

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 quarterly period ended June 30, 2007

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 000-32421

**Fusion Telecommunications International, Inc.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**58-2342021**

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

**420 Lexington Avenue, Suite 1718, New York, New York**

(Address of principal executive offices)

**10170**

(Zip Code)

**(212) 201-2400**

Registrant's telephone number, including area code

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

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, accelerated filer, or non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer

Accelerated Filer

Non-Accelerated Filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of capital stock as of August 6, 2007 is as follows:

<u>Title of each Class</u>	<u>Number of Shares Outstanding</u>
Common Stock, \$0.01 par value	26,971,465
Redeemable Common Stock Purchase Warrants	7,641,838

INDEX

	<u>Page</u>
<b>Part I: Financial Information</b>	
Item 1. Financial Statements	3
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	19
Item 3. Quantitative and Qualitative Disclosures About Market Risk	31
Item 4. Controls and Procedures	31
<b>Part II: Other Information</b>	
Item 1. Legal Proceedings	32
Item 1A. Risk Factors	33
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	33
Item 3. Defaults Upon Senior Securities	33
Item 4. Submission of Matters to a Vote of Security Holders	33
Item 5. Other Information	33
Item 6. Exhibits	34

**PART 1 - FINANCIAL INFORMATION**

**ITEM 1: FINANCIAL STATEMENTS**

**FUSION TELECOMMUNICATIONS INTERNATIONAL, INC.  
AND SUBSIDIARIES**

**Consolidated Balance Sheets**

	<u>June 30, 2007</u>	<u>December 31,</u>
	<u>(unaudited)</u>	<u>2006</u>
<b>ASSETS</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 1,316,698	\$ 2,743,155
Accounts receivable, net of allowance for doubtful accounts of approximately \$834,000 and \$694,000 in June 30, 2007 and December 31, 2006, respectively	5,852,841	6,743,753
Restricted cash	—	365,000
Prepaid expenses and other current assets	687,184	622,207
Assets held for sale	129,231	129,231
<b>Total current assets</b>	<b>7,985,954</b>	<b>10,603,346</b>
<b>Property and equipment, net</b>	<b>6,281,576</b>	<b>6,422,016</b>
<b>Other assets</b>		
Security deposits	72,867	141,868
Restricted cash	416,566	416,566
Goodwill	4,971,221	4,971,221
Intangible assets, net	4,895,427	4,913,360
Other assets	98,499	104,923
<b>Total other assets</b>	<b>10,454,580</b>	<b>10,547,938</b>
<b>TOTAL ASSETS</b>	<b>\$ 24,722,110</b>	<b>\$ 27,573,300</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Current liabilities</b>		
Long-term debt, current portion	\$ 150,000	\$ 150,000
Capital lease/equipment financing obligations, current portion	1,036,375	1,066,746
Accounts payable and accrued expenses	9,733,331	11,461,112
Investment in Estel	—	554,286
Liabilities of discontinued operations	15,819	95,085
<b>Total current liabilities</b>	<b>10,935,525</b>	<b>13,327,229</b>
<b>Long-term liabilities</b>	<b>734,790</b>	<b>800,113</b>
<b>Commitments and contingencies:</b>		
<b>Stockholders' Equity</b>		
Preferred stock, \$0.01 par value, 10,000,000 shares authorized, 7,995 and 3,875 shares issued and outstanding at June 30, 2007 and December 31, 2006, respectively	80	39
Common stock, \$0.01 par value, 105,000,000 shares authorized, 26,971,465 shares issued and 26,958,965 shares outstanding in June 30, 2007 and December 31, 2006, respectively	269,590	269,590
Common stock, Class A, \$0.01 par value, 21,000,000 shares authorized, 0 shares issued and outstanding in June 30, 2007 and December 31, 2006, respectively	—	—
Capital in excess of par value	118,729,981	114,514,725
Accumulated deficit	(105,947,856)	(101,338,396)
<b>Total stockholders' equity</b>	<b>13,051,795</b>	<b>13,445,958</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 24,722,110</b>	<b>\$ 27,573,300</b>

See accompanying condensed notes to consolidated financial statements.

**FUSION TELECOMMUNICATIONS INTERNATIONAL, INC.  
AND SUBSIDIARIES**

**Consolidated Statements of Operations**

	Three months ended		Six months ended	
	June 30,		June 30,	
	2007	2006	2007	2006
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
<b>Revenues</b>	\$ 13,744,209	\$ 10,543,112	\$ 26,950,163	\$ 20,065,270
<b>Operating expenses:</b>				
Cost of revenues, exclusive of depreciation and amortization shown separately below	12,751,750	9,382,411	24,837,521	17,987,714
Depreciation and amortization	418,635	247,302	810,817	477,842
Selling, general and administrative expenses (includes approximately \$144,000 and \$283,000 for the three months ended June 30, 2007 and June 30, 2006, respectively, and approximately \$316,000 and \$500,000 for the six months ended June 30, 2007 and June 30, 2006, respectively, of non-cash compensation)	3,269,297	3,960,763	6,696,666	7,614,724
Advertising and marketing	23,571	301,759	105,786	324,751
Total operating expenses	<u>16,463,253</u>	<u>13,892,235</u>	<u>32,450,790</u>	<u>26,405,031</u>
<b>Operating loss</b>	<u>(2,719,044)</u>	<u>(3,349,123)</u>	<u>(5,500,627)</u>	<u>(6,339,761)</u>
<b>Other income (expense)</b>				
Interest income	30,356	102,117	51,071	235,578
Interest expense	(27,830)	(29,514)	(50,979)	(59,514)
Gain on settlements of debt	—	465,854	—	465,854
Gain on sale from investment in Estel	937,578	—	937,578	—
Loss from investment in Estel	(15,000)	(33,080)	(60,000)	(70,638)
Other	13,501	48,758	13,497	38,311
Minority interests	—	2,235	—	8,527
Total other income (expense)	<u>938,605</u>	<u>556,370</u>	<u>891,167</u>	<u>618,118</u>
<b>Loss from continuing operations</b>	<u>(1,780,439)</u>	<u>(2,792,753)</u>	<u>(4,609,460)</u>	<u>(5,721,643)</u>
<b>Discontinued operations:</b>				
Loss from discontinued operations	—	(8,938)	—	(34,108)
<b>Net loss</b>	<u>\$ (1,780,439)</u>	<u>\$ (2,801,691)</u>	<u>\$ (4,609,460)</u>	<u>\$ (5,755,751)</u>
<b>Basic and diluted net loss per common share:</b>				
Loss from continuing operations	\$ (0.07)	\$ (0.10)	\$ (0.17)	\$ (0.22)
Loss from discontinued operations	—	—	—	—
Net loss per common share	<u>\$ (0.07)</u>	<u>\$ (0.10)</u>	<u>\$ (0.17)</u>	<u>\$ (0.22)</u>
<b>Weighted average shares outstanding</b>				
Basic and diluted	<u>26,958,965</u>	<u>26,894,211</u>	<u>26,958,965</u>	<u>26,546,842</u>

See accompanying condensed notes to consolidated financial statements.

**FUSION TELECOMMUNICATIONS INTERNATIONAL, INC.  
AND SUBSIDIARIES**

**Consolidated Statements of Cash Flows**

	<u>Six months ended June 30,</u>	
	<u>2007</u>	<u>2006</u>
	<u>(unaudited)</u>	<u>(unaudited)</u>
<b>Cash flows from operating activities:</b>		
Net loss	\$ (4,609,460)	\$ (5,755,751)
Adjustments to reconcile net loss to net cash used in operating activities:		
Gain from sale of assets	(9,759)	(40,683)
Loss on impairment discontinued operations	—	34,108
Depreciation and amortization	810,817	477,842
Bad debt expense, net	35,117	(68,250)
Non-cash compensation expense	315,742	499,665
Gain on forgiveness of debt	—	(465,854)
Gain on sale from investment in Estel	(937,578)	—
Loss from investment in Estel	60,000	70,638
Minority interests	—	(8,527)
Increase (decrease) in cash attributable to changes in operating assets and liabilities:		
Accounts receivable	715,796	(1,052,503)
Prepaid expenses and other current assets	(64,976)	(175,175)
Other assets	6,424	(26,703)
Accounts payable and accrued expenses	(1,740,567)	708,296
Liabilities of discontinued operations	(7,267)	(385,724)
Other long-term liabilities	(65,323)	—
<b>Net cash provided by (used in) operating activities</b>	<u>(5,491,034)</u>	<u>(6,188,621)</u>
<b>Cash flows from investing activities:</b>		
Purchase of property and equipment	(597,642)	(2,099,675)
Proceeds from sale of investments in Estel	484,985	—
Advances to Estel	(15,130)	(47,853)
Payments from Estel	20,563	67,102
Return of (payments for) security deposits	(3,000)	146,598
Repayments of (payments for) restricted cash	365,000	(238,390)
Payments of legal fees for intellectual property	—	(34,012)
Difference payment related to purchase of minority interest in Efonica joint venture	(171,852)	—
<b>Net cash used in investing activities</b>	<u>82,924</u>	<u>(2,206,230)</u>
<b>Cash flows from financing activities:</b>		
Proceeds from sale of Preferred Stock, Series A-2, A-3 and A-4, net	4,104,532	—
Proceeds from exercise of warrants	—	500
Payments of long-term debt and capital lease /equipment financing obligations	(122,879)	(484,150)
<b>Net cash provided by (used in) financing activities</b>	<u>3,981,653</u>	<u>(483,650)</u>
<b>Net decrease in cash and cash equivalents</b>	<u>(1,426,457)</u>	<u>(8,878,501)</u>
<b>Cash and cash equivalents, beginning of period</b>	<u>2,743,155</u>	<u>14,790,504</u>
<b>Cash and cash equivalents, end of period</b>	<u>\$ 1,316,698</u>	<u>\$ 5,912,003</u>

See accompanying condensed notes to consolidated financial statements.

**FUSION TELECOMMUNICATIONS INTERNATIONAL, INC.  
AND SUBSIDIARIES**

**Consolidated Statements of Cash Flows (continued)**

	<u>Six months ended June 30,</u>	
	<u>2007</u>	<u>2006</u>
	<u>(unaudited)</u>	<u>(unaudited)</u>
Supplemental disclosure of cash flow information:		
Cash paid during the period for interest	\$ 14,582	\$ 31,669
Supplemental disclosure of non-cash investing and financing activities:		
Acquisition of capital lease/equipment financing obligations	\$ 92,500	\$ 228,800
Acquisition of short term financing agreement	\$ —	\$ 492,964
Release of Efonica shares from escrow	\$ —	\$ 4,357,497
Issuance of restricted stock for consulting services	\$ —	\$ 66,250
Liability for acquisition of Intellectual Property Transfer Agreement	\$ —	\$ 120,000

**See accompanying condensed notes to consolidated financial statements.**

# FUSION TELECOMMUNICATIONS INTERNATIONAL, INC. AND SUBSIDIARIES

## CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### 1. Basis of Presentation

The accompanying condensed notes to consolidated financial statements should be read in conjunction with the Annual Report on Form 10-K for the fiscal year ended December 31, 2006 for Fusion Telecommunications International, Inc. and its Subsidiaries (the "Company"). These financial statements have been prepared in accordance with instructions to Form 10-Q and Article 10 of Regulation S-X and therefore, omit or condense certain footnotes and other information normally included in the financial statements prepared in accordance with accounting principles generally accepted in the United States. In the opinion of the Company's management, all adjustments (consisting of normal recurring accruals) considered necessary for fair financial statement presentation have been made. The results of operations for an interim period may not give true indication of the results for the year.

During the six months ended June 30, 2007 and 2006, comprehensive loss was equal to the net loss amounts presented for the respective periods in the accompanying Consolidated Statements of Operations.

#### *Earnings Per Share*

SFAS No. 128, "Earnings Per Share," requires dual presentation of basic and diluted income per share for all periods presented. Basic income per share excludes dilution and is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding during the period. Diluted income per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the income of the Company.

Unexercised stock options to purchase 3,849,371 and 2,852,033 shares of the Company's common stock as of June 30, 2007 and 2006, respectively, were not included in the computation of diluted earnings per share because the exercise of the stock options would be anti-dilutive to earnings per share.

Unexercised warrants to purchase 11,432,029 and 7,802,791 shares of the Company's common stock as of June 30, 2007 and 2006, respectively, were not included in the computation of diluted earnings per share because the exercise of the warrants would be anti-dilutive to earnings per share.

#### *Stock-Based Compensation*

The company accounts for stock-based compensation under the provisions of Statement of Financial Accounting Standard No. 123 (revised 2004), "Share-Based Payment" (SFAS No. 123R). The impact on the Company's results of operations of recording stock-based compensation expense for the three-months ended June 30, 2007 and 2006, was \$144,415 and \$245,639, respectively, and for the six months ended June 30, 2007 and 2006, was \$282,616 and \$449,871, respectively, which is included in selling, general and administrative expenses in the Consolidated Statements of Operations.

In May 2007, the Board of Directors voted to amend its 1998 Stock Option Plan ("Plan") to increase the number of shares of Common Stock available under the Plan from 4,000,000 to 7,000,000. On July 12, 2007, the shareholders approved the amendment to the Plan at the annual shareholders meeting.

FUSION TELECOMMUNICATIONS INTERNATIONAL, INC. AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation (continued)

The following table summarizes stock option activity for the six months ended June 30, 2007:

Activity	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Life	Aggregate Intrinsic Value
Outstanding at January 1, 2007	2,832,546	\$ 3.54		
Granted	1,141,851	0.69		
Cancelled or expired	(125,026)	2.87		
Outstanding at June 30, 2007	3,849,371	\$ 2.71	6.19	\$ -
Exercisable at June 30, 2007	1,997,938	\$ 3.94	4.44	\$ -

The Company calculated the fair value of each common stock option grant on the date of grant using the Black-Scholes option pricing model method with the following assumptions:

	Six Months Ended June 30,	
	2007	2006
Dividend yield	0.0%	0.0%
Stock volatility	81.7%	82%
Average Risk-free interest rate	4.52%	4.6%
Average option term	4	4

As of June 30, 2007 there was approximately \$791,000 of total unrecognized compensation cost, net of estimated forfeitures, related to stock options granted under our stock incentive plans, which is expected to be recognized over a weighted-average period of 2.26 years.

*Use of Estimates*

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the period. Actual results could differ from those estimates.

*Reclassifications*

Certain reclassifications have been made to the 2006 amounts to conform to the 2007 presentation.



## FUSION TELECOMMUNICATIONS INTERNATIONAL, INC. AND SUBSIDIARIES

### CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### 2. Going Concern

At June 30, 2007, the Company had a working capital deficit of approximately \$2,950,000 and an accumulated deficit of approximately \$105,948,000. The Company has continued to sustain losses from operations, and for the six months ended June 30, 2007 and 2006 has incurred net losses of approximately \$4,609,000 and \$5,756,000, respectively. In addition, the Company has not generated positive cash flow from operations since inception. Management is aware that its current cash resources are not adequate to fund its operations for the remainder of the year. During the six months ended June 30, 2007, the Company raised \$4.1 million from its second phase and over-allotment of the private placement. The Company's long-term liquidity is partially dependent on its ability to successfully complete the rollout of its full suite of retail VoIP paid services and effectively market its paid services, in order to attain profitable operations in the future. The Company cannot make any guarantees if and when it will be able to attain profitability. These conditions, among others, raise substantial doubt about the Company's ability to continue operations as a going concern. No adjustment has been made in the consolidated financial statements to the amounts and classification of assets and liabilities which could result, should the Company be unable to continue as a going concern.

#### 3. Acquisitions and Joint Ventures

##### *Efonica*

In December 2002, the Company acquired a 50.2% equity interest in a joint venture with Karamco, Inc. ("Karamco") to provide various VoIP services throughout the emerging markets. Operations of the joint venture began during 2003.

During February 2005, the Company closed on its agreement to acquire the remaining 49.8% minority interest in Efonica from Karamco. This acquisition was completed to better enable Efonica to serve as the retail VoIP services division of the Company, offering a full suite of VoIP solutions to customers in Asia, the Middle East, Africa, Latin America and the Caribbean. With 100% control, the Company can better leverage the significant experience and relationships of Efonica. The operating results for the 49.8% minority interest acquired are included in the Consolidated Statement of Operations from the date of acquisition.

Under its original terms, the purchase price ranged between a minimum of \$5.4 million and a maximum of \$14.3 million. At closing, Karamco received cash of \$500,000 and shares equal to the Base Purchase Price determined by the initial price of common stock at the date of the Company's IPO. The Base Purchase Price was equal to 49.8% of the initial estimated valuation of Karamco, or approximately \$9.8 million. At the date of the IPO, approximately 1.44 million of shares were issued under this agreement, of which Karamco received approximately 765,000 shares, and approximately 676,000 shares were held in escrow. During 2005, approval was given to release the shares then being held in escrow. Consequently, the value of these shares of approximately \$4.4 million was reflected as goodwill and as a long-term liability in the December 31, 2005 Consolidated Balance Sheet. In March 2006, under an amendment to the Efonica Purchase Agreement, the escrowed shares were released, subject to a lock-up period until February 15, 2007. The release of the 675,581 shares in escrow resulted in an increase to stockholders' equity of approximately \$4.4 million and a reduction to the recorded long-term liability.

Of the shares issued to Karamco, the Company agreed to register for resale 150,000 shares of common stock in a registration statement. Karamco was restricted from selling in excess of \$1 million worth of common stock during the one-year period following the Company's IPO Prospectus Date. If the sale of the 150,000 shares registered results in less than \$1 million of gross proceeds, the Company is required to pay Karamco the difference between the aggregate gross proceeds of Karamco's sale of the registered shares and \$1 million (the "Difference Payment"). Through December 31, 2006, the Company had paid Karamco \$430,000 towards the Difference Payment which is reflected as capital in excess of par value in the consolidated financial statements. The remainder of the Difference Payment was paid on May 9, 2007 in the amount of \$171,852.

On May 10, 2007, Mr. Roger Karam, CEO of Efonica FZ-LLC, wholly-owned subsidiary of the Company, and President of the Company's VoIP division, resigned from his position and entered into a consulting agreement with the Company. As a consultant, Mr. Karam will work with the Company's CEO to develop sales opportunities and business development opportunities. The consulting agreement is for a period of one year and will automatically renew on a three-month basis after the expiration of the initial term. The consulting agreement provides for an annual consulting fee of \$250,000 and a discretionary bonus of 25% of his consulting fee, based on the achievement of certain goals as set forth in the consulting agreement.

**Estel**

On May 15, 2007, the Company completed the sale of its 49% equity ownership of Estel Communications Pvt. Ltd. ("Estel") to Karuturi Networks Limited. Estel is organized under the laws of India, and has its offices in New Delhi, India. As consideration, the Company received approximately \$485,000 in proceeds from the transaction and recorded a gain on sale of approximately \$938,000 for the three months ended June 30, 2007.

**4. Prepaid expenses and other current assets**

Prepaid expenses and other current assets consist of the following at June 30, 2007 and December 31, 2006:

	<u>June 30, 2007</u> (unaudited)	<u>December 31,</u> <u>2006</u>
Prepaid expenses	\$ 487,778	\$ 440,028
Inventory	79,968	67,418
Notes receivables	48,212	47,313
Other	71,226	67,448
	<u>\$ 687,184</u>	<u>\$ 622,207</u>

**5. Accounts payable and accrued expenses**

Accounts payable and accrued expenses consist of the following at June 30, 2007 and December 31, 2006:

	<u>June 30, 2007</u> (unaudited)	<u>December 31,</u> <u>2006</u>
Trade accounts payable	\$ 6,534,300	\$ 8,778,068
Accrued expenses	832,454	725,287
Accrued Payroll and Vacation	225,852	255,792
Cost Accrual	1,183,291	732,403
Interest payable	435,164	398,768
Deferred revenue	199,175	239,511
Short-term financing agreement	164,653	172,863
Other	158,442	158,420
	<u>\$ 9,733,331</u>	<u>\$ 11,461,112</u>

**FUSION TELECOMMUNICATIONS INTERNATIONAL, INC. AND SUBSIDIARIES**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**6. Long-term debt and capital lease/equipment financing obligations**

At June 30, 2007 and December 31, 2006, components of long-term debt and capital lease/equipment financing obligations of the Company are comprised of the following:

	<b>June 30, 2007</b>	<b>December 31,</b>
	<b>(unaudited)</b>	<b>2006</b>
Promissory notes payable	\$ 150,000	\$ 150,000
Capital lease/equipment financing obligations	1,036,375	1,066,746
<b>Total long-term debt and capital lease/equipment obligations</b>	<b>1,186,375</b>	<b>1,216,746</b>
Less current portion	(1,186,375)	(1,216,746)
	<b>\$ —</b>	<b>\$ —</b>

***Promissory note payable***

During February 2004, the Company entered into a settlement agreement with a vendor for \$600,000. In the same month, the Company paid \$450,000 and agreed to make 12 monthly payments for the remaining \$150,000. The promissory note has not been repaid as of June 30, 2007, as the other party to the settlement agreement has not complied with the terms of the agreement.

***Capital lease/equipment financing obligations***

On March 6, 2007, the Company entered into an agreement to purchase certain hardware, software and software support for approximately \$251,000. The Company paid approximately \$158,000 in cash and financed the remaining balance. The interest rate is 10% and payments are due on a monthly basis over a 10-month period.

At June 30, 2007 and December 31, 2006, approximately \$720,000 of the capital lease obligations were in default and accordingly have been classified as currently due. See Legal Matters section of Note 10 below for further discussion.

Future aggregate principal payments as of for the Company's debt and capital lease/equipment financing obligations as of June 30, 2007 are as follows:

Total minimum payments due during the period ended June 30, 2007	\$ 1,624,716
Less amount representing interest	(438,341)
<b>Present value of minimum payments</b>	<b>1,186,375</b>
Less current portion	(1,186,375)
	<b>\$ —</b>

**7. Preferred Stock**

As of December 31, 2006, the Company had authorized 10,000,000 shares of its Preferred Stock. The Company had designated 1,100,000, 1,500,000 and 110,000 shares of \$10 Series A Convertible Redeemable Preferred Stock ("Series A Preferred Stock"), \$10 Series B Convertible Redeemable Preferred Stock ("Series B Preferred Stock") and \$90 Series C Convertible Redeemable Preferred Stock ("Series C Preferred Stock"), respectively. As of June 30, 2007, there were 0 shares issued and outstanding for both Series A Preferred Stock and Series B Preferred Stock.

In addition, during December 2006, the Company designated 10,000 shares of Cumulative Convertible Preferred Stock at \$1,000 per share to be sold via private placement for the purpose of raising working capital for the Company's operations. If the Company exceeded 7,000 shares, it could exercise an over-allotment option and sell the remaining 3,000 shares.

In December 2006, the Company completed the first phase of the private placement, and issued a total of 3,875 shares of Preferred Stock designated Series A-1 Preferred Stock, for which approximately \$3.8 million was received net of expenses of approximately \$67,000, and is being used for working capital. In addition, the Company issued warrants to purchase 1,160,204 shares of common stock exercisable at \$1.67 per share. The terms of the Series A-1 Preferred Stock will pay dividends at 8% and are convertible into the Company's common stock at a fixed conversion price of \$1.67 per share, which represent a 20% premium over the average price of the common stock for the three trading days prior to the closing date of the transaction. Investors will also receive warrants equal to 50% of the shares to be issued upon conversion. The warrants will have a fixed exercise price of \$1.67.

On May 9, 2007, the Company completed the second phase of the private placement, and issued a total of 3,375 shares of Preferred Stock designated Series A-2 Preferred Stock, for which approximately \$3.375 million was received net of expenses of approximately \$15,000, and is being used for working capital. In addition, the Company issued warrants to purchase 2,033,151 shares of common stock exercisable at \$0.83 per share. The terms of the Series A-1 Preferred Stock will pay dividends at 8% and are convertible into the Company's common stock at a fixed conversion price of \$0.83 per share, which represent a 20% premium over the average price of the common stock for the three trading days prior to the closing date of the transaction. Investors will also receive warrants equal to 50% of the shares to be issued upon conversion. The warrants will have a fixed exercise price of \$0.83.

In addition, the Company exercised its option to sell the remaining shares, upon the same terms and conditions as set forth in the Private Placement Subscription Agreement, and accordingly, extended the Offering Period up to and including June 8, 2007.

On May 9, 2007, the Company also completed the first round of the over-allotment portion of the private placement financing. The Company issued 700 shares of Preferred Stock, Series A-3 for which \$.7 million was received, and is being used for working capital. In addition, the Company issued warrants to purchase 421,687 shares of common stock exercisable at \$0.83 per share. The Series A-3 Preferred Stock will pay dividends at 8% per annum and will be convertible into the Company's common stock at a fixed price of \$0.83 per share, which represent a 20% premium over the average price of the common stock for the three trading days prior to the closing date of the transaction. Investors will also receive warrants equal to 50% of the shares to be issued upon conversion. The warrants will have a fixed exercise price of \$0.83.

On June 8, 2007, the Company completed the second and final round of the over-allotment portion of the private placement financing. The Company issued 45 shares of Preferred Stock, Series A-4 for which \$.045 million was received, and is being used for working capital. In addition, the Company issued warrants to purchase 28,482 shares of common stock exercisable at \$0.79 per share. The Series A-4 Preferred Stock will pay dividends at 8% per annum and will be convertible into the Company's common stock at a fixed price of \$0.83 per share, which represent a 20% premium over the average price of the common stock for the three trading days prior to the closing date of the transaction. Investors will also receive warrants equal to 50% of the shares to be issued upon conversion. The warrants will have a fixed exercise price of \$0.79.

## **Dividends**

The holders of the Series A-1, A-2, A-3 and A-4 Preferred Stock are entitled to receive cumulative dividends of 8% per annum payable in arrears, when as declared by the Company's Board of Directors, on January 1 of each year, commencing on January 1, 2008.

## **8. Equity Transactions**

On March 28, 2006, the Company entered into a consulting service agreement. In connection with the agreement, the Company issued 50,000 shares of restricted common stock. Of these shares, 25,000 shares were given to the consultant upon the signing of the agreement. The other 25,000 shares were held in escrow until the sixth (6<sup>th</sup>) month anniversary at which time 12,500 shares were released. The remaining 12,500 shares were released on August 1, 2007. In addition, the remaining expense balance of \$33,125 was amortized during the six months ended June 30, 2007.

## **9. New Accounting Pronouncements**

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement No. 115" ("SFAS 159"). This Statement allows all entities a one-time election to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value (the "fair value option"). SFAS 159 is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact of SFAS 159 on its consolidated results of operations and financial condition.

Effective January 1, 2007, the Company adopted the provisions of the Financial Accounting Standards Board ("FASB") Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109" ("FIN 48"). There were no unrecognized tax benefits as of January 1, 2007 and as of June 30, 2007. FIN 48 prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. For those benefits to be recognized, a tax position must be more-likely-than-not to be sustained upon examination by taxing authorities. The Company recognizes accrued interest and penalties related to unrecognized tax benefits as income tax expense. No amounts were accrued for the payment of interest and penalties at January 1, 2007. There was no change to this balance at June 30, 2007. Management is currently unaware of any issues under review that could result in significant payments, accruals or material deviations from its position. The adoption of the provisions of FIN 48 did not have a material impact on the Company's financial position, results of operations and cash flows.

## FUSION TELECOMMUNICATIONS INTERNATIONAL, INC. AND SUBSIDIARIES

### CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### 10. Commitments and Contingencies

##### *Legal Matters*

On May 28, 2003, Jack Grynberg, et al., an investor in one of the Company's private offerings, filed a complaint with the Denver District Court, State of Colorado (*Jack Grynberg, et al v. Fusion Telecommunications International, Inc., et al*, 03-CV-3912) seeking damages in the amount of \$400,000 for the purchase of an interest in Fusion's 1999 private placement offering of subordinated convertible notes through Joseph Stevens & Company, Inc., a registered broker dealer. This complaint asserted the following claims for relief against the Company: Breach of Fiduciary Duty, Civil Theft, Deceptive Trade Practices, Negligent Misrepresentation, Deceit Based on Fraud, Conversion, Exemplary Damages and Prejudgment Interest. On June 25, 2004, the Company filed with the Court a Motion to Dismiss, which was granted. The Company was awarded attorneys' fees by the court. A written order of Judgment in favor of the Company and against the plaintiffs in the amount of approximately \$40,000 was recorded on January 24, 2006. The plaintiffs filed an appeal of the motion, which the courts dismissed and awarded the Company attorney fees.

On March 30, 2006, a financing company affiliated with an equipment vendor filed a complaint with the Circuit Court in Broward County, State of Florida seeking damages in the amount of approximately \$1,380,000 allegedly due on two promissory notes plus accrued interest through March 1, 2006 and attorney's fees and costs. The Company asserted a counterclaim against the vendor which was settled subsequent to the year ended 2006, resulting in the amendment of an existing contract with the vendor. The Company's legal counsel has advised that, at this stage, they cannot accurately predict the likelihood of an unfavorable outcome or quantify the amount or range of potential loss, if any. Accordingly, with the exception of amounts previously accrued by the Company under the capital lease arrangement, no adjustment that may result from resolution of these uncertainties has been made in the accompanying financial statements.

On or about February 9, 2007, the Company filed a complaint against Patrick S. Dallas, InfoTel Holdings, Ltd., Phil Walton and John Does 1-5 in the Supreme Court of the State of New York (*Fusion Telecommunications International, Inc. vs. Patrick S. Dallas, et al.*, Index No. 2007001836) seeking damages associated with Mr. Dallas' sale of Convergent Technologies Ltd. Stock to us and InfoTel's breach of its October 2006 agreement to purchase Fusion Jamaica Limited's equipment in Jamaica and assume the real property lease in Jamaica. The Company believes Mr. Dallas owns or controls InfoTel. This complaint asserted the following claims for relief: Breach of Contract (the Stock Purchase Agreement); Breach of Mr. Dallas' Employment Agreement; Breach of Mr. Dallas' Non-Solicitation and Non-Compete Agreement; Breach of Contract (the InfoTel Agreement); Diversion and Waste of Corporate Assets; Conversion: Scheme to Defraud and Deceive and Demand for Accounting; Fraudulent Misconduct with Intent to Defraud (the Stock Purchase Agreement); Fraudulent Misconduct with Intent to Defraud (the InfoTel Agreement); Indemnification (the Stock Purchase Agreement); and Indemnification (the InfoTel Agreement). The Company's legal counsel has advised that, at this state, they cannot accurately predict the likelihood of an unfavorable outcome, or quantify the amount or range of damages the Company would be entitled to receive if the Company was to prevail.

The Company is currently undergoing an audit by New York State for franchise and excise taxes, and unemployment taxes, which have not yet been concluded and may result in an indeterminate amount of tax liability.

Due to the regulatory nature of the industry, the Company is periodically involved in various correspondence and inquiries from state and federal regulatory agencies. Management does not expect the outcome of these inquiries to have a material impact on the Company's operations or financial condition.

***Restricted Cash***

As of June 30, 2007 and December 31, 2006, the Company had approximately \$417,000 and \$782,000, respectively, of cash restricted from withdrawal and held by banks as certificates of deposit securing letters of credit. This restricted cash is required as security deposits for certain of the Company's non-cancelable operating leases for office facilities and to secure a license to do business in Turkey. The letter of credit related to the Turkey business license, which amounted to \$325,000 was cancelled in January 2007 and the full amount was returned in February 2007.

## FUSION TELECOMMUNICATIONS INTERNATIONAL, INC. AND SUBSIDIARIES

### CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### 11. Segment Information

The Company adopted SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information". SFAS No. 131 requires disclosures of segment information on the basis that is used internally for evaluating segment performance and deciding how to allocate resources to segments.

The Company has two reportable segments that it operates and manages which are organized by products and services. The Company measures and evaluates its reportable segments based on revenues and cost of revenues. This segment income excludes unallocated corporate expenses and other adjustments arising during each period. The other adjustments include transactions that the Chief Operating Decision Makers exclude in assessing business unit performance due primarily to their non-operational and/or non-recurring nature. Although such transactions are excluded from the business segment results, they are included in reported consolidated earnings. Each segment is managed according to the products, which are provided to the respective customers, and information is reported on the basis of reporting to the Company's Chief Operating Decision Maker. In previous years, the Company had three reportable segments with Consumers, Corporations and Other broken out into two separate segments. Since the Company's Chief Operating Decision Maker currently reviews these segments as one, the segment disclosures for the three and six months ended June 30, 2006 have been presented in a manner consistent with the three and six months ended June 30, 2007.

The Company's segments and their principal activities consist of the following:

***Voice to Carriers*** - Voice to Carriers includes VoIP to carriers, which is the termination of voice telephony minutes by the Internet rather than older circuit-switched technology. VoIP permits a less costly and more rapid interconnection between our network and international telecommunications carriers. This segment also includes Traditional Voice (the termination of voice telephony minutes from or to the countries we serve, utilizing traditional Time Division Multiplexing (TDM) or "circuit-switched" technology. Typically, this will include interconnection with traditional telecommunications carriers either located internationally or those carriers that interconnect with us at their U.S. Points of Presence (POP) and provide service to other destinations. These minutes are sold to carriers on a wholesale basis.

***Consumers, Corporations and Other*** - We provide VoIP services targeted to consumers and corporations. We offer services that permit our customers to originate calls via IP telephones or telephone systems and use the Internet to complete those calls to standard telephone lines anywhere in the world. We also provide PC-to-Phone services that allow consumers to use their personal computers to place calls to the telephone of the called party. For corporate customers, we offer fully hosted IP-PBX services, as well as IP trunking solutions and Internet access. In addition, we selectively offer point-to-point private lines, virtual private networking, and call center services to certain customers within our target markets.

The Company employs engineering and operations resources that service across multiple product lines. Depreciation and indirect operating expenses were allocated to each product line based upon their respective percent utilization of those resources. The amounts reflected as Corporate and unallocated represent those expenses that were not appropriate to allocate to each product line.



**FUSION TELECOMMUNICATIONS INTERNATIONAL, INC. AND SUBSIDIARIES**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**11. Segment Information - (continued)**

Operating segment information for the three months ended June 30, 2007 and 2006 is summarized as follows:

**Three months ended June 30, 2007**

	<b>Voice to Carriers</b>	<b>Consumers, Corporations and Other</b>	<b>Corporate &amp; Unallocated</b>	<b>Consolidated</b>
Net revenues	\$ 13,342,954	\$ 401,255	\$ —	\$ 13,744,209
Cost of revenues (exclusive of depreciation and amortization)	\$ (12,415,774)	\$ (335,976)	\$ —	\$ (12,751,750)
Depreciation and amortization	\$ (342,380)	\$ (75,846)	\$ (409)	\$ (418,635)
Selling, general and administrative	\$ (2,084,314)	\$ (1,141,151)	\$ (43,832)	\$ (3,269,297)
Advertising and marketing	\$ (13,987)	\$ (9,584)	\$ —	\$ (23,571)
Total Other income (expense)	\$ 931,449	\$ 7,156	\$ —	\$ 938,605
Net income (loss) from continuing operations	\$ (582,052)	\$ (1,154,146)	\$ (44,241)	\$ (1,780,439)
Income (Loss) from discontinued operations	\$ —	\$ —	\$ —	\$ —
Net Income (Loss)	\$ (582,052)	\$ (1,154,146)	\$ (44,241)	\$ (1,780,439)
Capital Expenditures	\$ 139,282	\$ 172,815	\$ —	\$ 312,097

**Three months ended June 30, 2006**

	<b>Voice to Carriers</b>	<b>Consumers, Corporations and Other</b>	<b>Corporate &amp; Unallocated</b>	<b>Consolidated</b>
Net revenues	\$ 9,574,317	\$ 968,795	\$ —	\$ 10,543,112
Cost of revenues (exclusive of depreciation and amortization)	\$ (8,755,496)	\$ (626,915)	\$ —	\$ (9,382,411)
Depreciation and amortization	\$ (234,246)	\$ (13,056)	\$ —	\$ (247,302)
Selling, general and administrative	\$ (2,234,023)	\$ (1,577,240)	\$ (149,500)	\$ (3,960,763)
Advertising and marketing	\$ (24,769)	\$ (276,990)	\$ —	\$ (301,759)
Total Other income (expense)	\$ 321,687	\$ 234,683	\$ —	\$ 556,370
Net income (loss) from continuing operations	\$ (1,352,530)	\$ (1,290,723)	\$ (149,500)	\$ (2,792,753)
Income (Loss) from discontinued operations	\$ —	\$ (8,938)	\$ —	\$ (8,938)
Net Income (Loss)	\$ (1,352,530)	\$ (1,299,661)	\$ (149,500)	\$ (2,801,691)
Capital Expenditures	\$ 70,301	\$ 839,565	\$ 861,900	\$ 1,771,766

Operating segment information for the six months ended June 30, 2007 and 2006 is summarized as follows:

**Six months ended June 30, 2007**

	<b><u>Voice to Carriers</u></b>	<b><u>Consumers, Corporations and Other</u></b>	<b><u>Corporate &amp;Unallocated</u></b>	<b><u>Consolidated</u></b>
Net revenues	\$ 26,101,633	\$ 848,530	\$ —	\$ 26,950,163
Cost of revenues (exclusive of depreciation and amortization)	\$ (24,192,914)	\$ (644,607)	\$ —	\$ (24,837,521)
Depreciation and amortization	\$ (656,244)	\$ (154,164)	\$ (409)	\$ (810,817)
Selling, general and administrative	\$ (4,182,587)	\$ (2,465,751)	\$ (48,328)	\$ (6,696,666)
Advertising and marketing	\$ (29,913)	\$ (75,873)	\$ —	\$ (105,786)
Total Other income (expense)	\$ 884,989	\$ 6,178	\$ —	\$ 891,167
Net income (loss) from continuing operations	\$ (2,075,036)	\$ (2,485,687)	\$ (48,737)	\$ (4,609,460)
Income (Loss) from discontinued operations	\$ —	\$ —	\$ —	\$ —
Net Income (Loss)	\$ (2,075,036)	\$ (2,485,687)	\$ (48,737)	\$ (4,609,460)
Capital Expenditures	\$ 356,780	\$ 240,862	\$ —	\$ 597,642

**Six months ended June 30, 2006**

	<b><u>Voice to Carriers</u></b>	<b><u>Consumers, Corporations and Other</u></b>	<b><u>Corporate &amp; Unallocated</u></b>	<b><u>Consolidated</u></b>
Net revenues	\$ 17,908,889	\$ 2,156,381	\$ —	\$ 20,065,270
Cost of revenues (exclusive of depreciation and amortization)	\$ (16,540,772)	\$ (1,446,942)	\$ —	\$ (17,987,714)
Depreciation and amortization	\$ (449,180)	\$ (28,662)	\$ —	\$ (477,842)
Selling, general and administrative	\$ (4,369,036)	\$ (2,927,945)	\$ (317,743)	\$ (7,614,724)
Advertising and marketing	\$ (36,020)	\$ (288,731)	\$ —	\$ (324,751)
Total Other income (expense)	\$ 346,499	\$ 271,619	\$ —	\$ 618,118
Net income (loss) from continuing operations	\$ (3,139,620)	\$ (2,264,280)	\$ (317,743)	\$ (5,721,643)
Income (Loss) from discontinued operations	\$ —	\$ (34,108)	\$ —	\$ (34,108)
Net Income (Loss)	\$ (3,139,620)	\$ (2,298,388)	\$ (317,743)	\$ (5,755,751)
Capital Expenditures	\$ 140,602	\$ 984,088	\$ 974,985	\$ 2,099,675
Assets				
June 30, 2007	\$ 10,694,624	\$ 12,712,870	\$ 1,314,616	\$ 24,722,110
December 31, 2006	\$ 11,664,585	\$ 13,129,701	\$ 2,779,014	\$ 27,573,300

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

The following discussion of our financial condition and results of operations should be read together with our consolidated financial statements and the related notes thereto included in another part of this Quarterly Report on Form 10-Q. This discussion contains certain forward-looking statements; within the meaning of the Private Securities Litigation Reform Act of 1995, that involve substantial risks and uncertainties. When used in this report the words "anticipate," "believe," "estimate," "expect" and similar expressions as they relate to our management or us are intended to identify such forward-looking statements. Our actual results, performance or achievements could differ materially from those expressed in, or implied by, these forward-looking statements. Historical operating results are not necessarily indicative of the trends in operating results for any future period.

We are an international communications carrier delivering VoIP to, from, in and between emerging markets in Asia, the Middle East, Africa, Latin America, and the Caribbean. We also offer on a limited basis, private networks, Internet access, and other advanced services. Our corporate strategy focuses our resources on customizing VoIP services to meet the demands of international communities of interest in the emerging markets and around the world. We seek to gain early entry in high growth emerging markets, often in partnership with local organizations that have strong distribution channels, regulatory experience, market intelligence, the ability to deliver local loops and the capability of providing customer service support. This approach enables us to introduce our Internet protocol communications services in these markets, thereby benefiting from the time-to-market advantages, expanded geographic reach and reduced capital requirements that local partnerships afford. Additionally, we have built a carrier grade retail infrastructure to expand our VoIP service and feature options and to better support the growth of our VoIP services to consumers and corporations.

The following table summarizes our results of operations for the periods indicated:

	<u>Three Months Ended June 30,</u>		<u>Six Months Ended June 30,</u>	
	<u>2007</u>	<u>2006</u>	<u>2007</u>	<u>2006</u>
Revenues	\$ 13,744,209	\$ 10,543,112	\$ 26,950,163	\$ 20,065,270
Operating expenses:				
Cost of revenues	12,751,750	9,382,411	24,837,521	17,987,714
Depreciation and amortization	418,635	247,302	810,817	477,842
Selling, general and administrative	3,269,297	3,960,763	6,696,666	7,614,724
Advertising and marketing	23,571	301,759	105,786	324,751
Total operating expenses	<u>16,463,253</u>	<u>13,892,235</u>	<u>32,450,790</u>	<u>26,405,031</u>
Operating Loss	(2,719,044)	(3,349,123)	(5,500,627)	(6,339,761)
Other income (expense):				
Interest income	30,356	102,117	51,071	235,578
Interest expense	(27,830)	(29,514)	(50,979)	(59,514)
Gain on settlement of debt	—	465,854	—	465,854
Gain on sale of investment in Estel	937,578	—	937,578	—
Loss from investment in Estel	(15,000)	(33,080)	(60,000)	(70,638)
Other	13,501	48,758	13,497	38,311
Minority interests	—	2,235	—	8,527
Total other income (expense)	938,605	556,370	891,167	618,118
Loss from continuing operations	(1,780,439)	(2,792,753)	(4,609,460)	(5,721,643)
Income from discontinued operations	—	(8,938)	—	(34,108)
Net loss	<u>\$ (1,780,439)</u>	<u>\$ (2,801,691)</u>	<u>\$ (4,609,460)</u>	<u>\$ (5,755,751)</u>

The following table presents our historical operating results as a percentage of revenues for the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Revenues	100%	100%	100%	100%
Operating expenses:				
Cost of revenues	92.8%	89.0%	92.2%	89.7%
Depreciation and amortization	3.0%	2.3%	3.0%	2.4%
Selling, general and administrative	23.8%	37.6%	24.8%	37.9%
Advertising and marketing	0.2%	2.9%	0.4%	1.6%
Total operating expenses	119.8%	131.8%	120.4%	131.6%
Operating loss	(19.8%)	(31.8%)	(20.4%)	(31.6%)
Other income (expense)				
Interest income	0.2%	1.0%	0.2%	1.2%
Interest expense	(0.2%)	(0.3%)	(0.2%)	(0.3%)
Gain on settlement of debt	0.0%	4.4%	0.0%	2.3%
Gain on sale of investment in Estel	6.8%	0.0%	3.5%	0.0%
Loss from investment in Estel	(0.1%)	(0.3%)	(0.2%)	(0.3%)
Other	0.1%	0.5%	0.0%	0.2%
Minority interests	0.0%	0.0%	0.0%	0.0%
Total other income (expense)	6.8%	5.3%	3.3%	3.1%
Loss from continuing operations	(13.0%)	(26.5%)	(17.1%)	(28.5%)
Income from discontinued operations	0.0%	(0.1%)	0.0%	(0.2%)
Net loss	(13.0%)	(26.6%)	(17.1%)	(28.7%)

## Revenues

Historically, we have generated the majority of our revenues from voice traffic sold to other carriers, with a primary focus in the last several years on VoIP terminations to the emerging markets. We focus on growing our existing customer base, which is primarily U.S based, as well as the addition of new customers, and the establishment of direct VoIP terminating arrangements with telecommunication carriers in emerging markets and around the world. Although we believe that this business continues to be of value to our strategy, ongoing competitive and pricing pressures have caused us to increase our focus on higher margin, value-added services (primarily VoIP to consumers and corporations), and market them to, or in conjunction with, distribution partners on a direct, co-branded or private label basis.

In an effort to further increase margins, expand our retail customer base, and develop more stable revenue streams, we have begun to focus significant effort and resources to build our VoIP business to consumers and corporations. While this does not yet represent a significant portion of our revenue base, we expect to continue to increase our emphasis in this area. We believe that this will complement our carrier business with a higher margin and more stable customer base.

In 2002, we established Efonica F-Z, LLC, as a retail services company marketing VoIP products to consumer and corporate customers in emerging markets. Beginning in the Middle East, Asia and Africa, then extending into Latin America, Efonica's services are primarily sold through distribution channels on a pre-paid basis. Efonica's customers can place calls from anywhere in the world to any destination using a personal computer, Internet protocol telephone or regular telephone when accompanied by a hardware device that may be purchased through Efonica. We believe that the introduction of advanced features such as voicemail, call waiting and call forwarding will enhance this value-added offering. In February 2005, we closed on the purchase of the 49.8% minority interest in Efonica.

We manage our revenues by product and customer. We manage our costs by provider (vendor). We track total revenue at the customer level because our sales force has to manage the revenue generation at the customer level, and invoices are billed to and collected at the customer level. We also have to track the same revenues by product, because different products have different billing and payment terms, and individual customers may have multiple billing and payment terms if they purchase multiple products from us.

We manage our revenue segments based on gross margin, which is net revenues less cost of revenues, rather than on net profitability, due to the fact that our infrastructure is built to support all products, rather than individual products. This applies both to the capital investments made (such as switching and transmission equipment), and to Selling, General and Administrative resources. The majority of our sales and operations personnel support all product lines within their market segment, i.e. carrier, and are not separately hired to support individual product segments. For segment reporting purposes, all expenses below cost of revenues are allocated based on percentage of utilization of resources unless the items can be specifically identified to one of the product segments.

## **Operating Expenses**

Our operating expenses are categorized as cost of revenues, depreciation and amortization, and selling, general and administrative expenses.

Cost of revenues includes costs incurred with the operation of our leased network facilities, and the purchase of voice termination and Internet protocol services from other telecommunications carriers and Internet service providers. We continue to work to lower the variable component of the cost of revenue through the use of least cost routing, and continual negotiation of usage-based and fixed costs with domestic and international service providers.

Depreciation and amortization includes depreciation of our communications network equipment, amortization of leasehold improvements of our switch locations and administrative facilities, and the depreciation of our office equipment and fixtures. It also includes amortization of the Efonica customer list.

Selling, general and administrative expenses primarily include salaries and benefits, insurance, occupancy costs, marketing and advertising, professional fees and other administrative expenses.

Advertising and marketing expense includes cost for promotional materials for the marketing of our retail products and services, as well as for public relations.

## Company Highlights

The following summary of significant events during the six months ended June 30, 2007 and 2006, highlight the accomplishments and events that have influenced our performance during the respective periods.

### *Six Months Ended June 30, 2007*

- *Efonica VoIP products at CeBIT* - Showcasing Efonica VoIP services, including retail and corporate focused VoIP solution to CeBIT (the world's largest trade fair showcasing digital IT and telecommunications solutions for home and work environments);
- *Efonica subscribers exceed 1,000,000* - Since launching our new Efonica VoIP service on June 19, 2006, we have registered more than one million subscribers;
- *Consummation of Private Placement* - In May 2007, the Company entered into subscription agreements with 28 individual investors for an offering of \$3.375 million in consideration for 3,375 shares of Series A-2 Cumulative Convertible Preferred Stock, (the "Series A-2 Preferred Stock");
- *Strategic Investment* - A global communications service provider, DigitalFX International, Inc. has made a \$700,000 strategic investment in the Company;
- *Sale of its Equity Interest in Indian Joint Venture* - The Company completed the sale of its 49% equity share of Estel Communications Pvt., LTD, an Internet service provider in India;
- *Interview with strategic investor*- DigitalFX International, Inc.'s President Amy Black and President and CEO Matthew Rosen of Fusion interviewed in a live web cast on MN1, the world's premier web-based business news outlet to discuss their agreement and other current events;
- *VoIP World Conference in Dubai*- On June 18<sup>th</sup> 2007, CEO, Mathew Rosen, delivered a keynote address to VoIP World Middle East 2007 conference in Dubai, UAE;

### *Six Months Ended June 30, 2006*

- *Acquired Proprietary Technology* - Acquired Proprietary Directed SIP Peer-to-Peer Technology That Avoids Routing Internet Phone Calls Through Network Of Users' Computers;
- *New Partnership* - Announced Partnership With AnchorFree To Market VoIP Services To Users Of Large WI-FI Network;
- *Licensed Market-Leading Technology* - Licensed Global IP Sound's Market-Leading Technology to Power its VoIP Softphone;
- *Filed Patent Application* - Filed Patent Application for our Proprietary VoIP Technology for S I P Peer-To-Peer VoIP Communication;
- *Completion of Softphone Development* - Completed Development of Our Proprietary PC-based VoIP Softphone, Which Allows Us to Differentiate Our Efonica® VoIP Offering;

- *Launched Free Internet Service* - Launched New Free Internet Phone Service, Which Allows Efonica® Subscribers Worldwide to Make Free Calls Without Computers. We Also Created the Internet Area Code™ which allows subscribers to use their existing telephone numbers preceded by a “10”;
- *Worldwide Internet Area Code Patent* - Filed Patent Application For Worldwide Internet Area Code™; and
- *Introduction of EFO Out* - Introduced One of Our New Paid Services, EFO Out, Which Allows Users to Call Any Landline or Mobile Telephone Number In The World At Extremely Competitive Prices.

The information in our period-to-period comparisons below represents only our results from continuing operations.

### **Three Months Ended June 30, 2007 Compared with Three Months Ended June 30, 2006.**

#### ***Revenues***

Consolidated revenues were \$13.7 million during the three months ended June 30, 2007, compared to \$10.5 million during the three months ended June 30, 2006, an increase of \$3.2 million or 30.4%.

Revenues for Voice to Carriers increased \$3.8 million or 39.4%, to \$13.4 million during the three months ended June 30, 2007 from \$9.6 million during the three months ended June 30, 2006. The increase revenues were the result of an increase in voice traffic as well as an increase in rates compared to the three months ended June 30, 2006. We expect the revenue from our Voice to Carriers segment to continue to increase in future quarters.

Revenues for Consumers, Corporations and Other decreased \$0.6 million or 58.6% to \$0.4 million during the three months ended June 30, 2007, from \$1 million during the three months ended June 30, 2006. This decrease was mainly due to technical difficulties encountered in the development of our Efonica retail services platform, which held back the growth in this service and due to the cancellation during late 2006 of a government contract and the loss of a high speed internet access arrangement for a foreign carrier. We have largely resolved the technical issues and expect this segment’s revenues to grow significantly during the next few years.

#### ***Cost of Revenues***

Consolidated cost of revenues increased \$3.4 million or 35.9% to \$12.8 million during the three months ended June 30, 2007 from \$9.4 million during the three months ended June 30, 2006. Approximately \$3.7 million of this increase or 41.8% was attributable to an increase in Voice to Carriers. This increase was partially offset by a decrease in the cost of revenues for Consumers, Corporations and Other by \$0.3 million or 46.4%, which went to \$0.3 million during the three months ended June 30, 2007 from \$0.6 million during the three months ended June 30, 2006, consistent with the revenue decrease.

The consolidated gross margin percentage decreased to 7.2% during the three months ended June 30, 2007 from 11% during the three months ended June 30, 2006. This decrease relates primarily to the Consumers, Corporation and Other due to difficulties encountered in the development of our Efonica retail service platform, cancellation of a government contract and the loss of a high speed internet access arrangement for a foreign carrier.

## Operating Expenses

**Depreciation and Amortization.** Depreciation and amortization increased by \$0.2 million or 69.3% to \$0.4 million during the three months ended June 30, 2007, from \$0.2 million during the three months ended June 30, 2006. Our depreciation expense increased as more assets were acquired to support the retail platform during the three months ended June 30, 2006.

**Selling, General and Administrative.** Selling, general and administrative expenses decreased \$0.7 million or 17.5% to \$3.3 million during the three months ended June 30, 2007, from \$4 million during the three months ended June 30, 2006. This decrease is primarily attributed to decreased salaries, benefits and other personnel related expenses as a result of the Company's increased focus on cost containment.

**Advertising and Marketing.** Advertising and marketing expenses decreased \$278,000 or 92.2% to \$24,000 during the three months ended June 30, 2007, from \$302,000 during the three months ended June 30, 2006. The decrease is a result of a more aggressive marketing campaign during the three months ended June 30, 2006.

**Operating Loss.** Our operating loss decreased \$0.6 million or 18.8% to a loss of \$2.7 million during the three months ended June 30, 2007, from a loss of \$3.3 million during the three months ended June 30, 2006. The decrease in operating loss was primarily attributable to the increased revenues and reduced selling, general and administrative expenses.

**Other Income (Expense).** Total other income (expense) changed from other income of approximately \$0.6 million during the three months ended June 30, 2006 to other income of \$0.9 million during the three months ended June 30, 2007. During the three months ended June 30, 2006, the Company recognized a gain on settlement of debt of approximately \$0.5 million and during the three months ended June 30, 2007, the Company recognized a gain on sale from investment in Estel of approximately \$0.9 million.

**Net Loss.** Net loss decreased \$1 million, or 36.5% for the three months ended June 30, 2007, compared to the three months ended June 30, 2006. The primary factors contributing to the improvement were the increase in revenue, a decrease in selling and general and administrative and gain on sale from investment in Estel, mentioned above.

## Six Months Ended June 30, 2007, Compared with Six Months Ended June 30, 2006.

### Revenues

Consolidated revenues were \$27 million during the six months ended June 30, 2007, compared to \$20.1 million during the six months ended June 30, 2006, an increase of \$6.9 million or 34.3%.

Revenues for Voice to Carriers increased \$8.2 million or 45.7%, to \$26.1 million during the six months ended June 30, 2007 from \$17.9 million during the six months ended June 30, 2006. The increase revenues were the result of an increase in voice traffic as well as an increase in rates compared to the same period of 2006. We expect the revenue from our Voice to Carriers segment to continue to increase in future quarters.

Revenues for Consumers, Corporations and Other decreased \$1.3 million or 60.7% to \$0.9 million during the six months ended June 30, 2007, from \$2.2 million during the six months ended June 30, 2006. This decrease was mainly due to technical difficulties encountered in the development of our Efonica retail services platform, which held back the growth in this service and also due to the cancellation of a government contract and the loss of a high speed internet access arrangement for a foreign carrier. We have largely resolved the technical issues and expect this segment's revenues to grow significantly during the next few years.



## **Cost of Revenues**

Consolidated cost of revenues increased \$6.8 million or 38.1% to \$24.8 million during the six months ended June 30, 2007 from \$18 million during the six months ended June 30, 2006. Approximately \$7.7 million of this increase or 46.3% was attributable to an increase in Voice to Carriers. This increase was partially offset by a decrease in the cost of revenues for Consumers, Corporations and Other by \$0.8 million or 55.5%, which went to \$0.6 million during the six months ended June 30, 2007 from \$1.4 million during the first six months ended June 30, 2006, consistent with the revenue decrease.

The consolidated gross margin percentage decreased to 7.8% during the six months ended June 30, 2007 from 10.4% during the six months ended June 30, 2006. This decrease relates primarily to the Consumers, Corporation and Other due to difficulties encountered in the development of our Efonica retail service platform, cancellation of a government contract and the loss of a high speed internet access arrangement for a foreign carrier.

## **Operating Expenses**

**Depreciation and Amortization.** Depreciation and amortization increased by \$0.3 million or 69.7% to \$0.8 million during the six months ended June 30, 2007, from \$0.5 million during the six months ended June 30, 2006. Depreciation expense increased as more assets were acquired to support the retail platform during the 2<sup>nd</sup> quarter of 2006.

**Selling, General and Administrative.** Selling, general and administrative expenses decreased \$0.9 million or 12.1% to \$6.7 million during the six months ended June 30, 2007, from \$7.6 million during the six months ended June 30, 2006. This decrease is primarily attributed to decreased salaries, benefits and other personnel related expenses as a result of the Company's increased focus on cost containment.

**Advertising and Marketing.** Advertising and marketing expenses decreased \$0.2 million or 67.4% to \$0.1 million during the six months ended June 30, 2007, from \$0.3 million during the six months ended June 30, 2006. The decrease is a result of a more aggressive marketing campaign during the six months ended June 30, 2006.

**Operating Loss.** Our operating loss decreased \$0.8 million or 13.2% to a loss of \$5.5 million during the six months ended June 30, 2007, from a loss of \$6.3 million during the six months ended June 30, 2006. The decrease in operating loss was primarily attributable to the increased revenues and reduced selling, general and administrative expenses

**Other Income (Expense).** Total other income (expense) changed from other income of approximately \$0.6 million during the six months ended June 30, 2006 to other income of \$0.9 million during the six months ended June 30, 2007.

Interest income decreased \$185,000 or 78.3% to \$51,000 during the six months ended June 30, 2007 from \$236,000 during the six month ended June 30, 2006. The reduction is primarily due to cash used in operating activities.

During the six months ended June 30, 2007, the Company sold its 49% equity ownership of Estel and recognized a gain on sale from investments of approximately \$0.9 million.

During the six months ended June 30, 2006, the Company recognized a gain on settlement of debt of approximately \$0.5 million as a result of a settlement agreement with a vendor, which cancelled the service agreement and released the Company from all indebtedness.

**Net Loss.** Net loss decreased \$1.1 million, or 19.9% for the six months ended June 30, 2007, compared to the six months ended June 30, 2006. The primary factors contributing to the improvement were the increase in revenue, a decrease in selling and general and administrative and a gain on sale from investment in Estel, mentioned above.

## Liquidity and Capital Resources

Since our inception, we have incurred significant operating and net losses. In addition, we are not generating positive cash flows from operations. As of June 30, 2007, we had stockholders' equity of approximately \$13.1 million as compared to \$13.4 million at December 31, 2006, and a working capital deficit of approximately \$2.9 million as compared to \$2.7 million at December 31, 2006. The proceeds have been and will continue to be used for working capital and general corporate purposes, international deployment, and to fund the development of our retail service offerings. During the six months ended June 30, 2007, we completed the second phase and over allotment of our private placement financing (See Note 7 to the consolidated financial statements contained in this quarterly report on Form 10-Q). We may seek further financing through the sale of debt or equity securities, although we have no commitments to do so.

Below is a summary of our cash flows for the periods indicated. These cash flow results are consistent with prior years, in that we continued to use significant cash in connection with our operating and investing activities and had significant cash provided by financing activities.

A summary of our cash flows for the periods indicated is as follows:

	<u>Six months Ended June 30,</u>	
	<u>2007</u>	<u>2006</u>
Cash used in operating activities	\$ (5,491,034)	\$ (6,188,621)
Cash provided by (used in) investing activities	82,924	(2,206,230)
Cash provided by (used in) financing activities	3,981,653	(483,650)
Decrease in cash and cash equivalents	(1,426,457)	(8,878,501)
Cash and cash equivalents, beginning of period	2,743,155	14,790,504
Cash and cash equivalents, end of period	<u>\$ 1,316,698</u>	<u>\$ 5,912,003</u>

### Source of Liquidity

As of June 30, 2007, we had cash and cash equivalents of approximately \$1.3 million. In addition, as of June 30, 2007, we had approximately \$0.4 million of cash restricted from withdrawal and held by banks as certificates of deposits securing letters of credit (equal to the amount of the certificates of deposit).

From our inception through June 30, 2007, we financed our operations from cash provided from financing activities. These activities were primarily through net proceeds of approximately \$23.3 million from our IPO, and the private placement of approximately \$58.98 million of equity securities, \$1.6 million from the exercise of stock options and warrants, and \$22 million from the issuance of notes. In addition, since inception we have financed the acquisition of \$8.2 million of fixed assets through capital leases.

Our long-term liquidity is dependent on our ability to attain future profitable operations. We cannot predict if and when we will be able to attain future profitability.

### Uses of Liquidity

Our short-term and long-term liquidity needs arise primarily from principal and interest payments related to our capital lease/equipment financing obligations, capital expenditures, working capital requirements as may be needed to support the growth of our business, and any additional funds that may be required for business expansion opportunities.

Our cash capital expenditures were approximately \$0.6 million and \$2.1 million for the six months ended June 30, 2007 and 2006, respectively. We expect our cash capital expenditures to be approximately \$0.7 million for the next six months ending December 31, 2007. The 2007 estimated capital expenditures primarily consist of additional retail infrastructure development, purchase of additional software for expanded product offerings, and international deployment.

Cash used in operations was approximately \$5.5 million and \$6.2 million during the six months ended June 30, 2007 and 2006, respectively. The cash used in our operations has historically been a function of our net losses, expenses for property and equipment, and changes in working capital as a result of the timing of receipts and disbursements. Our net cash used in operating activities decreased significantly during 2007, primarily due to the completion of the majority of the expenses associated with the buildout of our retail infrastructure. As we transition our existing customers to our new infrastructure and continue to build that revenue base, we expect our net cash used in operating activities to improve during future periods.

In some situations, we may be required to guarantee payment or performance under agreements, and in these circumstances we would need to secure letters of credit or bonds to do so.

### **Debt Service Requirements**

At June 30, 2007, we had approximately \$1.2 million of current debt, which relates primarily to our capital lease/equipment financing obligations.

### **Capital Instruments**

In December 2006, the Company completed the first phase of a private placement for the purpose of raising working capital to fund the Company's operations. The private placement provided for the issuance of a maximum of 10,000 shares of the Company's newly designated Preferred Stock, Series A-1 at \$1,000 per share. The total number of shares of Preferred Stock Series A-1 issued in this private placement was 3,875 shares, for which net proceeds of approximately \$3.8 million were received. In addition, the Company issued warrants to purchase 1,160,204 shares of common stock exercisable at \$1.67 per share. The Series A-1 Preferred Stock will pay dividends at 8% and are convertible into Fusion's common stock at a fixed conversion price of \$1.67 per share.

During the six months ended June 30, 2007, the Company completed the second phase and over-allotment of the private placement. During the second phase, the Company issued 3,375 shares of Preferred Stock, Series A-2 for net proceeds of approximately \$3.375 million. In addition, the Company issued warrants to purchase 2,033,151 shares of common stock exercisable at \$0.83 per share. The Company received an additional \$0.745 million towards the over-allotment and issued 700 shares of Preferred Stock, Series A-3 and 45 shares of Preferred Stock, Series A-4 and Warrants to purchase 421,687 and 28,482 shares of common stock at a fixed exercise price of \$0.83 and \$0.79, respectively (See Note 7 to the consolidated financial statements contained in this quarterly report on Form 10-Q).

### **Critical Accounting Policies and Estimates**

We have identified the policies and significant estimation processes below as critical to our business operations and the understanding of our results of operations. The listing is not intended to be a comprehensive list. In many cases, the accounting treatment of a particular transaction is specifically dictated by accounting principles generally accepted in the United States, with no need for management's judgment in their application. In other cases, management is required to exercise judgment in the application of accounting principles with respect to particular transactions. The impact and any associated risks related to these policies on our business operations is discussed throughout "Management's Discussion and Analysis of Financial Condition and Results of Operations" where such policies affect reported and expected financial results. For a detailed discussion on the application of these and other accounting policies, see Note 2 in the Notes to Consolidated Financial Statements for the year ended December 31, 2006, included in our Annual Report on Form 10-K. Our preparation of our consolidated financial statements requires us to make estimates and assumptions that affect the reported amount of assets and liabilities, disclosure of contingent assets and liabilities at the date of our consolidated financial statements, and the reported amounts of revenue and expenses during the reporting periods. Management bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. There can be no assurance that actual results will not differ from those estimates and such differences could be significant.

**Revenue Recognition** - Our revenue is primarily derived from fees charged to terminate voice services over our network, retail VoIP sales to consumers and corporations, and from monthly recurring charges associated with Internet and private line services.

Variable revenue is earned based on the number of minutes during a call and is recognized upon completion of a call, adjusted for allowance for doubtful accounts receivable and billing adjustments. Revenue for each customer is calculated from information received through our network switches. Customized software has been designed to track the information from the switch and analyze the call detail records against stored detailed information about revenue rates. This software provides us the ability to do a timely and accurate analysis of revenue earned in a period. Consequently, the recorded amounts are generally accurate and the recorded amounts are unlikely to be revised in the future.

Fixed revenue is earned from monthly recurring services provided to the customer that are fixed and recurring in nature, and are contracted for over a specified period of time. The initial start of revenue recognition is after the provisioning, testing and acceptance of the service by the customer. The charges continue to bill until the expiration of the contract, or until cancellation of the service by the customer.

Additionally, the majority of our VoIP services to consumers and corporations are prepaid. The revenue received from the prepayments that is related to VoIP termination services in the current month is booked to the current month's revenue, and the remainder of the prepayments is booked to deferred revenue, until usage occurs.

**Accounts Receivable** - Accounts receivable are recorded net of an allowance for doubtful accounts. On a periodic basis, we evaluate our accounts receivable and record an allowance for doubtful accounts, based on our history of past write-offs and collections and current credit conditions. Specific customer accounts are written off as uncollectible if the probability of a future loss has been established and payments are not expected to be received.

**Cost of Revenues and Cost of Revenues Accrual** - Cost of revenues is comprised primarily of costs incurred from other domestic and international communications carriers to originate, transport and terminate calls. The majority of our cost of revenue is variable, based upon the number of minutes of use, with transmission and termination costs being the most significant expense. Call activity is tracked and analyzed with customized software that analyzes the traffic flowing through our network switches. Each period the activity is analyzed and an accrual is recorded for minutes not invoiced. This cost accrual is calculated using minutes from the system and the variable cost of revenue based upon predetermined contractual rates.

In addition to the variable cost of revenue, there are also fixed expenses. One category of fixed expenses is associated with the network backbone connectivity to our switch facilities. These expenses would consist of hubbing charges at our New York switch facility that allow other carriers to send traffic to our switch, satellite or cable charges to connect to our international network, or Internet connectivity charges to connect customers or vendors to Fusion's switch via the public Internet, a portion of which are variable costs. The other category of fixed expenses is associated with charges that are dedicated point-to-point connections to specific customers (both private line and Internet access).

***Intangible Assets and Goodwill Impairment Testing*** - Absent any circumstances that warrant testing at another time, we test for goodwill and non-amortizing intangible asset impairment as part of our year-end closing process. Impairment losses are recorded when indicators of impairment are present based primarily upon estimated future cash flows.

***Income Taxes*** - We account for income taxes in accordance with the provisions of SFAS No. 109, "Accounting for Income Taxes" ("SFAS 109"). SFAS 109 requires companies to recognize deferred tax liabilities and assets for the expected future income tax consequences of events that have been recognized in our consolidated financial statements. Deferred tax liabilities and assets are determined based on the temporary differences between the consolidated financial statements carrying amounts and the tax bases of assets and liabilities, using enacted tax rates in the years in which the temporary differences are expected to reverse. In assessing the likelihood of utilization of existing deferred tax assets and recording a full valuation allowance, we have considered historical results of operations and the current operating environment.

### **Recently Issued Accounting Pronouncements**

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement No. 115" ("SFAS 159"). This Statement allows all entities a one-time election to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value (the "fair value option"). SFAS 159 is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact of SFAS 159 on its consolidated results of operations and financial condition.

### **FORWARD-LOOKING STATEMENTS**

Certain statements contained herein may constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Because such statements include risks and uncertainties, actual results may differ materially from those expressed or implied by such forward-looking statements. Factors that could cause actual results to differ materially include, but are not limited to, risks associated with the integration of businesses following an acquisition, concentration of revenue from one source, competitors with broader product lines and greater resources, emergence into new markets, the termination of any of the Company's significant contracts or partnerships, the Company's inability to maintain working capital requirements to fund future operations or the Company's inability to attract and retain highly qualified management, technical and sales personnel. All forward-looking statements included in this document are made as of the date hereof, based on information available to us as of the date thereof, and we assume no obligation to update any forward-looking statements.

Factors and risks, including certain of those described in greater detail herein, that could cause actual results or circumstances to differ materially from those set forth or contemplated in forward-looking statements include, without limitation:

- We have a history of operating losses and, prior to our IPO, a working capital deficit and stockholders' deficit. There can be no assurance that we will ever achieve profitability or have sufficient funds to execute our business strategy.
- If we are unable to manage our growth or implement our expansion strategy, we may increase our costs without maximizing our revenues.

- The success of our planned expansion is dependent upon market developments and traffic patterns, which may lead us to make expenditures that may not result in increased revenues.
- We may be unable to adapt to rapid technology trends and evolving industry standards, which could lead to our products becoming obsolete.
- We are pursuing new lines of business, and introducing new services. In some cases, the technology for these services and/or the market for those services are untested. Thus, there can be no assurance of our ability to introduce these services on a timely basis or our ability to derive significant revenues from them.
- Our new services are dependent upon multiple service platforms, network elements, and back-office systems, as well as the successful integration of these items. There can be no assurance of the success of this development and integration.
- There can be no assurance that the planned migration of existing VoIP service customers onto our new infrastructure will be successful.
- If our information and processing systems for billing and client service are not properly implemented, it could have a negative affect on our ability to collect revenues.
- Some of our new services depend on proprietary technology. There can be no assurance that others will not develop similar or competing technology, or that we will be successful in protecting our intellectual property rights.
- If we do not utilize our new Softswitch technology effectively, many of the potential benefits of the new technology may not be realized.
- We may be impacted by current litigation regarding patent infringement.
- Breaches in our network security systems may hurt our ability to deliver services and our reputation, and result in liability and lost sales.
- Our entry into new markets will rely upon our ability to obtain licenses to operate in those countries, and our ability to establish good working relationships with postal telephone and telegraph companies in order to interconnect to the telephone networks. There can be no assurance of our ability to accomplish either.
- The communications services industry is highly competitive and many of our competitors have more resources available to them, accordingly we may be unable to compete effectively.
- Industry consolidation could make it more difficult for us to compete.
- Our ability to provide services is often dependent on our suppliers and other service providers who may not prove to be effective.
- We rely on the cooperation of postal telephone and telegraph companies who may hinder our operations in certain markets.
- We are dependent on third-party equipment providers who may not be able to provide us the equipment necessary to deliver the services that we seek to provide.

- If we are unable to develop and maintain successful relationships with our joint venture partners, it could hinder our operations in an important market.
- Service interruptions could result in a loss of revenue and harm our reputation.
- Because we do business on an international level we are subject to an increased risk of tariffs, sanctions and other uncertainties that may hurt our revenues.
- The success of our business depends on the acceptance of the Internet in emerging markets that may be slowed by limited bandwidth, high bandwidth costs, and other technical obstacles.
- Additional taxation and the regulation of the communications industry may slow our growth, resulting in decreased demand for our products and services and increased costs of doing business.
- In addition to new regulations being adopted, existing laws may be applied to the Internet, which could hamper our growth.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We are exposed to certain market risks that are inherent in our financial instruments. These instruments arise from transactions in the normal course of business.

At June 30, 2007, the majority of our cash balances were held primarily in the form of short-term highly liquid investment grade money market funds held in major financial institutions. Due to the short-term nature of our investments, we believe that we are not subject to any material interest or market rate risks.

At June 30, 2007, all of our outstanding debt has fixed interest rates. As such, we are not subject to interest rate risk on any of our debt. Consequently, we currently believe that our interest rate risk is very low.

We currently do not conduct any significant amount of business in currencies other than the United States dollar. The reporting and functional currency for our Dubai international subsidiary is the United States dollar. Our Jamaican and Turkey subsidiaries currently do not have any significant operations that would provide foreign currency risk. However, in the future, we likely will conduct a larger percentage of our business in foreign currencies that could have an adverse impact on our future results of operations.

### **ITEM 4. CONTROLS AND PROCEDURES**

(a) *Evaluation of Disclosure Controls and Procedures.* As of the end of the period covered by this report, our management, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that our disclosure controls and procedures as of the end of the period covered by this report have been designed and are functioning effectively to provide reasonable assurance that the information we (including our consolidated subsidiaries) are required to disclose in reports filed under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

(b) **Changes in Internal Controls.** There were no changes in our internal control over financial reporting, that occurred during the quarter ended June 30, 2007, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

(c) **Limitations.** A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurances that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple errors or mistakes. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with its policies or procedures. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. We periodically evaluate our internal controls and make changes to improve them.

## **PART II: OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

On May 28, 2003, Jack Grynberg, et al., an investor in one of the Company's private offerings, filed a complaint with the Denver District Court, State of Colorado (*Jack Grynberg, et al v. Fusion Telecommunications International, Inc., et al*, 03-CV-3912) seeking damages in the amount of \$400,000 for the purchase of an interest in Fusion's 1999 private placement offering of subordinated convertible notes through Joseph Stevens & Company, Inc., a registered broker dealer. This complaint asserted the following claims for relief against the Company: Breach of Fiduciary Duty, Civil Theft, Deceptive Trade Practices, Negligent Misrepresentation, Deceit Based on Fraud, Conversion, Exemplary Damages and Prejudgment Interest. On June 25, 2004, the Company filed with the Court a Motion to Dismiss, which was granted. The Company was awarded attorneys' fees by the court. A written order of Judgment in favor of the Company and against the plaintiff in the amount of approximately \$40,000 was recorded on January 24, 2006. The plaintiffs filed an appeal of the motion, which the courts dismissed and awarded the Company attorney fees.

On March 30, 2006, a financing company affiliated with an equipment vendor filed a complaint with the Circuit Court in Broward County, State of Florida seeking damages in the amount of approximately \$1,380,000 allegedly due on two promissory notes plus accrued interest through March 1, 2006 and attorney's fees and costs. The Company asserted a counterclaim against the vendor which was settled subsequent to the year ended 2006, resulting in the amendment of an existing contract with the vendor. The Company's legal counsel has advised that, at this stage, they cannot accurately predict the likelihood of an unfavorable outcome or quantify the amount or range of potential loss, if any. Accordingly, with the exception of amounts previously accrued by the Company under the capital lease arrangement, no adjustment that may result from resolution of these uncertainties has been made in the accompanying financial statements.

On or about February 9, 2007, we filed a complaint against Patrick S. Dallas, InfoTel Holdings, Ltd., Phil Walton and John Does 1-5 in the Supreme Court of the State of New York (*Fusion Telecommunications International, Inc. vs. Patrick S. Dallas, et al.*, Index No. 2007001836) seeking damages associated with Mr. Dallas' sale of Convergent Technologies Ltd. Stock to us and InfoTel's breach of its October 2006 agreement to purchase Fusion Jamaica Limited's equipment in Jamaica and assume the real property lease in Jamaica. We believe Mr. Dallas owns or controls InfoTel. This complaint asserted the following claims for relief: Breach of Contract (the Stock Purchase Agreement); Breach of Mr. Dallas' Employment Agreement; Breach of Mr. Dallas' Non-Solicitation and Non-Compete Agreement; Breach of Contract (the InfoTel Agreement); Diversion and Waste of Corporate Assets; Conversion: Scheme to Defraud and Deceive and Demand for Accounting; Fraudulent Misconduct with Intent to Defraud (the Stock Purchase Agreement); Fraudulent Misconduct with Intent to Defraud (the InfoTel Agreement); Indemnification (the Stock Purchase Agreement); and Indemnification (the InfoTel Agreement). Our legal counsel has advised that, at this state, they cannot accurately predict the likelihood of an unfavorable outcome, or quantify the amount or range of damages we would be entitled to receive if we prevail.



The Company is currently undergoing an audit by New York State for franchise and excise taxes, which has not yet been concluded and may result in an indeterminate amount of tax liability.

Due to the regulatory nature of the industry, the Company is periodically involved in various correspondence and inquiries from state and federal regulatory agencies. Management does not expect the outcome of these inquiries to have a material impact on the Company's operations or financial condition.

#### **ITEM 1A. RISK FACTORS**

There were no material changes to the risk factors last disclosed in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2006, as filed with the SEC.

#### **ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

(a) Unregistered Sales of Securities

None.

(b) 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**

There were no matters required to be disclosed in a Current Report on Form 8-K during the fiscal quarter covered by this report that were not so disclosed.

There were no changes to the procedures by which security holders may recommend nominees to the Company's Board of Directors since the Company last disclosed these procedures.

**ITEM 6. EXHIBITS**

<b>Exhibit No.</b>	<b>Description</b>
31.1	Certification of the Chief Executive Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certification of the Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

## 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.

### FUSION TELECOMMUNICATIONS INTERNATIONAL, INC.

Date: August 14, 2007

By: /s/ Matthew D. Rosen

---

Matthew D. Rosen  
President and Chief Executive Officer  
(Principal Executive Officer)

Date: August 14, 2007

By: /s/ Barbara Hughes

---

Barbara Hughes  
Chief Financial Officer  
(Principal Financial Officer)

## INDEX TO EXHIBITS

<b>Exhibit No.</b>	<b>Description</b>
31.1	Certification of the Chief Executive Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certification of the Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

## CERTIFICATION

I, Matthew D. Rosen, certify that:

1. I have reviewed this quarterly report of Fusion Telecommunications International, Inc.;
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;
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;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - (b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: August 14, 2007

/s/ Matthew D. Rosen  
Matthew D. Rosen  
President and Chief Executive Officer

## CERTIFICATION

I, Barbara Hughes, certify that:

1. I have reviewed this quarterly report of Fusion Telecommunications International, Inc.;
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;
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;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - (b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: August 14, 2007

/s/ Barbara Hughes  
Barbara Hughes  
(Principal Financial Officer)

**CERTIFICATION**

**PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

**(SUBSECTIONS (A) AND (B) OF SECTION 1350, CHAPTER 63 OF TITLE 18, UNITED STATES CODE)**

Pursuant to section 906 of the Sarbanes-Oxley Act of 2002 (subsections (a) and (b) of section 1350, chapter 63 of title 18, United States Code), each of the undersigned officers of Fusion Telecommunications International, Inc., a Delaware corporation (the "Company"), does hereby certify, to such officer's knowledge, that:

The Quarterly Report on Form 10-Q for the quarter ended June 30, 2007, (the "Form 10-Q") of the Company fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934, and the information contained in the Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: August 14, 2007

/s/ Matthew D. Rosen  
Matthew D. Rosen  
President and Chief Executive Officer

Dated: August 14, 2007

/s/ Barbara Hughes  
Barbara Hughes  
Chief Financial Officer  
(Principal Financial Officer)