9278 COMMUNICATIONS INC
Form 10-Q
November 14, 2001

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

[X] QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2001

[ ] TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from __________ to __________

Commission file number: 333-37654

9278 COMMUNICATIONS, INC.
(Exact name of registrant as specified in its charter)

Delaware	13-4165136
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1942 Williamsbridge Road, Bronx, New York 10461
(Address of principal executive offices)

(718) 887-9278
(Registrant's telephone number, including area code)

Not applicable
(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 past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ]

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY
PROCEEDINGS DURING THE PRECEDING FIVE YEARS:

Indicate by check mark whether the registrant filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Securities Exchange Act of 1934 after the distribution of securities under a plan confirmed by a court. Yes [ ] No [ ]

APPLICABLE ONLY TO CORPORATE ISSUERS

State the number of shares outstanding of each of the registrant's classes of common equity, as of the latest practicable date:

Common Stock, $.001 par value - 22,932,912 shares issued and outstanding as of November 12, 2001

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

9278 COMMUNICATIONS INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

ASSETS

	September 30, 2001 (UNAUDITED)
Current Assets:	
Cash and cash equivalents	$ 7,031,313
Marketable Securities	--
Accounts receivable, less allowance for doubtful accounts of $165,000 and $675,000 at September 30, 2001 and December 31, 2000, respectively	15,456,796
Inventory	8,485,434
Prepaid expenses and all other current assets	140,306
Total Current Assets	31,113,849
Furniture and Equipment - Net of accumulated depreciation of $301,386 and $133,378 at September 30, 2001 and December 31, 2000, respectively	1,196,253
Intangible Assets, net of accumulated amortization of $216,759 and $17,154 at September 30, 2001 and December 31, 2000, respectively	3,784,555
Other Assets	58,694
	$ 36,153,351

LIABILITIES AND SHAREHOLDERS' EQUITY

Current Liabilities	
Accounts payable and accrued expenses	$ 31,078,201
Current maturities of notes payable	856,302
Current maturities of Debt obligations	41,790
Income taxes payable	40,125

Total Current Liabilities	32,016,418
Notes payable, shareholder, less current maturities	--
Debt obligations, less current maturities	69,942
	32,086,360
Commitment and Contingencies	
Shareholders' equity	
Convertible preferred stock	
Class B, $0.001 par value, 5,000,000 shares authorized 0 and 505 issued and outstanding, at September 30, 2001 and December 31, 2000, respectively	--
Common Stock, $0.001 par value; 40,000,000 shares authorized, 22,932,912 and 23,166,969 issued and outstanding, at September 30, 2001 and December 31, 2000, respectively	22,933
Paid in capital	8,248,458
Accumulated Deficit	(4,204,400)
Total Shareholders' Equity	4,066,991
	$ 36,153,351

The accompanying notes are an integral part of these financial statements

9278 COMMUNICATIONS INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS
(UNAUDITED)

	Three Months Ended September 30,		
	2001	2000	
Sales	$ 55,736,568	$ 20,032,204	$142
Cost of Sales	52,645,216	18,891,100	133
Gross Profit	3,091,352	1,141,104	9
Operating Expenses			
Selling	404,257	189,915	
General and administrative	1,964,447	748,130	4
Depreciation and amortization	133,500	42,834	
Loss on Disposition of Assets	--	--	
Provision for (Recovery) of Bad and Doubtful Debts	(48,277)	--	
Interest expense	19,332	50,000	
Litigation Settlement	207,000	--	
	2,680,259	1,030,879	6
Income/(Loss) from Operations Before Income Taxes	411,093	110,225	2
Provision for Income Taxes	46,275	8,000	
Net Income / (Loss) attributable to common stock	364,817	102,225	$ 2

Basic and diluted earnings (loss) per share	$ 0.02	$ 0.00	$
Shares used in the calculation of earnings (loss) per share	23,942,982	20,561,849	23

The accompanying notes are an integral part of these financial statements

9278 COMMUNICATIONS INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS
NINE MONTHS ENDED SEPTEMBER 30,
(UNAUDITED)

	2001	2000
Cash Flows From Operating Activities		
Net Income / (Loss)	$ 2,600,591	$ (283
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	367,612	137
Provision for Doubtful Accounts	73,340	303
Issuance of stock for services rendered	--	55
Loss attributable to sale of equipment	--	363
Changes in current assets and liabilities, net of acquisitions:		
Accounts receivable	(8,537,400)	(1,936
Inventory	(4,835,379)	(784
Prepaid expenses	(140,306)	14
Other Assets	(17,951)	(12
Accounts payable	16,370,251	1,833
Income taxes payable	15,870	
Net Cash provided by (used in) Operating Activities	5,896,628	(309
Cash flows From Investing Activities		
Acquisition of property and equipment	(705,164)	(279
Acquisition of businesses	(207,741)	
Disposition of Marketable Securities	20,962	
Net Cash used in Investing Activities	(891,943)	(279
Cash flows From Financing Activities		
Notes and Advances Payable, shareholder	(1,148,634)	(62
Notes Payable - Other	(900,000)	
Notes Payable - leases	--	75
Principal payments on debt obligations	(39,362)	(61
Repurcahse of Shares and Retired	(27)	
Issuance of common stock	--	923
Net cash (used in) provided by Financing Activities	(2,088,023)	873

Net Increase in Cash and Cash Equivalents	2,916,662	284
Cash and Cash Equivalents - Beginning of Period	4,114,651	26
Cash and Cash Equivalents - End of Period	$ 7,031,313	$ 311
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 89,671	$ 17
Cash paid for taxes	31,406	15
Noncash Investing and Financing Activities:		
Equipment acquired under capital leases	--	75
Conversion of notes and advances payable, shareholder for common stock	--	500
Conversion of preferred stock to common stock	505,000	525
Common stock issued for services rendered	--	55

The accompanying notes are an integral part of these financial statements

9278 COMMUNICATIONS INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2001
(UNAUDITED)

	Preferred Stock Amount	Common Stock Number of shares	Common Stock Amount	Additional Paid-in Capital
Balance at January 1, 2001	$ 505,000	23,166,969	$ 23,166	$ 7,743,252
Conversion of preferred stock to common stock	(505,000)	776,013	777	504,223
Repurchase of Common Stock and Retired--Note 5	(1,010,000)	(1,010)	983	(27)
Net income for the six months ended June 30, 2001	--	--	--	--
	$ --	22,932,982	$ 22,933	$ 8,248,458

The accompanying notes are an integral part of these financial statements

9278 COMMUNICATIONS INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS

1 - BASIS OF PRESENTION

The accompanying condensed consolidated unaudited financial statements of 9278 Communication Inc. and subsidiaries (collectively, the "Company") have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC") for quarterly reports on Form 10-Q and do not include all of the information and footnote disclosures generally required by accounting principles generally accepted in the United States and should be read in conjunction with our consolidated financial statements and notes thereto for the fiscal year ended December 31, 2000, included in the Company's Form 10-KSB as filed with the SEC. The accompanying condensed consolidated unaudited financial statements have been prepared in accordance with accounting principles generally accepted in the United States and reflect all adjustments (consisting of normal recurring accruals) which are, in the opinion of the management, considered necessary for a fair presentation of results for these interim periods. Operating results for the three and nine month periods ended September 30, 2001 and 2000 are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2001. Certain prior period amounts have been reclassified to conform to the current period presentation.

2 - NATURE OF BUSINESS

The Company markets and distributes prepaid telephone cards to small retail establishments and distributors through its various sales locations nationwide.

Inventories

Inventories consist of prepaid telephone cards that are stated at the lower of cost (first-in, first-out) or market.

Income Taxes

The Company accounts for income taxes under the Financial Accounting Standards Board Statement of Financial Accounting Standards ("SFAS") No. 109 "Accounting of Income Taxes" (SFAS 109). Under SFAS 109, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. Under SFAS109, the effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. The provision for income taxes for the nine months ended September 30, 2001 reflects the utilization of the Company's net operating loss carryforwards in the amount of approximately $2,685,000.

3 - EARNINGS PER SHARE

Basic earning per common share is calculated by dividing net income (loss) available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share for the three and nine months ended September 30, 2001 and 2000 excludes all potentially dilutive securities, as the effect of the related incremental shares (235,000 and 25,000 shares in 2001 and 2000, respectively) would be antidilutive.

9278 COMMUNICATIONS INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS

4 - ACQUISITIONS

On January 23, 2001, the Company purchased certain assets of two of its distributors in an asset purchase transaction, wherein the Company acquired all the accounts receivables, inventories, fixed assets and customer lists of the distributors net of accounts payable. The Company paid $100,000 in excess of their net assets for the customer lists. A summary of the transactions is as follows:

Assets purchased:	
Accounts receivable	$ 147,904
Inventories	68,015
Other assets	5,500
Customer Lists	100,000
	321,419
Liabilities assumed:	
Accounts payable	(113,667)
Net assets acquired	$ 207,742
Cash Paid	$ 207,742

Pro-forma results of operations are not presented, as they are not material to the historical results presented herein.

5 - INVESTMENTS AND OTHER TRANSACTIONS

On January 29, 2001 the Company acquired, for a nominal amount, a 27% equity interest in DMS Acquisition Corp., (a Delaware Corporation), as an inducement to enter into a long-term distribution agreement with DMS Acquisition Corp. DMS Acquisition Corp. is a facility-based carrier of long distance telephone service. On February 8, 2001 DMS Acquisition Corp. was a party to a triangular merger with Capital One Ventures Corp. (an OTC publicly traded company) with Capital One Ventures Corp. as the surviving entity. DMS Acquisition Corp. became a wholly owned subsidiary of Capital One Ventures Corp. Simultaneous with the merger Capital One Ventures Corp. changed the corporate name to Cirus Telecom, Inc. ("Cirus"). As a result of the merger, the Company's equity interest of 10,800,000 shares of Cirus was diluted to 18%. The Company's investment in Cirus was restricted and subject to other conditions pursuant to the distribution agreement. The investment in Cirus is accounted for at cost and is not material to the Company's financial position.

On September 26, 2001, under the terms of an agreement between Rapid Release Research LLC ("RRR") and the Company, RRR forfeited to the Company 200,000 vested shares of the Company it had earned pursuant to a Management Consulting Agreement dated as of September 1, 2000, and an additional 600,000 unvested shares of the Company held by them in escrow, in exchange for 600,000 shares of Cirus stock held by the Company. As an additional consideration, the two parties mutually agreed to declare the Management Consulting Agreement as null and void and of no further force and effect. The Company also delivered

60,000 shares of Cirus to a consulting firm, for its services in negotiating this settlement agreement. The Company has recorded no gain or loss from this transaction.

On September 26, 2001, the Company transferred the balance of 10,140,000 shares of Cirus back to Cirus in exchange for (i) Cirus' consent to the September 26, 2001 transaction between the Company and

RRR; (ii) 210,070 shares of the Company held by certain shareholders of Cirus; and (iii) an unconditional release from the Distribution Agreement dated February 6, 2001, signed between Cirus and the Company, from the day of its inception.

On September 30, 2001, the Company retired 1,010,070 shares its received from the above settlements.

6 - NOTES AND ADVANCES PAYABLE, SHAREHOLDER

On December 10, 1999 the Company declared $3,000,000 in dividends, of which $1,000,000 was paid at that time. On December 13, 1999, the Company executed a promissory note for the benefit of the shareholders in the amount of $2,000,000, payable to the Company's chief executive officer, who is also a shareholder. A principal payment of $1,000,000 was originally due on June 13, 2000, and the second payment was originally payable on December 13, 2001. In consideration for deferring these payments, on June 13, 2000, the Company issued warrants to purchase 200,000 shares of common stock at an exercise price of $1.625 per share. The warrants vested immediately and are exercisable until 2010.

Further, on March 22, 2001, the Company amended the terms of these promissory notes to defer the payments to March 31, 2002 and December 31, 2002, respectively, reserving the right to prepay on the note prior to the due date. As of September 30, 2001, the Company had repaid $1,142,500 on this note.

Interest on the note is payable at a rate of 8%. For the nine months ended September 30, 2001, interest expense on this note was $77,500 and was paid in full as of that date.

7 - RELATED PARTY TRANSACTIONS

Sales of inventory to a customer who is related to an officer were approximately $18,953,000 and $4,567,000 for the nine months ended September 30, 2001 and 2000 respectively. The Company also purchased inventory from this customer during this period in the amount of $8,865,000 in 2001 and $0 in 2000. Included in accounts receivable and accounts payable at September 30, 2001 is $1,866,574 and $193,286 respectively from this customer.

8 - LITIGATION

For the year ended December 31, 1999, purchases from one telephone card supplier were approximately 55% of total purchases. In November 1999, the Company commenced an action against this supplier to recover damages resulting from cancellation of the telephone card purchases by the Company. The supplier subsequently counter sued for unpaid bills for such telephone cards. The Company

incurred a net loss of $553,547, which was reflected in the fourth quarter of 1999. The Company subsequently mitigated, in substantial part, its reliance on this supplier by increasing its purchases from other vendors. On September 30, 2001, in order to avoid protracted litigation and mounting legal fees, the Company decided to settle the case wherein it agreed to pay $250,000 to the supplier over a period of four years beginning in August 2001. This amount is payable in four monthly installments of $7,500 and 44 subsequent monthly installments of $5,000 each exclusive of interest. During the three months period ended September 30, 2001, the Company has recorded a $207,000 charge representing the net present value of the settlement amount.

In November 1999, a distributor of the Company's prepaid telephone cards instituted an action for approximately $575,000, based on a purported breach of oral contract by the Company. The Company filed an answer and counterclaim against the distributor for approximately $575,000 of unpaid invoices. On September 30, 2001, the Company settled its case against this distributor and received $50,000, writing off

approximately $525,000 as uncollectible receivables. In previous years the Company had provided an allowance for this doubtful account equal to the total of unpaid invoices.

9 - PREFERRED STOCK

During the three months ended March 31, 2001 and June 30, 2001, the Company converted 225 and 280 preferred shares of Class B, $.001 par value convertible preferred stock into 426,184 and 349,829 shares of common stock, respectively.

10 - EFFECT OF RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In June 2001, the Financial Accounting Standards Board approved the issuance of SFAS No. 141- "Business Combinations" and SFAS 142- "Goodwill and Other Intangible Assets." The new standards require that all business combinations initiated after June 30, 2001 must be accounted for under the Purchase Method. In addition, all intangible assets acquired that are obtained through contractual or legal right, or are capable of being separately sold, transferred, licensed, rented or exchanged shall be recognized as an asset apart from goodwill. Goodwill and intangibles with indefinite lives will no longer be subject to amortization, but will be subject to, at least, an annual assessment for impairment by applying a fair value based test.

The company will continue to amortize goodwill existing under its current method until December 31, 2001. Thereafter, annual and quarterly goodwill amortization of $266,756 and $66,689 respectively will no longer be recognized. The company will perform a transitional fair value based impairment test at March 31, 2002 and if the fair value is less than the recorded value at January 1, 2002 the company will record an impairment loss in the March 31, 2002 quarter as a cumulative effect of a change in accounting principle.

In August 2001, the FASB issued statement of Financial Accounting Standard No. 144 "Accounting for the Impairment or Disposal of Long Lived Assets," ("SFAS 144"). This statement is effective for the fiscal years beginning after December 15, 2001. This supercedes SFAS 121, "Accounting for the Impairment of Long-lived Assets and for Long-lived Assets to be Disposed of", while retaining many of the requirements of such statement. The Company is currently evaluating the impact

of the statement.

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

The following discussion should be read in conjunction with the consolidated financial statements and notes thereto set forth in Item 1 of this Quarterly Report. In addition to historical information, this discussion and analysis contains forward-looking statements that involve risks, uncertainties and assumptions, which could cause actual results to differ materially from Management's expectations. Factors that could cause differences include, but are not limited to, expected market demand for the Company's products, fluctuations in pricing for products distributed by the Company and products offered by competitors, as well as general conditions of the telecommunications marketplace.

OVERVIEW

To date, our principal source of revenue has been the marketing and distribution of prepaid phone cards. We market and distribute private label proprietary prepaid phone cards produced exclusively for the Company by various long distance carriers and/or resellers, as well as branded prepaid phone cards produced by other telecommunications long distance carriers and resellers.

Prepaid phone cards are distributed through a vast network of retail outlets, including convenience stores, newsstands, grocery stores and discounts stores. The retail outlets are serviced by independent distributors, which often distribute newspapers or other items to them. Beginning July 2001, we have started selling prepaid cards to end users via the Internet through www.9278.com.

Private label cards are generally designed and produced by us, utilizing card numbers or Personal Identification Numbers provided by the telecommunications' carrier or reseller providing the long distance service for the card. We incur the upfront expense of printing the phone cards with the Personal Identification Numbers already printed on the cards. However, we do not pay the long distance carrier until it activates the cards, which occurs upon our sale to the distributor. In certain instances, we do not pay the carrier until the end user first uses the card. Accordingly, through the use of private label cards, our cost of inventory is significantly reduced, as purchases are effectively made on an as-needed basis. In addition, private label cards generally provide the Company with the ability to achieve a greater gross margin percentage, typically ranging from 6% to 10%.

In order to better serve our distributors, we also resell branded prepaid calling cards of other companies and resellers along with our private label cards. We purchase branded cards at a discount from the face value of the card, and resold to the distributor at a slightly lower discount. The difference between the two discount rates, typically from 1% to 6%, represents the gross margin we retain. We purchase branded cards on varying terms, from C.O.D. to "as used" basis. Sales of our product are generally made on a net 14 days basis.

We are continually seeking to develop and acquire rights to additional

prepaid telecommunications services and other prepaid products or services to diversify our product offerings and increase our overall gross margin.

HISTORICAL RESULTS OF OPERATIONS

THREE MONTHS ENDED SEPTEMBER 30, 2001 COMPARED TO THREE MONTHS ENDED SEPTEMBER 30, 2000

Net sales increased $35,704,000 to $55,737,000 for the three months ended September 30, 2001, up 178.2% from net sales of $20,032,000 for the three months ended September 30, 2000. The increase in net sales was primarily due to our acquisitions and geographic expansion since the third quarter of calendar year 2000 and continuing in the first three quarters of 2001. In September 2000 we acquired two businesses (in Yonkers, New York and Silver Springs, Maryland) that accounted for $7,973,000 of sales in the three months ended September 30, 2001. In December 2000, we acquired Reliable Networks, Inc., a competitor of ours located in Queens, New York, which accounted for $9,329,000 of sales for the three months ended September 30, 2001. In January 2001, we acquired two separate operations in Connecticut and opened an office in Connecticut, which accounted for an aggregate of $2,295,000 in sales for the three months ended September 30, 2001. In May 2001, we opened a new office in Los Angeles, California, which accounted for $5,351,000 in sales for the three months ended September 30, 2001. In August 2001, we opened two new locations, one in Brooklyn, New York, which accounted for $1,562,000 in sales since its inception, and, the second in Chicago, Illinois, which accounted for $1,583,000 in sales since its inception in August 2001. For the three months ended September 30, 2001, same location sales increased by approximately $6,528,000 or 34.3% to $25,587,000 in 2001 from $19,059,000 in the prior year due to the Company primarily selling private label cards as opposed to primarily distributing branded cards. Starting July 2001, we began actively selling phone cards over the Internet. Internet sales accounted for $2,056,000 for the three months ended September 30, 2001.

Gross profit increased to $3,091,000 for the three months ended September 30, 2001, as compared to $1,141,000 in same period in 2000, as a result of increased volume. As a percentage of sales, gross profit decreased to 5.55% for the three months ended September 30, 2001 as compared to 5.70% for the three months ended September 30, 2000. This decrease in gross profit was attributable to change in rates by the long distance carriers and increasing competition from additional cards entering the marketplace.

Operating expenses for the three months ended September 30, 2001 increased by $1,649,000 to $2,680,000, an increase of 160% over operating expenses of $1,031,000 for the three months ended September 30, 2000. Selling expenses increased by $214,000 to $404,000 for the three months ended September 30, 2001 from $190,000 for the same period in 2000, as a result of our utilizing commissioned sales staff to make bulk sales and promotional campaigns organized in connection with introduction of new products in the market. In addition, general and administrative expenses increased by $1,216,000 to $1,964,000 for the three months ended September 30, 2001, as compared to $748,000 for the same period in 2000. This increase was primarily due to the increase in salaries of $345,000 that is directly related to our growth and adding new locations, an increase in professional and consulting fees of $150,000 due to the retention of certain financial consultants and advisors, and an increase in trade publication advertising of $210,000. Credit card charges paid for processing credit card sales transactions over the Internet amounted to $85,000 for the three months

ended September 30, 2001. The remainder of the increase in general and administrative expenses of approximately $426,000 reflects the normal escalation of overhead required to support our growth.

Depreciation and amortization for the three months ended September 30, 2001 amounted to $134,000, an increase of $91,000 compared to the same period in 2000. The increase is comprised of $44,000 in increased depreciation of fixed assets and $47,000 in increased amortization of goodwill. In the three months ended September 30, 2001 we reduced our allowance for bad debts by $50,000 since we received $50,000 from a customer for whom we had set up an allowance in full.

We had been involved in litigation with one of our suppliers since November 1999. The supplier had sued for non-payment of its outstanding bills. We counter-sued the supplier for canceling service on the telephone cards supplied by them. In order to avoid protracted litigation and additional legal costs, we agreed to settle the lawsuit. Under the term of the agreement, we will pay the supplier an aggregate amount of $250,000 over a period of four years in 4 monthly payments of $7,500 and 44 successive monthly payments of $5,000 beginning August 2001. We had not anticipated this settlement, and therefore had not provided for the payment in previous years. During the three months ended September 30, 2001, we have taken a charge of $207,000 representing the net present value of the settlement amount.

We had a net profit before taxes of $411,000 for the three months ended September 30, 2001 as compared to $110,000 for the three months ended September 30, 2000. The increase in net income was due to the increase in sales volume and gross profit margins, improved control of overhead, reduced bad debts and lack of any other significant losses. For purposes of earnings per share, net income/loss attributable to common stock reflects net income of $375,000 for the three months ended September 30, 2001 as compared to $102,000 for the three months ended September 30, 2000.

NINE MONTHS ENDED SEPTEMBER 30, 2001 COMPARED TO NINE MONTHS ENDED SEPTEMBER 30, 2000

Net sales increased $88,981,000 to $142,754,000 for the nine months ended September 30, 2001, up 165.5% from net sales of $53,773,000 for the nine months ended September 30, 2000. The increase in net sales was primarily due to our acquisitions and geographic expansion since the third quarter of calendar year 2000 and continuing in the first three quarters of 2001. In September 2000 we acquired two businesses (in Yonkers, New York and Silver Springs, Maryland) that accounted for $19,858,000 of sales in the nine months ended September 30, 2001. In December 2000, we acquired Reliable Networks, Inc., a competitor of ours located in Queens, New York, which accounted for $31,217,000 of sales for the nine months ended September 30, 2001. In January 2001, we acquired two separate operations in Connecticut and opened an office in Connecticut, which accounted for an aggregate of $6,358,000 in sales for the nine months ended September 30, 2001. In May 2001, we opened a new office in Los Angeles, California, which accounted for $8,796,000 in sales for the nine months ended September 30, 2001. In August 2001, we opened two new locations, one in Brooklyn, New York, which accounted for $1,562,000 in sales since its inception, and, the second in Chicago, Illinois, which accounted for $1,583,000 in sales since its inception in August 2001. For the nine months ended September 30, 2001, same location sales increased by approximately $18,524,000 or 35% to $71,323,000 in 2001 from $52,799,000 in the prior year due to the Company primarily selling private label cards as opposed to primarily distributing branded cards. Starting July 2001, we began actively selling phone cards over the Internet. Internet sales accounted for $2,056,000 for the nine months ended September 30, 2001.

Gross profit increased to $9,006,000 for the nine months of 2001, as compared to $2,879,000 in same period in 2000, as a result of increased volume and greater sales margins. As a percentage of sales, gross profit increased to 6.31% for nine months ended September 30, 2001 as compared to 5.35% for the nine months ended September 30, 2000. This increase in gross profit was attributable to our addition of higher margin private label cards, slightly offset by the decrease in margins attributable to branded products and increasing competition from additional cards entering the marketplace.

Operating expenses for the nine months ended September 30, 2001 increased by $3,204,000 to $6,359,000, an increase of 101.6% over operating expenses of $3,155,000 for the nine months ended September 30, 2000. Selling expenses increased by $624,000 to $968,000 for the first nine months of 2001 from $344,000 for the same period in 2000, as a result of our utilizing commissioned sales staff to make bulk sales and promotional campaigns organized in connection with introduction of new products in the market. In addition, general and administrative expenses increased by $2,778,000 to $4,653,000 for the nine months of

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2001, as compared to $1,876,000 for the same period in 2000. This increase was primarily due to the increase in salaries of $937,000 that is directly related to our growth and adding new locations, an increase in professional and consulting fees of $576,000 due to legal, accounting and consulting fees incurred primarily in connection with the mergers and certain unfounded lawsuits instituted by former vendors and customers and communication with investors, and an increase in trade publication advertising of $340,000. The remainder of the increase in general and administrative expenses of approximately $925,000 reflects the normal escalation of overhead required to support our growth.

Depreciation and amortization for the nine months ended September 30, 2001 amounted to $368,000, an increase of $238,000 compared to the same period in 2000. The increase is comprised of $96,000 in increased depreciation of fixed assets and $142,000 in increased amortization of goodwill. In the nine months ended September 30, 2000 we recorded a loss on the disposition of assets of $363,000 and a provision for bad debts of $303,000. During the nine months ended September 30, 2001, the bad debt expense, net of bad debts recovery, was only $73,000.

We had been involved in litigation with one of our suppliers since November 1999. The supplier had sued for non-payment of its outstanding bills. We counter-sued the supplier for canceling service on the telephone cards supplied by them. In order to avoid protracted litigation and additional legal costs, we agreed to settle the lawsuit. Under the term of the agreement, we will pay the supplier an aggregate amount of $250,000 over a period of four years in 4 monthly payments of $7,500 and 44 successive monthly payments of $5,000 beginning August 2001. We had not anticipated this settlement, and therefore had not provided for the payment in previous years. During the nine months ended September 30, 2001, we have taken a charge of $207,000 representing the net present value of the settlement amount.

We had a net profit before taxes of $2,647,000 for the nine months ended September 30, 2001 as compared to a loss of $276,000 for the nine months ended September 30, 2000. The increase in net income was due to the increase in sales volume and gross profit margins, improved control of overhead, reduced bad debts and lack of any other significant losses. For purposes of earnings per share, net income/loss attributable to common stock reflects net income of $2,601,000 for the nine months ended September 30, 2001 as compared to a net loss of

$284,000 for the nine months ended September 30, 2000.

LIQUIDITY AND CAPITAL RESOURCES

At September 30, 2001, we had total current assets of approximately $31,114,000. This included $7,031,000 in cash, $8,485,000 of inventory and $15,457,000 of accounts receivable. Our cash balances vary significantly from day-to-day due the large volume of purchases and sales we make from the various prepaid phone cards companies and the numerous distributors to whom we sells cards.

We generated $5,794,000 in cash from operating activities during the nine months ended September 30, 2001 as compared to utilizing $310,000 during the same period in 2000. Increases in cash flows during the nine months ended September 30, 2001 are related to the higher net income and increase in accounts payable, offset by increase in accounts receivable and inventory.

Cash utilized by investing activities amounted to $790,000 during the nine months ended September 30, 2001, utilized to acquire additional fixed assets and acquire another business operation. Cash utilized by financing activities amounted to $2,088,000 during the nine months ended September 30, 2001, of which, $1,149,000 was utilized to pay down notes payable to shareholder, $900,000 to pay down notes payable to the former owner on acquisition of Reliable Networks, Inc. and $39,000 to pay down principal on debt obligations.

We believes that existing cash and cash equivalents, cash flow from operations and available vendor credit will be sufficient to meet its planned working capital and capital expenditure budget through the remainder of 2001. However, there are no assurances that we will not be required to seek additional financing. If we are required to seek other sources of financing, there can be no assurance that we will be able to obtain such financing on commercially reasonable terms, or otherwise, or that it will be able to otherwise satisfy it short-term cash flow needs from other sources in the future.

Effect of Recently issued Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board approved the issuance of SFAS No. 141- "Business Combinations" and SFAS 142- "Goodwill and Other Intangible Assets". The new standards require that all business combinations initiated after June 30, 2001 must be accounted for under the Purchase Method. In addition, all intangible assets acquired that are obtained through contractual or legal right, or are capable of being separately sold, transferred, licensed, rented or exchanged shall be recognized as an asset apart from goodwill. Goodwill and intangibles with indefinite lives will no longer be subject to amortization, but will be subject to, at least, an annual assessment for impairment by applying a fair value based test.

The Company will continue to amortize goodwill existing under its current method until December 31, 2001. Thereafter, annual and quarterly goodwill amortization of $266,756 and $66,689 respectively will no longer be recognized. The company will perform a transitional fair value based impairment test at March 31, 2002 and if the fair value is less than the recorded value at January 1, 2002 the company will record an impairment loss in the March 31, 2002 quarter as a cumulative effect of a change in accounting principle.

In August 2001, the FASB issued statement of Financial Accounting Standard No. 144 "Accounting for the Impairment or Disposal of Long Lived Assets", ("SFAS

144"). This statement is effective for the fiscal years beginning after December 15, 2001. This supercedes SFAS 121, "Accounting for the Impairment of Long-lived Assets and for Long-lived Assets to be Disposed of", while retaining many of the requirements of such statement. The Company is currently evaluating the impact of the statement.

FACTORS AFFECTING FUTURE RESULTS

We are actively looking for ways to increase sales and profitability. To achieve that goal, we are looking at various avenues for expansion. The first is geographical expansion, and to that end, we are currently negotiating opening three new locations, one in Toronto, Canada, the second in the London, United Kingdom and the third in Alexandria, Virginia area. These three new offices should be operating by December 2001. The second avenue for additional sales is "Internet E-Commerce" sales to the public. We unveiled our e-commerce website in May 2001 and began active sales over the Internet in July 2001. These sales are made utilizing consumer credit card payment and existing inventory. To date we have received a strong response to our web sales and are continuing to grow.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Not Applicable.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

We are subject to certain legal proceedings and claims which have arisen in the ordinary course of our business. These actions when ultimately concluded will not, in the opinion of management, have a material adverse effect on our financial position, results of operations or liquidity. We are also subject to other legal proceedings which we have previously disclosed.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS.

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

None.

ITEM 5. OTHER INFORMATION.

None.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K.

(a) Exhibits.

None.

(b) Reports on Form 8-K.

None.

SIGNATURES

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

9278 COMMUNICATIONS, INC.

Date: November, 14, 2001

By /s/ James Scigliano

James Scigliano
Chief Financial Officer
(Principal Financial and
Accounting Officer)