

DIAL THRU INTERNATIONAL CORP
Form 10-Q
September 16, 2002

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**United States
Securities and Exchange Commission**

Washington, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For the Period Ended July 31, 2002

or

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For the Transition Period From _____ to _____

Commission file number 0-22636

DIAL THRU INTERNATIONAL CORPORATION

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

75-2461665

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

**17383 Sunset Boulevard,, Suite 350
Los Angeles, California**

(Address of principal executive offices)

90272

(Zip Code)

(310) 566-1700

(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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

As of September 13, 2002, 14,986,779 shares of common stock, \$.001 par value per share, were outstanding.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

**DIAL THRU INTERNATIONAL CORPORATION
AND SUBSIDIARIES
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

| | July 31, 2002 | October 31, 2001 |
|--|----------------------|----------------------|
| | (unaudited) | |
| ASSETS | | |
| CURRENT ASSETS | | |
| Cash and cash equivalents | \$ 667,360 | \$ 94,985 |
| Trade accounts receivable, net of allowance for doubtful accounts of \$424,251 at July 31, 2002 and \$228,729 at October 31, 2001 | 1,384,448 | 1,832,768 |
| Prepaid expenses and other | 173,177 | 43,612 |
| Deferred financing fees, net | 45,932 | |
| Total current assets | 2,270,917 | 1,971,365 |
| PROPERTY AND EQUIPMENT, net | 3,573,822 | 5,135,027 |
| PROPERTY AND EQUIPMENT HELD FOR SALE | 320,307 | 320,307 |
| ADVERTISING CREDITS, net | 2,376,678 | 2,376,678 |
| OTHER ASSETS | 53,847 | 78,762 |
| INTANGIBLE ASSETS, net | 354,998 | 965,093 |
| GOODWILL, net | 1,886,917 | 1,796,917 |
| TOTAL ASSETS | \$ 10,837,486 | \$ 12,644,149 |
| LIABILITIES AND SHAREHOLDERS' (DEFICIT) EQUITY | | |
| CURRENT LIABILITIES | | |
| Convertible debenture, net of debt discount of \$320,582 at July 31, 2002 | \$ 775,351 | \$ |
| Current portion of capital leases | 398,550 | 385,787 |
| Trade accounts payable | 4,149,618 | 4,973,338 |
| Accrued carrier costs | 1,258,915 | 917,415 |
| Accrued liabilities | 2,332,739 | 1,416,159 |
| Deferred revenue | 321,366 | 346,294 |
| Deposits and other payables | 547,704 | 456,282 |
| Note payable to shareholder | | 102,443 |
| Total current liabilities | 9,784,243 | 8,597,718 |
| CAPITAL LEASES, net of current portion | 131,944 | 286,102 |
| NOTES PAYABLE RELATED PARTY, net of debt discount of \$529,114 at July 31, 2002 and \$819,470 at October 31, 2001 | 1,819,287 | 1,126,488 |
| CONVERTIBLE DEBENTURE, net of debt discount of \$445,155 at October 31, 2001 | | 554,845 |
| SHAREHOLDERS' (DEFICIT) EQUITY | | |
| Preferred stock, \$.001 par value, 10,000,000 shares authorized, none issued and outstanding | | |
| Common stock, \$.001 par value; 44,169,100 shares authorized; 14,969,966 shares issued at July 31, 2002 and 12,119,090 at October 31, 2001 | 14,970 | 12,119 |
| Additional paid-in capital | 38,887,516 | 38,174,588 |
| Accumulated deficit | (39,555,534) | (35,947,213) |
| Accumulated other comprehensive income | (188,169) | (88,548) |

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| | July 31, 2002 | October 31, 2001 |
|---|----------------------|----------------------|
| Treasury stock, 12,022 common shares at cost | (54,870) | (54,870) |
| Subscription receivable common stock | (1,901) | (17,080) |
| Total shareholders' (deficit) equity | (897,988) | 2,078,996 |
| TOTAL LIABILITIES AND SHAREHOLDERS' (DEFICIT) EQUITY | \$ 10,837,486 | \$ 12,644,149 |

The accompanying notes are an integral part of these statements.

DIAL THRU INTERNATIONAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

| | THREE MONTHS ENDED JULY 31, | | NINE MONTHS ENDED JULY 31, | |
|---|--------------------------------|---------------------|-------------------------------|-----------------------|
| | 2002 | 2001 | 2002 | 2001 |
| REVENUES | \$ 6,138,790 | \$ 1,654,079 | \$ 18,811,698 | \$ 3,448,338 |
| COSTS AND EXPENSES | | | | |
| Costs of revenues | 4,127,502 | 1,081,179 | 12,754,660 | 2,357,552 |
| Sales and marketing | 374,681 | 202,818 | 1,079,663 | 499,641 |
| Non-cash sales and marketing expense | | | | 258,616 |
| General and administrative | 1,767,549 | 702,317 | 5,740,654 | 2,042,678 |
| Depreciation and amortization | 596,065 | 165,527 | 1,889,148 | 468,029 |
| Total costs and expenses | 6,865,797 | 2,151,841 | 21,464,125 | 5,626,516 |
| Operating loss | (727,007) | (497,762) | (2,652,427) | (2,178,178) |
| OTHER INCOME (EXPENSE) | | | | |
| Interest expense and financing costs | (350,559) | (86,109) | (932,377) | (576,818) |
| Other income related to settlement of disputes | | | | 1,789,373 |
| Foreign exchange | (5,049) | | (32,071) | |
| Write off of investment in marketable securities | | (11,000) | | (446,820) |
| Gain on sales of equipment | | | 8,553 | |
| Total other income (expense) | (355,608) | (97,109) | (955,895) | 765,735 |
| NET LOSS | \$ (1,082,615) | \$ (594,871) | \$ (3,608,322) | \$ (1,412,443) |
| LOSS PER SHARE: | | | | |
| Basic and diluted loss per share | \$ (0.07) | \$ (0.05) | \$ (0.27) | \$ (0.14) |
| SHARES USED IN THE CALCULATION OF PER SHARE AMOUNTS: | | | | |
| Basic common shares | 14,436,350 | 11,523,403 | 13,558,049 | 10,677,487 |

THREE MONTHS ENDED
JULY 31,NINE MONTHS ENDED
JULY 31,

The accompanying notes are an integral part of these statements.

DIAL THRU INTERNATIONAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

| | NINE MONTHS ENDED JULY 31, | |
|---|-------------------------------|----------------|
| | 2002 | 2001 |
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net loss | \$ (3,608,322) | \$ (1,412,443) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Gain from disposal of fixed assets | (8,553) | |
| Stock and warrants issued for services | 13,750 | 258,616 |
| Bad debt expense | 550,120 | |
| Non-cash interest expense | 684,413 | 527,296 |
| Write off of investment in marketable securities | | 446,820 |
| Depreciation and amortization | 1,889,148 | 468,029 |
| Other income related to settlement of dispute | | (1,789,373) |
| (Increase) decrease in: | | |
| Trade accounts receivable | (101,800) | (441,174) |
| Prepaid expenses and other | (129,565) | 49,623 |
| Effects of changes in foreign exchange rates | (99,621) | |
| Other assets | 24,916 | (30,423) |
| Increase (decrease) in: | | |
| Trade accounts payable | (1,353,215) | 868,584 |
| Accrued carrier costs | 341,500 | |
| Accrued liabilities | 600,821 | (167,855) |
| Deferred revenue | (24,928) | 38,966 |
| Deposits and other payables | 91,422 | 59,000 |
| Net cash used in operating activities | (1,129,914) | (1,124,334) |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Purchase of property and equipment | (263,769) | (47,350) |
| Acquisition related goodwill | (90,000) | |
| Refund of license fee | 1,424,899 | |
| Net cash provided by (used in) investing activities | 1,071,130 | (47,350) |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Proceeds from related party note payable | 300,000 | 599,577 |
| Proceeds from convertible debentures | 550,000 | 1,000,000 |
| Payments on shareholder note payable | | (189,619) |
| Payments on capital leases | (141,395) | (30,956) |

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| | NINE MONTHS ENDED JULY 31, | |
|--|-------------------------------|----------------|
| Deferred financing fees | (92,625) | |
| Proceeds from exercise of stock options | | 34,343 |
| Subscription receivable common stock | 15,179 | |
| Net cash provided by financing activities | 631,159 | 1,413,345 |
| NET INCREASE IN CASH AND CASH EQUIVALENTS | 572,375 | 241,661 |
| Cash and cash equivalents at beginning of period | 94,985 | 73,867 |
| Cash and cash equivalents at end of period | \$ 667,360 | \$ 315,528 |

SUPPLEMENTAL SCHEDULE OF NON CASH INVESTING AND FINANCING ACTIVITIES

| | | |
|---|------------|-----------|
| Conversion of convertible debenture to common stock | \$ 500,000 | \$ |
| Warrants issued for debt | 176,858 | 86,875 |
| Exercise of stock options in exchange for retirement of 100,000 common shares | 70,000 | |
| Acquisition of customer base | (340,931) | |
| Conversion of debt to equity | | 1,000,000 |
| Additional shares issued as purchase consideration | | 1,031,200 |
| Convertible debt issued with below market conversion feature | | 329,931 |

The accompanying notes are an integral part of these statements.

DIAL THRU INTERNATIONAL CORPORATION AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 BASIS OF PRESENTATION

The consolidated financial statements of Dial Thru International Corporation and its subsidiaries, "DTI" or "the Company", included in this Form 10-Q are unaudited. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation of the financial position and operating results for the three and nine month periods ended July 31, 2002 and 2001 have been included. Operating results for the three and nine month periods ended July 31, 2002 are not necessarily indicative of the results that may be expected for the year ending October 31, 2002. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended October 31, 2001.

The Company is a full service, facility-based provider of communication products to small and medium size businesses, both domestically and internationally. The Company now provides a variety of international and domestic communication services including international dial-thru, Internet voice and fax services, e-Commerce solutions and other value-added communication services, using its Voice over Internet Protocol ("VoIP") Network to effectively deliver these services to the end user.

In addition to helping customers achieve significant savings on long-distance voice and fax calls by routing calls over the Internet or the Company's private network, the Company also offers new opportunities for existing Internet Service Providers who want to expand into voice services, private corporate networks seeking to lower long-distance costs, and Web-enabled corporate call centers engaged in electronic commerce.

The Company is also introducing VoIP to a new segment of customers by delivering a high quality, reliable and scaleable solution that uniquely addresses the needs of the rapidly growing VoIP industry.

Estimates and Assumptions

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The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that effect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

NOTE 2 GOING CONCERN

The Company has an accumulated deficit of approximately \$39.6 million as of July 31, 2002, as well as a working capital deficit of approximately \$7.5 million. Funding of the Company's working capital deficit, current and future operating losses, and expansion will require continuing capital investment. The Company's strategy is to fund these cash requirements through operations, debt facilities and additional equity financing. As of the date of this report:

- 1) the Company has obtained additional financing of \$550,000 in January 2002 and \$300,000 in July 2002. The Company is currently in negotiations to obtain an additional \$1,000,000 in financing.
- 2) the Company has successfully negotiated payment terms on approximately \$600,000 of its past due trade payables with one of its largest vendors, and has agreed to remit equal monthly installments in excess of its normal monthly usage billing. The Company is also in negotiations on approximately \$800,000 of trade payables with another large vendor.
- 3) the Company's trade accounts payable and carrier costs include disputes with certain vendors over what the Company believes are improper charges primarily for termination of its domestic and international minutes. The Company's trade accounts payable include approximately \$500,000 of such disputes at July 31, 2001. The Company received

approximately \$1,400,000 of such credits in fiscal 2001, and approximately \$200,000 in fiscal 2002.

- 4) the Company's German subsidiary received a net \$1 million refund for a license fee previously paid, which was used to pay down past due liabilities.

Although the Company has been able to arrange debt facilities and equity financing to date, there can be no assurance that sufficient debt or equity financing will continue to be available in the future or that it will be available on terms acceptable to the Company. Failure to obtain sufficient capital could materially affect the Company's operations and expansion strategies. As a result of the aforementioned factors and related uncertainties, there is doubt about the Company's ability to continue as a going concern.

NOTE 3 ADVERTISING CREDITS

On September 8, 2000, the Company issued 914,285 shares (which are fully vested and nonforfeitable) of the Company's common stock in exchange for \$3.2 million face value of advertising credits. These credits were issued by Millenium Media Ltd. and Affluent Media Network, national advertising agencies and media placement brokers. The Company recorded the advertising credits on the date the shares were issued, September 8, 2000, using the Company's quoted common stock price of \$3.3125, totaling \$3,028,569. Through October 31, 2001 the Company has recorded an impairment charge of \$575,542 to reduce the credits to their estimated fair value, and sold a portion of the credits for cash, reducing the balance by an additional \$76,349. The estimated fair value was established at the end of fiscal 2000 using a discount of 25% off the face value, which was based on management's estimate of the dollar value of the credits to be used in settling various outstanding trade obligations. Such credits can be used by the Company to place electronic media and periodical advertisements. The primary use for the media credits is to advertise products and services domestically. As the Company's focus to date has been on foreign traffic, the Company has not utilized any of the media credits. The Company is currently developing domestic products and services and management intends to utilize the media credits to advertise these new services. There is no contractual expiration date for these trade credits and there are no limitations relating to the use of these credits.

NOTE 4 CONCENTRATION OF CREDIT RISK AND SIGNIFICANT CUSTOMERS

At January 31, 2002, the Company had an outstanding receivable from a customer of \$215,853, which was overdue by approximately six months and was reserved in full. This receivable was subsequently written off.

The Company provided wholesale services to a single customer who accounted for 16% of the overall revenue of the Company for both the three and nine months ended July 31, 2002.

NOTE 5 RECENT ACCOUNTING PRONOUNCEMENTS

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 141, Business Combinations, and SFAS No. 142, Goodwill and Other Intangible Assets. SFAS No. 141 requires all business combinations initiated after June 30, 2001 to be accounted for using the purchase method. In addition, companies are required to review goodwill and intangible assets reported in connection with prior acquisitions, possibly disaggregate and report separately previously identified intangible assets and possibly reclassify certain intangible assets into goodwill. SFAS No. 142 establishes new guidelines for accounting for goodwill and other intangible assets. In accordance with SFAS No. 142, goodwill associated with acquisitions consummated after June 30, 2001 is not amortized. The Company implemented the provisions of SFAS No. 142 on November 1, 2001. Since adoption, existing goodwill is no longer amortized but instead will be assessed for impairment at least annually. The adoption of this standard has reduced amortization expense for the three and nine months ended July 31, 2002 by approximately \$55,000 and \$165,000, respectively, and improved loss per share by \$0 and \$0.02, respectively.

In July 2001, the FASB issued SFAS No. 144, Impairment or Disposal of Long-Lived Assets, which is effective for fiscal years beginning after December 15, 2001. The provisions of this statement provide a single accounting model for impairment of long-lived assets. The adoption of this standard will not have a material impact on the Company's results of operations or financial position.

NOTE 6 ACQUISITIONS*Rapid Link, Inc. Acquisition*

On October 12, 2001, the Company completed the acquisition of certain assets and liabilities of Rapid Link, USA, Inc. ("Rapid Link USA") and 100% of the common stock of Rapid Link Telecommunications, GMBH ("Rapid Link Germany"), a German Company, from Rapid Link Inc. ("Rapid Link"). The results of the businesses acquired from Rapid Link have been included in operations of the Company in the consolidated financial statements from the date of acquisition. Rapid Link was a provider of high quality integrated data and voice communications services to both wholesale and retail customers around the world. The aggregate purchase price was \$2,116,481, including \$1,450,000 in cash, common stock valued at \$468,000, and an additional \$198,481 in acquisition related costs. The value of the 600,000 common shares was determined based on the closing market price of DTI's common shares on October 12, 2001. The value of the common stock was guaranteed by DTI to be no less than \$300,000 at the time of the effectiveness of the Registration of the shares. As of the effectiveness of the Registration Statement relating to the shares, completed on March 28, 2002, the value of the common stock was \$210,000. Dial Thru has recorded an additional \$90,000 representing the amount required to ensure the minimum value of the consideration received of \$300,000. Any additional consideration will not change the recorded value of Rapid Link, however, in accordance with SFAS No. 141 Business Combinations, the Company has allocated the purchase price to net assets acquired, resulting in negative goodwill. Therefore the Company has reduced the net book value of fixed assets by \$1,345,630, the amount representing negative goodwill.

The following unaudited pro-forma consolidated results of operations for the three and nine months ended July 31, 2001 assume that the acquisition had occurred on November 1, 2000:

| | (Unaudited) Three months ended July 31, 2001 | (Unaudited) Nine months ended July 31, 2001 |
|---|--|---|
| Revenues | \$ 7,144,545 | \$ 26,199,240 |
| Net loss | \$ (1,646,222) | \$ (5,628,752) |
| Net loss per common share | \$ (0.13) | \$ (0.50) |
| Weighted average common shares outstanding (basic and diluted) | 12,123,403 | 11,277,487 |

NOTE 7 CONVERTIBLE DEBT*Convertible Debentures Issued to Accredited Investors*

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On February 4, 2000, the Company executed non-interest bearing convertible note agreements (the "Notes") with nine accredited investors, which provided financing of \$1,000,000. The notes were payable on the earlier of one year from the date of issuance or the Company's consummation of a debt or equity financing in excess of \$5,000,000, and to be converted into common stock at a rate of \$4.00 per share if the notes were not repaid within 90 days from the date of issuance. The Company recorded financing fees of approximately \$117,000 in February 2000 related to the Notes for the difference in the conversion price of \$4.00 and the market price of \$4.47 on the date the Notes were approved by the Board of Directors.

The Company also issued to the holders of the Notes warrants to acquire an aggregate of 125,000 shares of common stock at an exercise price of \$3.00 per share, which expire five years from the date of issuance. In February 2000, the Company recorded a debt discount of approximately \$492,000. This

amount represents the Company's estimate of the fair value of these warrants at the date of grant using the Black-Scholes pricing model with the following assumptions: applicable risk-free interest rate based on the current treasury-bill interest rate at the grant date of 6%; dividend yields of 0%; volatility factors of the expected market price of the Company's common stock of 1.62; and an expected life of the warrants of three years.

On August 4, 2000, additional warrants to acquire up to an aggregate of 125,000 shares of common stock at an exercise price of \$2.75 per share were issued to the holders of the Notes, as they had not been repaid within six months following the date of issuance. Additional debt discount of approximately \$386,000 was recorded during the fourth quarter of fiscal 2000 related to the issuance of additional warrants. This amount was calculated using the Black-Scholes pricing model with the following assumptions: applicable risk-free interest rate based on the current treasury-bill interest rate at the grant date of 6%; dividend yields of 0%; volatility factors of the expected market price of the Company's common stock of 2.01; and an expected life of the warrants of three years. The Company amortized the total debt discount of approximately \$878,000 over the initial maturity of the Notes of one year.

During March 2001, terms of the Notes were modified and the debt was converted into 400,000 common shares. Additionally, in connection with the conversion, the warrants to purchase 250,000 shares of common stock were modified to allow for an exercise price of \$0.01 per share and 150,000 additional warrants with an exercise price of \$3.00 per share were issued to the note holders. In connection with the grant of the additional 150,000 warrants to the note holders, the Company recorded additional debt discount of approximately \$142,000 which was immediately expensed as the warrants were exercisable at the date of grant, and the note has been redeemed in its entirety. This amount was calculated using the Black-Scholes pricing model with the following assumptions: applicable risk-free interest rate based on the current treasury-bill interest rate at the grant date of 5%; dividend yields of 0%; volatility factors of the expected market price of the Company's common stock of 1.47; and an expected life of the warrants of three years.

Convertible Debentures with Global Capital Funding Group L.P.

On April 11, 2001, the Company executed a 6% convertible debenture (the "Debenture") with Global Capital Funding Group L.P, which provided financing of \$1,000,000. The Debenture maturity date is April 11, 2003. The Debenture is secured by \$320,307 of property and equipment held for sale. The conversion price is equal to the lesser of (i) 100% of the volume weighted average of sales price as reported by the Bloomberg L.P. of the common stock on the last trading day immediately preceding the Closing Date and (ii) 80% of the average of the five (5) lowest volume weighted average sales prices as reported by Bloomberg L.P. during the twenty (20) Trading Days immediately preceding but not including the date of the related Notice of Conversion ("the "Formula Conversion Price"). In an event of default the amount declared due and payable on the Debenture shall be at the Formula Conversion Price. During the fourth quarter of 2001, the Formula Conversion Price was adjusted downward to 70% in accordance with the terms of the Debenture as the Company's registration statement was not declared effective by the Securities and Exchange Commission on the date required by the Debenture. The Company has calculated the beneficial conversion feature embedded in the Debenture in accordance with EITF No. 00-27 and recorded approximately \$497,000 as a deferred financing fee. This fee is being amortized over the two-year life of the Debenture. During the three and nine months ended July 31, 2002, the Company recorded approximately \$69,000 and \$207,000, respectively, as interest expense. The Company also issued to the holder of the debenture warrants to acquire an aggregate of 100,000 shares of common stock at an exercise price of \$0.89 per share, which expire on April 11, 2006. The Company recorded deferred financing fees of approximately \$80,000 relating to the issuance of the warrants. This amount represents the relative fair value of the warrants in accordance with EITF No. 00-27, and the Company is amortizing the fees over the two year life of the Debenture. During the three and nine months ended July 31, 2002, the Company has recorded interest expense of approximately \$10,000 and \$29,000, respectively, relating to the warrants.

On January 28, 2002, the Company executed a 6% convertible debenture (the "Second Debenture") with Global Capital Funding Group L.P, which provided financing of \$550,000. The Second Debenture maturity date is January 28, 2003. The Second Debenture is also secured by \$320,307 of property and equipment held for sale. The conversion price is equal to the lesser of (i) 100% of the volume weighted average of sales price as reported by the Bloomberg L.P. of the common stock on the last trading day immediately preceding the Closing Date and (ii) 85% of the average of the three (3) lowest volume weighted average sales prices as reported by Bloomberg L.P. during the twenty (20) Trading Days immediately preceding but not including the date of the related Notice of Conversion ("the "Formula Conversion Price"). In an event of default

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the amount declared due and payable on the Debenture shall be at the Formula Conversion Price. In connection with the Second Debenture, the Company paid \$92,625 as financing fees, which are being amortized over the one-year life of the Second Debenture using the Interest Method. For the three and nine months ended July 31, 2002, the Company recorded interest expense of approximately \$23,000 and \$47,000, respectively, relating to these financing fees. The Company has calculated the beneficial conversion feature embedded in the Second Debenture in accordance with EITF No. 00-27 and recorded approximately \$114,000 as a deferred financing fee. This fee is being amortized over the one-year life of the Second Debenture. During the three and nine months ended July 31, 2002, the Company recorded approximately \$28,000 and \$57,000, respectively, as interest expense. The Company also issued to the holder of the debenture warrants to acquire an aggregate of 50,000 shares of common stock at an exercise price of \$0.40 per share, which expire on January 28, 2007. The Company recorded deferred financing fees of approximately \$17,000 related to the issuance of the warrants. This amount represents the relative fair value of the warrants in accordance with EITF No. 00-27, and the Company is amortizing the fees over the one-year life of the Second Debenture. For the three and nine months ended July 31, 2002, the Company has recorded interest expense of approximately \$4,000 and \$9,000, respectively, relating to the warrants.

NOTE 8 NOTES PAYABLE RELATED PARTY

In October 2001, the Company executed 10% convertible notes (the "Notes") with three executives of the Company, which provided financing of \$1,945,958. The maturity date of each note is October 24, 2003. The Notes are secured by all Company assets. Each Note is convertible into the Company's common stock at the option of the holder at each of the six, twelve, eighteen and twenty-four month anniversary of the date of issuance of the note. The conversion price is equal to the closing bid price of the Company's common stock on the last trading day immediately preceding the conversion. The Company has calculated the beneficial conversion feature embedded in the Notes in accordance with EITF No. 00-27 and recorded debt discount of approximately \$171,000 which will be amortized over two years. The Company also issued to the holders of the Notes warrants to acquire an aggregate of 1,945,958 shares of common stock at an exercise price of \$0.78 per share, which expire on October 24, 2006. Additional debt discount of approximately \$657,000 was recorded during the fourth quarter of fiscal 2001. The Company determined the additional debt discount by allocating the relative fair value to the Note and the warrants. The Company is amortizing the additional debt discount over the initial maturity of the Note of two years. For the three and nine months ended July 31, 2002, the Company has recorded approximately \$102,000 and \$307,000, respectively, of interest expense. In January 2002, an additional \$102,433 was added to the Notes, representing incremental monies loaned by a shareholder. The Company also issued to the holder of the Notes warrants to acquire an additional 102,433 shares of common stock at an exercise price of \$0.40, which expire on January 28, 2007. Additional debt discount of approximately \$24,000 was recorded during the first quarter of fiscal 2002. The Company determined the additional debt discount by allocating the relative fair value to the Notes and the warrants. The Company is amortizing the additional debt discount over the remaining life of the Notes. For the three and nine months ended July 31, 2002, the Company has recorded approximately \$3,000 and \$7,000, respectively, of interest expense relating to the warrants. In July 2002, an additional \$300,000 was added to the Notes, representing incremental monies loaned by a shareholder. The Company also issued to the holder of the Notes warrants to acquire an additional

300,000 shares of common stock at an exercise price of \$0.75, which expire on July 8, 2007. Additional debt discount of approximately \$22,000 was recorded during the third quarter of fiscal 2002.

NOTE 9 SHAREHOLDERS' EQUITY

COMMON STOCK ISSUANCES

During the nine months ended July 31, 2002, the holder of the Company's Debenture converted \$500,000 of debt into approximately 2,751,000 shares of the Company's common stock.

For the nine month period ended July 31, 2002, the Company issued 175,000 shares in connection with the exercise of options. The exercise price was paid with 100,000 shares of common stock, which were subsequently retired.

In November 2001, the Company issued 25,000 shares of common stock for investor relations services and were recorded at the stock's fair market value.

NOTE 10 SETTLEMENT OF LEGAL/CARRIER DISPUTES

During the quarter ended January 31, 2001, the Company settled a pending lawsuit with Star Telecommunications, Inc. In conjunction with the settlement the Company received a carrier usage credit in the amount of \$780,000 for previous services and future services comprised of one year of no charge domestic carrier services for transporting traffic between Los Angeles, New York and Miami. The Company also received 1,100,000 shares of common stock of Star Telecommunications that were recorded at fair value totaling \$446,820. The Company has recorded the carrier usage credit and the fair value of the shares received as other income and expense in its first Quarter 2001 financial statements.

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In the quarter ended January 31, 2001 financial statements, the Company also recorded income of \$465,000 in connection with the settlement of disputes with RSL Communications, Inc. ("RSL"). This amount was originally credited to the Company by RSL during the year ended October 31, 2000. Subsequently, the credit was rescinded and as the outcome was unclear no benefit was recorded during fiscal 2000. During the first quarter of 2001, RSL management acknowledged the credit. The vendor is in the process of liquidating its United States operations. Accordingly, the Company has applied the credit to amounts owed to the vendor and recorded the effect as income in other income and expense in its 2001 financial statements.

NOTE 11 RECLASSIFICATIONS

Certain reclassifications were made to the 2002 and 2001 consolidated financial statements to conform to current year presentation.

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

FORWARD-LOOKING STATEMENTS

This quarterly report on Form 10-Q (this "Report") includes "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act") and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Forward-looking statements are statements other than historical information or statements of current condition. Some forward-looking statements may be identified by the use of such terms as "expects", "will", "anticipates", "estimates", "believes", "plans" and words of similar meaning. These forward-looking statements relate to business plans, programs, trends, results of future operations, satisfaction of future cash requirements, funding of future growth, acquisition plans and other matters. In light of the risks and uncertainties inherent in all such projected matters, the inclusion of forward-looking statements in this Form 10-Q should not be regarded as a representation by us or any other person that our objectives or plans will be achieved or that our operating expectations will be realized. Revenues and results of operations are difficult to forecast and could differ materially from those projected in forward-looking statements contained herein, including without limitation statements regarding our belief of the sufficiency of capital resources and our ability to compete in the telecommunications industry. Actual results could differ from those projected in any forward-looking statements for, among others, the following reasons: (a) increased competition from existing and new competitors using voice over Internet protocol ("VoIP") to provide telecommunications services over the Internet, (b) the relatively low barriers to entry for start-up companies using VoIP to provide telecommunications services over the Internet, (c) the price-sensitive nature of consumer demand, (d) the relative lack of customer loyalty to any particular provider of services over the Internet, (e) our dependence upon favorable pricing from our suppliers to compete in the telecommunications industry, (f) increased consolidation in the telecommunications industry, which may result in larger competitors being able to compete more effectively, (g) failure to attract or retain key employees, (h) continuing changes in governmental regulations affecting the telecommunications industry and the Internet and (i) changing consumer demand, technological developments and industry standards that characterize the industry. We do not undertake to update any forward-looking statements contained herein. Readers are cautioned not to place undue reliance on the forward-looking statements made in, or incorporated by reference into, this Report or in any document or statement referring to this Report.

GENERAL

On November 2, 1999, we consummated the DTI Acquisition and in the second quarter of fiscal 2000, we shifted focus toward our global VoIP strategy; providing connectivity to international markets experiencing significant demand for VoIP and other IP enabled services and then targeting the corresponding ethnic segment in the U.S. This change in focus has led to a shift from our prepaid long distance operations toward higher margin international opportunities. This strategy allows us to form local partnerships with foreign PTT's (entities responsible for providing telecommunications services in foreign markets, usually government owned or controlled) and Internet Service Providers ("ISP's"), and to provide IP enabled services based on the in-country regulatory environment affecting telecommunications and data providers. Through these relationships, we are able to acquire a direct equity interest or partnership/joint venture interest in the local business and expect our interest to increase as foreign ownership regulations of telecommunications companies diminish. As an early market entrant building "super-regional" networks, we believe that we are positioned for long-term growth and the provision of high margin, value-added services.

In the third quarter of fiscal 2000, we further concentrated our efforts toward our global VoIP telecommunications strategy by completing the consolidation of our Dallas, Texas and Los Angeles, California operations into a single facility in Los Angeles, which also houses two sets of our telecommunications switching equipment and enhanced services platforms. Significant reductions in cost have resulted from combining operational organizations. Costs incurred to accomplish this include the relocation of office facilities and staff, as well as costs associated with reduction of personnel resulting

from redundancies. Defocusing on the prepaid market caused us to incur other costs associated with the closure of certain distribution channels, and also resulted in a reduction of revenues. The reduction of revenues, however, came from the low or negative margin portion of the prepaid

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business. This refocusing and consolidation of operations has resulted in not only greater savings, but also higher profits and more sustainable revenues. This consolidation and reduction in staff has allowed us to significantly reduce our overhead, and although our operations have not yet produced positive cash flow, we believe that continued cost reductions and moderate revenue growth would allow us to achieve positive results in the near future.

On October 12, 2001, we completed the acquisition from Rapid Link of certain assets and executory contracts of Rapid Link, USA, Inc. ("Rapid Link USA") and 100% of the common stock of Rapid Link Telecommunications, GMBH ("Rapid Link Germany"), a German Company. Rapid Link is a leading provider of high quality integrated data and voice communications services to both wholesale and retail customers around the world.

CRITICAL ACCOUNTING POLICIES

The consolidated financial statements include accounts of the Company and all majority-owned subsidiaries. The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and assumptions in certain circumstances that affect amounts reported in the accompanying consolidated financial statements and related footnotes. In preparing these financial statements, we have made our best estimates and judgments of certain amounts included in the financial statements, giving due consideration to materiality. We do not believe there is a great likelihood that materially different amounts would be reported related to the accounting policies described below. However, application of these accounting policies involves the exercise of judgment and use of assumptions as to future uncertainties and, as a result, actual results could differ from these estimates.

Revenue Recognition

Our revenues are generated at the time a customer uses our network to make a phone call. We sell our services to small to medium sized businesses and end-users who utilize our network for international re-origination and dial-thru services, and to other providers of long distance usage who utilize our network to deliver domestic and international termination of minutes to their own customers. At times we receive payment from our customers in advance of their usage, which we record as deferred revenue, recognizing revenue as calls are made. The Securities and Exchange Commission's Staff Accounting Bulletin (SAB) No. 101, "Revenue Recognition", provides guidance on the application of generally accepted accounting principles to selected revenue recognition issues. We have concluded that our revenue recognition policy is appropriate and in accordance with generally accepted accounting principles and SAB No. 101.

Allowance for Uncollectible Accounts Receivable

Accounts receivable are reduced by an allowance for amounts that may become uncollectible in the future. All of our receivables are due from commercial enterprises and residential users in both domestic and international markets. The estimated allowance for uncollectible amounts is based primarily on our evaluation of the financial condition of the customer, and our estimation of the customer's willingness to pay amounts due. We review our credit policies on a regular basis and analyze the risk of each prospective customer individually in order to minimize our risk.

Goodwill, Intangible and Other Long-Lived Assets

Property, plant and equipment, certain intangible and other long-lived assets are amortized over their useful lives. Useful lives are based on our estimate of the period that the assets will generate revenue. Goodwill is assessed for impairment at least annually and other intangible assets are reviewed

for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable.

Financing, Warrants and Amortization of Warrants and Fair Value Determination

The Company has traditionally financed its operations through the issuance of debt instruments that are convertible into the Company's common stock, at conversion rates at or below the fair market value of the Company's common stock at the time of conversion, and typically include the issuance of warrants. The Company has recorded these financing transactions in accordance with Emerging Issues Task Force No. 00-27. Accordingly, the Company recognizes the beneficial conversion feature imbedded in the financings and the fair value of the related warrants on the balance sheet as deferred financing fees. The deferred financing fee is amortized over the life of the respective debt instrument.

Carrier Disputes

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The Company reviews its vendor bills on a monthly basis and periodically disputes amounts invoiced by its carriers. Prior to the second quarter of fiscal 2001, the Company recorded as trade accounts payable the entire amounts owed to its vendors, including amounts in dispute. Any disputes resolved and credited to the Company were recorded as other income at the time the credit was issued. The Company subsequently changed its policy to record cost of revenues excluding disputed amounts. The Company reviews its outstanding disputes on a quarterly basis as part of the overall review of its accrued carrier costs, and adjusts its liability based on management's estimate of amounts owed.

RESULTS OF OPERATIONS THREE MONTHS ENDED JULY 31, 2002 COMPARED TO THE THREE MONTHS ENDED JULY 31, 2001

REVENUES

Our primary source of revenue is the sale of voice and fax traffic internationally over our VoIP network, which is measured in minutes, primarily to small and medium sized enterprises. We charge our customers a fee per minute of usage that are dependent on the destination of the call and is recognized in the period in which the call is completed.

For the three months ended July 31, 2002, we had revenues of \$6,139,000, an increase of \$4,485,000, or 271%, over the same period in 2001. Revenues for the three months ended July 31, 2002 include \$5,295,000 resulting from the purchase of Rapid Link. For the three months ended July 31, 2002, 58% and 42% of our revenues were derived from our retail and wholesale customers, respectively, compared to 51% and 49%, respectively, for the three months ended July 31, 2001. In absolute dollars, our wholesale revenues have increased by 218% from the three months ended July 31, 2001 compared to the three months ended July 31, 2002. The overall growth in revenues and the increase in our wholesale revenues is attributable to the acquisition of Rapid Link, whose VoIP network is well positioned to take advantage of both retail and wholesale opportunities where rapid deployment and time to market are critical to achieving maximum returns.

OPERATING EXPENSES

Our costs of revenues are termination fees, purchased minutes and fixed costs for specific international and domestic Internet circuits and private lines used to transport our minutes. Termination fees are paid to local service providers and other international and domestic carriers to terminate calls received from our network. This traffic is measured in minutes, at a negotiated contract cost per minute.

For the three months ended July 31, 2002, we had total direct costs of revenues of \$4,128,000, an increase of \$3,046,000, or 282%, over the same period in 2001. Costs of revenues have increased in absolute dollars due to the growth in minutes and customers as well as the increased revenue and traffic acquired from Rapid Link. As a percentage of revenues, costs of revenues were 67% of revenues for the three months ended July 31, 2002 compared to 65% of revenues for the three months ended

July 31, 2001. Our costs of revenues as a percentage of revenues has increased due to a slight decline in our retail margins resulting from increased competition in certain markets, as well as a decline in wholesale margins as the telecommunications industry continues to experience price reductions in certain markets. We continue to focus our efforts on increasing both our retail and wholesale revenues, and anticipate that our margin will fluctuate quarterly depending on the traffic mix.

General and administrative expenses include salaries, payroll taxes, benefit expenses and related costs for general corporate functions, including executive management, finance and administration, legal and regulatory, information technology and human resources.

General and administrative expenses were \$1,768,000 and \$702,000 for the three months ended July 31, 2002 and 2001, respectively. This increase of \$1,065,000, or 152% includes \$834,000 attributable to Rapid Link operations. As a percentage of revenues, general and administrative expenses were 29% and 42% of revenues for the three months ended July 31, 2002 and 2001, respectively. Included in general and administrative expenses is bad debt expense of \$136,000 and \$0 for the three months ended July 31, 2002 and 2001, respectively. We review our general and administrative expenses regularly, and continue to reduce costs as appropriate to support the current business as well as anticipated near term growth.

Sales and marketing expenses include expenses relating to the salaries, payroll taxes, benefits and commissions that we pay for sales personnel and the expenses associated with advertising and marketing programs, including expenses relating to our outside public relations firms.

Sales and marketing expenses were \$375,000, or 6% of revenues for the three months ended July 31, 2002 compared to \$203,000, or 12% of revenues, for the same period last year. Included in sales and marketing expenses for 2002 is \$308,000 attributable to Rapid Link operations. A majority of our revenues are generated by outside agents, or through newspaper and periodical advertising, which is managed by a small in-house sales and marketing organization. Since we have been successful in growing our revenue base while maintaining a small in-house sales

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organization, sales and marketing expenses have decreased as a percentage of revenues. We will continue to focus our sales and marketing efforts on newspaper and periodical advertising and agent related expenses to generate additional revenues.

Depreciation and amortization expenses increased to \$596,000 from \$166,000 for the three months ended July 31, 2002 and 2001, respectively. The increase primarily relates to the depreciation and amortization of the assets of the business acquired from Rapid Link. A majority of our depreciation and amortization expense relates to the equipment utilized in our VoIP network, which requires the deployment of sophisticated routers and gateways strategically placed in our Points of Presence and vendor sights around the world.

Interest expense and financing costs are primarily attributable to the amortization of deferred financing fees relating to our various debt instruments. For the three months ended July 31, 2002 and 2001, interest expense and financing costs of \$351,000 and \$86,000, respectively, was primarily attributable to the amortization of deferred financing fees relating to our convertible debentures with Global Capital and our related party note payable.

As a result of the foregoing, we incurred a net loss of \$1,083,000 or \$0.07 per share, for the three months ended July 31, 2002, compared with a net loss of \$595,000 or \$0.05 per share, for the three months ended July 31, 2001.

RESULTS OF OPERATIONS NINE MONTHS ENDED JULY 31, 2002 COMPARED TO THE NINE MONTHS ENDED JULY 31, 2001

REVENUES

For the nine months ended July 31, 2002, we had revenues of \$18,812,000, an increase of \$15,363,000, or 446%, over the same period in 2001. Revenues for the nine months ended July 31, 2002 include \$15,480,000 resulting from the purchase of Rapid Link. For the nine months ended July 31,

2002, 60% and 40% of our revenues were derived from our retail and wholesale customers, respectively, compared to 64% and 36%, respectively, for the nine months ended July 31, 2001. In absolute dollars, our wholesale revenues have increased by 498% from the nine months ended July 31, 2001 compared to the nine months ended July 31, 2002. The overall growth in revenues and the increase in wholesale revenues is attributable to the acquisition of Rapid Link, whose VoIP network is well positioned to take advantage of retail and wholesale opportunities where rapid deployment and time to market are critical to achieving maximum greatest returns.

OPERATING EXPENSES

For the nine months ended July 31, 2002, we had total direct costs of revenues of \$12,755,000, an increase of \$10,397,000, or 441%, over the same period in 2001. Costs of revenues have increased in absolute dollars due to the growth in minutes and customers as well as the increased revenue and traffic acquired from Rapid Link. As a percentage of revenues, costs of revenue were 68% of revenues for the nine months ended July 31, 2002 compared to 68% of revenues for the nine months ended July 31, 2001. Our costs of revenues as a percentage of revenues has remained constants as the retail products acquired from Rapid Link achieve higher margins than the Company's existing retail traffic, thereby offsetting the declines experienced in the Company's existing retail and wholesale business. We continue to focus our efforts on increasing both our retail and wholesale revenues, and anticipate that our margin will fluctuate quarterly depending on the traffic mix.

General and administrative expenses were \$5,741,000 and \$2,043,000 for the nine months ended July 31, 2002 and 2001, respectively. This increase of \$3,698,000, or 181% includes \$2,983,000 attributable to Rapid Link operations. As a percentage of revenues, general and administrative expenses were 31% and 59% of revenues for the nine months ended July 31, 2002 and 2001, respectively. Included in general and administrative expenses is bad debt expense of \$550,000 and \$0 for the nine months ended July 31, 2002 and 2001, respectively. For the nine months ended July 31, 2002, the bad debt expense includes \$215,000 attributable to non-payment from one wholesale customer. We review our general and administrative expenses regularly, and continue to reduce costs as appropriate to support the current business as well as anticipated near term growth.

Sales and marketing expenses were \$1,080,000, or 6% of revenues for the nine months ended July 31, 2002 compared to \$500,000, or 14% of revenues, for the same period last year. Included in sales and marketing expenses for 2002 is \$806,000 attributable to Rapid Link operations. A majority of our revenues are generated by outside agents, or through newspaper and periodical advertising, which is managed by a small in-house sales and marketing organization. Since we have been successful in growing our revenue base while maintaining a small in-house sales organization, sales and marketing expenses have decreased as a percentage of revenues. We will continue to focus our sales and marketing efforts on newspaper and periodical advertising and agent related expenses to generate additional revenues.

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Depreciation and amortization expenses increased to \$1,889,000 from \$468,000 for the nine months ended July 31, 2002 and 2001, respectively. The increase primarily relates to the depreciation and amortization of the assets of the business acquired from Rapid Link. A majority of our depreciation and amortization expense relates to the equipment utilized in our VoIP network, which requires the deployment of sophisticated routers and gateways strategically placed in our Points of Presence and vendor sights around the world.

Interest expense and financing costs are primarily attributable to the amortization of deferred financing fees relating to our various debt instruments. For the nine months ended July 31, 2002, interest expense and financing costs of \$932,000 was primarily attributable to the amortization of deferred financing fees relating to our convertible debentures with Global Capital and our related party note payable. For the nine months ended July 31, 2001, \$577,000 of interest expense and financing fees were primarily attributable to amortization of deferred financing fees associated with our convertible notes which were converted to equity in March 2001, and the fair value of additional warrants issued to the holders of the notes which were fully vested at the time of issuance.

Settlements with two major carriers over charges in prior periods amounted to a total credit to the statements of operations of \$1,789,000 for the nine months ended July 31, 2001. Of this amount, \$780,000 is the result of a settlement with Star Telecommunications ("Star"). Also included is \$447,000 representing common stock received from Star in connection with our dispute settlement. During the nine months ended July 31, 2001, the Company recorded a charge of \$447,000 in connection with the decline in fair value of the marketable securities previously recorded in the settlement transaction with Star Telecommunications.

As a result of the foregoing, we incurred a net loss \$3,608,000, or \$0.27 per share, for the nine months ended July 31, 2002, compared with a net loss of \$1,412,000 or \$0.14 per share, for the nine months ended July 31, 2001.

LIQUIDITY AND CAPITAL RESOURCES

The growth model for our business is scalable, but the rate of growth is dependent on the availability of future financing for capital resources. Our funding of additional infrastructure development will be provided through the operations of our Telecommunications Business and externally through debt and/or equity offerings. We plan to obtain vendor financing for any equipment needs associated with expansion. We believe that, with sufficient capital, we can significantly accelerate our growth plan. Our failure to obtain additional financing could delay the implementation of our business plan and have a material adverse effect on our business, financial condition and operating results.

At July 31, 2002, we had cash and cash equivalents of approximately \$667,000, an increase of \$572,000 from the balance at October 31, 2001. As of July 31, 2002, we had a working capital deficit of approximately \$7,513,000, compared to a working capital deficit of approximately \$6,626,000 at October 31, 2001. As of July 31, 2002, our current assets of approximately \$2,271,000 included net accounts receivable of approximately \$1,384,000, which has decreased over the balance of \$1,833,000 at October 31, 2001 as the company has implemented more stringent credit requirements in fiscal 2002, and a \$215,000 writeoff of a receivable from a single customer.

Net cash used in operating activities was \$1,130,000 for the nine months ended July 31, 2002, compared to \$1,124,000 for the nine months ended July 31, 2001. The net cash used in operating activities for the nine months ended July 31, 2002 was primarily due to a net loss of \$3,608,000 adjusted for: bad debt expense of \$550,000; non-cash interest expense of \$684,000; depreciation and amortization of \$1,889,000; and net changes in operating assets and liabilities of (\$650,470). For the nine months ended July 31, 2001, the net cash used in operating activities was comprised of a net loss of \$1,412,000 adjusted for: depreciation and amortization of \$468,000; stock and warrants issued for services of \$259,000; non-cash interest expense of \$527,000; marketable securities and vendor credits received in settlement of disputes of (\$1,789,000); write off of marketable securities received in settlement of disputes of \$447,000 and net changes in operating assets and liabilities of \$377,000.

During the nine months ended July 31, 2002, net cash provided by investing activities was \$1,071,000, compared to net cash used in financing activities of \$47,000 for the nine months ended July 31, 2001. The net cash provided by investing activities for the nine months ended July 31, 2002 is primarily attributable to a refund of a license fee previously paid on behalf of our German subsidiary of \$1,425,000. Investing activities also include capital expenditures of \$264,000 and \$47,000 for the nine months ending July 31, 2002 and July 31, 2001, respectively, and, for the nine months ending July 31, 2002, an increase in goodwill of \$90,000 relating to the Rapid Link acquisition.

Net cash provided by financing activities for the nine months ended July 31, 2002, totaled \$631,000, compared to net cash provided by financing activities of \$1,413,000 for the nine months ended July 31, 2001. For the nine months ended July 31, 2002, significant components of net cash provided by financing activities include \$550,000 in net proceeds from a convertible debenture, \$300,000 in proceeds from a shareholder, offset by \$141,000 in payments on capital leases, and \$93,000 of deferred financing fees. For the nine months ended July 31, 2001, the significant components of net

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cash provided by financing activities include \$1,000,000 in proceeds from the issuance of our Convertible Debentures, and net proceeds from shareholder of \$410,000.

We are subject to various risks in connection with the operation of our business including, among other things, (i) changes in external competitive market factors, (ii) inability to satisfy anticipated working capital or other cash requirements, (iii) changes in the availability of transmission facilities, (iv) changes in our business strategy or an inability to execute our strategy due to unanticipated changes in the market, (v) various competitive factors that may prevent us from competing successfully in the marketplace, and (vi) our lack of liquidity and our ability to raise additional capital. We have an accumulated deficit of approximately \$39.5 million as of July 31, 2002, as well as a working capital deficit of approximately \$7.5 million. Funding of our working capital deficit, current and future operating losses, and expansion will require continuing capital investment. Our strategy is to fund these cash requirements through operations, debt facilities and additional equity financing. As of the date of this report:

- 1) we obtained additional financing of \$500,000 in January 2002 and \$300,000 in July 2002. We are currently in negotiations to obtain an additional \$1.0 million in financing.
- 2) we have successfully negotiated payment terms of approximately \$600,000 of our past due trade payables with one of our largest vendors, and we have agreed to remit equal monthly installments in excess of our normal monthly usage billing. We are also in negotiations on an additional \$800,000 of trade payables with another large vendor.
- 3) our trade accounts payable and carrier costs include disputes with certain vendors over what we believe are improper charges primarily for termination of our domestic and international minutes. Our trade accounts payable include approximately \$500,000 of such disputes at July 31, 2001. We received approximately \$1,400,000 of such credits in fiscal 2001, and approximately \$200,000 in fiscal 2002.
- 4) our German subsidiary received a net \$1 million refund for a license fee previously paid, which was used to pay down past due liabilities.

Although we have been able to arrange debt facilities and equity financing to date, there can be no assurance that sufficient debt or equity financing will continue to be available in the future or that it will be available on terms acceptable to us. Failure to obtain sufficient capital could materially affect the Company's operations and expansion strategies. As a result of the aforementioned factors and related uncertainties, there is doubt about the Company's ability to continue as a going concern.

Our current capital expenditure requirements are not significant, primarily due to the equipment acquired from Rapid Link. Our capital expenditures for the nine months ended July 31, 2002 were \$264,000 and we do not anticipate significant spending for the remainder of fiscal 2002.

On April 11, 2001, we executed a 6% convertible debenture (the "Debenture") with Global Capital Funding Group L.P, which provided financing of \$1,000,000. The Debenture maturity date is April 11, 2003. The conversion price equals the lesser of (i) 100% of the volume weighted average of sales price as reported by the Bloomberg L.P. of the common stock on the last trading day immediately preceding the Closing Date ("Fixed Conversion Price") and (ii) 70% of the average of the five (5) lowest volume weighted average sales prices as reported by Bloomberg L.P. during the twenty (20) Trading Days immediately preceding but not including the date of the related Notice of Conversion ("the "Formula Conversion Price"). In an event of default the amount declared due and payable on the Debenture shall be at the Formula Conversion Price.

In October 2001, we executed 10% convertible notes (the "Notes") with three of our executives, which provided financing of \$1,945,958. The Notes mature October 24, 2003. The Notes are secured by all Company assets and are convertible into our common stock at the option of the holder at each of the six, twelve, eighteen and twenty-four month anniversary of the date of issuance of the note. The conversion price is equal to the closing bid price of our common stock on the last trading day immediately preceding the conversion. We also issued to the holders of the Notes warrants to acquire

an aggregate of 1,945,958 shares of common stock at an exercise price of \$0.78 per share, which expire on October 24, 2006. For the nine months ended July 31, 2002, an additional \$402,000 was added to the Notes. An additional 402,000 warrants to acquire our common stock were issued in connection with the financing.

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On January 28, 2002, we executed a 6% convertible debenture (the "Second Debenture") with Global Capital Funding Group L.P, which provided financing of \$550,000. The Second Debenture maturity date is January 28, 2003. The conversion price is equal to the lesser of (i) 100% of the volume weighted average of sales price as reported by the Bloomberg L.P. of the common stock on the last trading day immediately preceding the Closing Date ("Fixed Conversion Price") and (ii) 85% of the average of the three (3) lowest volume weighted average sales prices as reported by Bloomberg L.P. during the twenty (20) Trading Days immediately preceding but not including the date of the related Notice of Conversion ("the "Formula Conversion Price"). In an event of default the amount declared due and payable on the Debenture shall be at the Formula Conversion Price.

Acquisitions

We continue to review an acquisition strategy within our Telecommunications Business. From time to time we will review acquisition candidates with products, technologies or other services that could enhance our offerings or services. Any material acquisitions could result in us issuing or selling additional debt or equity securities, or obtaining additional debt or other lines of credit and may result in a decrease of our working capital depending on the amount, timing and nature of the consideration to be paid. We are not currently a party to any agreements, negotiations or understandings regarding any material acquisitions.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We provide services primarily to customers located outside of the U.S. Thus, our financial results could be impacted by foreign currency exchange rates and market conditions abroad. However, the aggregate impact of any likely exchange rate fluctuations would be immaterial as most of our services are paid for in U.S. dollars. A strong dollar could make the cost of our services more expensive than the services of non-U.S. based providers in foreign markets. We have not used derivative instruments to hedge our foreign exchange risks though we may choose to do so in the future.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

On June 12, 2001, Cygnus Telecommunications, Technology, LLC ("Cygnus") filed suit in the United States District Court, Central District of California, alleging patent infringement by us for the use of "international call-back", a method whereby foreign based customers can initiate international telephone calls by first calling a switch in the United States, initiating a "call back" to the customer sight which provides the customer with an open phone line to place a call anywhere in the world. This service is more cost efficient for the customer in certain markets than placing a call from the customer's service area through the local phone company. Cygnus is seeking damages adequate to compensate for the infringement of the patent, increased damages up to three times the amount found by a jury, reasonable attorney fees and costs.

In August 2002, Cygnus filed a motion for a preliminary injunction to prevent the Company from providing "call back" services. In September 2002, the Company filed a cross motion for summary judgment of non-infringement. A hearing date has been set for October 4, 2002. Our ultimate legal and financial liability with respect to such legal proceeding cannot be estimated with any certainty at this time. We intend to defend the case vigorously.

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

The Company's 2002 Annual Meeting of Stockholders was held on May 6, 2002. Three items of business were acted upon at the meeting: (1) the election of six directors to serve until the next Annual Meeting of Stockholders and until their successors are duly elected and qualified; (2) the ratification of the selection of Arthur Andersen to serve as independent public accountants for the Company for the 2002 fiscal year; and (3) the approval of the Dial Thru International Corporation 2002 Equity Incentive Plan.

The results of the voting for the election of directors were as follows:

| Nominee | Votes For | Votes Withheld | Abstentions |
|--------------|------------|----------------|-------------|
| John Jenkins | 11,023,336 | 1,180 | 30,940 |
| Larry Vierra | 11,022,336 | 2,180 | 30,940 |
| Nick DeMare | 11,022,291 | 2,225 | 30,940 |

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| Nominee | Votes For | Votes Withheld | Abstentions |
|-----------------|------------|----------------|-------------|
| Robert Fidler | 11,023,536 | 980 | 30,940 |
| Allen Sciarillo | 11,022,636 | 1,880 | 30,940 |
| David Hess | 11,023,436 | 1,080 | 30,940 |

Accordingly, each of the six nominees received a plurality of the votes cast and was elected.

The results of the voting on the ratification of the selection of Arthur Andersen as the Company's independent auditors for the 2002 fiscal year were as follows:

| Votes For | Votes Withheld | Abstentions |
|------------|----------------|-------------|
| 10,493,039 | 528,557 | 32,760 |

Accordingly, the number of shares voted for the proposal constitute a majority of the shares entitled to vote thereon, and the selection of Arthur Andersen as the Company's independent auditors for the 2002 fiscal year was ratified.

The results of the voting on the approval of the Dial Thru International Corporation 2002 Equity Incentive Plan were as follows:

| Votes For | Votes Withheld | Abstentions |
|-----------|----------------|-------------|
| 5,754,605 | 397,776 | 33,486 |

Accordingly, the number of shares voted for the proposal constitute a majority of the shares entitled to vote thereon, and the approval of the Dial Thru International Corporation 2002 Equity Incentive Plan was ratified.

Item 6. Exhibits and Reports on Form 8-K

- (a) Exhibits:
- 99.1 Certification of the Chief Executive Officer, dated September 16, 2002, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
 - 99.2 Certification of the Chief Financial Officer, dated September 16, 2002, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- (b) Reports on Form 8-K
- None.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

DIAL THRU INTERNATIONAL CORPORATION

/s/ ALLEN SCIARILLO

By: Allen Sciarillo
*Executive Vice President and Chief Financial
Officer (Principal Financial Officer)*

Dated September 16, 2002

**Certification Pursuant to 18 U.S.C. Section 1350,
As Adopted Pursuant to
Section 302 of the Sarbanes-Oxley Act of 2002**

I, John Jenkins, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Dial Thru International Corporation;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report; and
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report.

By: /s/ JOHN JENKINS

John Jenkins
Chairman, Chief Executive Officer and President

Dated September 16, 2002

**Certification Pursuant to 18 U.S.C. Section 1350,
As Adopted Pursuant to
Section 302 of the Sarbanes-Oxley Act of 2002**

I, Allen Sciarillo, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Dial Thru International Corporation;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report; and
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report.

By: /s/ ALLEN SCIARILLO

Allen Sciarillo
*Executive Vice President and Chief Financial
Officer (Principal Financial and Principal
Accounting Officer)*

Dated September 16, 2002

QuickLinks

FORM 10-Q

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SIGNATURES

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