and advertising expenses of \$20,439 to \$21,948, all of which approximated \$1,295,975 or 87% of the increase in spending.

Net loss. mPhase recorded a net loss of \$7,758,586 for the year ended June 30, 2004 as compared to a loss of \$6,650,211 for the same period ended June 30, 2003. This represents a loss per common share of \$(.10) in 2004 as compared to \$(.10) in 2003, based upon weighted average common shares outstanding of 77,677,120 and 65,217,088 during the periods ending June 30, 2004 and June 30, 2003 respectively.

#### **Twelve Months Ended June 30, 2003 vs. June 30, 2002**

##### Revenue

Total revenues were \$1,581,639 for the year ended June 30, 2003 compared to \$2,582,446 for the year ended June 30, 2002. The decrease was attributable to the continued slowing sales during fiscal year 2003 of the Company's POTS Splitter product line, caused by the general downturn in the telecommunications market, including customers that order component products from the Company. The Company continues to believe that its line of POTS Splitter products is positioned to be competitively priced with high reliability and connectivity, and as such has the potential to be a significant part of DSL deployment worldwide. The Company cannot say when the demand for telecommunication equipment will resume.

##### Cost of Revenues

Cost of sales was \$1,493,394 for the fiscal year ended June, 2003 as compared to \$2,415,219 in the prior period, representing 94% of gross revenues, for each of the fiscal years ended June 30, 2003 and 2002, respectively. The margins have contracted dramatically in the past two fiscal years as spending among the telecommunications providers have contracted, coupled with downward pressures related to the supply and demand of telecommunications products.

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## Research and Development

Research and development expenses were \$3,538,305 for the fiscal year ended June 30, 2003 as compared to \$3,819,583 during the comparable period in 2002; or a decrease of \$281,278.

Such expenditures include \$100,000 incurred with GTRC for the fiscal year ended June 30, 2003 as compared to \$450,000 during the comparable period in 2002. In addition, the Company incurred research and development expenses for depreciation of test equipment located at Hart Telephone Company and at mPhase of \$839,735 and \$845,783 for the fiscal years ended June 30, 2003 and 2002, respectively.

Other portions of research and development expenses include (a) a decrease of research and development expenses incurred with

Microphase by \$322,640 to \$428,434 for the fiscal year ended June 30, 2003 from \$751,074 for the comparable period ended June 30, 2002, (b) non cash compensation of \$385,495 for the twelve month period ended June 30, 2003 compared to \$267,338 for the same period ending June 30, 2002 and (c) miscellaneous expenses of \$143,024 and \$298,227 for the periods ended June 30, 2003 and June 30, 2002, respectively.

The Company incurred increased charges with Lucent Technologies, Inc. in the current year, totaling \$1,112,500 incurred on development of the Broadcast Television Switch for use with Lucent's Stinger DSL product, \$437,500 incurred for the cost reduction effort for mPhase's set top box. In addition, \$75,000 was incurred for software development associated with mPhase's iPOTS3 product, as compared with \$156,250 incurred in the year ended June 30, 2002.

The elements contributing to the decrease in other research and development expenses included a decrease in the operations of the Company's joint venture, mPhase Television.net. The major costs incurred by the joint venture were payroll expenses attributable to research and development of the Company's transmission capabilities and acquisition of television content. Costs incurred by the joint venture during the fiscal year ended June 30, 2002 were \$232,334 as compared to \$62,352 for the period ended June 30, 2003. Additionally, this decrease can be attributed to the Company abandoning certain research projects on DSL components the Company believed were no longer commercially viable, this approximated \$12,960 in fiscal 2003 compared to \$440,295 in fiscal 2002.

The decrease in research expenditures incurred with GTRC is due to the Company's shift of capital expenditures from the Traverser DVDDS to the TV+ product. The Company's project with Lucent provides for cost reduction of the INI set top box and other product enhancements as well as development of a Broadcast Television Switch for use with Lucent's Stinger product. To date expenses incurred with respect to the TV+ platform and development of the new cost reduced set top box are \$593,750, and \$437,500 respectively for the fiscal year ended June 30, 2003.

Research expenditures incurred with Microphase were related to the continuing development of the Company's DSL component products, including the Company's line of POTS Splitters and Microfilters and the Company's newest products, the iPOTS and the mPhase

Stretch. We believe the mPhase iPOTS offers a much needed solution for the DSL industry; the iPOTS enables telecommunications service providers to remotely and cost-effectively perform loop management and maintenance including line testing, qualification and troubleshooting. Prior to the introduction of the iPOTS, loop management could not be remotely performed through a conventional POTS Splitter without the use of expensive cross connects or relay banks because of the mandatory DC blocking capacitors in traditional POTS splitters, as required by various telephone protocol and regulatory standards. The unique (patent pending) iPOTS circuit allows most test heads to perform both narrow and wideband testing of the local loop through the central office POTS Splitter without having to physically disconnect the POTS Splitter, thereby eliminating the need to dispatch personnel and a truckroll. The Company anticipates future demand for this product, as it significantly reduces the cost of deploying

and maintaining DSL services. Also recently developed is the DSL loop extender product called mPhaseStretch. This product extends the service distance for the mPhase Traverser and can be used in conjunction with other DSL services. The Company believes there will be future demand for the Stretch loop extender product as it addresses a primary issue in DSL services.

#### General and Administrative Expenses

General and administrative expenses were \$2,654,971 for the twelve-month period ended on June 30, 2003 as compared to \$6,490,373 for the same period ended June 30, 2002. This represents a decrease of these expenses of \$3,835,402, or approximately 59% in fiscal 2003 as a percentage of these expenses in fiscal 2002. The decrease in administrative costs included a decrease of \$1,696,771 in non-cash charges for the issuance of options to consultants which totaled \$748,840 for the year ended June 30, 2003 as compared to \$2,445,561 during the comparable period in 2002. The decrease also occurred as a result of the reduction in workforce and the reduction in marketing expenses which the Company began in Fiscal 2002 in response to the current contraction in the telecommunications equipment market. Other components of the decrease in selling, general and administrative expenses included decreases in (a) executive compensation and administrative payroll and related costs of approximately \$775,000, (b) marketing expenses such as trade shows of approximately \$250,000, (c) reductions in occupancy costs by approximately \$290,000, (d) decreases in shareholder services and related expenses by approximately \$190,000, (e) insurance and risk management costs by approximately \$145,000 and (f) various decreases in other administrative categories aggregating approximately \$490,000. The foregoing approximated reductions of general and administrative expenses other than non-cash charges of \$2,125,000 in the twelve months ended June 30, 2003 compared to the same period ended June 30, 2002.

We do not expect this downward trend to continue, yet administrative expenses are expected to remain at the current levels until the Company begins its marketing effort to roll out its TV+ products in the second quarter, and at such time we expect that selling and travel expenses will grow. Further when the Company begins to implement and support its Television over DSL platforms then administrative payroll and related costs will again rise as the Company will need to add employees to its administrative workforce.

#### Depreciation and Amortization

Depreciation and amortization expense was \$515,417 in fiscal 2003 as compared to \$670,183 for 2002. These expenses decreased \$154,766, or approximately 23% of the prior years expense as a result of the Company's reduced need for and outlays on capital expenditures in its two preceding fiscal years. We do not expect such downward trend to continue but such depreciation and amortization expense should remain at the current reduced levels until the Company commences deployment of its Television over DSL platforms. We expect to increase capital expenditures in connecting with the deployment of equipment at test sites with various telecommunications service providers globally as deployment of our TV+ product progresses and such equipment will need to be depreciated or amortized, as the case may be, that will result in increased depreciation at that time.

#### Net Loss

The Company recorded a net loss of \$6,650,211 for the period ended June 30, 2003 as compared to a loss of \$11,245,361 for the period ended June 30, 2002. This represents a loss per common share of \$.10 for the fiscal year ended June 30, 2003 as compared to a loss per common share of \$.23 for the fiscal year ended June 30, 2002 based upon weighted average common shares outstanding of 65,217,088 and 49,617,280 during the fiscal years ended June 30, 2003 and 2002, respectively.

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**Twelve Months Ended June 30, 2002 vs. June 30, 2001**

Revenue

Total revenues for the year ended June 30, 2002 decreased to \$2,582,446 from \$10,524,134 for the year ended June 30, 2001. The decrease was primarily attributable to slowing sales of the Company's POTS Splitter product line, caused by the general downturn in the telecommunications market, including among customers that order component products from the Company. The Company continues to believe that its line of POTS Splitter products is positioned to be competitively priced with high reliability and connectivity, and as such has the potential to be significant part of DSL deployment. The Company cannot predict when the demand for telecommunication equipment will resume, however we do not expect significant sales in the first two quarters of fiscal 2003.

Cost of Revenues

Cost of sales was \$2,415,129 for the year ended June 30, 2002 as compared to \$5,804,673 in the year ended June 30, 2001. Cost of revenues declined for the twelve months ended June 30, 2002 compared to the prior period ending June 30, 2001 primarily because of decreased sales. Operating margins for the period ended June 30, 2002 were 6%. The gross margins have varied dramatically as spending among telecommunication providers has contracted, coupled with downward pressures related to the supply and demand of telecommunications products. The single most significant reason the margins decreased dramatically was due to the reduced selling price of our POTS Splitter product. Discounts, consisting of 2% of the amount invoiced if paid within 29 days of the invoice date, amounted to \$14,389 for the period ended June 30, 2002. Such discounts were offered to two major customers that are leading telecommunications service providers. In each case, the discount was offered to an existing customer to accelerate collections in connection with a reorder of our POTS Splitter product and was treated as a purchase discount to our customer, and the resultant reduction to net sales lowered the gross margins in the period.

Research and Development

Research and development expenses were \$3,819,583 for the year ended June 30, 2002 as compared to \$10,779,570 in the year ended June 30, 2001. Such expenditures include \$450,000 incurred with GTRC for the year ended June 30, 2002 as compared to \$3,814,000 during the comparable period in 2001. In addition we incurred \$1,212,594 with Microphase and additional expenses with other strategic vendors for the year ended June 30, 2002 as compared to \$3,405,975 during the comparable period in 2001.

The decrease in research and development expenses with Microphase is due to the completion of the development of the POTS Splitter product line. The decrease in research and development expense of approximately \$3.1 million is due to the termination of the Company's relationship with a third party manufacturer, Flextronics, with whom the Company had incurred substantial costs for prototypes and pre-manufacturing costs.

The decrease in research expenditures incurred with GTRC is due to the Company's nearing completion of the design and manufacture of prototypes of the set top box and the central office equipment associated with its Traverser product in 2002. Generally, as the Company anticipates the completion of its Traverser product, overall research and development expenses are expected to decline, with variations based upon product cost reductions, product enhancements, if any, when such are undertaken.

Research expenditures incurred with Microphase were related to the continuing development of the Company's DSL component products, including the Company's line of POTS Splitters and Microfilters and the Company's newest products, the iPOTS and mPhase Stretch. We believe the mPhase iPOTS offers a much needed solution for the DSL industry; the iPOTS enables telcos to remotely and cost-effectively perform loop management and maintenance including line testing, qualification and troubleshooting. Prior to the introduction of the iPOTS's 153 loop management could not be remotely performed through a conventional POTS Splitter without manual deployment of

personnel. The unique (patent pending) iPOTS circuit allows most test heads to perform both narrow and wideband testing of the local telephone loop from a network operations center central office POTS Splitter without having to physically disconnect the POTS Splitter, thereby eliminating the need to dispatch personnel and a truckroll to either a central office in the field or a customer premises. The Company believes there will be a demand for this product, as it significantly reduces the cost of deploying and maintaining DSL services. Also recently developed is the DSL loop extender product called mPhaseStretch. This product extends the service distance for the mPhase Traverser and can be used in conjunction with other DSL services.

The Company believes there will be demand for the Stretch loop extender product as it extends the reach of delivery of television and data over DSL.

#### General And Administrative Expenses

Selling, general and administrative expenses were \$6,490,373 for the year ended June 30, 2002 down from \$16,150,711 for the comparable period in 2001. The decrease in the selling, general and administrative costs included a decrease of non-cash charges relating to the issuance of common stock and options to consultants, which totaled \$2,445,561 for the year ended June 30, 2002 as compared to \$6,227,552 during the comparable period in 2001. The decrease also occurred as a result of the reduction in workforce in Fiscal 2002 and the reduction in marketing expenses in Fiscal 2002 in response to the current contraction in the telecommunications equipment market. Other components of the decrease in selling, general and administrative expenses were a substantial decrease in payroll of approximately \$1,100,000 to \$450,000, use of outside consultants of approximately \$870,000 to \$70,000, marketing expenses such as trade shows of \$1,200,000 to \$270,000, and advertising expenses of \$415,000 to \$13,000, all of which approximated \$2,800,000.

#### Net Loss

mPhase recorded a net loss of \$11,245,361 for the year ended June 30, 2002 as compared to a loss of \$23,998,734 for the same period ended June 30, 2001. This represents a loss per common share of \$(.23) in 2002 as compared to \$(.72) in 2001, based upon weighted average common shares outstanding of 49,617,280 and 33,436,641 during the periods ending June 30, 2002 and June 30, 2001, respectively.

#### Nine Months Ended March 31, 2005 vs. March 31, 2004

#### Revenue

Total revenues were \$1,039,003 for the nine months ended March 31, 2005 compared to \$4,335,476 for the nine months ended March 31, 2004 representing a decrease of \$3,296,473. The decrease was primarily attributable to a decrease in sales of the Company's Pots Splitter product line. The Company continues to believe that its line of Pots Splitter products is positioned to be competitively priced with high reliability and connectivity, and as such has the potential to be a significant part of DSL deployment worldwide. The Company has experienced declines during each quarter of fiscal year 2004 that has continued into the first half of fiscal year 2005. The Company cannot predict if the downturn in sales of its Pots Splitter line will continue going forward.

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## Cost of Revenues

Cost of sales were \$823,217 for the nine months ended March 31, 2005 as compared to \$3,878,389 in the prior period, representing 79% of gross revenues for the first nine months of fiscal 2005 which ended March 31, 2005 and 89% for the nine months of fiscal 2004 which ended March 31, 2004, respectively. Our gross margins have been very volatile over the past three years as spending among the telecommunications providers has contracted, coupled with downward pressures related to the supply and demand of telecommunications products. Margins for the first nine months of fiscal 2005, which ended March 31, 2005, increased by 10% over the margins for the same period ended March 31, 2004 due to better cost of materials used in the Pots Splitter product line. We are unable to determine whether such increase in margins will continue for the remainder of fiscal year 2005.

## Research and Development

Research and development expenses were \$3,820,128 for the nine months ended March 31, 2005 as compared \$2,858,375 during the comparable period in 2004, or an increase of \$961,413. This increase consisted of increased spending in the Company's Nanotechnology battery products of approximately \$500,000, and approximately \$200,000 incurred in connection with commencement of research of the Company's new Magnetometer product both contracted with Lucent Technologies Inc. This increase was partially offset by a reduction of expenses incurred with Microphase Corporation for Research and Development.

The Company does, expect to increase such level of expenditures for research and development costs during the remainder of fiscal year 2005 and into fiscal year 2006. In order to broaden and diversify its current line of business into additional high growth technology areas, the Company entered into a Development Agreement, effective February 3, 2004, with the Bell Labs division of Lucent Technologies, Inc. to commercialize the use of nano power cell technology. Under the terms of the \$1.2 million contract, Lucent/Bell Labs will develop for mPhase micro-power source arrays fabricated using nanotextured, superhydrophobic materials. This new business arrangement with Lucent Bell Labs will give mPhase the opportunity to develop and offer breakthrough battery technology applications, initially to government market segments including defense and homeland security, and ultimately to the commercial market. The initial applications for the nano power cell technology will address the need to supply emergency and reserved power to a wide range of electronic devices for the defense department. In addition the Company entered into a Second Amendment to its Development Agreement with Lucent Technologies, Inc effective September 20, 2004 for Development of Release 3.0 of its TV+ product which is expected to be completed during the second quarter of fiscal year 2006. The contracts call for payments totaling \$1,536,680 payable in project milestones of \$158.6 thousand each over the contract. As of March 31, 2005 the Company has made payments of approximately \$2,000,000 under such contract with an aggregate of \$784,000 remaining in 5 equal payments. In addition the Company anticipates additional development cost to be incurred during fiscal year 2005 of approximately \$1,200,000 for software from other vendors and other development of its Release 3.0 of its TV+ product.

Research expenditures incurred with Microphase were related to the continuing development of the Company's DSL component products, including the Company's line of pots Splitters and microfilters and the Company's newest products, the *ipots* and the mPhase stretch. We believe the mPhase *ipots* offers a much-needed solution for the DSL industry; the *ipots* enables telcos to remotely and cost-effectively perform loop management and maintenance including line testing, qualification and troubleshooting. Prior to the introduction of the *ipots*, loop management could not be remotely performed without manual intervention. The unique (patent pending) *ipots* circuit allows most test heads to perform both narrow and wideband testing of the local loop through the central office Pots splitter without having to physically disconnect the Pots splitter, thereby eliminating the need to dispatch personnel and a truckroll. On November 23, 2004, the Company announced the first sale of its IPOTS3 product to a European broadband networking company. The Company anticipates future demand for this product, as it significantly reduces the cost of deploying and maintaining DSL services

## General and Administrative Expenses

Selling, general and administrative expenses were \$5,416,357 for the nine months ended March 31, 2005 up from \$2,196,052 or an increase of \$3,220,305 from the comparable period in 2004. The increase in the selling, general and administrative costs is comprised primarily of non-cash charges relating to the issuance of common stock and options to consultants and officers of the Company, which totaled \$2,582,148 for the nine months ended March 31, 2005 as compared to \$785,740 for the comparable period ended March 31, 2004 resulting in an increase of \$1,796,408. The increase in selling, general and administrative expenses is also attributable to \$181,721 of expenses associated with adjustments of offering prices of certain of the private placements completed in fiscal year 2005. Additionally sales and technical sales associates compensation and fringe costs increased approximately \$675,000, travel expenses increased by approximately \$52,000 and increased spending in advertising, trade shows and marketing and resulting expenses amounted to an aggregate of approximately \$180,000. We expect sales and travel expenses to grow as the Company's approaches the deployment of its TV+ products in the future.

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## Depreciation and Amortization

Depreciation and amortization expense was \$193,650 for the nine months ended March 31, 2005, up from \$100,883, or an increase of \$92,767 from the comparable period in 2004. . We expect such upward trend to continue but such depreciation and amortization expense should remain at the current reduced levels until the Company commences deployment of its television over DSL platforms. We expect to increase capital expenditures in connecting with the deployment of equipment at test sites with various telecommunications service providers globally as deployment of our TV+ product progresses.

## Net Loss

The Company recorded a net loss of \$9,484,240 for the nine months ended March 31, 2005 as compared to a loss of \$4,899,771 for the nine months ended March 31, 2004. This represents a loss per common share of \$.09 for the nine month period ended March 31, 2005 as compared to a loss per common share of \$.07 for the nine months ending March 31, 2004, based upon weighted average common shares outstanding of 101,062,839 and 75,312,435 during the periods ended March 31, 2005 and 2004, respectively.

Although it is difficult to predict the exact timing of additional material deployments of its TV+ product, the Company believes that significant revenue is not expected until the fourth quarter of fiscal year 2005, which along with any upturn of spending in the telephone industry, will also increase sales and improve the Company's operating margins and provide the Company with the opportunity to attain profitability sometime in fiscal year 2006.

## The Outlook for the Company's Flagship Product

The Company believes significant deployments and resultant revenues of its Flagship product the TV+ IPTV solution are not expected until the second half of fiscal year 2006, which, if accompanied by a material upturn in spending in the telephone industry could lead to increased sales and improve the Company's margins and provide the Company with the opportunity to become profitable.

## Research and Development Activities

mPhase throughout its history has outsourced its research and development activity with respect to both of its TV platforms as well as its POTS splitter products. GTARC has conducted a significant amount of research and development for mPhase pursuant to a research agreement comprised of a series of delivery orders, which outline the timing, necessary actions and form of payment for specific tasks related to the completion of certain components of the DVDDS legacy product. Microphase has performed research and development for mPhase with respect to certain component DSL products such as the iPOTS products, low pass filters and POTS Splitters and the legacy DVDDS product. Most recently, mPhase has engaged Lucent for development of Version 3.0 of its TV+ product and for development of a new extended shelf life battery using nanotechnology.

For the years ended June 30, 2004, 2003 and 2002 and for the period since inception (October 2, 1996) to June 30, 2004, approximately \$4,069,721, \$3,538,305, \$3,819,583 and \$38,416,800, respectively, has been billed to mPhase for research and development conducted by Lucent Technologies, Inc, Microphase Corporation and GTARC. With the completion of the DVDDS legacy product, the Company has shifted its research and development from GTARC to Lucent Technologies Inc. The Company has recently expanded its research and development efforts with Lucent Technologies to the NanoTechnology business segment. The Company incurred research and development expenses with Lucent for fiscal years ended June 30, 2004, June 30, 2003 and 2002 of \$2,328,602, \$1,112,500 and \$156,250, respectively.

In February of 2004, the Company and GTRC entered into a final agreement to convert approximately \$1.8 million in payables outstanding to GTRC and exchange mutual releases in consideration for the issuance to GTRC of a Warrant

(which may be exercised on a cashless basis) to purchase 5,069,242 shares of the Company's common stock valued at \$.35 per share. In January of 2005, GTRC exercised its cashless warrant and received 4,949,684 shares of common stock based upon a formula, which took into account the then current value of the Company's common stock. In addition the, under the terms of the final settlement, the Company was obligated to pay GTRC a total of \$100,000 in quarterly installments payments commencing at the end of March of 2004 which is currently the subject of a renegotiation of the parties downward as the Company reexamines the need to continue to maintain certain patent protection for the TraverserDVDDS. Under the terms of its license from GTRC mPhase is the sole, worldwide licensee of the technology developed by GTARC in conjunction with the legacy DVDDS product. Upon completion of the legacy DVDDS product, GTRC may receive a royalty of up to 5% of product sales.

The amount of research and development costs the Company has expended from October 2, 1996, its inception date, through June 30, 2004 is \$38,416,800. During the year ended June 30, 2004, the Company incurred research and development expenses of \$4,069,721 related to the continued development of its current TV+, IPOTS3 products plus exploratory development of certain nanotechnology battery product as compared to \$3,538,305 for the year ended June 30, 2003.

Research and development expensed were \$3,820,128 for the nine months ended March 31, 2005 as compared to \$2,858,715 during the comparable period in 2004 or an increase of \$961,413. The increased expenditures represented and expansion of contract R&D activities, consisting of approximately \$500,000 in increased spending on Nanotechnology and approximately \$200,000 in the start up of Magnetometer Research and Development. The balance of the increase is attributal to increased TV+ Version 3.0 spending.

#### Strategic Alliances Implemented

The Company has entered into a Co-Branding Agreement with Lucent for its redesigned cost reduced INI set top box as part of its TV+ product solution. In addition, pursuant to a Systems Integration Agreement with Lucent, the Company has been designated as the exclusive worldwide reseller of the Lucent Stinger when bundled as part of the mPhase TV+ product.

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## Critical Accounting Policies

### Revenue Recognition

All revenue included in the accompanying consolidated statements of operations for all periods presented relates to sales of mPhase's POTS Splitter Shelves and DSL component products.

As required, mPhase has adopted the Securities and Exchange Commission ("SEC") Staff Accounting Bulletin ("SAB") No. 101, "Revenue Recognition in Financial Statements", which provides guidelines on applying generally accepted accounting principals to revenue recognition based upon the interpretations and practices of the SEC. The Company recognizes revenue for its POTS Splitter Shelf and other DSL component products at the time of shipment, at which time, no other significant obligations of the Company exist, other than normal warranty support.

The deferred revenues balance recorded on the Balance Sheet for the fiscal year ended March 31, 2005 is made up of three customer deposits consisting of \$214,180 in the aggregate for the POTS product.

### Research and Development

Research and development costs are charged to operations as incurred in accordance with Statement of Financial Accounting Standards ("SFAS"), No.2, "Accounting for Research and Development Cost."

### Income Taxes

mPhase accounts for income taxes using the asset and liability method in accordance with SFAS No.109 "Accounting for Income Taxes." Under this method, deferred tax assets and liabilities are measured using currently enacted tax rates. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in results of operations in the period that includes the enactment date. Because of the uncertainty as to their future realizability, net deferred tax assets, consisting primarily of net operating loss carryforwards, have been fully reserved for. Accordingly, no income tax benefit for the net operating loss has been recorded in the accompanying financial statements.

Utilization of net operating losses generated through March 31, 2005 may be limited due to "changes in control" of our common stock that occurred.

### Stock-based Compensation

Financial Accounting Statement No. 123, Accounting for Stock Based Compensation, encourages, but does not require companies to record compensation cost for stock-based employee compensation plans at fair value. The Company has chosen to continue to account for stock-based compensation for grants to employees using the intrinsic method prescribed in Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. Accordingly, compensation cost for stock options is measured as the excess, if any, of the quoted market price of the Company's stock at the date of the grant over the amount an employee must pay to acquire the stock. The Company has adopted the "disclosure only" alternative described in SFAS 123 and SFAS 148, which require pro forma disclosures of net income and earnings per share as if the fair value method of accounting had been applied.

The Company accounts for non-employee stock based awards in which goods or services are the consideration received for the equity instruments issued based on the fair value of the consideration received or the fair value of the equity instrument issued, whichever is more readily determinable.

### Inventory Reserve and Valuation Allowance

The Company carries its inventory at the lower of cost, determined on a first-in, first-out basis, or market. Inventory consists mainly of the Company's POTS Splitter Shelf and Filters. In determining the lower of cost or market, the Company periodically reviews and estimates a valuation allowance to reserve for technical obsolescence and marketability. The allowance represents management's assessment and reserve for the technical obsolescence based upon the inter-operability of its component products, primarily filters and splitters, with presently deployed and next generation DSL infrastructures as well as a reserve for marketability based upon current prices and the overall demand for the individual inventory items. Material changes in either the technical standards of future DSL deployments or further erosion in the demand for deployments of DSL infrastructures could affect the estimates and assumptions resulting in the amounts reported. The allowance represents management's assessment and reserve for the technical obsolescence based upon the inter-operability of its component products, primarily filters and splitters, with presently deployed and next generation DSL infrastructures as well as a reserve for marketability based upon current prices and the overall demand for the individual inventory items. Material changes in either the technical standards of future DSL deployments or further erosion in the demand for deployments of DSL infrastructures could affect the estimates and assumptions resulting in the amounts reported. The allowance is estimated as the difference between inventory at historical cost, on a first in first out basis, and market based upon assumptions about future demand, current prices and product liability, and charged to the provision for inventory, which is a component of cost of sales. At the point the historical cost is adjusted, a lower cost-basis for that inventory is established, and subsequent changes in facts and circumstances do not result in the restoration or increase in that newly established cost basis.

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During the fiscal years ended June 30, 2004, 2003 and 2002, the Company reserved approximately \$98,000, approximately \$302,000, and approximately \$928,000, respectively, for technical obsolescence and marketability based upon current prices and overall demand and charged a like amount to expense, representing 5.9% of average inventory, at cost, of approximately \$1,671,000 on hand during the period in fiscal 2004; 8.4% of average inventory, at cost, of approximately \$3,588,000 on hand during the period in fiscal 2003; and 13.6% of average inventory, at cost, of approximately \$4,602,000 on hand during fiscal 2002. The reserve and corresponding charges in fiscal 2002 were increased as the Company experienced a dramatic decrease, along with the entire telephonic industry, in demand for our component products in addition to the decision to table the production of certain product line items built on certain European standards and which the Company does not expect to pursue in the near future. As of June 30, 2004, the Company recorded a cost adjustment of approximately \$86,902, recognizing permanent cost reductions due to price adjustments approximating \$11,212 and reductions due to obsolescence resulting from a lack of inter-operability of certain components in inventory with the Company's present product line approximating \$11,212. As a result on June 30, 2004 the Company had a total inventory valuation reserve of \$388,235 against its inventory with a total balance, at cost, of \$1,627,207, or 24%. If there was to be a sudden and significant decrease in demand for our products, or if there were a higher incidence of inventory obsolescence because of rapidly changing technology and customer requirements, we could be required to increase our inventory allowances and our gross margins could be adversely affected.

#### Material Related Party Transactions

The Company records material related party transactions. The Company incurs costs for engineering, design and production of prototypes and certain administrative functions from Microphase Corporation and the purchase of product components and finished goods, primarily consisting of DSL splitter shelves and filters, from Janifast Limited. Directors that are significant shareholders of Janifast Limited include Messrs Ronald A. Durando, Gustave T. Dotoli, and Necdet F. Ergul.

Mr. Abraham Biderman is a Managing Director of Eagle Advisers, an investment banking firm, which has earned finder's fees and reimbursement expense of \$514,000 in connection with raising approximately \$4,950,000 during the 9 months ended March 31, 2005 and \$253,500 in connection with raising approximately \$2,600,000 in June and July 2005.

Mr. Biderman, and Mr. Anthony Guerino own a relatively small amount of stock, warrants and options in mPhase Technologies, Inc.

The Company has also incurred charges for beta testing and on-site marketing, including the display of a live working model at Hart Telephone. In addition, the Company has entered into a supply agreement with Hart Telephone, which may commence upon the commercial production of Version 3.0 of the TV+ solution. A member of mPhase's Board of Directors, Mr. Michael McInerney who resigned on April 29, 2005, is employed by Lintel, Inc., the parent corporation of Hart Telephone.

Mr. Durando, the President and CEO of mPhase, owns a controlling interest and is a director and COB of Janifast Limited. Mr. Durando and Mr. Dotoli are officers of Microphase Corporation. Mr. Dotoli is also a shareholder of Janifast Limited. Mr. Ergul, the chairman of the board of mPhase, owns a controlling interest and is a director of Microphase Corporation and is a director and shareholder of Janifast Limited. Microphase, Janifast, Hart Telephone and Lintel Corporation are significant shareholders of mPhase. Microphase, Janifast and Hart Telephone have converted significant liabilities to equity in fiscal years June 30, 2001, 2002, 2003 and in the current fiscal year. Management believes the amounts charged to the Company by Microphase, Janifast, mPhase Television.Net and Hart Telephone are commensurate to amounts that would be incurred if outside parties were used. The Company believes Microphase, Janifast and Hart Telephone have the ability to fulfill their obligations to the Company without further support from the Company.

Mr. Durando's June 30, 2004 note payable balance of \$300,00 was repaid by the Company during the nine month period ending March 31, 2005. During the nine month period, Mr. Durando made additional bridge loans to the Company evidenced by various 12% demand notes in the aggregate of \$525,000. Mr. Durando was repaid a total of \$450,000 of such loans in January of 2005. In addition, Mr. Durando converted \$13,954 of the principal amount of a \$75,000 promissory note leaving unpaid principal of \$61,046 outstanding. Mr. Durando converted \$13,000 of accrued and unpaid interest on various promissory notes of the Company into 65,000 shares of common stock and a 5 year warrant to purchase a like amount of common stock at \$.25 per share.

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During the nine month period ended March 31, 2005 Mr. Dotoli and Mr. Smiley, the COO and CFO and General Counsel of the Company respectively, each lent the Company \$75,000. Mr. Dotoli was repaid the principal amount of such loan, in cash, in January of 2005 and Mr. Smiley converted his \$75,000 loan into 375,000 shares of common stock of the Company plus a 5 year warrant to purchase a like amount of shares at \$.25 per share. In addition, Mr. Smiley converted \$9,975 of accrued interest into 49,875 shares of common stock plus a 5 year warrant to purchase a like amount of shares at \$.25 per share. Finally Mr. Smiley received 25,000 additional shares of common stock as a market adjustment to his equity investment of \$25,000 on August 30, 2004. Mr. Dotoli cancelled \$3,750 of accrued and unpaid interest from August 15, 2004 through January 15, 2005 into 375,000 shares of common stock pursuant to the terms of a portion of a warrant that was exercised at \$.01 per share previously given by the Company to Mr. Dotoli in exchange for and cancellation of unpaid compensation.

Significant charges from related parties are summarized for the periods enumerated as follows:

**Charges and Expenses with Related Parties**

	<b>For the Years Ended June 30,</b>			
	2001	2002	2003	2004
<b>Charges incurred with Janifast included in:</b>				
Cost of sales and ending inventory	\$8,932,378	\$1,759,308	\$178,959	\$2,771,925
Total Janifast	\$8,932,378	\$1,759,308	\$178,959	\$2,771,925
<b>Charges incurred with Microphase Corp. included in:</b>				
Cost of sales and ending inventory (Including Royalties)	\$335,777	\$200,440	\$86,468	\$140,123
Research and development	1,660,606	876,074	428,434	84,494
General and administrative	132,600	136,080	133,200	161,496
Total Microphase Corp.	\$2,128,983	\$1,212,594	\$648,102	\$386,113
<b>Charges incurred with Lintel &amp; Affiliates included in:</b>				
Research and development	\$192,000	\$0	\$0	\$0
General and administrative	285,000	0	0	0
Total Lintel & Affiliates	\$477,000	\$0	\$0	\$0
<b>Charges incurred with Joint Venture Partners &amp; Affiliates included in:</b>				
Research and development	\$949,420	\$64,039	\$0	\$0
General and administrative	60,000	0	0	0
Total Joint Venture Partner & Affiliates	\$1,009,420	\$64,039	\$0	\$0
<b>Total Charges with Related Parties included in:</b>				
Cost of sales and ending inventory	\$9,268,155	\$1,959,748	\$265,427	\$2,912,048
Research and development	2,802,026	940,113	428,434	84,494
General and administrative	477,600	136,080	133,200	161,494
Total Charges with Related Parties	\$12,547,781	\$3,035,941	\$827,061	\$3,158,038

Nine Months Ended March 31

	<b>2004</b>	<b>2005</b>
<b>Charges incurred with Janifast included in:</b>		
Cost of sales and ending inventory	\$1,816,019	\$398,715

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Total Janifast	\$1,816,019	\$398,715
Charges incurred with Microphase Corp. included in:		
Cost of sales and ending inventory (Including Royalties)	\$191,133	\$11,784
Research and development	\$54,000	\$41,000

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General and administrative	\$15,000	\$147,213
Total Microphase Corp.	\$260,133	\$199,997
Charges incurred with Lintel & Affiliates		
included in:		
Research and development	\$0	\$0
General and administrative	\$0	\$0
Total Lintel & Affiliates	\$0	\$0
Charges incurred with Joint Venture Partners & Affiliates		
included in:		
Research and development	\$0	\$0
General and administrative	\$0	0
Total Joint Venture Partner & Affiliates	\$0	\$0
Total Charges with Related Parties		
included in:		
Cost of sales and ending inventory	\$2,007,152	\$410,499
Research and development	\$54,000	\$41,000
General and administrative	\$15,000	\$147,213
Total Charges with Related Parties	\$2,076,152	\$598,712
<b>Liquidity and Capital Resources</b>		

From inception (October 2, 1996) through March 31, 2005 and June 30, 2004 the Company has incurred cumulative (a) development stage losses and has an accumulated deficit of \$125,529,323 and \$115,775,083 respectively and (b) negative cash flow from operations of \$54,120,374 and \$47,842,742 respectively. The auditors report for the fiscal year ended June 30, 2004 includes the statement that "there is substantial doubt of the Company's ability to continue as a going concern". Management estimates that the Company needs to raise approximately \$5-10 million during the next 12 months to continue operations. As of March 31, 2005, June 30, 2004, and June 30, 2003, the Company had a negative net worth of \$2,537,180, \$2,917,962 and \$3,228,886 respectively..

At June 30, 2004 mPhase had working capital deficit of \$2,111,452 as compared to a working capital deficit of \$1,405,331 at June 30, 2003. Through June 30, 2004, the Company had incurred development stage losses totaling \$115,775,083. At June 30, 2004, the Company had \$90,045 of cash and cash equivalents and \$64,100 of net accounts receivables to fund short-term working capital requirements. At March 31, 2005 mPhase had working capital deficit of \$2,332,278 as compared to working capital deficit of \$2,111,452 at June 30, 2004. At March 31, 2005, the Company had approximately \$237,828 of cash, cash equivalents and approximately \$354,903 of trade receivables to fund short-term working capital requirements. The Company's ability to continue as a going concern and its future success is dependent upon its ability to raise capital in the near term to: (1) satisfy its current obligations, (2) continue its research and development efforts, and (3) the successful wide scale development, deployment and marketing of its products.

Historically, mPhase has funded its operations and capital expenditures primarily through private placements of common stock.

Management expects that its ongoing financial needs will be provided by financing activities and believes that the sales of its line of POTS Splitter products and other related DSL component products will provide some offset to cash flow used in operations, although there can be no assurance as to the level and growth rate of such sales in future periods as seen with quarter to quarter fluctuations in component sales. At June 30, 2004, the Company had cash and cash equivalents of \$90,045 compared to \$396,860 at June 30, 2003, net accounts receivable of \$64,100 and net inventory of \$1,237,972. This compared to \$287,135 of net accounts receivable and \$2,103,328 of net inventory at June 30, 2003. At March 31, 2005, the Company had cash and cash equivalents of \$237,828 compared to \$90,045 at June 30, 2004, accounts receivable of \$354,903 and inventory of \$862,963. This compared to \$64,100 of accounts receivable and \$1,237,972 of inventory at June 30, 2004.

Cash used in operating activities was \$6,277,632 during the nine months ending March 31, 2005. The cash used by operating activities principally consists of the net loss, and significant changes in assets and liabilities, including additional cash provided by increasing accounts payable and accrued expenses by approximately \$935,203 offset by depreciation and amortization of \$193,650, and by non-cash charges of \$2,763,861 for common stock options and warrants issued for officer compensation and services and offset by cash outflow from an increase in inventory of approximately \$160,209. The Company expects that it will not have a need to increase inventory significantly until the roll out of our TV+ platform.

The Company has entered into various agreements with GTARC, pursuant to which the Company receives technical assistance in developing the Digital Video and Data Delivery System. The Company has incurred expenses in connection with technical assistance from GTARC totaling approximately \$0 and \$0, for the three month periods ended March 31, 2005 and 2004, respectively, and \$13,539,932 from the period from inception through March 31, 2005.

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In February of 2004, the Company and GTRC entered into a final agreement to convert approximately \$1.8 million in payables outstanding to GTRC and exchange mutual releases in consideration for the issuance to GTRC of a Warrant (which has been exercised on a cashless basis in February of 2005) resulting in the issuance of 4,949,684 shares of the Company's common stock valued at \$.35 per share. In addition the Company was obligated to pay GTRC a total of \$100,000 in quarterly installments payments commencing at the end of March of 2004 that is currently the subject of a renegotiation downward as the Company reexamines its need to maintain certain patents with respect to the Traverser DVDDS product.. mPhase is the sole, worldwide licensee of the technology developed by GTARC in conjunction with the Traverser DVDDS product line. Upon completion of the commercial product, GTRC may receive a royalty of up to 5% of product sales.

Effective June 30, 2001 the Company converted \$2,420,039 of liabilities due to directors and related parties into 4,840,077 shares of the Company's common stock pursuant to debt conversion agreements.

During the fiscal year ended June 30, 2002 certain strategic vendors and related parties converted approximately \$2.7 million of accounts payable and accrued expenses into 7,492,996 shares of the Company's common stock and 5,953,490 warrants. Such vendors include Microphase Corporation, Janifast, Ltd., and Piper Rudnick LLP, mPhase's outside counsel.

During the twelve months ending June 30, 2003, certain strategic vendors and related parties converted approximately \$1.9 million of accounts payable and accrued expenses into 5,923,333 shares of the Company's common stock and warrants to purchase 3,706,800 shares of common stock of mPhase.

During the twelve months ending June 30, 2004, certain strategic vendors and related parties converted approximately 1,963,202 million of accounts payable and accrued expenses into 110,467 shares of the Company's common stock and warrants to purchase 5,069,242 shares of common stock of mPhase.

During the nine months ended March 31, 2005, certain strategic vendors and related parties converted approximately \$960,000 of accounts payable and accrued expenses into 3,437,271 shares of the Company's common stock and warrants to purchase 3,439,975 shares of common stock of mPhase.

As of December 31, 2004, mPhase is obligated to pay Lucent Technologies, Inc., the sum of \$784,000 in 5 payments of \$156,800 each against project milestones under its current Development Agreement for development of Version 3.0 of its TV+ product. In addition, the Company is obligated to make payments of \$100,000 per month through December of 2004 under a separate Development Agreement with Lucent covering development of its new battery developed through the science of NanoTechnology.

The Company does, however, expect an increase in research and development costs beginning in February, 2005 with the expansion of its research and development efforts with Lucent Technologies Inc in the science of Nanotechnology commencing with a renewal for an additional 12 months of a \$1.2 million contract with Lucent to continue work on its nano power cell technology and the entering of a second Research and Development Agreement in March of 2005 to develop a Magnetometer product through the science of Nanotechnology for an additional \$1.2 million contract for 12 months. In order to broaden and diversify its current line of business into additional high growth technology areas, the Company has previously entered into a Development Agreement, effective February 3, 2004, with the Bell labs division of Lucent Technologies, Inc. to commercialize the use of nano power cell technology. Under the terms of the \$1.2 million contract, Lucent/ Bell Labs will develop for mPhase micro-power source arrays fabricated using nanotextured, superhydrophobic materials. This new business arrangement with Lucent Bell Labs will give mPhase the opportunity to develop and offer breakthrough battery technology applications, initially to government market segments including defense and homeland security, and ultimately to the commercial market. The initial applications for the nano power cell technology will address the need to supply emergency and reserved power to a wide range of electronic devices for the defense department.

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The Company has no commitments from affiliates or related parties to provide additional financing. The Company has, from time to time, been able to obtain financing from affiliates when conditions in the capital markets make third party financing difficult to obtain or when external financing is available only upon very unattractive terms to the Company, and when such capital has been available from the affiliates. As a result, conversions of Debt with related parties and strategic vendors during the periods enumerated is as follows:

	For the Years Ended June 30,			For the Nine Months Ended March 31, (Unaudited)	
	2002	2003	2004	2004	2005
<b>Equity Conversions of Debt With Related Parties and Strategic Vendors</b>					
<b>Related Party Conversions</b>					
Number of shares	6,546,550	5,533,333	--	--	2,737,875
Number of warrants	3,733,334	3,491,800	--	--	2,739,995
Amount converted to equity	\$1,594,628	\$1,760,967	\$--	\$--	\$568,933
<b>Strategic Vendor Conversions</b>					
Number of shares	999,662	390,000	110,467	--	697,396
Number of warrants	870,000	215,000	5,069,242	5,069,242	700,000
Amount converted to equity	\$529,503	\$198,032	\$1,963,202	\$1,834,211	\$363,098
<b>Total Related Party and Strategic Party Conversions</b>					
Number of shares	7,546,212	5,923,333	110,467	--	3,437,271
Number of warrants	4,603,334	3,706,800	5,069,242	5,069,242	3,439,975
Amount converted to equity	\$2,124,131	\$1,958,999	\$1,963,202	\$1,834,211	\$932,031
Gain (Loss) on Extinguishment of Debt	\$142,236	\$61,226	\$(150,058)	\$(128,991)	\$(99,393)

Effective March 10, 2005, the Company entered into a Development Agreement with Lucent Technologies, representing a total obligation of \$1.2 million payable in 12 monthly installments of \$100,000 each through March of 2006 for development of a ultra cool magnetometer sensor utilizing the science of nanotechnology.

Effective November 28, 2004 and September 2, 2004, the Company entered into software development agreements with Espiral and Magpie respectively calling for the payments of \$95,000 and \$312,000 in connection with development of Version 3.0 of its TV+ system. Effective September 2, 2004, the Company became obligated to pay Lucent Technologies Inc. a total amount of \$1.2 million for development of Version 3.0 of its TV+ product. Such amount is payable in 8 installments of \$158,600 each against 7 project milestones all of which are expected to be completed during fiscal year 2005.

Effective February 3, 2004, the Company became obligated to pay a total of \$1.2 million to Lucent Technologies Inc. under a new Development Agreement in installments of \$100,000 per month for a period of 12 months to develop a micro power source array using nanotextured superhydrophobic materials. This Agreement was extended in February of 2005 for an additional 12 months for a total of \$1.2 million to Lucent Technologies, Inc. payable in installments of \$100,000 per month.

Effective August 30, 2004, the Company successfully renegotiated its payment agreement originally entered into in March of 2002 with Piper & Rudnick LLC, its outside counsel to cure all past arrearages owed under the original payment agreement. On August 30, 2004, the Company paid Piper & Rudnick LLC the sum of \$100,000 cash and agreed to make future payments of \$25,000 each on December 1, 2004, March 1, 2005, June 1, 2005, September 1, 2005 with a payment of \$50,000 on December 1, 2005 and payments of \$25,000 each on March 1, 2006, June 1, 2006, September 1, 2006 and a final payment of \$75,000 on December 1, 2006. In addition, the Company issued a 5 year cashless warrant for 750,000 shares of its common stock valued at \$.25 per share. The common stock in which such warrant is convertible into is being registered hereunder on this Form S-1 (See Selling Shareholders list on page 65) and could be sold in the open market (see Risk Factor on Page 8 hereof). In addition, Piper Rudnick LLC holds a cashless warrant covering 2,233,490 shares of its common stock that was originally issued as part of its original payment agreement in March of 2002 which shares are being registered as part of this Registration Statement filed on form S-1 by the Company (see Selling Shareholders).

Effective February 18, 2004 of fiscal year ended June 30, 2004, GTRC agreed to convert approximately \$1.8 million of aggregate invoices for work performed for the Company in development of its TraverserDVDDS product into a 5 year cashless warrant to purchase 5,069,200 shares of the Company's common stock or stock valued at \$.35 per share.

During the fiscal years ended June 30, 2002 and 2003 the Company was able to negotiate extended payment terms for overdue accounts payable with strategic vendors. These obligations are now classified as notes payable and included in current and long-term portions of notes payable in the accompanying balance sheets, based upon the revised payment terms. The Company believes they can maintain its present repayment schedule, or otherwise renegotiate such terms that are satisfactory to the Company and these vendors.

We have evaluated our cash requirements for fiscal year 2005 and beyond based upon certain assumptions, including our ability to raise additional working capital from equity financing and increased sales of our POTS Splitter. The Company anticipated that it would need to raise, at a minimum, approximately \$5-10 million primarily in private placement of its common stock with accredited investors, in the current fiscal year. As of March 31, 2005, the Company has raised in the current fiscal year approximately \$ 7 million. In addition, as of August 5, 2005, the Company has raised an additional \$3.2 million in a Private Placement of equity units at \$.20 per share consisting of one share of common stock plus a 5 year warrant for an additional share of common stock at \$.25 per share.

Management believes that the \$5-10 million to be raised, in new Private Placements in the capital markets, will be sufficient to cover its current operating expenses and permit the company to maintain its present operational levels. This amount may be supplemented with additional funds that could be received from investors, including selling

shareholders' listed in this prospectus, currently holding warrants to purchase up to a total of approximately 16.4 million shares of common stock at exercise prices of \$.25 per share which may trade "in the money" and can be exercised during the next 12 months; the likelihood and potential for which may increase should this prospectus become effective and should the price of the Company's common stock rise.

Should these cash flows not be available to us, we believe we would have the ability to revise our operating plan and make certain further reductions in expenses, so that our resources which were available at June 30, 2004, plus financing to be secured during fiscal year 2005, and expected POTS splitter revenues, will be sufficient to meet our obligations until the end of fiscal year 2005 and for the last quarter of fiscal year 2005. We have continued to experience operating losses and negative cash flows. To date, we have funded our operations with a combination of component sales, debt conversions with related parties and strategic vendors, and private equity offerings. Management believes that we will be able to secure the necessary financing in the short-term to fund our operations into our next fiscal year. However, failure to raise additional funds, or generate significant cash flows through revenues, could have a material adverse effect on our ability to achieve our intended business objectives.

The December 31, 2004 outstanding receivable balance of \$50,000 was fully collected in January of 2005 . Additionally, the December 2004 private placement was closed out in January of 2005 with the placement of an additional 3,600,000 equity units at \$.20 per unit consisting of one share of common stock plus 5 year warrants for a like amount of shares with a strike price of \$.25 per share. This generated net proceeds of \$720,000 to the Company.

A January Private Placement realized additional net proceeds of \$357,250 upon issuance of 1,793,750 shares of Common Stock at \$.20 per share plus 5 year warrants to purchase 1,793,750 shares of Common Stock at \$.25 per share. A later Private Placement realized net proceeds of \$1,351,000 upon issuance of 4,920,000 shares of Common Stock plus 5 year warrants to purchase 4,920,000 shares of Common Stock at \$.25 per share. A March Private Placement resulted in the realization of net proceeds of \$1,217,000 upon issuance of 4,396,667 shares of Common Stock at \$.30 per share plus 5 year warrants to purchase 4,396,667 shares of Common Stock at \$.30 per share

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On January 15, 2005, Martin Smiley converted a \$ 100,000 convertible note payable from the Company in exchange for 400,000 shares and a like number of warrants that were price at \$25 per unit or \$100,000 in aggregate.

Also in January of 2005, Martin Smiley was awarded additional compensation of 400,000 shares of common stock. This award will result in a charge to General and Administrative non-cash expense in the amount of \$ 131,750 in the third quarter of fiscal 2005, representing an expense recognition consistent with the market price of that stock of \$.35 on the date of that award.

In late February and early March of 2005, the Company converted approximately \$173,898 in accounts payable due various vendors into 535,296 shares of common stock aggregating \$183,310 in full settlement of those obligations.

During the months of January, February and March of 2005, the Company raised a total of \$2,759,000 in two Private Placements pursuant to Section 506 of Regulation D of the Securities Act of 1933 with approximately 21 Accredited Investors. The proceeds received from such placements is being used by the Company for general corporate purposes including working capital and the payment of Research and Development Expenses primarily to Lucent Technologies Inc. in connection with the continuing development of the Company's TV+ and Nanotechnology fuel cell products. The Company is focusing upon a dual strategy of maximizing sales from its new cutting edge products and continued development of such products to achieve maximum returns to its shareholders as a high growth technology enterprise.

On February 28, 2005, the Company announced that it will collaborate with Rutgers, the State University of New Jersey, on broadening of its nanotechnology based battery to include chemistries such as Lithium as well as the Zinc and Manganese Dioxide chemistries that it is developing through the Bell Labs division of Lucent Technologies Inc. The agreement with Rutgers is contingent upon obtaining federal and state funding for the project.

## BUSINESS

### Overview

We develop, market and sell innovative IPTV and DSL broadband telecommunications equipment. Our main focus is developing the most cost effective products to enable telecommunications service providers to deliver digital quality television (together with data and voice) over its existing infrastructure that may consist of copper, fiber, coax or some combination thereof. The primary markets for mPhase's television delivery products are regions of the world outside of the United State that do not have coaxial fiber infrastructure capable of delivering a large number of digital broadcast television channels. Therefore our television products are targeted primarily for International markets outside of the United States.

On February 3, 2004, mPhase entered into the emerging area of NanoTechnology as a new and second line of business with its execution of a new Research and Development Agreement with the Bell Labs division of Lucent Technologies, Inc. NanoTechnology involves the synthetic assembly of new structures and materials at the molecular level. NanoTechnology has many potential applications including in industries such as biotechnology, semi conductors and power cells and sensors. The Company is initially focusing its efforts in developing new power cells and sensors NanoTechnology products designed for military applications.

### Outsourcing

The Company practices an outsourcing model whereby it contracts with third party vendors to perform certain functions rather than performing those functions internally. For instance, mPhase out sources its research of both its TV+ product and exploratory research of micro electro mechanical systems development and its exploratory development of power source array fabrication using nanotextured superhydrophobic materials to the Bell Labs division of Lucent Technologies Inc.. It also out sources analog engineering development and certain administrative functions to Microphase Corporation and manufacturing of its POTS Splitter product to Janifast Ltd.

We currently have no contracts in place for the manufacturing of our products with either Microphase Corporation or Janifast Ltd. or any other non-affiliated third party manufacturers. We periodically execute purchase orders for the manufacture of quantities of POTS Splitters that are made by Janifast Ltd.

With respect to manufacturing of its IPTV TV+ solution, mPhase is targeting leading contract manufacturing companies with strategically located facilities globally with which it can establish long-term relationships. By using contract manufacturers, mPhase will attempt to avoid the substantial capital investments required for internal production. Janifast Ltd. has produced and delivered 1000 set top boxes to a major Russian telecommunication service provider in connection with the initial deployment of the Company's TV+ solution.

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The Company has entered into various Project Development Agreements with Lucent Technologies, Inc in fiscal years 2004 and 2005 described above, as well as other significant agreements that include a Co-Branding Agreement, dated as of January 21, 2003, allowing the Company to add the Lucent name and Logo to its cost-reduced INI set top box for use with its TV+ products. Such agreement is for an initial period of one year and is subject to renewal on an annual basis by mutual consent. In addition, the Company has entered into a Systems Integrator Agreement, dated as of April 4, 2003 designating the Company as a reseller of the Lucent Stinger DSL transport product when bundled as part of the mPhase TV+ platform globally. Such agreement gives mPhase the exclusive right to sell the TV+ product worldwide containing the Lucent Stinger as the DSL transport mechanism for delivering broadcast television, high speed data and voice over copper telephone wires. In order to qualify for such status, as an accredited reseller, Lucent Technologies, Inc. determined that the Company's TV+ solution added significant value to the Stinger DSL product by enabling such product to deliver broadcast television using internet protocol in addition to the Stinger's well known existing world-class capabilities for the delivery of voice and high-speed data over copper telephone lines. Such agreement is for an initial two year term provided that either party may cancel such agreement with 60 days' notice to the other party.

As a member of the Lucent Business Partner organization, mPhase is able to leverage established relationships with an existing Stinger customer base without having to expand its sales force. To date there are approximately 4 million ports of the Stinger deployed around the world some of which may represent potential future deployments and upgrades for the IPTV TV+ solution. mPhase and the Lucent Global Business Partners group are also targeting other Business partners in markets where there currently is a lack of cable television infrastructure.

mPhase also develops and designs component DSL products including Plain Old Telephone Service Splitters (POTS Splitters) and low pass filters. Since its inception in 1996, virtually all of mPhase's sales revenue has been derived from the sales of POTS Splitters and other DSL component products. mPhase's product line also includes its intelligent line of POTS Splitter product known as the Broadband Loop Watch. This is a device which allows telecommunications service providers to perform DSL loop qualification from a central office without having to deploy workers to the field.

#### Industry Background

The Company believes there is a significant market for its latest TV+ solution for the delivery of IPTV. Telephone companies worldwide need to deliver a combination of services (i.e., voice, television and data) in order to reverse negative economic trends of reduced margins and customers. The multichannel television business is a growing industry. Much of the world is largely underserved, with little access to digital television programming. Cable, outside the US and pockets of Europe, is in the early stages of deployment. In fact, according to Kagan World Media, the percent of television-owning households subscribing to multichannel television services outside of North America in 2002 was only 36%. The mPhaseTV+ solution empowers telecommunications service providers to (a) capitalize upon this growing revenue-generating segment and (b) be able to compete more effectively with other technologies, such as cable where installed, and direct broadcast satellite (DBS) services.

We believe the incentive for telephone companies to deploy advanced digital services is significant. The traditional revenue model for telecommunications service providers is shifting as fixed line calling revenues are continuing to decline with the advent of as wireless telephony and voice delivered over the Internet. Traditional telephone companies can no longer rely on a captured market and need to offer new, revenue-generating services in order to maintain or increase profitability and by offering new services to their customers.

Cable television providers are also beginning to offer cable telephony and cable modems for high-speed Internet service, in addition to their traditional multichannel television services. Additionally, in the U.S., direct broadcast satellites providers (DBS) are upgrading to two-way satellite communication to provide data services. In more advanced markets, these technologies have converged, leaving telephone, cable and direct satellite television providers competing for the same customers and the same dollars.

mPhase's flagship TV+ solution enables telephone companies and other communications service providers utilizing twisted pair telephone wires or any other existing infrastructure to respond to these competitive threats and immediately offer fully integrated broadband service packages to their subscribers. Importantly, with mPhase's products, telecommunications service providers are able to compete with cable and satellite providers in the high-margin multichannel digital television market. mPhase's product solution do not require a capital-intensive fiber nor cable build- out, long lead times, or a technically challenging deployment. Instead, utilizing their already installed telephone line infrastructure, telephone companies can increase their per subscriber revenue, capture additional marketshare, stave off competition and ultimately increase their overall market valuation by becoming full-service communications providers today.

Incumbent telecommunications service providers will have an opportunity to preempt wide digital cable or satellite adoption that deploy mPhase's IPTV solution and become market leaders in providing data and video services. Most telecommunications companies and industry analysts currently understand that data-only solutions are not sufficient to attract new customers, retain existing ones, and maintain or achieve profitability.

#### Our IP Television Solution

mPhase markets and sells its innovative IPTV delivery middleware/software as part of its TV+ solutions and is developing a next generation set top box as an additional component of such solution and as a stand alone product. The Company has refocused its efforts on IPTV software/middleware based upon carrier class open standards from its original development of delivery of TV as part of broadband DSL proprietary hardware Our flagship product line is our TV+ solution enabling the delivery of IP TV, voice and high-speed interned over any type of infrastructure of a telecommunications service provider. mPhase has developed its TV+ solution with a specific target in mind, namely, telephone companies in parts of the world where access to multi-channel television is limited, as well as domestic, rural telephone operators.

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mPhase introduced its first TV over DSL product, the Traverser Digital Video and Data Delivery System, (DVDDS) in 1998. The DVDDS, is an end-to-end system based upon proprietary technology developed in conjunction with Georgia Tech Research Corporation. Because it is an end-to-end video-over-ADSL (asymmetric digital subscriber line) equipment. The proprietary transport method utilized in the Traverser System is patent protected. The intellectual property embodied by the DVDDS System includes the ability to deliver a plurality of channels to a plurality of users, ensuring that all channels are available to all users at all times. The Company has replaced this legacy product with its newer TV+ solution.

The DVDDS was originally installed at Hart Telephone Company in Hartwell, Georgia, as part of a beta trial of over 80 customers. Another DVDDS system is installed at the BMW manufacturing plant in Spartanburg, South Carolina for use as a closed television system in a commercial setting.

In September of 2005, the Company expects to release its IPTV solution. Over the years, the Company has spent over \$30 million on research and development culminating in the IPTV product and believes it has significant experience and market knowledge in the field as a result of over 7 years of development efforts, changing market conditions and new technology developments in connection with Internet Protocol delivery of video.

Bell Labs and mPhase initially commenced research on the TV+ solution in December of 2002 as a compliment to and enhancement of the software and set top boxes needed to delivery television over DSL using the Lucent Stinger DSLAM. Bell Labs had previously been working in a contract engineering capacity helping mPhase to cost-reduce its digital set top box.

The two companies elected to team and create what we believe to be the most reliable, scaleable and cost-effective system for the delivery of television services over copper telephone wires. This collaborative platform combines the data centric strengths of Lucent's Stinger with the TV-centric strengths of mPhase's Traverser<sup>153</sup> resulting in a best of breed solution. For mPhase, the TV+ Solution marks a shift in strategy from selling a complete, proprietary platform to providing an industry-standard, modular solution. This joint approach offered a number of advantages. For instance, by utilizing the Lucent Stinger for transport, mPhase's mPhaseTV+ platform can capitalize upon the proven, extremely robust and cost effective method of supporting and delivering data combined with the Traverser's method of supporting video.

Releases 1.0 and 2.0 of the TV+ solution were designed as ATM (asynchronous transfer mode) solutions then targeted to the traditional reliability and use of such protocol by the majority of telecommunications service providers. Release 3.0 of the TV+ solution marks the final evolution of the IP based solution ideally suited for large-scale deployments, and in parts of the world which cannot afford the cost of upgrading to cable infrastructure.

#### NanoTechnology

mPhase has recently entered the business of NanoTechnology which represents the latest scientific area involving the disciplines of molecular engineering, quantum physics and electrochemistry, amongst others to create new advances in products. mPhase is currently focusing primarily upon exploratory research for the development of advanced battery and power cell products and Electro Mechanical Sensor for a new generations of sensors for military applications.

#### Business Development, Organization, and Acquisition Activities

We were incorporated in New Jersey in 1979 under the name Tecma Laboratory, Inc. In 1987, we changed our name to Tecma Laboratories, Inc. As Tecma Laboratories, Inc., the Company has primarily engaged in the research, development and exploitation of products in the skin care field. On February 17, 1997, we acquired Lightpaths, Inc., a Delaware corporation, which was engaged in the development of telecommunications products incorporating DSL technology, and we changed our name to Lightpaths TP Technologies, Inc.

On January 29, 1997, we formed another wholly-owned subsidiary called TLI Industries, Inc. The shares of TLI were spun off to our stockholders on March 31, 1997 after we transferred the assets and liabilities, including primarily fixed assets, patents and shareholder loans related to the prior business of Tecma Laboratories. As a consequence of these transactions, we became the holding company of our wholly owned subsidiary, Lightpaths, Inc. on February 17, 1997.

On June 2, 1997, we completed a reverse merger with Lightpaths TP Technologies, Inc. and changed our name to mPhase Technologies, Inc.

On June 25, 1998, we acquired Microphase Telecommunications, Inc., a Delaware corporation, by issuing 2,500,000 shares of our common stock. Microphase Telecommunications' principal assets were patents and patent applications utilized in the development of our proprietary Traverser technology (as discussed in related footnote 11 of financial statements on P F-35). See also "Material Related Party Transactions," contained with "Critical Accounts Policies" on P 27 and "Certain Relationships and Related Transaction" P 51.

In March 2000, we entered into a joint venture with Alphastar International, Inc. to form a company called mPhase Television.net, Inc., (mPhaseTV) in which we held a 50% interest. On May 1, 2000, we acquired an additional 6.5% interest in mPhaseTV, and made it one of our consolidated subsidiaries.

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On March 14, 2000, we entered into an agreement with BMW Manufacturing Corp., located in South Carolina. Under the agreement, we installed version 1.0 of the Traverser for BMW's telephone transmission network. BMW has agreed that, upon its notice and consent, we will be able to demonstrate to potential customers the functioning system at BMW's facilities. BMW has made two (2) subsequent purchases increasing the size of its deployment to 48 unique units.

Our flagship installation, Hart Telephone, has completed the build and development of its digital headend during fourth quarter of 2001. The completion of their digital headend marks the move from beta to commercial deployment of the Traverser platform. Hart currently has approximately 70 customers receiving about 80 channels of television services.

In May of 2002 mPhase initiated discussions for development of a cost-reduced intelligent network interface (INI) set top box with the Bell Laboratories division of Lucent Technologies, Inc.

Effective December 1, 2002, mPhase entered into a Development Agreement with the Bell Laboratories division of Lucent

Technologies, Inc. for the development of mPhase's broadcast television switch (BTS) as an intergrated platform with the Lucent Stinger DSL Access Concentrator.

On December 9, 2002, pursuant to a Statement of Work, Lucent commenced development of the BTS for mPhase.

On December 15, 2003, mPhase engaged Lucent for the cost-reduction of its Traverser INI set top box.

On January 21, 2003, mPhase entered into a Co-Branding Agreement with Lucent under which mPhase's INI set top box will be co-branded with the Lucent Technologies, Inc. name and logo.

On April 4, 2003, mPhase entered into a Systems Integration Agreement with Lucent. Under the terms of the agreement, mPhase has been given the exclusive right to sell worldwide a "bundled" solution consisting of mPhase BTS and the Lucent Stinger.

In May of 2003, MPhase has announced development of the mPhaseTV+ Platform with Lucent Technologies' Bell Labs. This modular product, as described in the "Our Solutions" section earlier, utilizes the industry-standard Lucent Stinger for transport. Bell Labs has been design contracted to design the mPhase BTS and Traverser CPE to be used in conjunction with the Lucent Stinger. A redesigned cost reduced second generation set top box CPE equipment has been completed. A prototype version of the BTS is also completed and has been successfully tested with 3 customers at Hart telephone in July of 2003. The first version of our TV+ product is scheduled to be completed during the second quarter of fiscal year 2004.

In November of 2003, mPhase announced that it had entered into a \$1.0 million Project Development contract with Lucent Technologies' Bell Labs division to complete development of Version 1.0 of its TV+ solution by the summer of 2004.

In February of 2004, mPhase announced that it had entered into a \$1.2 million Project Development contract with Lucent Technologies' Bell Labs division to perform exploratory research and development of micro power source arrays fabricated using nanotextured, superhydrophobic materials.

In September of 2004, mPhase announced that it had entered into a new \$1.2 million Project Development contract with Lucent Technologies' Bell Labs division to develop Version 3.0 of the TV+ solution centered around a new "Video Soft Switch" enabling the delivery of broadcast television, high speed internet and voice over an new IP based system with an open standards architecture.

In November of 2004, mPhase announced the selection by Lucent Russia to deploy 1,000 ports of mPhase's TV+ solution to a telecom services company in the far eastern region of Russia that is one of 7 regional mega communications service providers. In addition the Company announced that it had received a \$1 million order for its IPOT3 product renamed as the Broadband Loop Watch from Lucent Saudi Arabia.

In March of 2005, mPhase extended its Project Development Agreement with Lucent Technologies Inc. covering its power cell product for an additional 12 months at a cost of \$1.2 million and also entered into a new 12 month Project Development Agreement for development of its new MEMS based Magnetometer sensor product.

Our revenue, historically, has been derived from sales of component telephone equipment parts, the majority of which has come from our sales of POTS Splitter Shelves. In our fiscal years ended June 30, 2003 and June 30, 2004 respectively, we generated approximately \$2.6 million and \$4.8 million in revenue and \$1,039,003 in revenue for the nine months ended March 31, 2005, respectively, from the commercial sale of our component products. Our other component products, including Filters and Central Office POTS Filter Shelves, are marketed to other DSL equipment vendors. We do not believe that the sales of our TV+ feature product will be materially impaired by the sale of these component products to these potential competitors.

mPhase is in the process of evaluating a full range of contract manufacturers, including manufacturers outside of the U.S. We believe that there are many qualified manufacturers around the world. mPhase is likely to contract with multiple companies depending on which countries the TV+ product is deployed and depending upon cost-competitiveness.

#### Our Products & Services

To date mPhase's revenue has been derived almost exclusively from sales of DSL component telephone equipment parts, the majority of which has come from our sales of POTS Splitter Shelves. In November of 2005 we received our first order for 1000 ports of our TV+ solution and our first order for \$1 million of our IPOTS-3 or Broadband Loop watch Product. In our fiscal years ended June 30, 2004 and June 30, 2003 we generated approximately \$4.8 million and \$1.6 million in revenue, respectively, from the commercial sale of our component products and overall losses for such years of \$7,758,586 and \$6,650,211, respectively.

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mPhase supplies the telecommunications industry with products designed to enable, enhance or support broadband DSL services. mPhase's line of TV-over-DSL products include Versions 1.0 and 2.0 of its TV+ Platform with Version 3.0 of its TV+ product expected to be available during the third quarter of fiscal year 2002. Additionally, mPhase markets a line of DSL component products ranging from commodity items such as traditional POTS Splitters and microfilters to higher-end, feature-rich products such as the recently introduced Intelligent POTS Splitter.

#### Traverser DVDDS

mPhase's legacy television-over-DSL System is the Traverser DVDDS. This system is a patented end-to-end solution enabling the delivery of digital broadcast television, high speed data services, and traditional voice services (requires Class5E voice switch) over a pair of copper telephone wires. It has been recently replaced by the mPhase TV+ solution.

#### History of the IPTV+ Solution

mPhase and Bell Labs Lucent Technologies have teamed together to create an industry-standard, high quality and cost effective television over DSL platform known as the mPhaseTV+ solution. Releases 1.0 and 2.1 of this solution consists of three key elements:

The mPhase BTS (broadcast television switch) layer interfacing the video headend and the DSLAM;

Lucent's Stinger DSL Access Concentrator, a field-tested central office (CO) piece of equipment which provides DSL connections to individual customers; and

mPhase CPE, a highly integrated set top box to deliver video in the home environment from the DSL link.

This hybrid, collaborative platform capitalizes upon the strengths of both Lucent's and mPhase's technology. The BTS embodies the same video networking intelligence as the Traverser DVDDS. However, when combined with the proven, robust Stinger, which effectively and cost-effectively supports data, the end result is what we believe to be a best-of-breed, industry-standard solution.

The mPhase BTS resides between the DSLAM and the video headend and provides video networking intelligence that enables television services over DSL. The BTS is also responsible for video-related functionality such as demuxing and mapping MPEG-2 bitstreams, video subscriber management, video content management and billing management.

mPhase has developed, in conjunction with Bell Labs, a low cost, efficient and compact digital set top box with an integrated DSL Modem called the INI Version 400. Various versions of this device exist or are in development such as a standards-based product inoperable with the Lucent Stinger as well as other manufactures' DSLAMs.

Together with a digital video headend (or PCC) and the Lucent Stinger, the Versions 1.0 and 2.0 of the TV+ platform provide an ATM (asynchronous transfer mode) based end-to-end solution for customers wanting to provide television and high-speed data services over their existing copper infrastructure. Based on a streamlined, modular architecture, future upgrade, additional features and ancillary services can be implemented without major modifications to the entire system.

The Company expects to sell Release 3.0 or its IP(internet protocol) based TV+ platform to customers planning to support large scale deployments, delivering both high speed data and television services. Such system is designed for maximum flexibility cost effectiveness and highly scaleable for large deployments by telephone service providers and represents a shift of the Company's focus from hardware to software. Since most telecommunications providers require an IP rather than ATM mode for deploying digital broadcast television and video on demand, we believe that our Release 3.0 will supercede our earlier releases of the TV+ solution.

The Company believes the initial major deployments and any revenues from sales of its flagship IPTV solution, are not expected until the third quarter of fiscal year 2006. An upturn of spending in the telephone industry should also increase sales and improve the Company's margins and provide the Company with the opportunity to attain profitability.

#### Component Parts Pots Splitter Shelves Intelligent Pots Splitter (iPots)

Although the Company has repositioned itself mainly as a software/middleware provider of IPTV solutions, mPhase also designs and markets a line of DSL component products ranging from commodity items such as carrier-class POTS splitters located at the central office as well as customer premises equipment splitters and filters located in the home. Recently, mPhase has introduced a line of innovative loop management products intended to lower the operational costs involved with supporting DSL services. The Broadband Loop Watch (intelligent POTS Splitter), product line marks a significant advancement in automating loop management by utilizing "intelligent functionality" thereby enabling testing of a telephone loop for DSL deployment without having to dispatch personnel to the field to manually perform such tests. This product reduce the operational costs of deploying and maintaining DSL services. The Broadband Loop Watch (originally named the *iPOTS3*) is a significant advancement from the Company's original *iPOTS1*, allowing service providers a 3-way view of the network and is compatible with DSLAM's of most vendors. The *iPOTS1* was *originally* designed for use only with the Lucent Stinger DSLAM.

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## Microfilters

We have developed a complete line of microfilters, including a 2 and 4 pole filter for use in single and multiphone households, as well as a network interface splitter.

## Research and Development Activities

As of June 30, 2004, we had been billed approximately \$13,563,000 for research and development conducted by Georgia Tech Research Institute (GTRC) in connection with the development, over 5 years of the legacy Traverser DVDDS system. On March 26, 1998, we entered into a license agreement with Georgia Tech which owns the Digital Video and Data System technology. GTRC and its affiliates have granted us the exclusive license to use and re-sell Traverser DVDDS worldwide. We are obligated to pay Georgia Tech royalties of up to 5% on future sales of the Traverser. The license agreement expires automatically when the patents covering the invention expire.

The Company has paid Lucent Technologies, Inc, through March 31, 2005 a total of \$784,000 for development of its TV+ solution which commenced in the second quarter of fiscal year 2004. In September of 2004, mPhase announced a new Project Development contract with the Bell Labs division of Lucent Technologies Inc to develop Release 3.0 of its TV+ platform as a new IP based system with an open standards-based architecture based upon a new "Soft Switch" software enabling the delivery of broadcast TV, high-speed internet and voice over fiber and copper. The Company is obligated to pay \$900,400 primarily to Lucent Technologies Inc and Magpie as of March 31, 2005 in remaining payments in order to complete Release 3.0 of the TV+ product.

In February of 2004 mPhase announced that it had entered into a new \$1.2 million Project Development contract with the Bell Labs division of Lucent Technology Inc. for the exploratory research of micro power cell arrays using superhydrophobic nanotextured materials with the first commercial application expected to be a new miniature power cell with a very long shelf life for military and commercial applications. Under the terms of such agreement the Company has paid Lucent \$100,000 per month commencing in February of 2004 for a 12 month period for a total of \$1.2 million. The Company and Lucent have extended such contract for another 12 months on similar terms to continue development of the miniature power cell product.

## Market

Currently, mPhase's target market for its IPTV solution include telephone companies and telecommunications service providers worldwide. By deploying converged voice, video and data over their existing telephone infrastructure, telecommunications service providers can increase revenue and profitability and retain valuable market share. In most parts of the world, the telephone company is strongly positioned to be first to market with an integrated bundle of communications services. There are over 1 billion telephone lines serving consumers around the globe compared to only 586.9 (source: Kagan World Media) million homes passed by cable. In today's competitive telecommunications landscape, the mPhaseTV+ solution for delivery of IP TV has now become a compelling solution for many large international telecommunications service providers to compete effectively in today's marketplace.

We estimate that on average, a typical telecommunications service provider using mPhase's IP TV+ solution can generate significant revenue with a payback on its initial investment in either system within 2-3 years depending on the size and scope of the deployment. Importantly, this relatively short payback period is still applicable in countries where the average cost of a basic cable television package is well below the US average. The economics of mPhase's IPTV+ solution are such that, for example, when charging as little as \$7 per month per subscriber for a basic television package, the system operator can expect a full return on investment within a three-year period of time. Furthermore, over 5 years a telecommunications service provider can achieved a significantly higher rate of return on its investment in our IPTV solution than would be possible with deploying voice and data alone. mPhase has developed a detailed and highly customizable return on investment model to assist the telco in assessing its rates of return and profitability based on additional revenue generated by the new services.

mPhase expects to derive the majority of its revenue from the sale of its TV+ solution developed in conjunction with Lucent Technologies, for a number of reasons:

1. The platform has been designed to achieve maximum cost efficiencies by maximizing scalability using IPTV .
  2. mPhase believes its business partnership with Lucent will help validate our products and result in greater sales.
  3. Version 3.0 of the TV+ solution is a market driven IP based solution and is a powerful software/middleware enabling tool providing complete standards-based flexibility for any combination of transport hardware including all major DSLAM's, set top boxes and other features necessary to optimize a solution by a telephone service provider for the delivery of broadcast television, voice and high-speed internet.
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mPhase is currently targeting international incumbent telephone companies and rural independent domestic local exchange carriers for sale of its TV+ solution . The Company expects to derive the majority of its system sales abroad, specifically from telephone service providers in Europe, Latin America, Asia and Africa.

mPhase believes that foreign markets will adopt its IPTV solution more rapidly than domestic service providers since there is not generally intense competition from cable television. Therefore, the Company has placed much of its initial emphasis on targeting the international market.

The demand for alternative television options is high in Europe, Asia and Latin America. According to the Yankee Group, European countries have been early adopters of video-over-DSL and alternative video delivery technologies, deploying and testing services more aggressively than North America. These markets possess pockets of moderate to high-income households willing and able to purchase advanced digital services, but very few alternatives exist. According to the Gartner Group, another industry analyst, the number of carriers in the Europe, Middle East and African regions planning on deploying video over DSL services has "leapt from 40 percent to almost 75% in 2002." Analysts from the Gartner Group commented that, "This is a clear sign that carriers realize they need to move upstream with broadband value-added services."

Cable television and digital broadcast satellite (DBS) services are less competitive internationally than in North America. Because of the limited expansion of cable, especially two-way digital cable and satellite networks abroad, access to advanced communications services such as high-speed Internet and digital television in many areas is limited to copper-based delivery methods.

Parts of the world representing the largest opportunities for mPhase include Latin America, Eastern Europe and parts of Africa. For instance, multichannel television service providers in Latin America have only penetrated 18.3% of the 94.7 million television-owning households (source: Kagan World Media). In Latin American telecommunications service providers deploying one of mPhase's solutions for IPTV will be able to offer television services at very competitive rates. Currently, multichannel television services are only available to the top-tier consumers in Latin America as well as in other developing parts of the world. mPhase's return on investment models indicate that telecommunications service providers charging as little as \$7 a month for basic services can anticipate a return on investment within a very short period of time. This attractive business model will help make digital multichannel television service available to a large number of potential new users.

The U.S. multichannel television market is highly competitive, because the penetration of cable services in North America is much higher than the rest of the world and there are numerous service options for multichannel pay TV customers, telecommunications service providers must provide incentives for cable television subscribers to switch service providers. However, in foreign markets, where (a) there is a high penetration of television sets, a very limited number of broadcast television channels are received using antennas from "through-the-air" broadcast and (b) direct-to-home satellite providers cannot currently support the delivery of reliable, two-way data services. In such markets we believe that a telephone company is much better positioned to be the initial and primary provider of bundled converged services.

The following table represents the estimated number of television viewers in select countries.

	<b>TV Households</b>	<b>*Multichannel Subscribers (in millions)</b>
<b>Worldwide</b>	<b>994</b>	<b>430.55</b>
<b>Asia</b>	<b>519.3</b>	<b>207.6</b>
<b>Europe</b>	<b>233.3</b>	<b>94.8</b>
<b>Latin America</b>	<b>118.7</b>	<b>24</b>
<b>North America</b>	<b>112.7</b>	<b>104.15</b>

\* Multichannel subscribers includes cable and DBS subscribers

Source: Global Multichannel Markets 2002: Performance and Projections for 59 countries. Kagan World Media.

Competition in the worldwide telecommunications market is becoming increasingly aggressive due to changing telecommunications regulation, heightened competitive threats from alternative technologies, such as cable and digital broadcast satellite, and price declines in local and long distance telephony services.

To date, there are several significant deployments of IPTV worldwide including Fastweb in Italy, Imagenio, operated by Telefonica in Spain, Yahoo BB/Softbank in Japan, SuperSun in China in Hong Kong and Media on Demand in the Republic of China operated by Chunghwa Telecom. mPhase believes that the deployment of IPTV worldwide is still in its very early stages with many initial deployments such as by Microphase with Swiss Telecom experiencing significant technical difficulties. The market has been slower to develop than many commentators have predicted owing to the technical complexity of the systems software and hardware to deliver feature rich television and video on demand where many international telecommunications operators have varied topologies, existing infrastructure, complex regulations to comply with in order to successfully deploy such a system. Nevertheless, mPhase believes that telecommunications service providers around the world have the incentive to deploy

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Domestic telecommunications service providers face difficulty in maintaining market share and revenue. Price declines in traditional voice services and the proliferation of Internet telephony are impacting operating margins. mPhase believes that the independent, rural domestic telecommunications service providers are especially vulnerable to these competitive threats and have a need to develop new product delivery capabilities to increase revenues and margins. However, independent telecommunications service providers are not as well capitalized as the larger domestic regional bell operating companies and other large incumbent service providers and therefore tend to be very cost conscious in equipment deployment. Nevertheless, in areas where there is sparse cable deployment, or the cable infrastructure is antiquated, there is an increasing demand for better quality of service, more programming channels and additional services. The independent telecommunications service providers operating in these areas can potentially benefit from the incremental revenue generated by services offered through mPhase's TV+ solution. Since the flexibility of the solution allows for favorable economic returns for both small and large customer deployments, mPhase believes that there may be certain opportunities in the United States for deployment of its IP TV+ solution.

mPhase is in the process of evaluating market opportunities in North America and around the world to address commercial applications of the TV+ solution. However, the Company believes that commercial sales to manufacturing or enterprise customers will only represent a marginal source of revenue because of the limited scope and demand for internal broadcasting networks in the commercial market.

### Sales Strategy

#### IPTV

mPhase will pursue sales opportunities through a variety of channels, including direct sales by the Company's internal sales team, distributors and in conjunction with Lucent Technologies, Inc.

mPhase should be able to leverage the Lucent brand and the reputation of the Stinger as a highly scaleable and cost-effective transport medium. An example of this is found with respect to mPhase's initial deployment of 1000 ports of its TV+ solution to a major telephone service provider in Russia through Lucent Russia as an addition to the Lucent Stinger DSLAM.

In markets where Lucent is directly selling into accounts deemed to be strong potential markets, the two companies can collaborate their efforts to bring forth a compelling product solution.

#### Joint Venture Opportunities

There also exist opportunities for mPhase to capture recurring revenue from the sale and deployment of its video over DSL systems through a joint venture business model. Under this scenario, mPhase would sell its equipment to a joint venture company, of which mPhase retains a minority position. This company would negotiate either a line leasing or revenue share program with the incumbent telephone company and subsequently deploy and operate one of mPhase's television over DSL platforms. mPhase believes a JV may provide additional opportunities for sales to international telephone carriers that may not have the funds to procure mPhase's IP TV solution, yet recognize the potential business opportunity in deploying our product.

Funding of the equipment and operation of the system would be the responsibility of the JV. Member companies of the JV would include entities interested in controlling television services such as the government and large media groups. For example, mPhase has established a JV in Turkey with Beyaz Holdings a significant provider of Turkish Television content. Although a JV requires greater involvement from mPhase in terms of organizing and coordinating the appropriate parties, the long-term potential benefits to mPhase are great. mPhase would not only secure sales of its TV+ solution, but would benefit from the recurring revenues from a JV engaged in being a broadcast television service provider.

## DSL Component Products

mPhase continues to sell a line of DSL component products including: POTS Splitter Shelves, DSL Loop Diagnostic systems such as the Broadband Loop Watch product, in-line microfilters, Continuity Test Cards and Network Intelligent Device splitters. These products are essential components to any DSL installation, regardless of the DSL equipment vendor. The mPhase components are interoperable with Digital Subscriber Line Access Multiplexing equipment from a broad range of DSL manufacturers. Potential customers for the DSL component products include other DSL equipment manufacturers, re-sellers, network integrators and telecommunications service providers deploying DSL worldwide.

To date, mPhase has deployed over 250,000 POTS Splitter ports. The mPhase DSL component products are sold both by mPhase directly as well as through established distribution agreements.

The Company recognizes the depressed market conditions that began in 2001 that continue to pervade the telecommunications equipment industry. Although the Company experienced a rebound in the market in the first quarter sales of POTS Splitters during fiscal year ended June 30, 2004, it has continued to experience a decline in such sales in each quarter thereafter through the six months ended December 31, 2004. Sales through March 31, 2005 have continued to be weak.

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We are continuously in discussions with various original equipment manufacturers of telecommunications equipment to identify opportunities for joint bids for infrastructure deployment with major domestic and international telecommunications service providers. We also continue to market our component products directly.

#### Intellectual Property, Patents and Licenses

The Company has entered into software development and licensing agreements with Magpie with respect to certain software used in connection with Release 3.0 of its TV+ product. Under such development and licensing Agreement the Company has made aggregate payments of approximately \$320,000 as of April 21, 2005. In addition the Company will pay a licensing fee per set top box sold as part of the TV+product. In the third quarter of fiscal year 2005, the Company entered into a second development agreement with Magpie calling for payments of approximately \$430,000 in order to complete software development necessary for Release 3.0 of its TV+ solution. Such payments are payable monthly subject to completion of milestones.

We have filed and intend to file United States patent and/or copyright applications relating to some of our proposed products and technologies, either with our collaborators, strategic partners or on our own. There can be no assurance, however, that any of the patents obtained will be adequate to protect our technologies or that we will have sufficient resources to enforce our patents.

Because we may license our technology and products in foreign markets, we may also seek foreign patent protection. With respect to foreign patents, the patent laws of other countries may differ significantly from those of the United States regarding patent protection of our products or technology. In addition, it is possible that competitors in both the United States and foreign countries, many of which have substantially greater resources and have made substantial investments in competing technologies, may have applied for, or may in the future apply for and obtain, patents that will have an adverse impact on our ability to make and sell our products. There can also be no assurance that competitors will not infringe our patents or will not claim that we are infringing on their patents. Defense and prosecution of patent suits, even if successful, are both costly and time consuming. An adverse outcome in the defense of a patent suit could subject us to significant liabilities to third parties, require disputed rights to be licensed from third parties or require us to cease our operations.

The intellectual property owned and licensed by us falls into two general categories, analog and digital intellectual property. We have a pending patent application that was filed in June 1999 claiming priority to three provisional patent applications for the analog portion of our technology used in relation to the Traverser DVDDS platform.

Our DSL filter technology enables increased video clarity over copper wire, longer transmission distances and decreased signal error rate. The intellectual property related to the DSL filters includes:

low pass filter shelves and POTS Splitters, which combine the Traverser DSL spectrum from the traditional voice service; and

ADSL filters, which are filters that conform to the worldwide DSL standard and are utilized in the transmission of data and voice service at up to 8 Mbps. We believe that both of these components are key to providing a DSL signal at sufficient quality and service distances for combined video and data delivery.

We license our digital intellectual property. We also have an exclusive, worldwide license to manufacture and market products using the technology developed by Georgia Tech under our contract with them. The exclusive license with Georgia Tech is applicable for the duration of their patent protecting the system design and other technology related to the legacy Traverser DVDDS platform.

The licensed patented and patent-pending technology developed at Georgia Tech covers the capabilities of the Traverser DVDDS.

A patent for the System and Method for the Delivery of Digital Video and Data over a Communications Channel was issued on November 28, 2000 to the Georgia Tech Research Corporation. The Company is expected to maintain this patent in the United States and certain foreign countries.

On July 12, 2005, mPhase announced that it had been awarded a U.S. Patent for Signal Splitting Technology used in its new Broadband Loop Watch product.

We also have patents pending that protect:

the software management and control of the individual Traverser links, the DVDDS, and the channel changing methodology and interface to the electronic program guide at the customer site through the Intelligent Network Interface;

apparatus and methods of remote control of the Intelligent Network Interface; and,

systems and methods to provide subscribers means to playback previously recorded video content.

We purchase from GlobeSpan telecommunication rate adaptive DSL chipsets used in the Traverser DVDDS.

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The Company has filed 7 patents that consist of a combination of (a) patents granted to mPhase from the bell labs division of Lucent Technologies, Inc. and (b) joint patents developed by mPhase and employees of bell labs with respect to the nanotechnology products currently under development.

We also rely on unpatented proprietary technology, and we can make no assurance that others may not independently develop the same or similar technology to ours or otherwise obtain access to our unpatented technology. If we are unable to maintain the proprietary nature of the Traverser technology, our future operations could be adversely affected.

With the migration of the Company's television delivery platform from the Traverser to the TV+ solution, the Company is currently reexamining the need to maintain the cost of patent protection with respect to the legacy Traverser product.

### Regulation

The Federal Communication Commission, or FCC, and various state public utility and service commissions, regulate most of our potential domestic customers. Changes to FCC regulatory policies may affect the accessibility of communications services, and otherwise affect how telecommunications providers conduct their business. These regulations may adversely affect our potential penetration into certain markets. In addition, our business and results of operations may also be adversely affected by the imposition of certain tariffs, duties and other import restrictions on components, which we obtain from non-domestic component suppliers. Changes in current or future laws or regulations, in the U.S. or elsewhere, could materially adversely affect our business.

### Competition

mPhase competes with broadband equipment manufacturers including cable and digital broadcast satellite equipment manufacturers, as well as other equipment vendors manufacturing IP TV middleware solutions and set top boxes. The global telco customer base has the ability to adopt other forms of content distribution if it chooses to compete in the multi-channel home entertainment market. However, mPhase believes its IPTV solution is attractive to a broader range of customers of telecommunication service providers. The following sections outline the competitive landscape for mPhase.

#### Direct Broadcast Satellite Services

In the US, direct broadcast satellite (DBS) providers have experienced increased market penetration over the past few years. DBS service is the only alternative television delivery method in rural areas where cable has not been deployed, or antiquated analog cable is predominant. However, in some cases, DBS service does not include local off-air channels and most DBS operators are not able to provide competitively-priced wireless high-speed Internet service. Technology enabling two-way, high-speed Internet access over DBS is relatively new and we expect it will take time to reach broad market acceptance as a cost-effective, reliable data delivery method.

#### Cable Television Network Operators

Although the cable industry is our indirect competitor, the Company believes that two-way cable service provides incentive to telecommunications service providers to explore additional services. Cable companies pose a serious competitive threat to telephone company market share. However, in order for cable companies to compete for high-speed Internet and telephony customers, the cable plant must be upgraded to two-way digital cable. Cable companies have invested large amounts of capital to upgrade dense service population areas in the US. However, cable operators typically underserved less densely populated regions with antiquated analog cable systems. Outside of the U.S., very little two-way cable plants have been installed.

Telecommunications service providers around the world have the incentive to deploy IPTV solutions either because of the threat of the cable companies, or because of the lack of cable infrastructure. The Company believes that its TV+solution is the most cost effective and robust video delivery technology deployable by our primary target market of international telecommunications service providers. Installing our IPTV+ solution will facilitate telephone companies in retaining and capturing market share, as well as generating incremental revenue. mPhaseTV+ solution enable telecommunications service providers to compete effectively in a converging services market with a "triple play" of services-digital television, high-speed data and voice services in an attractive bundled package.

#### Other IP TV Vendors

mPhase competes with both vendors of middleware and set top boxes. Companies that supply middleware for IPTV include a joint venture of Microsoft and Alcatel, Minerva, Orca Interactive, Siemens, VBrick Systems, and Video Furnance. Other set top box vendors for IP TV include Advanced Digital Broadcast, Amino Communications, i3 micro, Kreatel, Pace Micro Technology, Samsung, Telsey Telecommunication and VBrick Systems. IP end to end systems competitors include UTStarcom,mxWare and Industria. Lucent has recently established a partnership with Orca Interactive, a company located in Israel, that makes software/middleware for the delivery of IPTV that is in direct competition with mPhase's IPTV product.

#### Differentiating Factors

mPhase believes that its IPTV product offers the most reliable, scaleable and cost effective solution for delivery of broadcast

television programming on a cost-effective basis. mPhase's future IP solution is a streamlined solution is designed to be the most cost-effective scaleable solution in emerging international markets as well as flexible enough to be upgraded with enhanced features of more robust systems for high end customers.

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### Headend Equipment Providers

mPhase does not manufacture digital head end gear. All customers interested in deploying an mPhase IP TV+ solution must build a digital headend to receive, digitize and groom the television signals. Through extensive lab and field testing, mPhase has established an approved vendor list of several headend providers.

### Nanotechnology

The science of nanotechnology is very new and evolving. There has been significant venture capital fundings of start up companies during calendar year 2005 focusing upon development of a wide range of potential products and applications. mPhase believes that its power cell and magnetometer products may be the earliest products commercialized using the science of nanotechnology. Nevertheless, the Company does not expect any material revenues from such product for 2-3 years.

### Employees

We presently have approximately (19) full employees, two (2) of whom are also employed by Microphase Corporation. See the description in the section entitled "Certain Relationships and Related Transactions."

### Properties.

We maintain our corporate headquarters at 587 Connecticut Avenue, Norwalk, Connecticut 06854, under a facilities agreement with Microphase. The agreement with Microphase provides that we lease office space, lab facilities and administrative staff on a month-to-month basis. We also maintain offices in New York, N.Y and Little Falls , New Jersey.

### LEGAL PROCEEDINGS

The Company has recently been advised that, following an investigation by the staff of the Securities and Exchange Commission, the staff intends to recommend that the Commission file a civil injunctive action against Packetport, Inc. and its Officers and Directors. Such recommendation relates to alleged civil violations by Packetport and such Officers and Directors of various sections of the Federal Securities Laws. The staff has alleged civil violations of Sections 5 and 17(a)of the Securities Act of 1933 and Sections 10(b)and 13(d)of the Securities Exchanges Act of 1934. As noted in other public filings of mPhase, the CEO and COO of mPhase also serve as Directors and Officers of Packetport. Such persons have advised mPhase that they deny any violation of law on their part and intend to vigorously contest such recommendation.

From time to time we may be involved in various legal proceedings and other matters arising in the normal course of business.

## OUR MANAGEMENT

### Executive Officers and Directors

Our officers and directors, and their ages, as of August 1, 2005, are as follows:

<b>Name</b>	<b>Age</b>	<b>Position(s)</b>
<b>Necdet F. Ergul</b>	<b>81</b>	<b>Chairman of the Board and Director</b>
<b>Ronald A. Durando</b>	<b>48</b>	<b>President, Chief Executive Officer And Director</b>
<b>Gustave T. Dotoli (2)</b>	<b>70</b>	<b>Chief Operating Officer and Director</b>
<b>Martin S. Smiley</b>	<b>58</b>	<b>Executive Vice President, Chief Financial Officer and General Counsel</b>

### Outside Directors

<b>Anthony H. Guerino, Esq. (1)(2)</b>	<b>58</b>	<b>Director</b>
<b>Abraham Biderman (1)(2)</b>	<b>57</b>	<b>Director</b>

(1) Member of Audit Committee. (2) Member of Compensation Committee.

The following is biographical information about each of our Officers and Directors.

Necdet F. Ergul

has served as our Chairman of the Board since October 1996 with the exception of a three-month period in 2000 when he temporarily resigned. Mr. Ergul also currently serves as the President and Chief Executive Officer of Microphase Corporation, a leading developer of military electronic defense and telecommunications technology, which he founded in 1955. He is also a Director of Janifast Ltd. In addition to his management responsibilities at Microphase, he is active in engineering design and related research and development. Mr. Ergul holds a Masters Degree in Electrical Engineering from the Polytechnic Institute of Brooklyn, New York.

Ronald A. Durando

is a co-founder of mPhase Technologies, Inc. and has served as our President, Chief Executive Officer and a Director since its inception in October 1996. In addition, Mr. Durando has been the Chief Operating Officer of Microphase Corporation since 1994. From 1986 to 1994, he was President and Chief Executive Officer of Nutley Securities, Inc., a registered broker-dealer. He is also Chairman of the Board of Janifast Ltd., a Hong Kong corporation for operational and manufacturing companies in China. Mr. Durando is also President and Chief Executive Officer and Director of PacketPort.com, Inc.

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Gustave T. Dotoli has served as our Chief Operating Officer and a Director since our inception in October 1996. In addition, Mr. Dotoli has been the Vice President of Corporate Development of Microphase Corporation since December of 1996. Mr. Dotoli is also a Director and Vice President Corporate Secretary of PacketPort.com, Inc. He formerly was the President and Chief Executive Officer of the following corporations: Imperial Electro-Plating, Inc., World Imports USA, Industrial Chemical Supply, Inc., SISCO Beverage, Inc. and Met Pack, Inc. Mr. Dotoli received a B.S. in Industrial Engineering from Fairleigh Dickinson University in 1959.

*Martin Smiley* joined us as Executive Vice President, Chief Financial Officer and General Counsel on August 20, 2000. With over twenty years experience as a corporate finance and securities attorney and as an investment banker, Mr. Smiley serves as mPhase's strategic financial leader. Prior to joining the Company, Mr. Smiley served as a Principal at Morrison & Kibbey, Ltd., a mergers and acquisitions and investment banking firm from 1998 to 2000, and as a Managing Director for CIBC Oppenheimer Securities from 1994 to 1998. He served as a Vice President of Investment Banking at Chase Manhattan Bank from 1989 to 1994, and as a Vice President and Associate General Counsel for Chrysler Capital Corporation from 1984 to 1989. Mr. Smiley graduated with a B.A. in Mathematics from the University of Pennsylvania and earned his law degree from the University of Virginia School of Law.

*Anthony H. Guerino* has been a member of the Board since February 23, 2000. Since December 1997, Mr. Guerino has been an attorney in private practice in New Jersey. Prior thereto, Mr. Guerino served as a judge of the Newark Municipal Courts for over twenty (20) years, periodically sitting in the Essex County Central Judicial Processing Court at the Essex County Courthouse. Mr. Guerino has been a chairperson for and member of several judicial committees and associations in New Jersey, and has been an instructor for the Seton Hall School of Law's Trial Moot Court Program.

*Abraham Biderman* has been a member of our board since August 3, 2000. Mr. Biderman is Executive Vice President of Lipper & Company; Executive Vice President, Secretary and Treasurer of The Lipper Funds; and Co-Manager of Lipper Convertibles, L.P. Prior to joining Lipper & Company in 1990, Mr. Biderman was Commissioner of the New York City Department of Housing, Preservation and Development from 1988 to 1989 and Commissioner of the New York City Department of Finance from 1986 to 1987. He was Chairman of the New York City Retirement System from 1986 to 1989. Mr. Biderman was Special Advisor to former Mayor Edward I. Koch from 1985 to 1986 and assistant to former Deputy Mayor Kenneth Lipper from 1983 to 1985. Mr. Biderman is a Director of the Municipal Assistance Corporation for the City of New York. Mr. Biderman graduated from Brooklyn College and is a certified public accountant.

#### Board Committees

Our Board of Directors has an audit committee and a compensation committee. The audit committee approves of our independent accountants and determines the appropriateness of their fees, reviews the scope and results of the audit plans of the independent accountants, oversees the scope and adequacy of our internal accounting control and record-keeping systems and confers independently with the independent accountants. The audit committee consists of Messrs. Biderman, and Guerino. Consistent with NASD regulations, an audit charter was developed and adopted by the Board and the audit committee on August 2, 2000.

The compensation committee makes recommendations to our Board of Directors regarding our stock incentive plans and all matters of compensation. The compensation committee consists of three (3) Directors, Messrs. Biderman, Dotoli and Guerino.

#### Director Compensation

For their attendance of Board and Committee meetings, we compensate the Directors in cash as well as in the form of stock options granted under our Stock Incentive Plan, which grants are included in the table "Security Ownership of Certain Beneficial Owners and Management" and the notes thereto.

Executive Compensation

The following table sets forth, for the fiscal year ended June 30, 2004 and the two previous fiscal years, the compensation paid by us to, as well as any other compensation paid to or earned by, our Chief Executive Officer, and our four most highly compensated executive officers, other than the Chief Executive Officer, whose compensation during the fiscal year ended June 30, 2004 was greater than \$100,000 for services rendered to us in all capacities during such year.

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## Summary Compensation Table

Name And Principal Position	Year	Annual Compensation			Long-Term Compensation
		Salary	Bonus	Award(s)	Securities Underlying Options/Sars (Shares) Restricted Stock
Ronald A. Durando(1)(2) Chief Executive Officer and President	2004	\$285,000	-	-	1,500,000
	2003	\$234,504	-	-	450,000
	2002	\$388,504	-	-	1,850,000
Gustave T. Dotoli(1)(2) Chief Operating Officer	2004	\$225,000	-	-	750,000
	2003	\$193,254	-	-	350,000
	2002	\$313,504	-	-	1,225,000
David L. Klimek(1)(4) Chief Technology Officer	2004	\$89,062	-	-	100,000
	2003	\$90,958	-	-	75,000
	2002	\$106,606	-	-	162,500
Martin S. Smiley Executive VP, Chief Financial Officer & General Counsel	2004	103,958	-	-	
	2003	109,583	-	-	200,000
	2002	158,712	-	-	540,000

1. Includes \$7,500 stipend as a director for fiscal year ended June 30, 2002. No such cash stipend was recorded for fiscal years ended June 30, 2003 and June 30, 2004.
2. Does not include warrants to purchase 1,395,400 shares of common stock issued Mr. Durando and Warrants to purchase 1,096,400 of common stock of Mr. Dotoli respectively to cancel previously unpaid compensation. Such warrants relate to \$234,362 and \$35,000 of unpaid cash compensation to Mr. Durando for fiscal years 2002 and 2003 and \$184,105 and \$27,500 of unpaid cash compensation to Mr. Dotoli for fiscal years 2002 and 2003, respectively the amount of which is included as cash compensation in the above table.
3. No individual named above received prerequisites or non-cash compensation during the years indicated which exceeded the lesser of \$50,000 or an amount equal to 10% of such person's salary. No other executive officer received compensation and bonuses that exceeded \$100,000 during any year.
4. Mr. Klimek declined to stand for reelection as a Director and Chief Technical Officer of the Company as of July 20, 2005, the date of the Company's most recent annual meeting.

## STOCK OPTIONS

The following table contains information regarding options granted in the fiscal year ended June 30, 2004 to the executive officers named in the summary compensation table above. For the fiscal year ended June 30, 2004, mPhase granted options to acquire up to an aggregate of 1,615,000 shares to employees and directors.

## Option Grants in Last Fiscal Year (Individual Grants)

Number of Securities Underlying	% of Total Options/SARS Granted to	Weighted Average Exercise	Weighted Average Market	Potential Realizable
				Value of Assumed Annual Rates of Stock Price Appreciation for 5

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Name	Options/SARS	Employees	or Base	Price	Expiration	Year Option Term		
	Granted (#)	in Fiscal Year	Price (\$/Share)	on Grant Date		0%	5%	10%
<b>Ronald A. Durando</b>	<b>1,500,000</b>	<b>44%</b>	<b>\$.45</b>	<b>\$.39</b>	<b>2009</b>	<b>\$0</b>	<b>\$0</b>	<b>\$42,750</b>
<b>Gustave T. Dotoli</b>	<b>750,000</b>	<b>22%</b>	<b>.45</b>	<b>.39</b>	<b>2009</b>	<b>0</b>	<b>\$0</b>	<b>\$21,375</b>
<b>David Klimek</b>	<b>100,000</b>	<b>3%</b>	<b>.45</b>	<b>.39</b>	<b>2009</b>	<b>0</b>	<b>\$0</b>	<b>\$2,850</b>

The following table sets forth information with respect to the number and value of outstanding options held by executive officers named in the summary compensation table above at June 30, 2004. During the fiscal year ended June 30, 2003, no options were exercised. The value realized is the difference between the closing price on the date of exercise and the exercise price. The value of unexercised in-the-money options is based upon the difference between the closing price of mPhase's common stock on June 30, 2004, and the exercise price of the options.

Fiscal Year-End Option Values

Name	Shares Acquired on Exercise	Value Realized \$	Number of Securities Underlying Unexercised Options at year end (#)		Value of Unexercised In-the-Money Options at Year-End (\$)	
			Exercisable	Unexercisable	Exercisable	Unexercisable
<b>Ronald A. Durando</b>	-	-	<b>4,730,000</b>	-	<b>\$-</b>	<b>\$-</b>
<b>Gustave T. Dotoli</b>	-	-	<b>3,000,000</b>	-	-	-
<b>David Klimek</b>	-	-	<b>372,500</b>	-	-	-
<b>Martin Smiley</b>	-	-	<b>1,070,000</b>	-	-	-

### **Employment Agreements**

All employment agreements with our current management have expired and are in the process of being renegotiated subject to approval of the Board of Directors of the Company.

### **Long-Term Stock Incentive Plan**

We have a Long-Term Stock Incentive Plan, under which we have reserved for issuance 15,000,000 shares of common stock. Our shareholders approved our 2001 Stock Incentive Plan at our annual meeting of shareholders on May 30, 2001. The plan provides for grants of incentive stock options and nonqualified stock options to our key employees and consultants and those key employees and consultants of our subsidiaries.

With respect to our current plan, the compensation committee of the Board of Directors administers and interprets our current plan. The exercise price of common stock underlying an option may be greater, less than or equal to fair market value. However, the exercise price of an incentive stock option must be equal to or greater than the fair market value of a share of common stock on the date such incentive stock option is granted. The maximum term of an option is five years from the date of grant. In the event of a dissolution, liquidation or change in control transaction, we may require option holders to either exercise their options within 30 days or surrender such options (or unexercised portion thereof).

Upon stockholder approval, the Board of Directors merged our prior Long-Term Stock Incentive Plan into the 2001 Plan.

The purpose of the 2001 Plan is to promote our long-term growth and profitability by providing key people with incentives to improve stockholder value and contribute to our growth and financial success and by enabling us to attract, retain and reward the best available people.

The maximum number of shares of common stock that we may issue with respect to awards under the 2001 Plan is 20,000,000 shares, in addition to the shares previously authorized for issuance under our Company plan, but which are not issued before our current plan is merged into the 2001 Plan.

The maximum number of shares of common stock subject to awards of any combination that may be granted under the 2001 Plan during any fiscal year to any one individual is limited to 2,500,000 subject to the exceptions made by the Board of Directors. These limits will be adjusted to reflect any stock dividends, split-ups and reverse stock split, unless the Board determines otherwise. If any award, or portion of an award, under the 2001 Plan expires or terminates unexercised, becomes unexercisable or is forfeited or otherwise terminated, surrendered or canceled as to any shares, or if any shares of common stock are surrendered to us in connection with any award (whether or not such surrendered shares were acquired pursuant to any award), or if any shares are withheld by us, the shares subject to such award and the surrendered or withheld shares will thereafter be available for further awards under the 2001 Plan. Those shares that are surrendered to or withheld by us, or that are forfeited after issuance, however, will not be available for incentive stock options.

The 2001 Plan is administered by our Board of Directors or by a committee or committees as the Board of Directors may appoint from time to time. The administrator has full power and authority to take all actions necessary to carry out the purpose and intent of the 2001 Plan, including, but not limited to, the authority to: (i) determine who is eligible for awards, and the time or times at which such awards will be granted; (ii) determine the types of awards to be granted; (iii) determine the number of shares covered by or used for reference purposes for each award; (iv) impose such terms, limitations, restrictions and conditions upon any such award as the administrator deems appropriate; (v) modify, amend, extend or renew outstanding awards, or accept the surrender of outstanding awards and substitute new awards (provided however, that, except as noted below, any modification that would materially adversely affect any outstanding award may not be made without the consent of the holder); (vi) accelerate or otherwise change the time in which an award may be exercised or becomes payable and to waive or accelerate the lapse, in whole or in part, of any

restriction or condition with respect to such award, including, but not limited to, any restriction or condition with respect to the vesting or exercisability of an award following termination of any grantee's employment or consulting relationship; and (vii) establish objectives and conditions, if any, for earning awards and determining whether awards will be paid after the end of a performance period.

In the event of changes in our common stock by reason of any stock dividend, split-up, recapitalization, merger, consolidation, business combination or exchange of shares and the like, the administrator may make adjustments to the number and kind of shares reserved for issuance or with respect to which awards may be granted under the 2001 Plan, in the aggregate or per individual per year, and to the number, kind and price of shares covered by outstanding award.

Without the consent of holders of awards, the administrator in its discretion is authorized to make adjustments in the terms and conditions of, and the criteria included in, awards in recognition of unusual or nonrecurring events affecting us, or our financial statements or those of any of our affiliates, or of changes in applicable laws, regulations, or accounting principles, whenever the administrator determines that such adjustments are appropriate in order to prevent dilution or enlargement of the benefits or potential benefits intended to be made available under the 2001 Plan.

Participation in the 2001 Plan will be open to all of our employees, officers, directors and other individuals providing bona fide services to us or any of our affiliates, as the administrator may select from time to time. All two (2) non-employee directors and approximately nineteen (19) employees will be eligible to participate in the 2001 Plan.

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The 2001 Plan allows for the grant of stock options, stock appreciation rights, stock awards, phantom stock awards and performance awards. The administrator may grant these awards separately or in tandem with other awards. The administrator will also determine the prices, expiration dates and other material conditions governing the exercise of the awards. We, or any of our affiliates, may make or guarantee loans to assist grantees in exercising awards and satisfying any withholding tax obligations arising from awards.

Because participation and the types of awards available for grant under the 2001 Plan are subject to the discretion of the administrator, the benefits or amounts that any participant or groups of participants may receive if the 2001 Plan is approved are not currently determinable. For this purpose, the benefits or amounts that participants may receive if the 2001 Plan is approved do not include awards granted under the Prior Plan that are amended and restated to become awards covering the same number of shares under the terms of the 2001 Plan. These amended and restated awards are not contingent on stockholder approval since the Prior Plan was previously approved by the stockholders.

Our Board of Directors may terminate, amend or modify all or any provision of the 2001 Plan at any time.

#### COMPENSATION COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION

The members of the Compensation Committee during fiscal 2005 were Messrs. Dotoli, Mr. Biderman and Guerino. Mr. Dotoli is our Chief Operating Officer. Neither Messrs Guerino nor Biderman is not one of our officers or employees. None of our directors or executive officers served as a member of the compensation committee (or other board committee performing equivalent functions or, in the absence of such committee, the entire board of directors) of another entity during fiscal 2004 that has a director or executive officer serving on our Board of Directors except that Mr. Dotoli is also a member of the Board of Directors of PacketPort.com, Inc., a company in which Mr. Durando serves as Chief Executive Officer. Mr. Ergul is a controlling shareholder and Director of Microphase corporation (which provides certain administrative services to mPhase) and Mr. Dotoli and Mr. Durando are Officers of Microphase., Mr. Dotoli, together with Mr. Durando and Mr. Ergul, are controlling shareholders, officers and directors of Janifast Ltd. Janifast Ltd. has produced components for the TV+ product and is expected to produce a material amount of DSL components for us in the future.

#### SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

##### ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth as of May 6, 2005 certain information regarding the beneficial ownership of our shares:

- by each person who is known by us to be the beneficial owner of more than five percent (5%) of its outstanding common stock; .
- each of our directors;
- by each executive officer named in the Summary Compensation Table; and, .
- by all of our directors and executive officers as a group.

Name and Address of Beneficial Owner(1)	Number of "Shares" of Common Stock Beneficially Owned	Percentage Ownership of Common Stock(2)
Necdet F. Ergul(5)(6)	2,616,250	2.0%
Ronald A. Durando(3)(5)	11,644,382	8.4%
Gustave T. Dotoli(5)(7)	6,021,100	4.5%
David Klimek(5)	424,500	*
Abraham Biderman(4)(5)	694,000	*
Anthony Guerino(5)	657,500	*
Martin Smiley(8)	5,676,132	4.2%

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Microphase Corporation (9)	14,704,686	10.8%
Janifast(10)	10,935,000	8.7%
All executive Officers Directors, and (2) beneficial owners	53,272,783	59.4%

\* Less than 1%

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(1) Unless otherwise indicated, the address of each beneficial owner is 587 Connecticut Avenue, Norwalk, Connecticut 06854-1711.

(2) Unless otherwise indicated, mPhase believes that all persons named in the table have sole voting and investment power with respect to all shares of the Company shares beneficially owned by them. The percentage for each beneficial owner listed above is based on 130,410,957 shares outstanding on May 6, 2005, and, with respect to each person holding options or warrants to purchase shares that are exercisable within 60 days after May 6, 2005, the number of options and warrants are deemed to be outstanding and beneficially owned by the person for the purpose of computing such person's percentage ownership, but are not deemed to be outstanding for the purpose of computing the percentage ownership of any other person. The number of shares indicated in the table include the following number of shares issuable upon the exercise of warrants or options:

Necdet F. Ergul	1,766,250
Ronald A. Durando	8,614,367
Gustave Dotoli	4,278,067
Martin Smiley	3,554,543
Abraham Biderman	1,017,500
Anthony Guerino	552,000
Microphase Corporation	5,650,000
Janifast Ltd.	2,200,000

(3) Includes 1,396,148 shares held by Durando Investment LLC, and does not include, as separately stated below, 8,395,000 shares and 2,200,000 warrants held by Janifast which Mr. Durando controls and 530,000 shares owned by Karen and Ronald Durando Foundation; and 695,000 shares owned by Durando Charitable Remainder Trust.

(4). Includes 5,233 shares of common stock, options and warrants for 272,500 shares of common stock. Does not include 1,103,225 shares held by Lipper & Co, where Mr. Biderman is a director.

(5) Includes options for 25,000 shares of common stock received as compensation for participation on the Board of Directors.

(6) Includes 200,000 shares owned by Berrin Snyder, his daughter and 150,000 owned by Eda Peterson, his daughter. This does not include, as separately stated below, 8,244,667 shares and 3,200,000 warrants and 1,200,000 shares and warrants to purchase 1,200,000 shares issuable pursuant to the terms of a convertible note held by Microphase Corporation, a company in which Mr. Ergul is the President and Chief Executive Officer.

(7) Includes 277,500 shares owned by Patricia and Gustave Dotoli Foundation; and 195,000 shares owned by Dotoli.

(8) Includes 333,334 shares and warrants to purchase 333,334 shares that reserved for conversion of a convertible note that are included in the beneficially owned shares of Mr. Martin Smiley.

(9) Includes 8,244,667 shares and warrants to purchase 3,200,000 shares and a convertible note that may be converted into 1,200,000 shares, the totals of which are included in the beneficial ownership of Mr. Necdet F. Ergul.

(10) Includes 7,350,000 shares and warrant to purchase 1,200,000 shares, to totals of which are included in the beneficially owned shares of Mr. Ronald A. Durando.

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CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Material Related Party Transactions

The Company records material related party transactions. The Company incurs costs for engineering, design and production of prototypes and certain administrative functions from Microphase Corporation and the purchase of component parts and finished goods, primarily consisting of DSL splitter shelves and filters, from Janifast Limited.

Management believes the amounts charged to the Company by Microphase, Janifast, mPhase Television.Net and Hart Telephone are commensurate to amounts that would be incurred if outside parties were used. The Company believes Microphase, Janifast and Hart Telephone have the ability to fulfill their obligations to the Company without further support from the Company.

Transactions with Officers, Directors and their Affiliates

Directors that are significant shareholders of Janifast Limited include Messrs Ronald A. Durando, Gustave T. Dotoli, and Necdet F. Ergul.

Mr. Durando, the President and CEO of mPhase, owns a controlling interest and is a director of Janifast Ltd. Mr. Durando and Mr. Dotoli are officers of Microphase Corporation. Mr. Ergul, the chairman of the board of mPhase, owns a controlling interest and is a director of Microphase Corporation. Microphase Corporation, and Janifast Ltd, are significant shareholders of mPhase. Microphase and Janifast Ltd. have converted significant liabilities to equity in fiscal years June 30, 2001, 2002 and 2003 and Janifast Ltd. and Microphase Corporation converted \$200,000 and \$250,000 of accounts payable respectively into common stock and warrants as of December 31, 2004. Management believes the amounts charged to the Company by Microphase, and Janifast Ltd. are commensurate to amounts that would be incurred if outside parties were used. The Company believes Microphase, and Janifast Ltd have the ability to fulfill their obligations to the Company without further support from the Company.

Mr. Durando's June 30, 2004 note payable balance of \$300,00 was repaid by the Company during the nine month period ended March 31, 2005. During the nine month period, Mr. Durando made additional bridge loans to the Company evidenced by various 12% demand notes in the Aggregate of \$525,000. Mr. Durando was repaid a total of \$450,000 of such loans in January of 2005. In addition, Mr. Durando converted \$13,954 of the principal amount of a \$75,000 promissory note leaving unpaid principal of \$61,046 outstanding. Mr. Durando converted \$13,000 of accrued and unpaid interest on various promissory notes of the Company into 65,000 shares of common stock and a 5 year warrant to purchase a like amount of common stock at \$.25 per share.

During the nine month period ended March 31, 2005 Mr. Dotoli and Mr. Smiley, the COO and CFO and General Counsel of the Company respectively, each lent the Company \$75,000. Mr. Dotoli was repaid, the principal amount of such loan, in cash in January of 2005 and Mr. Smiley converted his \$75,000 loan into 375,000 shares of common stock of the Company plus a 5 year warrant to purchase a like amount of shares at \$.25 per share. In addition, Mr. Smiley converted \$9,975 of accrued interest into 49,875 shares of common stock plus a 5 year warrant to purchase a like amount of shares at \$.25 per share. Finally Mr. Smiley received 25,000 additional shares of common stock as a market adjustment to his equity investment of \$25,000 on August 30, 2004. Mr. Dotoli cancelled \$3,750 of accrued and unpaid interest from August 15, 2004 through January 15, 2004 into 375,000 shares of common stock pursuant to the terms of a portion of a warrant that was exercised at \$.01 per share previously given by the Company to Mr. Dotoli in exchange for and cancellation of unpaid compensation.

During the, 9 month period ended March 31, 2005, Eagle Advisers, an investment banking firm founded by Mr. Abraham Biderman, a member of the Board of Directors of the Company, earned fees and reimbursement expenses of approximately \$514,000 in connection with services in connection with private placements of common stock and warrants for the Company that raised a total of approximately \$4,950,000 proceeds to net of fees for the Company.

In January of 2005, Martin Smiley was awarded additional compensation of 400,000 shares of common stock.

On October 8, 2004, Mr. Durando agreed to lend the Company \$75,000 and the Company issued a demand note for such amount at 12% interest.

On September 30, 2004, Mr. Durando agreed to lend the Company \$175,000 and the Company issued a demand note for such amount at 12% interest.

On September 28, 2004, Mr. Durando agreed to lend the Company \$75,000 and the Company issued a demand note for such amount at 12% interest.

On August 30, 2004, Mr. Durando agreed to lend the Company \$200,000 and the Company issued a demand note for such amount at 12% interest.

On August 30, 2004, Messrs. Dotoli and Smiley each agreed to lend the Company \$75,000 and the Company issued two demand notes for such amount at 12% interest. Mr. Smiley also invested \$25,000 in the Company's August Private Placement receiving 100,000 shares of the Company's common stock valued at \$.25 per share plus a 5 year warrant to purchase an additional 100,000 shares of common stock at \$.25 per share.

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On July 25, 2004, Mr. Smiley agreed to convert his 12% convertible promissory note for \$100,000 that had matured into a demand promissory at the same interest rate with interest payable quarterly, in arrears.

On November 11, 2002 and November 12, 2002, the Company issued warrants to purchase 2,491,080 shares of common stock of the Company which were valued at \$480,917 or \$.193 per share with an exercise price of \$.01 per share for the cancellation of unpaid compensation to two officer's of the Company as of October 14, 2002.

In March of 2003, Messrs, Durando, Dotoli and Smiley participated in a private placement of the company investing \$20,000, \$20,000 and \$75,000 respectively, receiving common stock of mPhase at \$.30 per share plus 5 year warrants of mPhase to purchase a like amount of common stock at \$.30 per share.

In March of 2003, Messrs. Durando the CEO and President and Smiley the CFO and General Counsel of the Company lent the Company \$30,000 and \$100,000 respectively evidenced by two promissory notes bearing interest at 12% per annum due in September of 2003. As of June 30,2003 the Company prepaid Mr. Durando's promissory note in full together with accrued interest. In June 2003, Mr. Smiley agreed to extend his note until July, 2004. Also in June, 2003, Microphase agreed to convert \$360,000 of accounts payable to a note payable, interest at 12%, due in July, 2004. The notes have provisions for prepayment by the Company, and, at the option of the holder, provide for the conversion of unpaid principal and interest into units valued at \$.30 each, each unit consisting of one share of the Company's common stock and a one warrant to purchase the Company's common stock at \$.30 per share for a period of 5 years.

Necdet F. Ergul, Ronald A. Durando and Gustave T. Dotoli, our Chairman, Chief Executive Officer and Chief Operating Officer, respectively, are executive officers and shareholders of Microphase and Ronald Durando and Gustave T. Dotoli are president and vice- president of PacketPort.com., respectively.

On November 26, 1999, Mr. Durando acquired, via a 100% ownership of PacketPort, Inc., a controlling interest in Linkon

Corporation, now known as PacketPort.com, Inc. On November 26, 1999, PacketPort, Inc., a company owned 100% by Mr. Durando, acquired controlling interest in Linkon Corp., which subsequently changed its name to PacketPort.com, Inc. In connection with this transaction, Mr. Durando transferred 350,000 shares of our common stock to PacketPort, Inc.

During the year ended June 30, 2001, the Company issued 140,350 shares of common stock for investment banking services rendered during the period and recorded an additional \$69,000 of fees which is included in accrued expenses at June 30, 2001 to Lipper & Company.

Abraham Biderman became a member of our Board in August 2000. Mr. Biderman is the Executive Vice President of Lipper & Company, L.P., which received a total of 265,125 shares of common stock for its services as a placement agent for our May 2000, September 2000 and January 2001 private placements. In July, 2001 and November, 2001 Lipper and Company received 138,000 shares and 300,000 shares in additional common stock in mPhase for services rendered to the Company as placement agent in a Private Placement and for general investment banking and financial advice services.

In September 2001, certain of our officers and directors purchased an aggregate of 2,000,000 shares of common stock for an aggregate investment of \$1,000,000. These issuances included 1,000,000 shares to Mr. Lee Barton, a director of the Company at that time, for an investment of \$500,000; 400,000 shares to Mr. Ronald A. Durando, the Company's president and a director, for an investment of \$200,000; 400,000 shares to Mr. Gustave Dotoli , the Company's vice-president and a director, for an investment of \$200,000; and; 200,000 shares to Mr. Martin S. Smiley, the Company's vice-president, for an investment of \$100,000; and were exempt pursuant to Section 4(2) and/or Rule 506 of Regulation D of the Act.

For consulting services rendered in connection with the joint venture, the Company agreed to pay two officers of the Company and a related party \$412,400, which was included on the June 30, 2000 consolidated balance sheet of the Company. This amount was paid by the Company during the year ended June 30, 2001.

Messrs. Biderman and Mr. Anthony Guerino own a relatively small amount of stock, warrants and options in mPhase Technologies, Inc.

#### Transactions with Microphase Corporation

On September 28, 2004, Microphase lent to mPhase the sum of \$175,000 as evidenced by a 12% demand promissory note issued from mPhase to Microphase.

mPhase's President and Chairman of the Board of the Company are also employees of Microphase Corporation. On May 1, 1997, the Company entered into an agreement with Microphase Corporation, whereby it will use office space as well as the administrative services of Microphase Corporation, including the use of accounting personnel. This agreement for fiscal year 2004 was for \$10,000 per month. Microphase Corporation also charges fees for specific projects on a project-by-project basis. During the year ended June 30, 2004 and for the period from inception (October 2, 1996) to June 30, 2004, 386,113 and \$7,610,639 and \$7,224,526, respectively, have been charged to expense or inventory under these Agreements and is included in operating expenses in the accompanying consolidated statements of operations. Management believes that amounts charged to the Company by Microphase are commensurate to amounts that would be incurred if outside third parties were used.

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The Company is obligated to pay a 3% royalty to Microphase Corporation on revenues from its legacy Traverser DVDDS product and DSL component products. During the year ended June 30, 2004 such amount equaled \$140,123.

At June 30, 2004, approximately \$60,000 of undelivered purchase orders remain outstanding at Microphase Corporation.

On February 15, 1997, mPhase entered into a Technology, Patent and Trademark License Agreement (the "Agreement") with MicroTel (Note 4). The Agreement permits the Company to utilize the patent and trademark technology of MicroTel under a licensing arrangement. The Company made payments of \$37,500 per month, commencing June 1, 1997 for technology development. During the period ended June 30, 1997 and 1998, \$37,500 and \$450,000 had been charged to expense under this Agreement and is included in licensing fees in the consolidated statement of operations. As of June 25, 1998, the Company acquired MicroTel and as of that date this Agreement was no longer in effect.

During the fiscal year ended June 30, 2000, \$2,600,000 was advanced to Microphase in the form of a note, which was repaid by Microphase during the year. mPhase recorded \$39,000 of interest income on this note for the year ended June 30, 2000.

The Company is obligated to pay a 3% royalty to Microphase on revenues from its proprietary Traverser Digital Video and Data Delivery System and DSL component products. During the years ended June 30, 2001, 2002 and 2003 mPhase recorded royalties to Microphase totaling \$297,793, \$78,762 and \$47,304, respectively.

Pursuant to a debt conversion agreement between the Company and Microphase for the year ended June 30, 2001, Microphase received 1,278,000 shares of mPhase common stock. For the year ended June 30, 2002 consideration for a direct investment of \$100,000 and pursuant to debt conversion agreements, Microphase received 2,900,000 shares of mPhase common stock and warrants to purchase 2,200,000 mPhase common stock in connection with the cancellation of \$740,000 of outstanding liabilities. As of June 30, 2002, the Company had \$92,405 of payables to Microphase.

During the fiscal year ended June 30, 2003 Microphase received 4,033,333 shares of common stock plus five year warrants to purchase 1,000,000 shares of common stock of mPhase at \$.30 per share in exchange for the cancellation of accounts payable totaling \$920,000. As of June 30, 2002, the Company had \$92,405 included in other liabilities-related parties in the accompanying consolidated balance sheet and as of June 30, 2003 and 2004, \$360,000 and \$180,000 in notes payable-related parties, respectively. Additionally, at June 30, 2003, approximately \$61,789 of payables and \$142,000 of undelivered purchase orders remain outstanding with Microphase.

#### Transactions with Janifast

Janifast Ltd., a Hong Kong corporation manufacturer, which has produced components for our prototype Traverser DVDDS product, and may produce such components for us in the future. Necdet F. Ergul, Ronald A. Durando and Gustave T. Dotoli are controlling shareholders of Janifast Ltd. with an aggregate ownership interest of greater than 75% of Janifast Ltd. Mr. Durando is Chairman of the Board of Directors and Mr. Ergul is a Director of Janifast. During the year ended June 30, 2004 and for the period from inception to June 30, 2004 respectively, \$2,771,925 and \$13,581,611 of products and services have been charged to inventory expense-other liabilities-related parties as long term liabilities in the consolidated balance sheet as of June 30, 2004. Additionally, at June 30, 2004, approximately \$400,000 of undelivered purchase orders remain outstanding with Janifast Ltd. and outstanding payables to Janifast Ltd. amounted to \$422,905.

During the year ended June 30, 2000, mPhase advanced money to Janifast Ltd., which is a related party of which three directors of mPhase are significant shareholders, in connection with the manufacturing of POTS Splitter Shelves and DSL component products. As of June 30, 2000, the amount advanced to Janifast was approximately \$1,106,000, which is included in production advances-related parties on the accompanying balance sheet. There were no such



advances as of June 30, 2001 and June 30, 2002.

Pursuant to a debt conversion agreement between the Company and Janifast Ltd, for the year ended June 30, 2001, Janifast Ltd received 1,200,000 shares of the Company's common stock. For the year ended June 30, 2002, pursuant to debt conversion agreements, Janifast Ltd. received 3,450,000 shares of mPhase common stock and warrants to purchase 1,200,000 shares of common stock in connection with the cancellation of \$720,000 of outstanding liabilities. During the year ended June 30, 2003, Janifast Ltd. was issued 1,500,000 shares of mPhase common stock in connection with the cancellation of \$360,000 of outstanding liabilities of mPhase, the value of which was based upon the price of the Company's common stock on the effective date of the settlement. No gain or loss was recognized in connection with the conversion by Janifast Ltd. for the fiscal year ended June 30, 2003. During the years ended June 30, 2001, 2002, 2003 and 2004, and the period from inception (October 2, 1996) to June 30, 2004, \$8,932,378, \$1,759,308, \$178,959, \$2,771,925 and \$13,642,570 respectively, of invoices for products and services have been charged to inventory or expense-other liabilities-related parties and long term liabilities in the consolidated balance sheet. And as of June 30, 2003 no amounts remained payable to Janifast Ltd.. Additionally, at June 30, 2003, approximately \$1,435,000 of undelivered purchase orders remained outstanding with Janifast Ltd.

#### Transactions with Other Related Parties

In March 2000, mPhase acquired a 50% interest in mPhaseTelevision.Net (formerly Telco Television Network, Inc.), an incorporated joint venture, for \$20,000. The agreement provided for the grant of warrants to the joint venture partner, in consideration of the execution of the Joint Venture Agreement, to purchase 200,000 shares of the Company's common stock for \$4.00 per share (valued at \$2,633,400). This non-cash charge was included in general and administrative expenses in the statement of operations for the year ended June 30, 2000. The fair value of the warrants granted to the joint venture partner as of the date of grant was based on the Black- Scholes stock option pricing model, using the following weighted average assumptions: annual expected rate of return of 0%, annual volatility of 115%, risk free interest rate of 5.85% and an expected option life of 3 years.

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The agreement stipulated for mPhase's joint venture partner, AlphaStar International, Inc., ("Alphastar"), to provide mPhaseTelevision.Net right of first transmission for its transmissions of MPEG-2 digital satellite television. In addition, in March 2000, mPhase loaned the joint venture \$1,000,000 at 8% interest per annum. The loan is repayable to the Company from equity infusions to the subsidiary, no later than such time that mPhaseTelevision.Net qualifies for a NASDAQ Small Cap Market Listing. During April 2000, the Company acquired an additional 6.5% interest in mPhaseTelevision.Net for \$1,500,000. As of June 30, 2003 mPhase owns a 56.5% interest in mPhaseTelevision.net. The Company terminated the lease of the earth station for business reasons, and there was no material impact on mPhaseTelevision.net's operating activities.

Pursuant to an agreement dated as of June 18, 2002, mPhaseTelevision.Net has terminated its lease of the earth station and Alphastar and its affiliated entity have converted certain accounts payable into shares of the Company's common stock.

Additionally, under this Agreement, mPhase is obligated to pay Alphastar and its affiliates \$35,000, which is included in amounts due to related parties in the consolidated balance sheet as of June 30, 2003.

During the fiscal years ended June 30, 2002, 2003 and 2004, the joint venture was charged \$64,039, \$0 and \$0, respectively for fees and costs by its joint venture partner and its affiliates.

#### Transactions with Strategic Vendors

#### Transactions with Other Significant Beneficial Owners of mPhase Common Stock and Warrants

As of June 30, 2004, the Company was approximately \$473,787 in arrears with respect to a Promissory Note issued to Piper Rudnick LLP plus other legal fees of \$118,773. It should be noted that Piper Rudnick received such Promissory Note plus two warrants received in March of 2002 in exchange for cancellation of certain payables. Such warrants have conversion rights into our common stock for a total of 2,233,490 shares that have been registered under a recently effective Form S-1 Registration Statement, and are cashless. On September 3, 2003, the Company paid \$100,000 in cash to Piper in exchange for reducing the total payable to \$550,000 plus the issuance of additional cashless warrant for \$150,000 worth of the Company's common stock valued at \$.25 per share. The remaining \$300,000 payable has the following future payment schedule:

1. Payments of \$25,000 each on December 1, 2004, March 1, 2005, June 1, 2005, September 1, 2005, March 1, 2006, June 1, 2006 and September 1, 2006. 2. A payment of \$50,000 on December 1, 2005 3. A payment of \$75,000 due on December 1, 2006 As of June 1, 2004, the Company is current with respect to payments to Piper Rudnick LLP.

On February 18, 2004, the Company entered into an Agreement with Georgia Tech Applied Research Corporation and Georgia Tech Research Corporation (collective "GTRC") to settle a payable of approximately \$1.8 million pursuant to the issuance of a warrant convertible into 5,069,200 shares of the Company's common stock on a cash-less basis plus a note for \$100,000 payable over a 18 month period of installments of \$16,667 per quarter. The Company is presently renegotiating the amount and payment terms of the Note with GTRC since the Note covered certain licensing fees for patents that the Company may determine are not necessary in connection with its TV platforms going forward.

Effective March 31, 2002, the Company converted \$420,872 of liabilities due to Piper Rudnick LLP, outside legal counsel to mPhase into a warrant to purchase up to a total of 1,683,490 shares of the Company's common stock which pursuant to EITF 96-18, has an approximate value of \$.30 per share; and a warrant to purchase 550,000 shares of the Company's common stock at an exercise price of \$.30 per share pursuant to the terms of payment agreement. In addition, Piper agreed to accept a Promissory Note for \$420,872 of current payables at an interest rate of 8% with payments of \$5,000 per month commencing June 1, 2002 and continuing through December 1, 2003, with a final payment of principal plus accrued interest due at maturity on December 31, 2003. As of August 11, 2003 the Company is \$35,000 in arrears with respect to the \$5,000 per month payment of the Promissory Note. On December

31, 2003, the Company became in arrears with respect to \$420,872 of a balloon payment on a Note payable to its outside Law Firm, Piper Rudnick LLC. The Company is in discussion with respect to such law firm to extend and/or cancel all or portions of this debt. It should be noted that Piper Rudnick holds warrants received in March of 2001 in exchange for cancellation of certain payables. Such warrants have conversion rights into our common stock for 2,233,490 shares that are being registered hereunder (see Selling Shareholders list-page 65 hereof) and are cashless. Such warrants could be exercised shares of our common stock which could then be sold in the open market upon the effectiveness of this Registration Statement on Form S-1 in the open market to recover our outstanding payable. See also Risk Factor Section on Page 8 hereof.

On October 14, 2002, the Company entered into a memorandum on intention with Georgia Tech Research Corporation (GTRC) and its affiliate, Georgia Tech Applied Research Corporation (GTARC), which memorandum was revised on November 12, 2002 and in October of 2003 and is subject to the approval of the respective board of directors of the parties thereto and the exchange of mutual releases. The memorandum provides for the settlement of any and all amounts outstanding to GTRC and GTARC in consideration of the issuance of warrants to purchase 5,069,242 shares of the Company's common stock at \$.01 per share (with a cashless exercise right) in exchange for cancellation of an approximately \$1.3 million portion of the Company's accounts payable. In addition the Company would issue a term promissory note in the principal amount of \$674,235 with interest at prime+1% and varied payments through 2008 in exchange for cancellation of an account payable by the Company in an same amount. The non-current amount of two promissory notes plus two warrants that were part of the proposed transaction as originally negotiated and as reflected in the memorandum of November 12, 2002 are reflected on the balance sheet dated June 30, 2003 as long-term debt and other liabilities for the amounts that were expected on June 30, 2003 to be converted to the two promissory notes payable and the warrants respectively. As of February 12, 2004 we are finalizing an agreement to convert all of such payables, approximating \$1.8 million and including amounts reflected as Notes Payable as of June 30, 2003 and September 30, 2003, into a warrant convertible into our Common Stock on a cashless basis of approximately \$.35 per share. This agreement is still subject to final execution of legal documentation by GTRC.

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Effective June 30, 2001 the Company converted \$2,420,039 of liabilities due to directors and related parties into 4,840,077 shares of the Company's common stock pursuant to debt conversion agreements. During the fiscal year ended June 30, 2002 certain strategic vendors and related parties converted approximately \$2.7 million of accounts payable and accrued expenses into 7,492,996 shares of the Company's common stock and 5,953,490 warrants. During the twelve months ending June 30, 2003, certain strategic vendors and related parties converted approximately \$1.9 million of accounts payable and accrued expenses into 5,923,333 shares of the Company's common stock and warrants to purchase 3,706,800 shares of common stock of mPhase. Such vendors include Microphase Corporation, Janifast, Ltd., and Strategic Vendors including Piper Rudnick LLP, mPhase's outside counsel. Conversions with related parties only consisted of the following:

	For the Years Ended June 30,			For the Nine Months Ended March 31, (Unaudited)	
	2002	2003	2004	2004	2005
<b>Equity Conversions of Debt and Other Financial Instruments with Related Parties</b>					
<b>Janifast</b>					
Number of shares	3,450,000	1,500,000	0	0	1,000,000
Number of warrants	1,200,000	0	0	0	1,000,000
Amount converted to equity	\$720,000	\$360,000	\$0	\$0	\$200,000
<b>Microphase Corporation</b>					
Number of shares	2,700,000	4,033,333	0	0	1,250,000
Number of warrants	2,200,000	1,000,000	0	0	1,250,000
Amount converted to equity	\$740,000	\$920,000	\$0	\$0	250,000
<b>Lintel Corporation and Affiliates</b>					
Number of shares	0	0	0	0	0
Number of warrants	0	0	0	0	0
Amount converted to equity	\$0	\$0	\$0	\$0	\$0
<b>Officers</b>					
Number of shares	333,334	0	0	0	489,875
Number of warrants (A)	333,334	2,491,800	0	0	489,875
Amount converted to equity	\$103,000	\$480,967	\$0	\$0	118,933
<b>Joint Venture Partner and Affiliates</b>					
Number of shares	63,216	0	0	0	0
Number of warrants	0	0	0	0	0
Amount converted to equity	\$31,628	\$0	\$0	\$0	\$0
<b>Total Related Party Conversions</b>					
Number of shares	6,546,550	5,533,333	0	0	2,739,875
Number of warrants	3,733,334	3,491,800	0	0	2,739,875
Amount converted to equity	\$1,594,628	\$1,760,967	\$0	\$0	\$568,933

(A) Includes \$12,206 settlement expense incurred to the Company's President and Vice President in connection with the exchange of warrants to purchase the company's common stock to cancel unpaid compensation, which is included as a reduction to gain on Settlements in fiscal 2003.

**SELLING STOCKHOLDERS**

The following table sets forth information regarding the beneficial ownership of shares of common stock by the selling stockholders as of the date of this prospectus, and the number of shares of common stock covered by this prospectus. Except as otherwise noted below, none of the selling stockholders has held any position or office, or has had any other material relationship with us or any of our affiliates within the past three years.

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The number of shares of common stock that may be actually purchased by certain selling stockholders under the warrants and the number of shares of common stock that may be actually sold by each selling stockholder will be determined by such selling stockholder. Because certain selling stockholder may purchase all, some or none of the shares of common stock which can be purchased under the warrants and each selling stockholder may sell all, some or none of the shares of common stock which each holds, and because the offering contemplated by this prospectus is not currently being underwritten, no estimate can be given as to the number of shares of common stock that will be held by the selling stockholders upon termination of the offering. The information set forth in the following table regarding the beneficial

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ownership after resale of shares is based on the basis that each selling stockholder will purchase the maximum number of shares of common stock provided for by the warrants owned by the selling stockholder and each selling stockholder will sell all of the shares of common stock owned by that selling stockholder and covered by this prospectus.

NAME	Beneficial Shares	Maximum Number of Shares Being Offered	Note
Abraham Grinberger	6,000	6,000	A-1
Abraham Hoffert	7,000	7,000	A-2
Abraham Zirsha Rausman	20,000	20,000	A-3
Alexander Hasenfeld Inc.	100,000	100,000	A-4
Alexander Hasenfeld Inc.	100,000	100,000	A-5
Angela Bolletteri	40,000	40,000	A-6
Barry Rausman	20,000	20,000	A-7
Beth Mayer Associates	500,000	500,000	A-8
Bnei David	5,000	5,000	A-9
Boro Park Health Food Inc	1,700	1,700	A-10
Chaim Stefansky	50,000	50,000	A-11
Charles Hannen	50,000	50,000	A-12
Chaya Etta Rausman	30,000	30,000	A-13
Colel Chabad/Sholom Duchman	3,000,000	3,000,000	A-14
Congregational Acheinu Bnei Yisroel	150,000	150,000	A-15
David Farber	500,000	500,000	A-16
David Gluck	34,000	34,000	A-17
Double U Master Fund L.P.	2,000,000	2,000,000	A-18
Dr. Scott K. Hannen/Aneesha Hannen	50,000	50,000	A-19
Emil & Joan Rausman	30,000	30,000	A-20
Emil & Joan Rausman	40,000	40,000	A-21
Emily Rausman and Joan Rausman	40,000	40,000	A-22
Eshel LP Ltd./Solomon Lesin	500,000	500,000	A-23
Eugene L. Kelly	50,000	50,000	A-24
Gary Rieder	1,000,000	1,000,000	A-25
George Rider	3,000,000	3,000,000	A-26
Germilas Chesed Ach TOV	442,900	442,900	A-27
Hasenfeld-Stein	300,000	300,000	A-28
Herbert Rausman and Rifka Rausman	200,000	200,000	A-29
HSI Partnership/Nachum Stein, Partner	50,000	50,000	A-30
HSI Partnership/Nachum Stein, Partner	200,000	200,000	A-31
IBER Int'l Ltd./Akra Building	5,000,000	5,000,000	A-32
Irgun Shivrei	1,800,000	1,800,000	A-33
J&E Rausman	20,000	20,000	A-34
Jacob Joseph & Basya Abikhzer	40,000	40,000	A-35
Jacob Joseph Rausman	30,000	30,000	A-36
Joshua Teitelbaum & Helena Teitelbaum	750,000	750,000	A-37
Leon Goldenberg	500,000	500,000	A-38
Leslie Rieder	1,000,000	1,000,000	A-39
Mark Rieder	1,000,000	1,000,000	A-40
Mary E. Coons	1,250,000	1,250,000	A-41
Mary Park Properties/Mayer Rooz	1,000,000	1,000,000	A-42

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Matthew Fischer	8,000	8,000	A-43
Mesamche Lev	8,000	8,000	A-44
Michael F. Cusick	250,000	250,000	A-45
Michael Spitzer	100,000	100,000	A-46
Morris Friedman	2,000,000	2,000,000	A-47

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Mosdos Ohr Hatorah	200,000	200,000	A-48
Murray Sternfeld			
Nachum Stein	300,000	300,000	A-50
Nachum Stein	100,000	100,000	A-51
Pearl Rausman	30,000	30,000	A-52
Peter J. Gidas and Cynthia Gidas	200,000	200,000	A-53
PJT Family Trust	83,400	83,400	A-54
Platinum Partners Value Arbitrage Fund L.P./Mark Nordlicht	4,000,000	4,000,000	A-55
Rausman Pearl Guy	20,000	20,000	A-56
Rausman Somerset LLC	100,000	100,000	A-57
Richard Klien	50,000	50,000	A-58
Rivka Tyberg	2,000	2,000	A-59
Rutgers Casualty Insurance Company/Nachum Stein, Chairman	50,000	50,000	A-60
Rutgers Casualty Insurance Company/Nachum Stein, Chairman	100,000	100,000	A-61
Rutgers Enhanced Insurance Company/Nachum Stein, Chairman	50,000	50,000	A-62
Ruth Englad	14,000	14,000	A-63
Salvatore Amato	350,000	350,000	A-64
Seven Grandchildren	40,000	40,000	A-65
Seven Grandchildren	40,000	40,000	A-66
Seven Grandchildren	40,000	40,000	A-67
Seven Grandchildren	40,000	40,000	A-68
Seven Grandchildren	40,000	40,000	A-69
ShazamStocks Inc	250,000	250,000	A-70
Teresa L. Peterkin	20,000	20,000	A-71
The E&J Rausman	20,000	20,000	A-72
The Rausman Family Trust	20,000	20,000	A-73
Tommy Cheng	50,000	50,000	A-74
Tower 50 Partners LP/Aaron Elbogen	1,000,000	1,000,000	A-75
Trane Rausman Trust	20,000	20,000	A-76
Trust FBO Abraham Abikhzer	20,000	20,000	A-77
Wesco Inc./ Alfred West	500,000	500,000	A-78
Wesley R. Calhoun/Brenda Calhoun	50,000	50,000	A-79
Yakov Stein	250,000	250,000	A-80

(A-1) Includes Warrants to Purchase up to 6,000

(A-2) Includes Warrants to Purchase up to 7,000

(A-3) Includes Warrants to Purchase up to 10,000 Shares of Common Stock

(A-4) Includes Warrants to Purchase up to 50,000 Shares of Common Stock

(A-5) Includes Warrants to Purchase up to 50,000 Shares of Common Stock

(A-6) Includes Warrants to Purchase up to 20,000 Shares of Common Stock

(A-7) Includes Warrants to Purchase up to 10,000 Shares of Common Stock

(A-8) Includes Warrants to Purchase up to 250,000 Shares of Common Stock

(A-9) Includes Warrants to Purchase up to 5,000

(A-10) Includes Warrants to Purchase up to 1,700

(A-11) Includes Warrants to Purchase up to 25,000 Shares of Common Stock

(A-12) Includes Warrants to Purchase up to 25,000 Shares of Common Stock

(A-13) Includes Warrants to Purchase up to 15,000 Shares of Common Stock

(A-14) Includes Warrants to Purchase up to 1,500,000 Shares of Common Stock

(A-15) Includes Warrants to Purchase up to 100,000



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- (A-16) Includes Warrants to Purchase up to 250,000 Shares of Common Stock
  - (A-17) Includes Warrants to Purchase up to 22,000
  - (A-18) Includes Warrants to Purchase up to 1,000,000 Shares of Common Stock
  - (A-19) Includes Warrants to Purchase up to 25,000 Shares of Common Stock
  - (A-20) Includes Warrants to Purchase up to 15,000 Shares of Common Stock
  - (A-21) Includes Warrants to Purchase up to 20,000 Shares of Common Stock
  - (A-22) Includes Warrants to Purchase up to 20,000 Shares of Common Stock
  - (A-23) Includes Warrants to Purchase up to 250,000 Shares of Common Stock
  - (A-24) Includes Warrants to Purchase up to 25,000 Shares of Common Stock
  - (A-25) Includes Warrants to Purchase up to 500,000 Shares of Common Stock
  - (A-26) Includes Warrants to Purchase up to 1,500,000 Shares of Common Stock
  - (A-27) Includes Warrants to Purchase up to 442,900
  - (A-28) Includes Warrants to Purchase up to 150,000 Shares of Common Stock
  - (A-29) Includes Warrants to Purchase up to 100,000 Shares of Common Stock
  - (A-30) Includes Warrants to Purchase up to 25,000 Shares of Common Stock
  - (A-31) Includes Warrants to Purchase up to 100,000 Shares of Common Stock
  - (A-32) Includes Warrants to Purchase up to 2,500,000 Shares of Common Stock
  - (A-33) Includes Warrants to Purchase up to 900,000 Shares of Common Stock
  - (A-34) Includes Warrants to Purchase up to 20,000
  - (A-35) Includes Warrants to Purchase up to 20,000 Shares of Common Stock
  - (A-36) Includes Warrants to Purchase up to 15,000 Shares of Common Stock
  - (A-37) Includes Warrants to Purchase up to 375,000 Shares of Common Stock
  - (A-38) Includes Warrants to Purchase up to 250,000 Shares of Common Stock
  - (A-39) Includes Warrants to Purchase up to 500,000 Shares of Common Stock
  - (A-40) Includes Warrants to Purchase up to 500,000 Shares of Common Stock
  - (A-41) Includes Warrants to Purchase up to 625,000 Shares of Common Stock
  - (A-42) Includes Warrants to Purchase up to 500,000 Shares of Common Stock
  - (A-43) Includes Warrants to Purchase up to 8,000
  - (A-44) Includes Warrants to Purchase up to 8,000
  - (A-45) Includes Warrants to Purchase up to 125,000 Shares of Common Stock
  - (A-46) Includes Warrants to Purchase up to 50,000 Shares of Common Stock
  - (A-47) Includes Options to Purchase up to 1,000,000 Shares of Common Stock
  - (A-48) Includes Warrants to Purchase up to 100,000 Shares of Common Stock
  - (A-49) Includes Warrants to Purchase up to 6,500 Shares of Common Stock
  - (A-50) Includes Warrants to Purchase up to 150,000 Shares of Common Stock
  - (A-51) Includes Warrants to Purchase up to 50,000 Shares of Common Stock
  - (A-52) Includes Warrants to Purchase up to 15,000 Shares of Common Stock
  - (A-53) Includes Warrants to Purchase up to 100,000 Shares of Common Stock
  - (A-54) Includes Warrants to Purchase up to 53,400 Shares of Common Stock
  - (A-55) Includes Warrants to Purchase up to 2,000,000 Shares of Common Stock
  - (A-56) Includes Warrants to Purchase up to 10,000 Shares of Common Stock
  - (A-57) Includes Warrants to Purchase up to 50,000 Shares of Common Stock
  - (A-58) Includes Options to Purchase up to 25,000 Shares of Common Stock
  - (A-59) Includes Options to Purchase up to 2,000 Shares of Common Stock
  - (A-60) Includes Warrants to Purchase up to 25,000 Shares of Common Stock
  - (A-61) Includes Warrants to Purchase up to 50,000 Shares of Common Stock
  - (A-62) Includes Warrants to Purchase up to 25,000 Shares of Common Stock
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- (A-63) Includes Warrants to Purchase up to 14,000
- (A-64) Includes Warrants to Purchase up to 175,000 Shares of Common Stock
- (A-65) Includes Warrants to Purchase up to 20,000 Shares of Common Stock
- (A-66) Includes Warrants to Purchase up to 20,000 Shares of Common Stock
- (A-67) Includes Warrants to Purchase up to 20,000 Shares of Common Stock
- (A-68) Includes Warrants to Purchase up to 20,000 Shares of Common Stock
- (A-69) Includes Warrants to Purchase up to 20,000 Shares of Common Stock
- (A-70) Includes Warrants to Purchase up to 125,000 Shares of Common Stock
- (A-71) Includes Warrants to Purchase up to 20,000 Shares of Common Stock
- (A-72) Includes Warrants to Purchase up to 10,000 Shares of Common Stock
- (A-73) Includes Warrants to Purchase up to 10,000 Shares of Common Stock
- (A-74) Includes Warrants to Purchase up to 50,000 Shares of Common Stock
- (A-75) Includes Warrants to Purchase up to 500,000 Shares of Common Stock
- (A-76) Includes Warrants to Purchase up to 10,000 Shares of Common Stock
- (A-77) Includes Warrants to Purchase up to 10,000 Shares of Common Stock
- (A-78) Includes Warrants to Purchase up to 250,000 Shares of Common Stock
- (A-79) Includes Warrants to Purchase up to 25,000 Shares of Common Stock
- (A-80) Includes Warrants to Purchase up to 125,000 Shares of Common Stock

### PLAN OF DISTRIBUTION

We are registering for resale by the selling stockholders and certain transferees a total of shares of common stock, of which shares are issued and outstanding and up to shares are issuable upon exercise of warrants. We will not receive any of the proceeds from the sale by the selling stockholders of the shares of common stock, although we may receive up to approximately \$39,122,942 upon the conversion of convertible notes and the exercise of all of the warrants and options by the selling stockholders. We will bear all fees and expenses incident to our obligation to register the shares of common stock. If the shares of common stock are sold through broker-dealers or agents, the selling stockholder will be responsible for any compensation to such broker-dealers or agents.

The selling stockholders may pledge or grant a security interest in some or all of the shares of common stock owned by them and, if they default in the performance of their secured obligations, the pledgees or secured parties may offer and sell the shares of common stock from time to time pursuant to this prospectus.

The selling stockholders also may transfer and donate the shares of common stock in other circumstances in which case the transferees, donees, pledgees or other successors in interest will be the selling beneficial owners for purposes of this prospectus.

The selling stockholders will sell their shares of common stock subject to the following:

1. all or a portion of the shares of common stock beneficially owned by the selling stockholders or their respective pledgees, donees, transferees or successors in interest, may be sold on the OTC Bulletin Board Market, any national securities exchange or quotation service on which the shares of our common stock may be listed or quoted at the time of sale, in the over-the-counter market, in privately negotiated transactions, through the writing of options, whether such options are listed on an options exchange or otherwise, short sales or in a combination of such transactions;
  2. each sale may be made at market prices prevailing at the time of such sale, at negotiated prices, at fixed prices, or at varying prices determined at the time of sale;
  3. some or all of the shares of common stock may be sold through one or more broker-dealers or agents and may involve crosses, block transactions, or hedging transactions. The selling stockholders may enter into hedging transactions with broker-dealers or agents, which may in turn engage in short sales of the common stock in the course of hedging in positions they assume. The selling stockholders may also sell shares of common stock short and deliver shares of common stock to close out short positions, or loan or pledge shares of common stock to broker-dealers or agent that in turn may sell such shares; and
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4. in connection with such sales through one or more broker-dealers or agents, such broker-dealers or agents may receive compensation in the form of discounts, concessions or commissions from the selling stockholders and may receive commissions from the purchasers of the shares of common stock for whom they act as broker-dealer or agent or to whom they sell as principal (which discounts, concessions or commissions as to particular broker-dealers or agents may be in excess of those customary in the types of transactions involved). Any broker-dealer or agent participating in any such sale may be deemed to be an "underwriter" within the meaning of the Securities Act and will be required to deliver a copy of this prospectus to any person who purchases any share of common stock from or through such broker-dealer or agent. We have been advised that, as of the date hereof, none of the selling stockholders have made any arrangements with any broker-dealer or agent for the sale of their shares of common stock.

The selling stockholders and any broker-dealer participating in the distribution of the shares of common stock may be deemed to be "underwriters" within the meaning of the Securities Act, and any profits realized by the selling stockholders and any commissions paid, or any discounts or concessions allowed to any such broker-dealer may be deemed to be underwriting commissions or discounts under the Securities Act. In addition, any shares of common stock covered by this prospectus which qualify for sale pursuant to Rule 144 may be sold under Rule 144 rather than pursuant to this prospectus.

If required at the time a particular offering of the shares of common stock is made, a prospectus supplement or, if appropriate, a post-effective amendment to the shelf registration statement of which this prospectus is a part, will be distributed which will set forth the aggregate amount of shares of common stock being offered and the terms of the offering, including the name or names of any broker-dealers or agents, any discounts, commissions and other terms constituting compensation from the selling stockholder and any discounts, commissions or concessions allowed or reallocated or paid to broker-dealers.

Under the securities laws of some states, the shares of common stock may be sold in such states only through registered or licensed brokers or dealers. In addition, in some states the shares of common stock may not be sold unless such shares have been registered or qualified for sale in such state or an exemption from registration or qualification is available and is complied with. There can be no

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assurance that any selling stockholder will sell any or all of the shares of common stock registered pursuant to the shelf registration statement, of which this prospectus forms a part.

The selling stockholders and any other person participating in such distribution will be subject to applicable provisions of the Exchange Act and the rules and regulations thereunder, including, without limitation, Regulation M of the Exchange Act, which may limit the timing of purchases and sales of any of the shares of common stock by the selling stockholders and any other participating person. Regulation M may also restrict the ability of any person engaged in the distribution of the shares of common stock to engage in market-making activities with respect to the shares of common stock. All of the foregoing may affect the marketability of the shares of common stock and the ability of any person or entity to engage in market-making activities with respect to the shares of common stock.

We will bear all expenses of the registration of the shares of common stock including, without limitation, Securities and Exchange Commission filing fees and expenses of compliance with state securities or "blue sky" laws. The selling stockholders will pay all underwriting discounts and selling commissions and expenses, brokerage fees and transfer taxes, as well as the fees and disbursements of counsel to and experts for the selling stockholders, if any. We will indemnify the selling stockholders against liabilities, including some liabilities under the Securities Act, in accordance with the registration rights agreement or the selling stockholders will be entitled to contribution. We will be indemnified by the selling stockholders against civil liabilities, including liabilities under the Securities Act that may arise from any written information furnished to us by the selling stockholders for use in this prospectus, in accordance with the related registration rights agreement or will be entitled to contribution. Once sold under this shelf registration statement, of which this prospectus forms a part, the shares of common stock will be freely tradable in the hands of persons other than our affiliates.

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### DESCRIPTION OF SECURITIES

Our authorized capital stock consists of 500,000,000 shares of common stock, \$.01 par value as of July 20, 2005 the date of our most recent annual meeting. As of July 22, 2005, approximately 141 million shares of our common stock are issued and outstanding and held by approximately 12,000 stockholders of record. Of the shares of our issued and outstanding common stock, shares are covered by this prospectus. In addition shares of our common stock authorized but unissued as of the date of this prospectus will be issued on exercise of warrants held by certain selling stockholders.

The following description of our capital stock is a summary of the material terms of such stock. It does not purport to be complete and is subject in all respects to the provisions of our Certificate of Incorporation and our Bylaws, copies of which have been filed as exhibits to the registration statement of which this prospectus is a part and to applicable New Jersey law.

Common Stock

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Each holder of our common stock is entitled to one vote for each share held of record on all matters submitted to a vote of stockholders. Cumulative voting for the election of Directors is not provided for in our Certificate of Incorporation, which means that the holders of a majority of the shares of common stock voted elects the Directors then standing for election. The holders of outstanding shares of common stock are entitled to receive dividends out of assets legally available for dividends, at such appropriate times and in such amounts as our Board of Directors decides. The common stock is not entitled to preemptive rights or other subscription rights and is not subject to conversion or redemption. Upon liquidation, dissolution or winding up of our affairs, the holders of common stock will be entitled to share ratably in all assets remaining after the payment of liabilities. Shares of common stock shall be transferred only on our books upon surrender to us or a duly appointed transfer agent of the certificate or certificates properly endorsed or accompanied by proper evidence of succession, assignment or authority to transfer.

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### Common Stock Warrants

This prospectus also covers shares of common stock purchasable pursuant to outstanding warrants and options. The exercise price of these warrants range from \$.25 to \$.45. These warrants and options have expiration terms ranging from years 2005-2010.

### Filling Vacancies on the Board

The Certificate of Incorporation provides that any vacancy on the Board that results from an increase in the number of Directors during the interim between annual meetings or special meetings of shareholders may be filled by the Board. These provisions could temporarily prevent any shareholder from obtaining majority representation on the Board by enlarging the Board and filling the new directorships with its own nominees.

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### New Jersey Shareholders Protection Act

There are provisions of New Jersey law, and our Certificate of Incorporation and Bylaws, that may have an anti-takeover effect. These provisions are designed to protect shareholders against coercive, unfair or inadequate tender offers and other abusive tactics and to encourage any person contemplating a business combination with us to negotiate with our Board of Directors for the fair and equitable treatment of all shareholders.

New Jersey has adopted a type of anti-takeover statute known as the New Jersey Shareholders Protection Act. Subject to numerous qualifications and exceptions, the statute prohibits an interested shareholder of a corporation from effecting a business combination with the corporation for a period of five years unless the corporation's board approved the combination prior to the shareholder becoming an interested shareholder. In addition, but not in limitation of the five-year restriction, if applicable, corporations covered by the New Jersey statute may not engage at any time in a business combination with any interested shareholder of that corporation unless the combination is approved by the board prior to the interested shareholder's stock acquisition date, the combination receives the approval of two-thirds of the voting stock of the corporation not beneficially owned by the interested shareholder, or the combination meets minimum financial terms specified by the statute. An "interested shareholder" is defined to include any beneficial owner of 10% or more of the voting power of the outstanding voting stock of the corporation and any affiliate or associate of the corporation who within the prior five year period has at any time owned 10% or more of the voting power. The term "business combination" is defined broadly to include, among other things:

the merger or consolidation of the corporation with the interested shareholder or any corporation that after the merger or consolidation would be an affiliate or associate of the interested shareholder,

the sale, lease, exchange, mortgage, pledge, transfer or other disposition to an interested shareholder or any affiliate or associate of the interested shareholder of 10% or more of the corporation's assets, or

the issuance or transfer to an interested shareholder or any affiliate or associate of the interested shareholder of 5% or more of the aggregate market value of the stock of the corporation.

The effect of the statute is to protect non-tendering, post-acquisition minority shareholders from mergers in which they will be "squeezed out" after the merger, by prohibiting transactions in which an acquirer could favor itself at the expense of minority shareholders. The New Jersey statute generally applies to corporations that are organized under New Jersey law, have either their principal executive offices or significant business operations located in New Jersey, and have a class of stock registered or traded on a national securities exchange or registered with the Securities and Exchange Commission pursuant to Section 12(g) of the Securities Exchange Act of 1934.

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### LEGAL MATTERS

The validity of the common stock we are offering pursuant to this prospectus will be passed upon by Martin S. Smiley General Counsel to the Company. Mr. Smiley beneficially owns an aggregate of 5,676,132 shares of common stock of the Company.

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### EXPERTS

The financial statements and schedules included in this prospectus and elsewhere in the registration statement, to the extent and for the periods indicated in their reports, have been audited or reviewed, as the case may be, by Rosenberg, Rich, Baker, Berman & Company and audited or reviewed, as the case may be, by Arthur Andersen, LLP and Schuhalter, Coughlin & Suozzo, PC, independent public accountants, and are included in reliance upon the authority of said firms as experts in giving said reports. Prior to the date of this prospectus, Arthur Andersen was indicted in connection with its rendering of services to another company. Therefore, Arthur Andersen withdrew from practice before the SEC effective prior to the date hereof and many of the accountants at Arthur Andersen have left their current jobs or have been searching for a new place of employment. Based on these factors, after reasonable efforts, including numerous phone calls, we were unable to contact our former

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audit partner at Arthur Andersen and therefore were unable to obtain Arthur Andersen's consent to the inclusion of their report dated October 12, 2001. Accordingly, we have dispensed with the requirement to file their consent in reliance upon Rule 437a of the securities act. Because Arthur Andersen has not consented to the inclusion of their report in this prospectus, you will not be able to recover against Arthur Andersen under Section 11 of the securities act for any untrue statements of a material fact contained in the financial statements audited by Arthur Andersen or any omissions to state a material fact required to be stated therein. As of June 1, 2005, Schuhalter, Coughlin & Suozzo, PC, owns approximately 250,000 shares of common stock directly and indirectly; options to purchase 495,000 shares of common stock and warrants to purchase 250,000 shares of common stock, of which 1,085,800 shares are being registered pursuant to this prospectus. All of such securities owned by Schuhalter, Coughlin & Suozzo, PC, other than 146,800 shares of common stock which it has acquired on the open market subsequent to April 2001, were issued to Schuhalter, Coughlin & Suozzo, PC in consideration for non-audit consulting services and/or satisfaction of payables related to non-audit consulting services and were issued after Schuhalter, Coughlin & Suozzo, PC was no longer our independent public accountants.

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### WHERE YOU CAN FIND ADDITIONAL INFORMATION

We are subject to the information requirements of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). In accordance with the Exchange Act, we file reports, proxy statements and other information with the Securities and Exchange Commission. Our reports, proxy statements and other information filed with the SEC may be inspected and copied at the public reference facilities maintained by the SEC at 450 Fifth Street, N.W., Room 1024, Washington, D.C. 20549. Copies of such material also may be obtained at prescribed rates from the Public Reference Branch of the Commission at 450 Fifth Street, N.W., Washington, D.C. 20549-1004. Please call the SEC at 1-800-SEC-0330 for further information on the public reference rooms. The SEC maintains a web site at <http://www.sec.gov> that contains reports, proxy and information statements and other information regarding registrants that file electronically with the SEC.

You may request a copy of these filings, at no cost by writing or telephoning us at the following address:

mPhase Technologies, Inc.  
587 Connecticut Avenue  
Norwalk, Connecticut 06854-0566  
Attention: General Counsel  
(203) 831-2242

You should rely only on the information incorporated by reference or provided in this prospectus or any prospectus supplement. We have not authorized anyone else to provide you with different information. The selling security holders will not make an offer of the shares of our common stock in any state where the offer is not permitted. You should not assume that the information in this prospectus or any prospectus supplement is accurate as of any date other than the date on the front of those documents.

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mPHASE TECHNOLOGIES, INC.

## INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

Report of Rosenberg Rich Baker Berman & Company	F-1
Report of Arthur Andersen LLP	F-2
Report of Schuhalter, Coughlin & Suozzo, PC	F-3
Consolidated Balance Sheets as of June 30, 2003, June 30, 2004 and March 31, 2005 (Unaudited)	F-4
Consolidated Statements of Operations for the years ended June 30, 2002, 2003, 2004, and for the period from inception (October 2, 1996) through June 30, 2004	F-5
Unaudited Consolidated Statements of Operations for the Nine months ended March 31, 2005 and for the period from inception (October 2, 1996) through March 31, 2005	F-6
Consolidated Statements of Changes in Stockholders' Equity (Deficit) for the period from inception (October 2, 1996) to June 30, 1998 and for each of the six years in the period ended June 30, 2004	F-7-12
Unaudited Consolidated Statement of Changes in Shareholders' Deficit for the Nine months ended March 31, 2005	F-13
Consolidated Statements of Cash Flows for the years ended June 30, 2002, 2003 and 2004, and for the period from inception (October 2, 1996) through June 30, 2004	F-14
Unaudited Consolidated Statements of Cash Flows for the Nine months ended March 31, 2005 and 2004, and for the period from inception (October 2, 1996) through March 31, 2005	F-15
Notes to Consolidated Financial Statements	F-16

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## REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Board of Directors and Stockholders of mPhase Technologies, Inc.:

We have audited the accompanying consolidated balance sheets of mPhase Technologies, Inc. (a New Jersey corporation in the development stage) and subsidiaries as of June 30, 2004 and June 30, 2003, and the related consolidated statements of operations, changes in stockholders' equity (deficit), cash flows and Schedule II (Valuation and Qualifying Accounts, Item 14B) for each of the three years in the period ended June 30, 2004 and for the period from inception (October 2, 1996) to June 30, 2004. 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 did not audit the financial statements of mPhase Technologies, Inc. for the period from inception to June 30, 2001. Such amounts are included in the cumulative from inception to June 30, 2004 totals of the statements of operations, changes in stockholders' equity and cash flows and reflect total net loss of 78 percent of the related cumulative totals. Those statements were audited by other auditors whose report has been furnished to us and our opinion, insofar as it relates to amounts for the period from inception to June 30, 2001, included in the cumulative totals, is based solely upon the report of the other auditors.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material accounting 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 and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of mPhase Technologies, Inc. and subsidiaries as of June 30, 2004 and 2003 and the results of their operations and their cash flows for each of the three years in the period ended June 30, 2004 and for the period from inception to June 30, 2004, in conformity with accounting principles generally accepted in the United States.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 2 to the consolidated financial statements, the Company has suffered recurring losses from operations and is in a working capital deficit position that raises substantial doubt about its ability to continue as a going concern. Management's plans concerning these matters are also described in Note 2. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Rosenberg Rich Baker Berman & Company  
Bridgewater, NJ

August 27, 2004

F-1

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## REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Board of Directors and Stockholders of mPhase Technologies, Inc.:

We have audited the accompanying consolidated balance sheets of mPhase Technologies, Inc. (a New Jersey corporation in the development stage) and subsidiaries as of June 30, 2001 and 2000, and the related consolidated statements of operations, changes in stockholders' equity and cash flows for each of the three years in the period ended June 30, 2001 and for the period from inception (October 2, 1996) to June 30, 2001. 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 did not audit the financial statements of mPhase Technologies, Inc. for the period from inception to June 30, 1998. Such amounts are included in the cumulative from inception to June 30, 2001 totals of the statements of operations, changes in stockholders' equity and cash flows and reflect total net loss of 6 percent of the related cumulative totals. Those statements were audited by other auditors whose report has been furnished to us and our opinion, insofar as it relates to amounts for the period from inception to June 30, 1998, included in the cumulative totals, is based solely upon the report of the other auditors.

We conducted our audits in accordance with auditing standards generally accepted in the United States. 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 and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of mPhase Technologies, Inc. and subsidiaries as of June 30, 2001 and 2000, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 2001 and for the period from inception to June 30, 2001, in conformity with accounting principles generally accepted in the United States.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 2 to the consolidated financial statements, the Company has suffered recurring losses from operations and is in a working capital deficit position that raises substantial doubt about its ability to continue as a going concern. Management's plans concerning these matters are also described in Note 2. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Arthur Andersen LLP  
Stamford, Connecticut

October 12, 2001

PURSUANT TO SEC RELEASE NO. 33-8070 AND RULE 437A UNDER THE SECURITIES ACT OF 1933, AS AMENDED, mPHASE TECHNOLOGIES, INC. HAS NOT RECEIVED WRITTEN CONSENT AFTER REASONABLE EFFORT TO USE THIS REPORT. THIS REPORT IS A COPY OF A PREVIOUSLY ISSUED ARTHUR ANDERSEN LLP REPORT. THIS REPORT HAS NOT BEEN REISSUED BY ARTHUR ANDERSEN LLP. WITH RESPECT TO THIS INSTANT 10K/A, YOU WILL NOT BE ABLE TO RECOVER AGAINST ARTHUR ANDERSEN LLP UNDER SECTION 11 OF THE SECURITIES ACT FOR ANY UNTRUE STATEMENTS OF A MATERIAL FACT CONTAINED IN THE FINANCIAL STATEMENTS AUDITED BY ARTHUR ANDERSEN LLP OR ANY OMISSIONS TO STATE A MATERIAL FACT REQUIRED TO BE STATED THEREIN.

F-2

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### REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

To the Board of Directors and Stockholders of mPhase Technologies, Inc.:

We have audited the statements of operations, changes in stockholders's equity, and cash flows for the period October 2, 1996 (date of inception) through June 30, 1998 of mPhase Technologies, Inc. (a development stage company). These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audit.

We conducted our audit 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 audit provides a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the results of its operations and its cash flows for the period of October 2, 1996 (date of inception) through June 30, 1998 in conformity with generally accepted accounting principles.

Schuhalter, Coughlin & Suozzo, PC  
Raritan, New Jersey

January 28, 1999

F-3

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mPHASE TECHNOLOGIES, INC.  
(A DEVELOPMENT STAGE COMPANY)  
CONSOLIDATED BALANCE SHEETS

	2003	June 30, 2004	March 31, 2005 (unaudited)
<b>ASSETS</b>			
Current assets:			
Cash and cash equivalents	\$396,860	\$90,045	\$237,828
Accounts receivable, net of bad debt reserve of \$0 and \$0 for each period	287,135	64,100	354,903
Stock subscription receivable	110,000	886,000	---
Inventory	2,103,328	1,237,972	862,963
Production Advances-Janifast Ltd.	----	----	337,709
Prepaid expenses and other current assets	100,329	81,061	169,503
Total current assets	2,997,652	2,359,178	1,962,906
Property and equipment, net	581,890	52,685	178,626
Patents and licenses, net	184,857	161,605	176,972
Other assets	17,250	17,250	---
Total assets	\$3,781,649	\$2,590,718	\$2,318,504
<b>LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)</b>			
Current liabilities:			
Accounts payable	\$2,352,961	2,088,658	2,565,629
Accrued expenses	885,735	691,033	957,925
Due to related parties	187,372	625,956	280,739
Notes payable, related party	-	300,000	242,000
Current Portion of Long-Term Debt	762,735	550,803	----
Deferred revenue	214,180	214,180	248,891
Total current liabilities	4,402,983	4,470,630	4,295,184
Long Term Debt, net of current portion	586,303	139,500	281,000
Other liabilities	1,561,249	618,550	279,500
Notes payable, related parties	460,000	280,000	---
<b>COMMITMENTS AND CONTINGENCIES (Note 13)</b>			
<b>STOCKHOLDERS' EQUITY (DEFICIT):</b>			
Common Stock, stated value \$.01, 250,000,000 shares authorized; 71,453,521, 88,899,962 and 109,743,391 (unaudited), shares issued and outstanding, respectively			
Additional paid-in capital	104,081,049	111,976,095	121,430,506
Deficit accumulated during development stage	(108,016,497)	(115,775,083)	(125,259,323)
Less-treasury stock, 13,750 shares, at cost	(7,973)	(7,973)	(7,973)
Total stockholders' equity (deficit)	(3,228,886)	(2,917,962)	(2,537,180)
Total liabilities and stockholders' equity	\$3,781,649	2,590,718	2,318,504

The accompanying notes are an integral part of these consolidated balance sheets.

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mPHASE TECHNOLOGIES, INC.  
(A DEVELOPMENT STAGE COMPANY)  
CONSOLIDATED STATEMENTS OF OPERATIONS

For the Years Ended June 30,

**2002**  
TOTAL NET REVENUES \$ 2,582,446  
COSTS AND EXPENSES:  
Cost of Sales (see also note 11 Related Party Transactions) 2,415,129  
Research and development (including non-cash stock related charges of \$267,338, \$385,495, \$72,000 and \$2,503,114 respectively, see also note 11 Related Party Transactions) 3,819,583  
General and administrative (including non-cash stock related charges of \$2,994,111, \$748,840, \$1,242,793 and \$47,333,142 respectively, see also note 11 Related Party Transactions) 7,038,923

Years Ended December 31, 2008, 2007 and 2006  
(in thousands, except per share data)

	Common Stock	Surplus	Undivided Profits	Treasury Stock	Com (
Balances, December 31, 2005	\$ 3 600	\$ 2 400	\$ 21 158	\$ (1 850)	\$
Comprehensive income					
Net income □ 2006	--	--	4 035	--	
Other comprehensive income:					
Unrealized holding gains arising during the period (net of tax, \$63)	--	--	--	--	
Total comprehensive income					
Adjustment to initially apply SFAS No. 158, in regard to pension and other postretirement benefits (net of tax, \$441)	--	--	--	--	
2% stock dividend	72	1 149	(1 221)	--	
Purchase of treasury shares: 27,093 shares	--	--	--	(429)	
Stock-based compensation expense	--	112	--	--	
Cash dividends □ 2006 (\$.38 per share)	--	--	(1 295)	--	
Balances, December 31, 2006	\$ 3 672	\$ 3 661	\$ 22 677	\$ (2 279)	\$
Comprehensive income					
Net income □ 2007	--	--	3 530	--	

Other comprehensive income:				
Unrealized holding gains arising during the period (net of tax, \$159)	--	--	--	--
Change in benefit obligations and plan assets for pension and other postretirement benefits (net of tax, \$97)	--	--	--	--
Total other comprehensive income				
Total comprehensive income				
Purchase of treasury shares:				
28,083 shares	--	--	--	(422)
Stock-based compensation expense	--	110	--	--
Cash dividends □ 2007 (\$ .42 per share)	--	--	(1 420)	--
Balances, December 31, 2007	\$ 3 672	\$ 3 771	\$ 24 787	\$ (2 701)

See Notes to Consolidated Financial Statements.

34

**POTOMAC BANCSHARES, INC. AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY**  
**(CONTINUED)**  
**Years Ended December 31, 2008, 2007 and 2006**  
**(in thousands, except per share data)**

	Common Stock	Surplus	Undivided Profits	Treasury Stock	
Balances, December 31, 2007	\$ 3 672	\$ 3 771	\$ 24 787	\$ (2 701)	\$
Comprehensive income					
Net income □ 2008	--	--	1 862	--	
Other comprehensive (loss):					
Unrealized holding gains arising during the period (net of tax, \$40)	--	--	--	--	
Change in benefit obligations and plan assets for pension and other postretirement benefits (net of tax, \$780)	--	--	--	--	
Total other comprehensive (loss)					
Total comprehensive income					
Purchase of treasury shares:					
13,935 shares	--	--	--	(149)	
Sale of treasury shares:					
2,040 shares	--	10	--	13	
Stock-based compensation expense	--	70	--	--	
Reduction due to change in pension measurement date (net of tax, \$16)	--	--	(31)	--	
Cash dividends □ 2008 (\$ .46 per share)	--	--	(1 548)	--	
Balances, December 31, 2008	\$ 3 672	\$ 3 851	\$ 25 070	\$ (2 837)	\$

See Notes to Consolidated Financial Statements.

**POTOMAC BANCSHARES, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
Years Ended December 31, 2008, 2007 and 2006  
(in thousands)**

	2008
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>	
Net income	\$ 1 862
Adjustments to reconcile net income to net cash provided by (used in) operating activities:	
Provision for loan losses	2 934
Depreciation	532
Deferred tax (benefit)	(474)
Discount accretion and premium amortization on securities, net	(21)
Loss on sale of other real estate	185
Loss on disposal of premises and equipment	5
Loss on sale of repossessed assets	23
Stock-based compensation expense	70
Proceeds from sale of loans	12 153
Origination of loans for sale	(4 349)
Changes in assets and liabilities:	
Decrease (increase) in accrued interest receivable	258
(Increase) in other assets	(441)
(Decrease) increase in accrued interest payable	(276)
Increase (decrease) in other liabilities	304
Net cash provided by (used in) operating activities	\$ 12 765
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>	
Proceeds from maturity of securities available for sale	\$ 5 500
Proceeds from call of securities available for sale	22 000
Purchases of securities available for sale	(15 267)
Net (increase) decrease in loans	(26 719)
Purchases of premises and equipment	(2 315)
Proceeds from sale of other real estate	1 815
Net cash (used in) provided by investing activities	\$ (14 986)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>	
Net (decrease) in noninterest-bearing deposits	\$ (2 525)
Net increase in interest-bearing deposits	3 239
Net (repayment) proceeds of securities sold under agreements to repurchase and federal funds purchased	(4 185)
Net proceeds (repayment) of Federal Home Loan Bank advances	4 564
Purchase of treasury shares	(149)
Sale of treasury shares	23
Cash dividends	(1 548)
Net cash (used in) provided by financing activities	\$ (581)
(Decrease) increase in cash and cash equivalents	\$ (2 802)
<b>CASH AND CASH EQUIVALENTS</b>	
Beginning	11 151
Ending	\$ 8 349
<b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION</b>	
Cash payments for:	
Interest	\$ 6 753
Income taxes	\$ 1 642
<b>SUPPLEMENTAL DISCLOSURES OF NON-CASH</b>	

INVESTING AND FINANCING ACTIVITIES	
Unrealized gain on securities available for sale	\$ 117
Change in benefit obligations and plan assets for pension and other postretirement benefits	\$ (2 295)
Loans transferred to OREO	\$ 3 238
Loans made on sale of other real estate owned	\$ 775

See Notes to Consolidated Financial Statements.

36

## POTOMAC BANCSHARES, INC. AND SUBSIDIARY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### Note 1. Nature of Banking Activities and Significant Accounting Policies

Potomac Bancshares, Inc. and Subsidiary (the company) grant commercial, financial, agricultural, residential and consumer loans to customers, primarily in Berkeley County and Jefferson County, West Virginia. The company's market area also includes Washington County and Frederick County, Maryland and Frederick County, Loudoun County and Clarke County, Virginia. The loan portfolio is well diversified and loans generally are collateralized by assets of the customers. The loans are expected to be repaid from cash flows or proceeds from the sale of selected assets of the borrowers.

The accounting and reporting policies of the company conform to accounting principles generally accepted in the United States of America and to general practices within the banking industry. The following is a summary of the more significant policies.

#### Principles of Consolidation

The consolidated financial statements of Potomac Bancshares, Inc. and its wholly-owned subsidiary, Bank of Charles Town (the bank), include the accounts of both companies. All material intercompany balances and transactions have been eliminated in consolidation.

#### Interest-bearing Deposits in Financial Institutions

Interest-bearing deposits in financial institutions mature within one year and are carried at cost.

#### Securities

Debt securities that management has the positive intent and ability to hold to maturity are classified as "held to maturity" and recorded at amortized cost. Securities not classified as held to maturity, including equity securities with readily determinable fair values, are classified as "available for sale" and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income.

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

#### Loans

The company grants mortgage, commercial and consumer loans to customers. A substantial portion of the loan portfolio is comprised of loans secured by real estate. The ability of the

company's debtors to honor their contracts is dependent upon the real estate and general economic conditions of the company's market area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff, generally, are reported at their outstanding unpaid principal balances adjusted for the allowance for loan losses and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method.

The accrual of interest on loans is discontinued at the time the loan is 90 days delinquent unless the credit is well-secured and in process of collection. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal or interest is considered doubtful.

37

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Note 1. Nature of Banking Activities and Significant Accounting Policies (Continued)

Loans (Continued)

All interest accrued but not collected for loans that are placed on nonaccrual or charged-off is reversed against interest income. The interest on these loans is accounted for on the cash-basis cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance is based on two basic principles of accounting: (1) SFAS No. 5, "Accounting for Contingencies," which requires that losses be accrued when they are probable of occurring and are capable of estimation and (2) SFAS No. 114, "Accounting by Creditors for Impairment of a Loan," which requires that losses be accrued based on the differences between the value of collateral, present value of future cash flows or values that are observable in the secondary market and the loan balance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience, nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as either doubtful or substandard. For such loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified and special mention loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects that margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.



A loan is considered impaired when, based on current information and events, it is probable that the company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the company does not separately identify individual consumer and residential loans for impairment disclosures.

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Note 1. Nature of Banking Activities and Significant Accounting Policies (Continued)

Loans Held for Sale

Loans originated and intended for sale in the secondary market are carried at the lower of cost or market determined in the aggregate. The company does not retain mortgage servicing rights on loans held for sale.

In 2007, the bank entered into an agreement with BlueRidge Bank whereby Bank of Charles Town would fund loans for BlueRidge Bank until such time as BlueRidge Bank could obtain its charter. The balance of these loans was \$7.8 million at December 31, 2007. Upon receiving its charter in 2008, BlueRidge Bank purchased the loans from Bank of Charles Town.

Premises and Equipment

Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed on the straight-line method. Estimated useful lives range from five to forty years for premises and improvements and three to twenty-five years for furniture and equipment.

Maintenance and repairs of property and equipment are charged to operations and major improvements are capitalized. Upon retirement, sale or other disposition of property and equipment, the cost and accumulated depreciation are eliminated from the accounts and gain or loss is included in operations.

Other Real Estate

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at the lower of the loan balance or the fair value net of estimated selling costs at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in net expenses from foreclosed assets.

Employee Benefit Plans

The company sponsors the following employee benefit plans:

- a noncontributory, defined benefit pension plan covering employees meeting certain age and service requirements,
- a postretirement life insurance plan covering current and future retirees with 25 years of service over the age
- a postretirement life insurance plan covering certain current retirees who met certain requirements that is not available for future retirees,
- a health care plan for current retirees who met certain eligibility requirements that is not available for future retirees and
- a 401(k) retirement savings plan available to all employees meeting certain age and service requirements. Under this plan, the employer may make a discretionary matching contribution each plan year and may also make other discretionary contributions to the plan.

#### Stock Dividends

On March 14, 2006, the Board of Directors declared a 2% stock dividend. Shares increased from 3,600,000 to 3,671,691.

#### Earnings Per Share

Basic earnings per share represent income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from their assumed issuance. Potential common shares that may be issued by the company relate solely to outstanding stock options and are determined using the treasury method. All amounts have been retroactively restated for the stock dividends as described above.

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#### Note 1. Nature of Banking Activities and Significant Accounting Policies (Continued)

##### Income Taxes

Deferred income tax assets and liabilities are determined using the balance sheet method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary difference between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws.

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on the available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying consolidated balance sheets along with any associated interest and penalties that would be payable to the taxing authorities upon examination. Interest and penalties associated with unrecognized tax benefits are classified as additional income taxes in the consolidated statements of income.

##### Cash and Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amount due from banks, interest-bearing deposits in financial institutions, securities purchased under agreements to resell and federal funds sold. Generally, securities purchased under agreements to resell and federal funds sold are purchased and sold for one-day periods.

#### Trust Division

Securities and other property held by the Trust Division in a fiduciary or agency capacity are assets of the company and are not included in the accompanying consolidated financial statements.

#### Use of Estimates

In preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses and the valuation of foreclosed real estate, deferred tax assets and the pension benefit obligation.

#### Advertising

The company follows the policy of charging the costs of advertising to expense as incurred.

#### Comprehensive Income

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available for sale securities and changes in pension and postretirement benefit obligations, are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income.

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#### Note 1. Nature of Banking Activities and Significant Accounting Policies (Continued)

##### Stock-Based Compensation Plan

The 2003 Stock Incentive Plan was approved by stockholders on May 13, 2003. This is the first stock incentive plan adopted by the company. Under the plan, the option price cannot be less than the fair market value of the stock on the date granted. An option's maximum term is ten years from the date of grant. Options granted under the plan may be subject to a graded vesting schedule.

The stockholders initially authorized up to 183,600 shares of common stock to be used in the granting of incentive options to employees and directors. These shares have been restated to reflect the 2% stock dividend declared March 14, 2006. On April 24, 2007, the shareholders authorized an additional 250,000 shares of common stock to be used in the granting of incentive options to employees and directors.

Stock option compensation expense is the estimated fair value of options granted, and is amortized on a straight-line basis over the requisite service period for each separately vesting portion of the award. There were no options granted in 2008. The weighted average estimated fair value of stock options granted in the twelve months ended December 31, 2007 and 2006 was \$3.76 and \$3.88, respectively. Fair value is estimated using the Black-Scholes option-pricing model with the following assumptions for grants during 2007 and 2006: option term until exercise of 10 years, expected volatility of 19.56% and 17.86%, risk-free interest rates of 4.66% and 4.43%, and expected dividend yields of 2.74% and 2.66%, respectively. Expected volatility is

based on the historic volatility of the company's stock price over the expected life of the option. We have determined that the expected term for options is their contractual life of 10 years. The risk-free interest rate is the U. S. Treasury zero-coupon issue with a remaining term equal to the expected term of the options granted. The dividend yield is estimated as the ratio of the company's historical dividends paid per share of common stock to the stock price on the date of grant.

#### Reclassifications

Certain reclassifications have been made to prior period amounts to conform to the current year presentation.

#### Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) reached a consensus on Emerging Issues Task Force (EITF) Issue 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements," (EITF Issue 06-4). In March 2007, the FASB reached a consensus on EITF Issue 06-10, "Accounting for Collateral Assignment Split-Dollar Life Insurance Arrangements," (EITF Issue 06-10). Both of these standards require a company to recognize an obligation over an employee's service period based upon the substantive agreement with the employee such as the promise to maintain a life insurance policy or provide a death benefit postretirement. The company adopted the provisions of these standards effective January 1, 2008. The adoption of these standards was not material to the consolidated financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements" (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements, but rather, provides enhanced guidance to other pronouncements that require or permit assets or liabilities to be measured at fair value. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those years. The FASB has approved a one-year deferral for the implementation of the statement for nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis. The company adopted SFAS 157 effective January 1, 2008. The adoption of SFAS 157 was not material to the consolidated financial statements.

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#### Note 1. Nature of Banking Activities and Significant Accounting Policies (Continued)

##### Recent Accounting Pronouncements (Continued)

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, "Fair Value Option for Financial Assets and Financial Liabilities" (SFAS 159). This statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective of this statement is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. The fair value option established by this statement permits all entities to choose to measure eligible items at fair value at specified election dates. A business entity shall report unrealized gains and losses on the items for which the fair value option has been elected in earnings at each subsequent reporting date. The fair value option may be applied instrument by instrument and is irrevocable. SFAS 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007, with early adoption available in certain circumstances. The company adopted SFAS 159 effective January 1, 2008. The company decided not to report any existing financial assets or liabilities at fair value that are not already reported, thus the adoption of this statement did not have a material impact on the consolidated financial statements.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141(R), "Business Combinations" (SFAS 141(R)). The standard will significantly change the financial

accounting and reporting of business combination transactions. SFAS 141(R) establishes principles for how an acquirer recognizes and measures the identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree; recognizes and measures goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS 141(R) is effective for acquisition dates on or after the beginning of an entity's first year that begins after December 15, 2008. The company does not expect the implementation of SFAS 141(R) to have a material impact on its consolidated financial statements, at this time.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, "Noncontrolling Interests in Consolidated Financial Statements, an Amendment of ARB No. 51" (SFAS 160). The standard will significantly change the financial accounting and reporting of noncontrolling (or minority) interests in consolidated financial statements. SFAS 160 is effective as of the beginning of an entity's first fiscal year that begins after December 15, 2008, with early adoption prohibited. The company does not expect the implementation of SFAS 160 to have a material impact on its consolidated financial statements, at this time.

In November 2007, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 109, "Written Loan Commitments Recorded at Fair Value Through Earnings" (SAB 109). SAB 109 expresses the current view of the staff that the expected net future cash flows related to the associated servicing of the loan should be included in the measurement of all written loan commitments that are accounted for at fair value through earnings. SEC registrants are expected to apply the views in Question 1 of SAB 109 on a prospective basis to derivative commitments issued or modified in fiscal quarters beginning after December 15, 2007. Implementation of SAB 109 did not have a material impact on the company's consolidated financial statements.

In December 2007, the SEC issued Staff Accounting Bulletin No. 110, "Use of a Simplified Method in Developing Expected Term of Share Options" (SAB 110). SAB 110 expresses the current view of the staff that it will accept a company's election to use the simplified method discussed in SAB 110 for estimating the expected term of "plain vanilla" share options regardless of whether the company has sufficient information to make more refined estimates. The staff noted that it understands that detailed information about employee exercise patterns may not be widely available by December 31, 2007. Accordingly, the staff will continue to accept, under certain circumstances, the use of the simplified method beyond December 31, 2007. Implementation of SAB 110 did not have a material impact on the company's consolidated financial statements.

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Note 1. Nature of Banking Activities and Significant Accounting Policies (Continued)

Recent Accounting Pronouncements (Continued)

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities" (an amendment of SFAS No. 133) (SFAS 161). SFAS 161 requires that an entity provide enhanced disclosures related to derivative and hedging activities. SFAS 161 is effective for the company on January 1, 2009 and is not expected to have a material impact on the company's consolidated financial statements.

In April 2008, the FASB issued FASB Staff Position (FSP) No. 142-3, "Determination of the Useful Life of Intangible Assets" (FSP 142-3). FSP 142-3 amends the factors an entity should consider in determining the useful life of recognized intangible assets under SFAS No. 142, "Goodwill and Other Intangible Assets" (SFAS 142). The intent of FSP 142-3 is to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flows used to measure the fair value of the assets under SFAS 141(R). FSP 142-3 is effective for the company on January 1, 2009, and applies prospectively to intangible assets that are acquired individually or with a group of other assets in business combinations and asset acquisitions. The adoption of FSP 142-3 is not expected to have a material impact on the company's consolidated financial statements.

In May 2008, the FASB issued SFAS No. 162, "The Hierarchy of Generally Accepted Accounting Principles," (SFAS 162). SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles. SFAS 162 is effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, "The Meaning of Present Fairly Conformity With Generally Accepted Accounting Principles." Management does not expect the adoption of the provision of SFAS 162 to have any impact on the consolidated financial statements.

In September 2008, the FASB issued FSP FAS 133-1 and FIN 45-4, "Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161," (FSP 133-1 and FIN 45-4). FSP 133-1 and FIN 45-4 require a seller of credit derivatives to disclose information about its credit derivatives and hybrid instruments that have embedded credit derivatives to enable users of financial statements to assess their potential effect on its financial position, financial performance and cash flows. The disclosures required by FSP 133-1 and FIN 45-4 will be effective for the company on December 31, 2008 and are not expected to have a material impact on the consolidated financial statements.

In October 2008, the FASB issued FSP FAS 157-3, "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active," (FSP 157-3). FSP 157-3 clarifies the application of SFAS 157 in determining the fair value of a financial asset during periods of inactive markets. FSP 157-3 was effective as of September 30, 2008 and did not have a material impact on the company's consolidated financial statements.

In December 2008, the FASB issued FSP No. FAS 140-4 and FIN 46(R)-8, "Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities." FSP No. FAS 140-4 and FIN 46(R)-8 requires enhanced disclosures about transfers of financial assets and interests in variable interest entities. The FSP is effective for interim and annual periods ending after December 15, 2008. Since the FSP requires only additional disclosures concerning transfers of financial assets and interest in variable interest entities, adoption of the FSP will not affect the company's financial condition, results of operations or cash flows.

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Note 1. Nature of Banking Activities and Significant Accounting Policies (Continued)

Recent Accounting Pronouncements (Continued)

In January 2009, the FASB reached a consensus on EITF Issue 99-20-1. This FSP amends the impairment guidance in EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets," to achieve more consistent determination of whether an other-than-temporary impairment has occurred. The FSP also retains and emphasizes the objective of an other-than-temporary impairment assessment and the related disclosure requirements in SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," and other related guidance. The FSP is effective for interim and annual reporting periods ending after December 15, 2008 and shall be applied prospectively. The FSP was effective as of December 31, 2008 and did not have a material impact on the consolidated financial statements.

Note 2. Securities

There were no securities held to maturity as of December 31, 2008 and 2007.

The amortized cost and fair value of securities available for sale as of December 31, 2008 and 2007 (in thousands) are as follows:

	2008			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Obligations of U.S. Government agencies	\$ 23 996	\$ 493	\$ - -	\$ 24 489
State and municipal obligations	3 132	8	(151)	2 999
	\$ 27 128	\$ 501	\$ (151)	\$ 27 478

	2007			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Obligations of U.S. Government agencies	\$ 36 471	\$ 246	\$ (16)	\$ 36 701
State and municipal obligations	2 868	5	(2)	2 871
	\$ 39 339	\$ 251	\$ (18)	\$ 39 572

The amortized cost and fair value of the securities available for sale as of December 31, 2008 (thousands), by contractual maturity, are shown below:

	Amortized Cost	Fair Value
Due in one year or less	\$ 5 645	\$ 5 747
Due after one year through five years	19 377	19 768
Due after five years	2 106	1 963
	\$ 27 128	\$ 27 478

There were no sales of securities available for sale during 2008 or 2007.

44

## Note 2. Securities (Continued)

The primary purpose of the investment portfolio is to generate income and meet liquidity needs of the company through readily saleable financial instruments. The portfolio is made up of fixed income securities, whose prices move inversely with rates. At the end of any accounting period, the investment portfolio has unrealized gains and losses. The company monitors the portfolio which is subject to liquidity needs, market rate changes and credit risk changes to see if adjustments are needed. The primary concern in a loss situation is the credit quality of the business behind the instrument. The primary cause of impairments is the decline in the prices of the bonds as rates have risen. There are approximately 9 accounts in the consolidated portfolio that have losses as of December 31, 2008. These securities have not suffered credit deterioration and the company has the ability and intent to hold these issues to maturity or recovery of value; therefore, the gross unrealized losses are considered temporary as of December 31, 2008.

The following table summarizes the fair value and gross unrealized losses for securities aggregated by investment category and length of time that individual securities have been in continuous gross unrealized loss position as of December 31, 2008 and 2007 (in thousands).

	December 31, 2008					
	Less than 12 months		More than 12 months		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
State and municipal obligations	\$ 2 077	\$ (151)	\$ - -	\$ - -	\$ 2 077	\$ (151)

	Less than 12 months		December 31, 2007 More than 12 months		Total	
	Gross Unrealized		Gross Unrealized		Gross Unrealized	
	Fair Value	Losses	Fair Value	Losses	Fair Value	Losses
Obligations of U.S. Government agencies	\$ --	\$ --	\$ 4 984	\$ (16)	\$ 4 984	\$ (16)
State and municipal obligations	469	(1)	371	(1)	840	(2)
	\$ 469	\$ (1)	\$ 5 355	\$ (17)	\$ 5 824	\$ (19)

Securities with a carrying value of \$18.4 million and \$25.6 million at December 31, 2008 and 2007 were pledged to secure public funds and other balances as required by law.

### Note 3. Loans and Related Party Transactions

The loan portfolio is composed of the following:

	December 31	
	2008	2007
	(in thousands)	
<b>Mortgage loans on real estate:</b>		
Construction and land development	\$ 65 643	\$ 55 042
Secured by farm land	1 380	1 328
Secured by 1-4 family residential	97 064	98 864
Secured by multifamily residential	1 937	1 749
Secured by nonfarm nonresidential	58 332	47 726
Commercial loans (except those secured by real estate)	9 671	4 987
Consumer loans	11 970	14 718
All other loans	457	193
Total loans	\$ 246 454	\$ 224 607
Less: allowance for loan losses	4 079	2 779
	\$ 242 375	\$ 221 828

45

### Note 3. Loans and Related Party Transactions (Continued)

At December 31, 2008 and 2007, overdraft demand deposits reclassified to loans totaled \$457 thousand and \$193 thousand, respectively.

Loans to directors and executive officers of the company or to their associates at December 31, 2008 and 2007 totaled \$3.1 million and \$2.8 million, respectively. Such loans were made on substantially the same terms as those prevailing for comparable transactions with similar risk. During 2008, total principal additions were \$963 thousand and total principal payments were \$725 thousand.

### Note 4. Allowance for Loan Losses

The following is a summary of transactions in the allowance for loan losses for 2008, 2007 and 2006 (in thousands):

	2008	2007	2006
--	------	------	------



Balances at beginning of year	\$ 2 779	\$ 2 423	\$ 2 163
Provision charged to operating expense	2 934	678	331
Recoveries added to the allowance	199	182	138
Loan losses charged to the allowance	(1 833)	(504)	(207)
Balances at end of year	\$ 4 079	\$ 2 779	\$ 2 423

The following is a summary of information pertaining to impaired loans as of December 31 for each of the years presented (in thousands):

	2008	2007
Impaired loans without a valuation allowance	\$ 7 469	\$ 3 157
Impaired loans with a valuation allowance	4 245	2 656
Total impaired loans	\$ 11 714	\$ 5 813
Valuation allowance related to impaired loans	\$ 1 302	\$ 636
Total nonaccrual loans	\$ 2 669	\$ 1 584
Total loans past due ninety days or more and still accruing	\$ 1 263	\$ 21

	2008	2007	2006
Average investment in impaired loans	\$ 7 770	\$ 1 163	\$ -
Interest income recognized on impaired loans	\$ 471	\$ 48	\$ -
Interest income recognized on a cash basis on impaired loans	\$ 4	\$ -	\$ -

No additional funds are committed to be advanced in connection with impaired loans. Nonaccrual loans excluded from impaired loan disclosure under SFAS No. 114 at December 31, 2008 and 2007 totaled \$607 thousand and \$517 thousand, respectively. If interest had been accrued on these nonaccrual loans, such income would have approximated \$36 thousand in 2008 and \$33 thousand in 2007.

46

#### Note 5. Premises and Equipment, Net

Premises and equipment consists of the following:

	December 31	
	2008	2007
	(in thousands)	
Premises and improvements	\$ 8 676	\$ 6 614
Furniture and equipment	4 539	4 393
	\$ 13 215	\$ 11 007
Less accumulated depreciation	5 200	4 770
	\$ 8 015	\$ 6 237

Depreciation included in operating expense for 2008, 2007 and 2006 was \$532 thousand, \$566 thousand and \$582 thousand, respectively.

#### Note 6. Deposits

The aggregate amount of time deposits with a balance of \$100,000 or more was \$31.8 million and \$28.2 million at December 31, 2008 and 2007, respectively.

At December 31, 2008, the scheduled maturities of all time deposits (in thousands) are as follows:

2009	\$ 70 484
2010	18 130
2011	18 368
2012	5 550
2013	2 800
	\$ 115 332

Brokered deposits (all in the form of certificates of deposit) totaled \$9.6 million and \$3.4 million at December 31, 2008 and 2007, respectively.

Deposits of the company's directors, executive officers and associates totaled \$1.6 million and \$1.4 million at December 31, 2008 and 2007, respectively.

Deposits of one public funds entity exceed 5% of the bank's total deposits.

#### Note 7. Borrowings

Short-term borrowings consist of securities sold under agreements to repurchase.

Short-term borrowings totaled \$8.4 million and \$12.5 million as of December 31, 2008 and 2007, respectively, in securities sold under agreements to repurchase through secured transactions with customers.

During 2008, the bank incurred fixed rate long term debt consisting of a Federal Home Loan Bank, five year loan, with an original balance of \$5 million and monthly payments of interest and principal with an interest rate of 4.61%. The seven year loan with Federal Home Loan Bank with an original balance of \$2.5 million was paid off in June 2008.

Principal payments on the note are due as follows:

2009	\$ 921
2010	964
2011	1 009
2012	1 057
2013	825
	\$ 4 776

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#### Note 7. Borrowings (Continued)

The company has unused lines of credit with the Federal Home Loan Bank and other financial institutions totaling approximately \$135 million at December 31, 2008.

#### Note 8. Employee Benefit Plans

The company sponsors a 401(k) retirement savings plan available to all employees meeting certain age and service requirements. Employees become eligible to participate in the plan upon reaching age 21 and completing one year of service. Entry dates are January 1, April 1, July 1 and October 1. Employees can make a salary deferral election authorizing the employer to withhold up to the amount allowed by law each calendar year. The employer may make a discretionary matching contribution each plan year. The employer may also make other discretionary contributions to the plan. The company made 401(k) matching contributions of \$100 thousand, \$92 thousand and \$56 thousand in 2008, 2007 and 2006, respectively.

The company sponsors a funded noncontributory, defined benefit pension plan covering full-time employees over 21 years of age upon completion of one year of service. Benefits are based on average compensation for the five consecutive full calendar years of service which produces the highest average.

The company sponsors an unfunded postretirement life insurance plan covering current and future retirees with 25 years of service over the age of 60 and an unfunded health care plan for current retirees that met certain eligibility requirements.

The company has entered into contracts with three retirees where the company agrees to pay participants' beneficiaries \$50,000 upon the participants' death. The present value of this postretirement benefit has been accrued as of December 31, 2008 in the amount of \$127 thousand. While these liabilities are unfunded, life insurance has been obtained by the company to help offset these payments.

48

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Note 8. Employee Benefit Plans (Continued)

Obligations and funded status:

	Pension Benefit	2008	2007
	(in thousands)		
<b>Change in benefit obligation:</b>			
Benefit obligation, beginning	\$	6,374	\$
Service cost		344	
Interest cost		474	
Actuarial (gain) loss		514	
Benefits paid		(305)	
Benefit obligation, ending	\$	7,401	\$
<b>Change in plan assets:</b>			
Fair value of plan assets, beginning	\$	5,303	\$
Actual return on plan assets		(1,457)	
Employer contributions		485	
Benefits paid		(305)	
Fair value of plan assets, ending	\$	4,026	\$
Funded status at end of year	\$	(3,375)	\$
Unrecognized net (gain)		--	
Unrecognized transition asset		--	
<b>Accounts recognized on consolidated balance sheet as:</b>			
Accrued benefit liabilities	\$	(3,375)	\$
<b>Amounts recognized in accumulated other comprehensive loss consist of:</b>			
Net loss (gain)	\$	3,255	\$
Transition liability		--	
Deferred tax asset		(1,107)	
	\$	2,148	\$

The accumulated benefit obligation for the defined benefit pension plan was \$7.4 million and \$6.9 million at December 31, 2008 and 2007, respectively.

## Note 8. Employee Benefit Plans (Continued)

Components of net periodic benefit cost and other amounts recognized in accumulated other comprehensive (loss):

	Pension Benefits	
	2008	2007
	(in thousands)	
<b>Components of net periodic benefit cost:</b>		
Service cost	\$ 301	\$ 251
Interest cost	410	361
Expected return on plan assets	(313)	(351)
Amortization of net obligation at transition	-	-
Recognized actuarial loss	71	41
<b>Net periodic benefit cost</b>	<b>\$ 469</b>	<b>\$ 302</b>
<b>Other changes in plan assets and benefit obligations recognized in accumulated other comprehensive loss:</b>		
Net loss (gain)	\$ 2,319	\$ (271)
Transition liability	-	-
Deferred tax	(789)	91
<b>Total recognized in accumulated other comprehensive loss</b>	<b>\$ 1,530</b>	<b>\$ (180)</b>
<b>Total recognized in net periodic benefit cost and accumulated other comprehensive loss</b>	<b>\$ 1,999</b>	<b>\$ 122</b>
<b>Adjustment to retained earnings due to change in measurement date:</b>		
Service cost		
Interest cost		
Expected return on plan assets		
Deferred tax benefit		
Amortization of loss		
<b>Net period benefit cost</b>		

The estimated net loss and prior service cost for the defined benefit pension plan that will be amortized from accumulated other comprehensive income into net periodic benefit cost over the next fiscal year approximates \$71 thousand. The estimated unrecognized transition liability for the other defined benefit postretirement plans that will be amortized from accumulated other comprehensive income into net periodic benefit cost over the next fiscal year is \$17 thousand.

## Note 8. Employee Benefit Plans (Continued)

## Assumptions

Pension Benefits	Other Postretirement Benefits
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	2008	2007	2006	2008	2007
Weighted-average assumptions used to determine net periodic benefit cost:					
Discount rate	6.00%	6.00%	6.00%	6.00%	6.00%
Expected return on plan assets	6.00%	7.50%	8.00%	- -	- -
Rate of compensation increase	3.50%	4.50%	4.00%	3.00%	3.00%
Weighted-average assumptions used to determine benefit obligations:					
Discount rate	6.00%	6.00%	6.00%	6.00%	6.00%
Rate of compensation increase	3.50%	4.50%	4.00%	3.00%	3.00%

#### Long-Term Rate of Return

The plan sponsor selects the expected long-term rate-of-return-on-assets assumption in consultation with their investment advisors and actuary. This rate is intended to reflect the average rate of earnings expected to be earned on the funds invested or to be invested to provide plan benefits. Historical performance is reviewed, especially with respect to real rates of return (net of inflation), for the major asset classes held or anticipated to be held by the trust, and for the trust itself. Undue weight is not given to recent experience that may not continue over the measurement period, with higher significance placed on current forecasts of future long-term economic conditions.

Because assets are held in a qualified trust, anticipated returns are not reduced for taxes. Further, solely for this purpose, the plan is assumed to continue in force and not terminate during the period during which assets are invested. However, consideration is given to the potential impact of current and future investment policy, cash flow into and out of the trust, and expenses (both investment and non-investment) typically paid from plan assets (to the extent such expenses are not explicitly estimated within periodic cost).

#### Asset Allocation

The pension plan's weighted-average asset allocations at December 31, 2008 and October 31, 2007 (the plan's valuation date), by asset category are as follows:

Asset Category	Plan Assets at	
	December 31 2008	October 31 2007
Equities	57%	61%
Fixed income/cash	43%	39%
Total	100%	100%

The trust fund is sufficiently diversified to maintain a reasonable level of risk without imprudently sacrificing return, with a targeted asset allocation of 60% equities and 40% fixed income/cash. The trust fund allocation is reviewed on a quarterly basis and rebalanced back to the original weighting if the actual weighting varies by at least 5% from the target allocation. The investment manager selects investment fund managers with demonstrated experience and expertise and funds with demonstrated historical performance for the implementation of the plan's investment strategy. The investment manager will consider both actively and passively managed investment strategies and will allocate funds across the asset classes to develop an efficient investment structure.

It is the responsibility of the trustee to administer the investments of the trust within reasonable costs, being careful to avoid sacrificing quality. These costs include, but are not limited to, management and custodial fees, consulting fees, transaction costs and other administrative costs.

chargeable to the trust.

There is no company common stock included in the equity securities of the pension plan at December 31, 2008 and 2007.

51

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Note 8. Employee Benefit Plans (Continued)

Cash Flow

The company expects to contribute \$1 million to its pension plan in 2009 and \$26 thousand to its postretirement plan in 2009.

The following benefit payments, which reflect future service, are expected to be paid:

	Pension Benefits	Other Postretirement Benefits
	(in thousands)	
2009	\$ 285	\$ 26
2010	286	27
2011	291	28
2012	338	30
2013	340	31
2014-2019	2 213	174

For measurement purposes, a 7.10%, 7.35% and 7.60% annual rate of increase in per capita health care costs of covered benefits was assumed for 2008, 2007 and 2006, with such annual rate of increase gradually declining to 5% in 2013.

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A 1% change in assumed health care cost trend rates would have the following effects:

	1% Increase (in thousands)	1% Decrease (in thousands)
Effect on the health care component of the accumulated postretirement benefit obligation	\$ 60	\$ (53)
Effect on total of service and interest cost components of net periodic postretirement health care benefit cost	3	(4)

Note 9. Weighted Average Number of Shares Outstanding and Earnings Per Share

The following shows the weighted average number of shares used in computing earnings per share and the effect on weighted average number of shares of diluted potential common stock. Potential diluted common stock had no effect on earnings per share available to stockholders.

	2008	Per Share Amount	2007	Per Share Amount	2006
	Average Shares (in thousands)		Average Shares (in thousands)		Average Shares (in thousands)
Basic earnings per share	3 402	\$ .55	3 423	\$ 1.03	3 455

Effect of dilutive securities:					
Stock options		2		8	13
Diluted earnings per share		3 404	\$ .55	3 431	\$ 1.03

Shares outstanding have been restated to reflect the 2% stock dividend in 2006.

Stock options for 132,620, 120,534 and 83,811 shares of common stock were not considered in computing diluted earnings per common share for 2008, 2007 and 2006, respectively, because they were anti-dilutive.

52

#### Note 10. Stock-Based Compensation

During 2003, the company adopted an incentive stock plan which allows key employees and directors to increase their personal financial interest in the company. This plan permits the issuance of incentive stock options and non-qualified stock options. The plan authorizes the issuance of up to 183,600 shares of common stock (shares have been restated to reflect the 2% stock dividend declared March 14, 2006). In 2007, the shareholders authorized an additional 250,000 shares of common stock to be used in the granting of incentive options to employees and directors.

A summary of option activity under the plan as of December 31, 2008, and changes during the year then ended is presented below:

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life in Years	Aggregate Intrinsic Value (in thousands)
Outstanding at beginning of year	151 116	\$ 14.77		
Granted	--	--		
Exercised	(2 040)	11.28		
Forfeited	(16 456)	15.33		
Outstanding at end of year	132 620	\$ 14.75	7	\$ --
Exercisable at end of year	90 381	\$ 14.41	6	\$ --

The aggregate intrinsic value of a stock option in the table above represents the total pre-tax intrinsic value (the amount by which the current market value of the underlying stock exceeds the exercise price of the option) that would have been received by the option holders had all option holders exercised their options on December 31, 2008. The amount changes based on changes in the market value of the company's stock.

The exercise price of stock options granted under this plan, both incentive and non-qualified, cannot be less than the fair market value of the common stock on the date that the option is granted. The maximum term for an option granted under this plan is ten years and options granted may be subject to a vesting schedule. The non-qualified options granted are exercisable immediately. The incentive options granted are subject to a five year vesting period whereby the grantees are entitled to exercise one fifth of the options on the anniversary of the grant date of the next five years. The following table summarizes options outstanding at December 31, 2008:

Options Outstanding  
Weighted

Options Exercisable

Exercise Price	Number Outstanding	Average Remaining Contractual Life (in years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$ 11.28	27 184	5.0	\$ 11.28	23 920	\$ 11.28
14.00	35 819	6.0	14.00	27 169	14.00
17.25	37 787	7.0	17.25	23 774	17.25
15.60	31 830	8.0	15.60	15 518	15.60
	132 620			90 381	

As of December 31, 2008, there was \$97 thousand of total unrecognized compensation expense related to nonvested stock options, which will be recognized over the remaining requisite service period. The unrecognized compensation expense has a weighted average life of two years.

53

#### Note 11. Income Taxes

The company files income tax returns in the U. S. Federal jurisdiction and the state of West Virginia. With few exceptions, the company is no longer subject to U. S. Federal, state and local income tax examinations by tax authorities for years prior to 2005.

The company adopted the provisions of FIN 48, *Accounting for Uncertainty in Income Taxes*, January 1, 2007 with no impact on the financial statements.

Net deferred tax assets consist of the following components as of December 31, 2008 and 2007

	2008	2007
	(in thousands)	
<b>Deferred tax assets:</b>		
Reserve for loan losses	\$ 1 229	\$ 790
Accrued pension expense	1 148	438
Accrued postretirement benefits	229	208
Nonaccrual interest	80	17
Stock option expense	35	35
Home equity closing costs	64	72
Net loan origination fees	35	14
OREO expense	11	11
	\$ 2 831	\$ 1 585
<b>Deferred tax liabilities:</b>		
Depreciation	\$ 114	\$ 122
Securities available for sale	119	79
	\$ 233	\$ 201
<b>Net deferred tax assets</b>	<b>\$ 2 598</b>	<b>\$ 1 384</b>

The provision for income taxes charged to operations for the years ended December 31, 2008, 2007 and 2006 consists of the following:

	2008	2007	2006
	(in thousands)		
Current tax expense	\$ 1 327	\$ 2 248	\$ 2 400
Deferred tax expense (benefit)	(474)	(250)	(1 300)
	\$ 853	\$ 1 998	\$ 2 300



The income tax provision differs from the amount of income tax determined by applying the U.S. federal income tax rate to pretax income for the years ended December 31, 2008, 2007 and 2006 due to the following (in thousands):

	2008	2007	2006
Computed (expected) tax expense	\$ 923	\$ 1 880	\$ 2 000
Increase (decrease) in income taxes resulting from:			
Tax exempt income	(217)	(107)	(107)
State income taxes, net of federal income tax benefit	123	191	191
Other	24	34	34
	\$ 853	\$ 1 998	\$ 2 000

54

#### Note 12. Commitments and Contingent Liabilities

In the normal course of business, there are outstanding various commitments and contingent liabilities which are not reflected in the accompanying financial statements. The company does not anticipate losses as a result of these transactions. See Note 14 with respect to financial instruments with off-balance-sheet risk.

The company has approximately \$1 million in deposits in other financial institutions in excess of amounts insured by the Federal Deposit Insurance Corporation (FDIC) at December 31, 2008.

The company must maintain a reserve against its deposits in accordance with Regulation D of the Federal Reserve Act. For the final bi-weekly reporting periods which included December 31, 2008 and 2007, the aggregate amounts of daily average required balances were approximately \$30 thousand for each time period.

#### Note 13. Retained Earnings

Transfers of funds from the banking subsidiary to the parent company in the form of loans, advances and cash dividends are restricted by federal and state regulatory authorities. As of December 31, 2008, the aggregate amount of unrestricted funds which could be transferred from the banking subsidiary to the parent company without prior regulatory approval, totaled \$3.5 million or 12.5% of the consolidated net assets.

#### Note 14. Financial Instruments With Off-Balance-Sheet Risk

The company is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. Those financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet. The contract or notional amounts of those instruments reflect the extent of involvement the company has in particular classes of financial instruments.

The company's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. The company uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

A summary of the contract or notional amount of the company's exposure to off-balance-sheet instruments as of December 31, 2008 and 2007 (in thousands) is as follows:

	2008	2007
<b>Financial instruments whose contract amounts represent credit risk:</b>		
Commitments to extend credit	\$ 48,726	\$ 53,333
Standby letters of credit	2,467	3,333

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the company upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property and equipment, and income-producing commercial properties.

Unfunded commitments under commercial lines of credit are commitments for possible future extensions of credit to existing customers. The majority of these lines of credit are collateralized and usually contain a specified maturity date and may not be drawn upon to the extent to which the company is committed.

Standby letters of credit are conditional commitments issued by the company to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements, including commercial paper, bond financing, and similar transactions. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The company generally holds collateral supporting those commitments if deemed necessary.

55

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#### Note 14. Financial Instruments With Off-Balance-Sheet Risk (Continued)

At December 31, 2008, the company had rate lock commitments to originate mortgage loans amounting to \$1.1 million and mortgage loans held for sale in the amount of \$329 thousand. The company enters into corresponding mandatory commitments, on a best-efforts basis, to sell the loans. These commitments to sell loans are designed to eliminate the company's exposure to fluctuations in interest rates in connection with rate lock commitments and loans held for sale.

#### Note 15. Fair Value Measurements

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

##### Cash and Short-Term Investments

For those short-term instruments, the carrying amount is a reasonable estimate of fair value.

##### Securities

For securities held for investment purposes, fair values are based on quoted market prices or dealer quotes.

##### Loans

For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. The fair values for other loans were estimated using discounted cash flow analyses, using interest rates currently being offered.

## Loans Held for Sale

The carrying amount of loans held for sale approximates fair value.

## Deposit Liabilities

The fair value of demand deposits, savings accounts, and certain money market deposits is the amount payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities.

## Short-Term Borrowings

The carrying amounts of borrowings under repurchase agreements and federal funds sold approximate fair value.

## FHLB Advances

The fair values of the company's FHLB advances are estimated using discounted cash flow analysis based on the company's incremental borrowing rates for similar types of borrowing arrangements.

## Accrued Interest

The carrying amounts of accrued interest approximate fair value.

## Off-Balance Sheet Financial Instruments

The fair value of commitments is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates. The fair value of letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date.

At December 31, 2008 and 2007, the fair value of loan commitments and standby-letters of credit was immaterial. Therefore, they have not been included in the following table.

56

## Note 15. Fair Value Measurements (Continued)

The carrying amounts and estimated fair values of the company's financial instruments are as follows:

	2008		2007	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(in thousands)		(in thousands)	
<b>Financial assets:</b>				
Cash	\$ 5 036	\$ 5 036	\$ 6 031	\$ 6 031
Securities purchased under agreements to resell and federal funds sold	3 313	3 313	5 120	5 120
Securities available for sale	27 478	27 478	39 572	39 572
Loans, net	242 375	244 138	221 828	223 920

Loans held for sale	329	329	8 133	8 133
Accrued interest receivable	1 108	1 108	1 366	1 366
<b>Financial liabilities:</b>				
Deposits	254 088	252 521	253 374	253 430
Securities sold under agreements to repurchase	8 352	8 352	12 537	12 537
FHLB advances	4 776	5 034	212	212
Accrued interest payable	481	481	757	757

The company assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. As a result, the fair values of the company's financial instruments will change when interest rate levels change and that change may be either favorable or unfavorable to the company. Management attempts to match maturities of assets and liabilities to the extent believed necessary to minimize interest rate risk. However, borrowers with fixed rate obligations are less likely to prepay in a rising rate environment and more likely to prepay in a falling rate environment. Conversely, depositors who are receiving fixed rates are more likely to withdraw funds before maturity in a rising rate environment and less likely to do so in a falling rate environment. Management monitors rates and maturities of assets and liabilities and attempts to minimize interest rate risk by adjusting terms of new loans and deposits and by investing in securities with terms that mitigate the company's overall interest rate risk.

The company adopted SFAS No. 157, "Fair Value Measurements" (SFAS 157), on January 1, 2008, to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. SFAS 157 clarifies that fair value of certain assets and liabilities is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants.

In February of 2008, the FASB issued Staff Position No. 157-2 (FSP 157-2) which delayed the effective date of SFAS 157 for certain nonfinancial assets and nonfinancial liabilities except for those items that are recognized or disclosed at fair value in the financial statements on a recurring basis. FSP 157-2 defers the effective date of SFAS 157 for such nonfinancial assets and nonfinancial liabilities to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. Thus, the company has only partially applied SFAS 157. The items affected by FSP 157-2 include other real estate owned.

In October of 2008, the FASB issued Staff Position No. 157-3 (FSP 157-3) to clarify the application of SFAS 157 in a market that is not active and to provide key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. FSP 157-3 was effective upon issuance, including prior periods for which financial statements were not issued.

SFAS 157 specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the company's market assumptions. The three levels of the fair value hierarchy under SFAS 157 based on these two types of inputs are as follows:

57

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Note 15. Fair Value Measurements (Continued)

Level 1 Valuation is based on quoted prices in active markets for identical assets and liabilities.

Level 2

Valuation is based on observable inputs including quoted prices in active markets for similar assets and liabilities, quoted prices for identical or similar assets and liabilities in less active markets, and model-based valuation techniques for which significant assumptions can be derived primarily from or corroborated by observable data in the market.

Level 3

Valuation is based on model-based techniques that use one or more significant inputs or assumptions that are unobservable in the market.

The following describes the valuation techniques used by the company to measure certain financial assets and liabilities recorded at fair value on a recurring basis in the financial statements:

**Securities available for sale:** Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that consider observable market data (Level 2).

The following table presents the balances of financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2008:

Description	Balance as of December 31 2008	Fair Value Measurements at December 31, 2008 Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale securities	\$ 27 478	\$ - -	\$ 27 478	\$ -

Certain financial assets are measured at fair value on a nonrecurring basis in accordance with generally accepted accounting principles. Adjustments to the fair value of these assets usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets.

The following describes the valuation techniques used by the company to measure certain financial assets recorded at fair value on a nonrecurring basis in the financial statements:

**Loans held for sale:** Loans held for sale are carried at the lower of cost or market value. These loans currently consist of one-to-four family residential loans originated for sale in the second market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the company records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale during the year ended December 31, 2008. Gains and losses on the sale of loans are recorded within other operating income on the consolidated statements of income.

## Note 15. Fair Value Measurements (Continued)

**Impaired Loans:** Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Fair value is measured based on the value of the collateral securing the loans. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the collateral is real estate. The value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is over two years old, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business' financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivable collateral are based on financial statement balances or age reports (Level 3). Impaired loans allocated to the Allowance for Loan Losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred and are a provision for loan losses on the consolidated statements of income.

The following table summarizes the company's financial assets that were measured at fair value on a nonrecurring basis during the period.

Description	Balance as of December 31 2008	Carrying Value at December 31, 2008		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Input (Level 2)	Significant Unobservable Input (Level 3)
Assets				
Impaired Loans	\$ 2 943	\$ -	\$ 2 943	\$ -

## Note 16. Regulatory Matters

The company (on a consolidated basis) and the bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory — possibly additional discretionary — actions by regulators that, if undertaken, could have a direct material effect on the company's and the bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the company and bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Quantitative measures established by regulation to ensure capital adequacy require the company and the bank to maintain minimum amounts and ratios (set forth in the table below) of total assets to risk-weighted assets, of Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined). Management believes, as of December 31, 2008 and 2007, that the company and the bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2008, the most recent notification from the Federal Deposit Insurance Corporation categorized the bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the institution's category.

59

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Note 16. Regulatory Matters (Continued)

The company's and the bank's actual capital amounts and ratios are also presented in the table below.

	Actual		Minimum Capital Requirement		Minimum Well Capitalized Amount
	Amount	Ratio	Amount	Ratio	
(in thousands)					
<b>As of December 31, 2008:</b>					
Total capital (to risk-weighted assets):					
Consolidated	\$ 32,775	13.63%	\$ 19,238	8.0%	\$ 23,000
Bank of Charles Town	\$ 31,423	13.14%	\$ 19,133	8.0%	\$ 23,000
Tier 1 capital (to risk-weighted assets):					
Consolidated	\$ 29,756	12.37%	\$ 9,619	4.0%	\$ 14,000
Bank of Charles Town	\$ 28,420	11.88%	\$ 9,567	4.0%	\$ 14,000
Tier 1 capital (to average assets):					
Consolidated	\$ 29,756	9.85%	\$ 12,081	4.0%	\$ 15,000
Bank of Charles Town	\$ 28,420	9.45%	\$ 12,030	4.0%	\$ 15,000
<b>As of December 31, 2007:</b>					
Total capital (to risk-weighted assets):					
Consolidated	\$ 32,308	14.23%	\$ 18,161	8.0%	\$ 22,000
Bank of Charles Town	\$ 31,814	14.04%	\$ 18,124	8.0%	\$ 22,000
Tier 1 capital (to risk-weighted assets):					
Consolidated	\$ 29,529	13.01%	\$ 9,081	4.0%	\$ 13,000
Bank of Charles Town	\$ 29,035	12.82%	\$ 9,062	4.0%	\$ 13,000
Tier 1 capital (to average assets):					
Consolidated	\$ 29,529	9.99%	\$ 11,818	4.0%	\$ 14,000
Bank of Charles Town	\$ 29,035	9.84%	\$ 11,799	4.0%	\$ 14,000

60

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Note 17. Parent Company Only Financial Statements

POTOMAC BANCSHARES, INC.  
(Parent Company Only)

Balance Sheets  
December 31, 2008 and 2007  
(in thousands)

	2008	2007
<b>ASSETS</b>		
Cash	\$ 48	\$ 36
Investment in subsidiary	26 468	28 521
Other assets	1 288	458
<b>Total Assets</b>	<b>\$ 27 804</b>	<b>\$ 29 015</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>STOCKHOLDERS' EQUITY</b>		
Common stock	\$ 3 672	\$ 3 672
Surplus	3 851	3 771
Undivided profits	25 070	24 787
Accumulated other comprehensive (loss)	(1 952)	(514)
	\$ 30 641	\$ 31 716
Less cost of shares acquired for the treasury	2 837	2 701
<b>Total Stockholders' Equity</b>	<b>\$ 27 804</b>	<b>\$ 29 015</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$ 27 804</b>	<b>\$ 29 015</b>

POTOMAC BANCSHARES, INC.  
(Parent Company Only)  
Statements of Income  
Years Ended December 31, 2008, 2007 and 2006  
(in thousands)

	2008	2007	2006
<b>Income</b>			
Dividends from subsidiary	\$ 2 582	\$ 1 942	\$ 1 905
Interest income	3	1	1
<b>Total Income</b>	<b>\$ 2 585</b>	<b>\$ 1 943</b>	<b>\$ 1 906</b>
<b>Expenses</b>			
Stock-based compensation expense	\$ 70	\$ 110	\$ 112
Other professional fees	43	57	39
Other operating expenses	58	65	56
<b>Total Expenses</b>	<b>\$ 171</b>	<b>\$ 232</b>	<b>\$ 207</b>
<b>Income before Income Tax (Benefit) and Equity in Undistributed Income of Subsidiary</b>	<b>\$ 2 414</b>	<b>\$ 1 711</b>	<b>\$ 1 699</b>
<b>Income Tax (Benefit)</b>	<b>(32)</b>	<b>(56)</b>	<b>(51)</b>
<b>Income before Equity in Undistributed Income of Subsidiary</b>	<b>\$ 2 446</b>	<b>\$ 1 767</b>	<b>\$ 1 750</b>



Equity in Undistributed (Loss) Income of Subsidiary	(584)	1 763	2 285
Net Income	\$ 1 862	\$ 3 530	\$ 4 035

61

## Note 17. Parent Company Only Financial Statements (Continued)

POTOMAC BANCSHARES, INC.  
(Parent Company Only)  
Statements of Cash Flows  
Years Ended December 31, 2008, 2007 and 2006  
(in thousands)

	2008	2007	2006
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
Net income	\$ 1 862	\$ 3 530	\$ 4 035
Adjustments to reconcile net income to net cash provided by operating activities:			
Equity in undistributed loss (income) of subsidiary	584	(1 763)	(2 285)
Stock-based compensation expense	70	110	112
(Increase) in other assets	(830)	(24)	(153)
Net cash provided by operating activities	\$ 1 686	\$ 1 853	\$ 1 709
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Cash dividends	\$ (1 548)	\$ (1 420)	\$ (1 295)
Purchase of treasury shares	(149)	(422)	(429)
Sale of treasury shares	23	--	--
Net cash (used in) financing activities	\$ (1 674)	\$ (1 842)	\$ (1 724)
Increase (decrease) in cash and cash equivalents	\$ 12	\$ 11	\$ (15)
<b>CASH AND CASH EQUIVALENTS</b>			
Beginning	36	25	40
Ending	\$ 48	\$ 36	\$ 25

62

**Item 9. Changes In and Disagreements with Accountants on Accounting and Financial Disclosure.**

Not Applicable.

**Item 9A(T). Controls and Procedures.**

The company's chief executive officer and chief financial officer, based on their evaluation of the date of this report of the company's disclosure controls and procedures (as defined in F

13(a)-14(e) of the Securities Exchange Act of 1934), have concluded that the company's disclosure controls and procedures are adequate and effective for purposes of Rule 13(a)-14(c) and timely alerting them to material information relating to the company required to be included in the company's filings with the Securities and Exchange Commission under the Securities Exchange Act of 1934.

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

There were no significant changes in the company's internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation.

### **Management's Report on Internal Control Over Financial Reporting**

#### **To the Stockholders:**

Management is responsible for the preparation and fair presentation of the financial statements included in this annual report. The financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and reflect management's judgments and estimates concerning effects of events and transactions that are accounted for or disclosed.

Management is also responsible for establishing and maintaining adequate internal control over financial reporting. The company's internal control over financial reporting includes those policies and procedures that pertain to the company's ability to record, process, summarize and report reliable financial data. Management recognizes that there are inherent limitations in the effectiveness of any internal control over financial reporting, including the possibility of human error and the circumvention or overriding of internal control. Accordingly, even effective internal control over financial reporting can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, the effectiveness of internal control over financial reporting may vary over time.

In order to ensure that the company's internal control over financial reporting is effective, management regularly assesses such controls and did so most recently for its financial report as of December 31, 2008. This assessment was based on criteria for effective internal control over financial reporting described in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. Based on this assessment, management has concluded that the internal control over financial reporting was effective as of December 31, 2008.

The Board of Directors, acting through its Audit Committee, is responsible for the oversight of the company's accounting policies, financial reporting and internal control. The Audit Committee of the Board of Directors is comprised entirely of outside directors who are independent of management. The Audit Committee is responsible for the appointment and compensation of the independent registered public accounting firm and approves decisions regarding the appointment or removal of the company's internal auditor. It meets periodically with management, the independent registered public accounting firm and the internal auditor to ensure that they are carrying out their responsibilities. The Audit Committee is also responsible for performing an oversight role by reviewing and monitoring the financial, accounting and auditing procedures of the company in addition to reviewing the company's financial reports. The independent registered public accounting firm and the internal auditor have full and unlimited access to the Audit Committee, with or without management, to discuss the adequacy of internal control over financial reporting, and any other matter which they believe should be brought to the attention of the Audit Committee.

#### **Item 9B. Other Information.**

None.

63

**PART III****Item 10. Directors and Executive Officers of the Registrant.**

The information contained on pages 7-8 of the Proxy Statement dated April 8, 2009, for the May 19, 2009 Annual Meeting under the captions Management Nominees to the Board of Potomac and Directors Continuing to Serve Under the Terms, and page 15 under the caption Section 16(a) Beneficial Ownership Reporting Compliance is incorporated herein by reference.

The Executive Officers are as follows:

Name	Position Since	Age	Principal Occupation
Robert F. Baronner, Jr.	President & CEO 2001	50	Employed by bank as of 1/1/01 as President and CEO
David W. Irvin	Executive Vice President 2004	45	Employed at bank from 2001 to present as Commercial Loan Division Manager.
Gayle Marshall Johnson	Sr. Vice President & Chief Financial Officer 1994	59	Employed with the bank 1977-1985 and 1988-present as Vice President and Chief Financial Officer since 1994 and Sr. Vice President since 2005.

The bank has adopted a Code of Ethics that applies to all employees, including Potomac's and the bank's chief executive officer and chief financial officer and other senior officers. Additionally, there is a Code of Ethics for Senior Financial Officers which applies to Potomac's and the bank's chief executive officer and chief financial officer. These Codes of Ethics are attached to this document as Exhibits 14.1 and 14.2. If we make any substantive amendments to this code or grant a waiver from a provision of the code to our chief executive officer or chief financial officer, we will disclose the amendment or waiver in a report on Form 8-K.

**Item 11. Executive Compensation.**

The information contained on pages 10-14 of the Proxy Statement dated April 8, 2009, for the May 19, 2009 Annual Meeting under the captions Executive Compensation, Employee Benefit Plans, Employment Agreement, and Compensation of Directors is incorporated herein by reference.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.**

The information contained on pages 9-10 of the Proxy Statement dated March 31, 2009, for the May 19, 2009 Annual Meeting under the caption Ownership of Securities by Nominees, Directors and Officers is incorporated herein by reference.

Securities authorized for issuance under Potomac's 2003 Stock Incentive Plan are listed below:

Number of securities to be issued upon exercise of	Weighted-average exercise price of	Number of securities remaining available for future issuance under equity compensation plans
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Plan category	outstanding options, warrants and rights	outstanding options, warrants and rights	(excluding securities reflected in column (a))
2003 Stock Incentive Plan amended by shareholders April 24, 2007	132,620	\$ 14.75	298,94

**Item 13. Certain Relationships and Related Transactions.**

The information contained on page 14 of the Proxy Statement dated April 8, 2009, for the May 19, 2009 Annual Meeting under the caption "Certain Transactions with Directors, Officers and Their Associates" is incorporated herein by reference.

64

**Item 14. Principal Accountant Fees and Services.**

The information contained on pages 6-7 of the Proxy Statement dated April 8, 2009, for the May 19, 2009 Annual Meeting under the caption "[Audit Committee Report]" is incorporated herein by reference.

**Item 15. Exhibits and Financial Statement Schedules.**

- (a) (1) Financial Statements. Reference is made to Part II, Item 8 of this Annual Report on Form 10-K.
- (2) Financial Statement Schedules. These schedules are omitted as the required information is inapplicable or the information is presented in the consolidated financial statements or related notes.
- (3) Exhibits. See below.

2.1 Agreement and Plan of Merger dated March 8, 1994, by and between Potomac Bancshares, Inc., and Bank of Charles Town filed with and incorporated by reference from the Registration on Form S-4 filed with the Securities and Exchange Commission on June 10, 1994, Registration No. 33-80092.

3.1 Articles of Incorporation of Potomac Bancshares, Inc. filed with and incorporated by reference from the Registration Statement on Form S-4 filed with the Securities and Exchange Commission on June 10, 1994, Registration No. 33-80092.

3.2 Amendments to Articles of Incorporation of Potomac Bancshares, Inc. adopted by shareholders on April 25, 1995 and filed with the West Virginia Secretary of State on May 23, 1995, and incorporated by reference from Potomac's Form 10-KSB for the year ended December 31, 1995 and filed with the Securities and Exchange Commission, File No. 0-24958.

3.3 Amended and Restated Bylaws of Potomac Bancshares, Inc. and subsequent amendments thereto.\*

10.1 2003 Stock Incentive Plan adopted by the Potomac Board February 20, 2003 and approved by the company's shareholders on May 13, 2003, amended by the company's shareholders on April 24, 2007 and incorporated by reference from Potomac's Form 10-K for year ended December 31, 2006 and filed with the Securities and Exchange Commission, File No. 0-24958.

10.2 Employment Agreement of Mr. Robert F. Baronner, Jr., filed with and incorporated by reference from Form 10-KSB for the year ended December 31, 2001, and filed with the Securities and Exchange Commission, File No. 0-24958.

14.1 Code of Ethics (for all employees)\*

14.2 Code of Ethics for Senior Financial Officers\*

21 Subsidiaries of the Registrant\*

23.1 Consent of Independent Registered Public Accounting Firm \*

31.1 Rule 13a-15(e)/15d-15(e) Certification of Chief Executive Officer\*

31.2 Rule 13a-15(e)/15d-15(e) Certification of Chief Financial Officer\*

32.1 Section 1350 Certification of Chief Executive Officer\*

32.2 Section 1350 Certification of Chief Financial Officer\*

99.1 Proxy Statement for the 2009 Annual Meeting for Potomac, portions are incorporated by reference in Form 10-K Annual Report\*

\* Filed herewith.

65

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SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

POTOMAC BANCSHARES, INC.

By /s/ Robert F. Baronner, Jr. March 31, 2009  
Robert F. Baronner, Jr.  
President & Chief Executive Officer

By /s/ Gayle Marshall Johnson March 31, 2009  
Gayle Marshall Johnson  
Sr. Vice President & Chief Financial Officer

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<u>Signature &amp; Title</u>	<u>Date</u>
By /s/ Dr. Keith Berkeley Dr. Keith Berkeley, Director	March 31, 2009

