CITY NATIONAL CORP
Form SC 13G/A
February 14, 2005

SCHEDULE 13G

Amendment No. 3
City National Corporation
Common Stock
Cusip #178566105

Cusip #178566105
Item 1: Reporting Person - FMR Corp.
Item 4: Delaware
Item 5: 170
Item 6: 0
Item 7: 1,045,070
Item 8: 0
Item 9: 1,045,070
Item 11: 2.125%
Item 12: HC

Cusip #178566105
Item 1: Reporting Person - Edward C. Johnson 3d
Item 4: United States of America
Item 5: 0
Item 6: 0
Item 7: 1,045,070
Item 8: 0
Item 9: 1,045,070
Item 11: 2.125%
Item 12: IN

Cusip #178566105
Item 1: Reporting Person - Abigail P. Johnson
Item 4: United States of America
Item 5: 0
Item 6: 0
Item 7: 1,045,070
Item 8: 0
Item 9: 1,045,070
Item 11: 2.125%
Item 12: IN

SCHEDULE 13G - TO BE INCLUDED IN
STATEMENTS
FILED PURSUANT TO RULE 13d-1(b) or 13d-2(b)

Item 1(a). Name of Issuer:

City National Corporation

Item 1(b). Name of Issuer's Principal Executive Offices:

400 North Roxbury Drive
City National Center
Beverly Hills, CA 90210

Item 2(a). Name of Person Filing:

FMR Corp.

Item 2(b). Address or Principal Business Office or, if None, Residence:

82 Devonshire Street, Boston, Massachusetts 02109

Item 2(c). Citizenship:

Not applicable

Item 2(d). Title of Class of Securities:

Common Stock

Item 2(e). CUSIP Number:

178566105

Item 3. This statement is filed pursuant to Rule 13d-1(b) or 13d-2(b) and the person filing, FMR Corp., is a parent holding company in accordance with Section 240.13d-1(b)(ii)(G). (Note: See Item 7).

Item 4. Ownership

(a) Amount Beneficially Owned: 1,045,070

(b) Percent of Class: 2.125%

(c) Number of shares as to which such person has:

(i) sole power to vote or to direct the vote: 170

(ii) shared power to vote or to direct the vote: 0

(iii) sole power to dispose or to direct the disposition of: 1,045,070

(iv) shared power to dispose or to direct the disposition of: 0

Item 5. Ownership of Five Percent or Less of a Class.

If this statement is being filed to report the fact that as of the date hereof, the reporting person has ceased to be the beneficial owner of more than five percent of the class of securities, check the following (X).

Item 6. Ownership of More than Five Percent on Behalf of Another Person.

Not applicable

Item 7. Identification and Classification of the Subsidiary Which Acquired the Security Being Reported on By the Parent Holding Company.

See attached Exhibit(s) A, B.

Item 8. Identification and Classification of Members of the Group.

Not Applicable. See attached Exhibit A.

Item 9. Notice of Dissolution of Group.

Not applicable.

Item 10. Certification.

Inasmuch as the reporting persons are no longer the beneficial owners of more than five percent of the number of shares outstanding, the reporting persons have no further reporting obligation under Section 13(d) of the Securities and Exchange Commission thereunder, and the reporting persons have no obligation to amend this Statement if any material change occurs in the facts set forth herein.

Signature

After reasonable inquiry and to the best of my knowledge and belief, I certify that the information set forth in this Schedule 13G in connection with FMR Corp.'s beneficial ownership of the Common Stock of City National Corporation at December 31, 2004 is true, complete and correct.

February 14, 2005
Date

/s/Eric D. Roiter
Signature

Eric D. Roiter
Duly authorized under Power of Attorney
dated December 30, 1997 by and on behalf
of FMR Corp. and its direct and indirect
subsidiaries

SCHEDULE 13G - TO BE INCLUDED IN STATEMENTS
FILED PURSUANT TO RULE 13d-1(b) or 13d-2(b)

Pursuant to the instructions in Item 7 of Schedule 13G, Fidelity Management & Research Company ("Fidelity"), 82 Devonshire Street, Boston, Massachusetts 02109, a wholly-owned subsidiary of FMR Corp. and an investment adviser registered under Section 203 of the

Investment Advisers Act of 1940, is the beneficial owner of 1,045,070 shares or 2.125% of the Common Stock outstanding of City National Corporation ("the Company") as a result of acting as investment adviser to various investment companies registered under Section 8 of the Investment Company Act of 1940.

Edward C. Johnson 3d, FMR Corp., through its control of Fidelity, and the funds each has sole power to dispose of the 1,045,070 shares owned by the Funds.

Neither FMR Corp. nor Edward C. Johnson 3d, Chairman of FMR Corp., has the sole power to vote or direct the voting of the shares owned directly by the Fidelity Funds, which power resides with the Funds' Boards of Trustees. Fidelity carries out the voting of the shares under written guidelines established by the Funds' Boards of Trustees.

Members of the Edward C. Johnson 3d family are the predominant owners of Class B shares of common stock of FMR Corp., representing approximately 49% of the voting power of FMR Corp. Mr. Johnson 3d owns 12.0% and Abigail Johnson owns 24.5% of the aggregate outstanding voting stock of FMR Corp. Mr. Johnson 3d is Chairman of FMR Corp. and Abigail P. Johnson is a Director of FMR Corp. The Johnson family group and all other Class B shareholders have entered into a shareholders' voting agreement under which all Class B shares will be voted in accordance with the majority vote of Class B shares. Accordingly, through their ownership of voting common stock and the execution of the shareholders' voting agreement, members of the Johnson family may be deemed, under the Investment Company Act of 1940, to form a controlling group with respect to FMR Corp.

SCHEDULE 13G - TO BE INCLUDED IN STATEMENTS
FILED PURSUANT TO RULE 13d-1(b) or 13d-2(b)
RULE 13d-1(f)(1) AGREEMENT

The undersigned persons, on February 14, 2005, agree and consent to the joint filing on their behalf of this Schedule 13G in connection with their beneficial ownership of the Common Stock of City National Corporation at December 31, 2004.

FMR Corp.

By /s/ Eric D. Roiter
Eric D. Roiter
Duly authorized under Power of Attorney dated December 30, 1997, by and on behalf of FMR Corp. and its direct and indirect subsidiaries

Edward C. Johnson 3d

By /s/ Eric D. Roiter
Eric D. Roiter

Duly authorized under Power of Attorney
dated December 30, 1997, by and on behalf
of Edward C. Johnson 3d

Abigail P. Johnson

By /s/ Eric D. Roiter
Eric D. Roiter
Duly authorized under Power of Attorney
dated December 30, 1997, by and on behalf
of Abigail P. Johnson

Fidelity Management & Research Company

By /s/ Eric D. Roiter
Eric D. Roiter
Senior V.P. and General Counsel

; FONT-FAMILY: Times New Roman">2,149,514

Total		
	$	11,166,062
	$	13,184,061

NOTE H - LOAN PAYABLE

The loan payable of $3,396,011 and $4,685,236 at June 30, 2006 and December 31, 2005, respectively, is owed to a lending institution. This loan bears interest at 12.5%, and is repayable through June 2007 if the loan's repayment schedule is not accelerated or modified. Additional borrowings under this facility are contingent upon, among other things, the Company raising certain levels of additional equity financing. Interest expensed and paid under this debt facility during the six months ended June 30, 2006, and 2005 was $258,954 and $53,446, respectively.

The loan agreement contains customary covenants and restrictions and provides the lender the right to a perfected, first-priority security interest in all of the Company's assets, as well as rights to preferred stock warrants. The Company was in violation of certain requirements of this debt facility at June 30, 2006. As a result, the full amount of the loan at June 30, 2006 has been classified as current. To date, the lender has not declared this loan in default.

NOTE I - CONVERTIBLE NOTES AND WARRANTS PAYABLE

At June 30, 2006 and December 31, 2005 convertible notes payable consisted of the following:

	2006	2005
Payable to WQN, Inc.	$ 3,700,000	$ 3,700,000
Payable to accredited investors	12,138,023	1,496,804
Subtotal	15,838,023	5,196,804
Less discounts	(7,713,548)	(1,797,006)
Total	$ 8,124,475	$ 3,399,798

In July and October 2005, the Company issued and sold $3,085,832 in principal amount of convertible notes to accredited investors at a discount, receiving net proceeds of $2,520,320. These notes are immediately convertible at the option of the note holders into shares of the Company's common stock at $0.80 per share. These note holders also received five-year warrants to purchase 3,569,792 shares of the Company's common stock for prices ranging from $1.37 to $1.65 per share. These notes are secured by a subordinated lien on the Company's assets, and the notes bear interest at an effective rate of approximately 20%. The principal balance of these notes was $923,702 and $1,496,804 at June 30, 2006 and December 31, 2005, respectively. Half of these notes became payable beginning in October 2005, and the other half beginning in January 2006 (three months following their respective issuances), over two years in cash or, at the option of the Company, in registered common stock at the lesser of $0.80 per share or 85% of the weighted average price of the stock on the OTC Bulletin Board (the "OTCBB"). In May 2006, the Company repriced these warrants to $0.78 per share, at which time these warrants were exercised, resulting in net proceeds to the Company of $2,720,120. The Company then agreed to issue warrants to purchase a like number of shares to the investors, entitling them to purchase such shares for $0.80 for five years. At June 30, 2006, the Company had not made scheduled payments of $142,520 on these notes. In July 2006, the Company was also in violation of the registration requirements contained in the related subscription agreements. The Company will incur related liquidated damages of $13,856 per month until a registration statement related to the shares and warrants is declared effective by the SEC. One of the note holders, owed approximately $1.1 million, has declared its notes in default. As such, the full amount of the notes at June 30, 2006 has been classified as current.

In January and February 2006, the Company issued and sold $11,959,666 principal amount of convertible notes to accredited investors at a discount, receiving net proceeds of $9,879,400. These notes were immediately convertible at the option of the note holders into shares of the Company's common stock at $1.40 per share. These note holders also received five-year warrants to purchase 4,254,297 shares of the Company's common stock for $1.46 per share, and one-year warrants to purchase 4,254,297 shares for $1.59 per share. In May 2006, the note conversion rate and warrant exercise prices were repriced to $1.00 per share. Approximately $7.6 million of these notes are secured by a subordinated lien on the Company's assets. The principal balance of these notes was $11,214,321 at June 30, 2006. All these notes bear interest at an effective rate of approximately 20%, and are payable (as amended in May 2006) over two years beginning either July 6, 2006 or August 15, 2006 in cash or, at the option of the Company, in registered common stock at the lesser of $1.00 per share or 85% of the weighted average price of the stock on the OTCBB. Since April 2006, the Company has been in violation of the registration requirements contained in the related subscription agreements. As related liquidated damages, in May 2006, the Company issued 166,366 shares to certain of the investors, has incurred an additional $181,870 through June 30, 2006, and will continue to incur additional liquidated damages of $168,215 per month until the required amount of shares and warrants are registered. At August 15, 2006, the Company had also not made scheduled payments of $21,008 for these notes. One of the note holders, owed approximately $1.1 million, has declared its notes in default. As such, the full amount of the notes at June 30, 2006 has been classified as current.

In October 2005, the Company acquired substantially all of the operating assets and liabilities of WQN, for a total purchase price of $9.8 million. The acquisition was financed in part with the issuance of a convertible note in the principal amount of $3.7 million. A debt discount was established to reflect an effective interest rate of 20%, bringing the original net note payable value to $3,216,000. This note is convertible at the option of WQN into shares of the Company's common stock at a price of $0.78 per share. This note is payable over 12 months beginning February 2006, and bears nominal interest at 6%. However, the scheduled payments have not been made, and WQN has agreed to subordinate its repayment claim to the convertible note holders described in the two preceding paragraphs. At June 30, 2006 the Company was in violation of certain requirements of this note. While WQN has not declared the note in default, the full amount of the note at June 30, 2006 has been classified as current.

No interest was paid on any of the convertible notes described above during the six months ended June 30, 2006.

12

The Company had insufficient authorized common shares to satisfy the warrant obligations associated with the convertible notes issued in January and February 2006 on the dates the warrants were issued. Therefore, in accordance with Emerging Issues Task Force Issues 00-27 and 00-19, the $3,526,077 initial value of these warrants at their issuance dates was recorded as a debt discount and a warrant liability on the Company's consolidated balance sheet. In addition, $770,314 of the proceeds received from the May 2006 warrant repricing and exercise discussed in the fourth preceding paragraph above were allocated to these warrants, and recorded as a warrant liability on the Company's balance sheet. The liability has since been marked-to-market, resulting in a $2,424,502 decrease in the liability at June 30, 2006, and a corresponding credit to earnings for the six months ended June 30, 2006.

NOTE J - ADVANCES FROM INVESTORS

Advances from investors of $386,675 at June 30, 2006 represent funds deposited with the Company in anticipation of the issuance of future notes payable. The unsecured advances from investors of $3,000,000 at December 31, 2005 represent funds deposited with the Company in anticipation of the issuance of convertible notes payable, which were issued in January 2006 (see NOTE I).

These advances are not interest bearing, and are unsecured.

NOTE K - ACQUISITIONS

On May 31, 2005, the Company acquired 100% of Caerus and its wholly owned subsidiaries Volo Communications, Inc. ("Volo"), Caerus Networks, Inc., and Caerus Billing, Inc. in exchange for approximately 16,900,000 of the Company's common shares (plus 2,000,000 million escrowed shares).

The goodwill, intangible assets and property recorded for the acquisition of Caerus represent the fair market value of liabilities as of the date of acquisition, plus approximately $18.3 million, which represents the value of the Company's common stock and options issued pursuant to the acquisition.

On October 5, 2005, the Company acquired substantially all of the operating assets and liabilities of WQN, for a total purchase price of $9.8 million. The acquisition was financed with the issuance of $3.7 million of convertible debt ($3.2 million net of discount), 1,250,000 shares of the Company's common stock, and 5,000,000 warrants to purchase the Company's common stock at $0.001 per share.

Condensed balance sheets of the Caerus and WQN acquisitions, reflecting the net fair value amounts assigned to each major asset and liability, as of their respective acquisition dates are as follows:

	Caerus, Inc.	WQN, Inc.
Current assets	$ 617,000	$ 3,775,000
Property and equipment, net	7,869,000	508,000
Other assets	131,000	463,000
Accounts payable and other current liabilities	(14,674,000)	(2,031,000)
Note payable	(4,832,000)	-
Net liabilities assumed	(10,889,000)	2,715,000
Goodwill	17,778,000	4,120,000
Intangible assets - other	13,800,000	2,925,000
Intangible assets	31,578,000	7,045,000

Net fair value assets acquired	$ 20,689,000	$ 9,760,000

NOTE L - LITIGATION

MCI

On April 8, 2005, The Company's subsidiary Volo filed suit against MCI WorldCom Network Services, Inc. d/b/a UUNET ("MCI WorldCom"). Volo alleges that MCI WorldCom engaged in a pattern and practice of over-billing Volo for the telecommunications services it provided pursuant to the parties' Services Agreement, and that MCI WorldCom refused to negotiate such overcharges in good faith. Volo also seeks damages arising out of MCI WorldCom's fraudulent practice of submitting false bills by, among other things, re-routing long distance calls over local trunks to avoid access charges, and then billing Volo for access charges that were never incurred.

On April 4, 2005, MCI WorldCom declared Volo in default of its obligations under the Services Agreement, claiming that Volo owes a past due amount of $8,365,980, and threatening to terminate all services to Volo within five days. By this action Volo alleges claims for (1) breach of contract; (2) fraud in the inducement; (3) primary estoppel; and (4) deceptive and unfair trade practices. Volo also seeks a declaratory judgment that (1) MCI WorldCom is in breach of the Services Agreement; (2) $8,365,980 billed by MCI WorldCom is not "due and payable" under that agreement; and (3) MCI WorldCom's default letter to Volo is in violation of the Services Agreement. Volo seeks direct, indirect and punitive damages in an amount to be determined at trial.

On May 26, 2005, MCI WorldCom filed an Answer, Affirmative Defenses, Counterclaim and Third-Party Complaint naming Caerus as a third-party defendant. MCI WorldCom asserts a breach of contract claim against Volo, a breach of guarantee claim against Caerus, and a claim for unjust enrichment against both parties, seeking an amount to be determined at trial. On July 11, 2005, Volo and Caerus answered the counterclaim and third-party complaint, and filed a third-party counterclaim against MCI WorldCom for declaratory judgment, fraud in the inducement, and breach of implied duty of good faith and fair dealing. Volo and Caerus seek direct, indirect and punitive damages in an amount to be determined at trial.

On August 1, 2005, MCI WorldCom moved to strike most of Volo's and Caerus' affirmative defenses and demand for attorney's fees, and to dismiss Caerus' counterclaims. On October 6, 2005, the Court denied the motions in part, granted them in part with leave to amend, and deferred ruling on the motions in part. On October 13, 2005, Volo and Caerus filed amended affirmative defenses, and Caerus filed amended counterclaims.

Discovery is in progress. MCI WorldCom has served requests for documents and for admissions and interrogatories on Volo and Caerus, to which Volo and Caerus have responded. Volo has served document requests and interrogatories on MCI WorldCom. Volo has also initiated third party discovery. The Court on March 9, 2006 granted in part and denied in part motions to compel disclosures brought by Volo and MCI WorldCom and directed the appointment of an independent expert to review and report to the Court on certain matters relevant to the parties' claims and defenses. The Court on April 12, 2006 granted in part and denied in part motions brought by Volo for a protective order and by MCI WorldCom to compel disclosures, and MCI WorldCom's motion for clarification of the March 9, 2006 Order. On May 4, 2006, the Court entered an order directing the appointment of an independent expert to review and report to the Court and the parties upon the routing and termination of calls received by MCI WorldCom from Volo. Volo has contended that such routing and termination is relevant, *inter alia*, to its allegations that MCI WorldCom engaged in a fraudulent and systematic re-routing of traffic through local trunks in order to avoid paying access fees to terminate such calls. On May 4, 2006, the Court issued a Case Management and Scheduling Order directing the parties to mediate by February 1, 2007 and setting a target trial date of February/March 2007.

The Company is currently unable to assess the outcome of this litigation or its impact on the Company’s financial condition and results of operations.

Netrake Corporation

The Company and its subsidiaries Caerus and Volo were involved in disputes with Netrake Corporation ("Netrake") arising from an equipment purchase contract under which Volo agreed to purchase approximately $2.0 million of Netrake’s telephonic equipment and software. Through mediation, these disputes were settled July 27, 2006, primarily requiring Volo to return equipment purchased in connection with the contract and to make an immaterial monetary payment to Netrake. In conjunction with this settlement, the Company recognized a $397,821 gain during the three months ended June 30, 2006, primarily related to the excess of accounts payable over the net book value of the equipment to be returned.

NOTE M - STOCK BASED COMPENSATION

A total of 4,000,000 shares of common stock have been reserved for issuance under the Company's 2004 Employee Stock Option Plan. In addition, on December 7, 2005, the Company’s Board of Directors approved, subject to shareholder approval, the Company’s 2006 Equity Incentive Plan (the “2006 Plan”). The 2006 Plan provides that key employees, consultants and non-employee directors of the Company or an affiliate may be granted: (1) options to acquire shares of the Company’s common stock; (2) shares of restricted common stock; (3) stock appreciation rights; (4) performance-based awards; (5) “Dividend Equivalents”; and (6) other stock-based awards. The Company is seeking shareholder approval at its 2006 annual meeting of shareholders for the future issuance of options under the 2006 Plan to allow its participants to acquire up to 10,000,000 shares of the Company’s common stock. The activity in these plans, subject to shareholder approval of the 2006 Plan, for the six months ended June 30, 2006 is as follows:

	Number		Exercise Price Range		Weighted Average Exercise Price
Options outstanding at December 31, 2005	3,746,562	$	0.85 - $1.56	$	1.21
Options returned to the plan due to employee terminations	(2,113,812)	$	0.85 - $1.56	$	1.29
Options exercised	(319,650)	$	0.85 - $1.56	$	1.04
Options granted	3,500,000	$	1.00 - $1.56	$	1.21
Options outstanding at June 30, 2006	4,813,100	$	0.85 - $1.56	$	1.19

The Company recorded compensation expense of $4,392,478 and $366,738 for the six months ended June 30, 2006 and 2005, respectively, in connection with options, warrants and stock granted to employees. As of June 30, 2006, approximately $1,219,000 in total compensation cost related to non-vested options remains to be expensed in future periods.

The value of options and warrants was estimated using the Black-Scholes pricing model. The Black-Scholes pricing calculations were made using volatilities at either one-year or three-year, monthly or weekly, trailing measures, as appropriate, and risk-free rates as determined by the nearest maturity Treasury yield as of respective valuation dates.

NOTE N - WARRANTS

Through June 30, 2006 the Company has issued to employees and financial services firms warrants to purchase the Company's common stock. During the six months ended June 30, 2006 and 2005, the Company issued 3,776,042 and 750,000 shares, respectively, of common stock in exchange for these warrants. As of June 30, 2006 and December 31, 2005, the Company had outstanding 13,621,438 warrants, excluding warrants issued in conjunction with convertible debt issuances referred to in NOTE I, to purchase its common stock at a weighted average exercise price of $1.79 per share.

NOTE O - COMMITMENTS

The Company is obligated under non-cancelable operating leases for its office facilities, and apartments used for business purposes by its employees. Future minimum lease payments under the Company's non-cancelable operating leases as of June 30, 2006 are as follows:

Year ending December 31		
2006 (six months)	$	202,312
2007		268,556
2008		98,388
2009		43,736
Total	$	612,992

Rent expense for these leases for the six months ended June 30, 2006 and 2005 was $159,684 and $83,124, respectively**.**

NOTE P - RELATED PARTY TRANSACTIONS

As of June 30, 2006 and 2005 the amount due from related parties consisted of an account receivable from WQN, a shareholder of the Company.

In December 2004 the Company issued a $560,000 note payable to a shareholder, bearing interest at 3.75%, with an original maturity date of December 2005. In January 2005 the Company issued another note payable for $1,040,000 to the same shareholder under similar terms. At June 30, 2006 and December 31, 2005, the outstanding balance of these notes was $303,666 and $1,572,894, respectively. The notes are currently due on demand.

Interest paid under these notes was $9,469 and $0 during the six months ended June 30, 2006 and 2005, respectively.

NOTE Q - DISCONTINUED OPERATIONS

On April 19, 2006, the Company sold its wholly-owned subsidiary, DTNet Technologies, to the Company's former Chief Operating Officer (the "Purchaser"), pursuant to a stock purchase agreement. The consideration for the sale consisted primarily of (1) the return for cancellation of warrants to purchase 200,000 shares of the Company's common stock held by the Purchaser; and (2) the return for cancellation of 200,000 shares of the Company's common stock held by the Purchaser. Because DTNet Technologies' operations were the primary component of the Company's hardware sales business segment, the Company recorded an impairment charge of $839,101 in its statement of operations for the three months ended March 31, 2006. The remaining $198,000 of goodwill for this segment approximated the excess of the sales proceeds received over DTNet Technologies' carrying value (excluding goodwill) and was written off in conjunction with the sale of DTNet Technologies.

The following summarizes the results of DTNet Technologies' operations for the six and three months ended June 30, 2006 (through the April 19, 2006 date of sale) and 2005, classified as discontinued operations for all periods presented.

	Six Months Ended June 30		Three Months Ended June 30	
	2006	2005	2006	2005
Revenues	$ 421,722	$ 866,446	$ 54,724	$ 470,088
Cost of Sales	326,127	671,903	43,391	368,697
Gross Profit	95,595	194,543	11,333	101,391
Compensation and benefits	116,985	186,578	27,958	101,971
Other operating expenses*	946,871	133,981	5,157	121,316
Net loss	$ (968,261)	$ (126,016)	$ (21,782)	$ (121,896)

*Includes $839,101 impairment of goodwill recorded in March, 2006.

NOTE R - INCOME TAXES

The components of the Company's consolidated income tax provision are as follows:

	Six Months ended June 30,	
	2006	2005
Current benefit	$ 5,695,083	$ 479,158
Deferred benefit (expense)	417,579	(75,014)
Subtotal	6,112,662	404,144
Less valuation allowances	(6,112,662)	(404,144)
Net	$ -	$ -

The reconciliation of the income tax provision at the statutory rate to the reported income tax expense is as follows:

	Six Months ended June 30,	
	2006	2005
Computed at statutory rate	34%	34%
Options and warrants expense	(2%)	(8%)
Valuation allowance	(32%)	(26%)
Total	-	-

At June 30, 2006 the Company's net deferred tax assets consisted of the following:

Net operating loss carryforwards	$ 14,592,781
Excess of goodwill impairment charge over tax basis amortization	734,694
Excess book over tax amortization of intangible assets	733,280
Subtotal	16,060,755
Less valuation allowances	(16,060,755)
Total	$ -

The Company's net operating loss carryforwards for federal income tax purposes were approximately $42,900,000 as of June 30, 2006. These carryforwards expire in 2018 ($4,200,000), 2019 ($22,000,000), and 2020 ($16,700,000),

respectively.

VoIP, INC. AND SUBSIDIARIES
UNAUDITED PRO FORMA CONDENSED COMBINED FINANCIAL STATEMENTS

The following unaudited pro forma condensed combined financial statements are derived from and should be read in conjunction with the historical consolidated financial statements and related notes of the Company, Caerus, and WQN.

On June 1, 2005, the Company and Caerus announced the closing of the merger of Volo, a wholly-owned subsidiary of the Company with and into Caerus, with Caerus as the surviving corporation (the "Merger"). The Merger was completed pursuant to an Agreement and Plan of Merger (the "Merger Agreement'), executed on May 31, 2005.

On October 6, 2005, the Company purchased substantially all of the assets of WQN's VoIP business. Such assets consist of WQN's properties and infrastructure for its services platform for both retail and wholesale voice over internet business.

The unaudited pro forma condensed combined statements of operations for the three and six months ended June 30, 2005 assume that the mergers of Caerus, WQN and the Company were consummated at January 1, 2005.

The unaudited pro forma condensed combined statements of operations have been prepared based on currently available information and assumptions that are deemed appropriate by the Company's management. The pro forma information is for informational purposes only and is not intended to be indicative of the actual consolidated results that would have been reported had the transactions occurred on the dates indicated, nor does the information represent a forecast of the consolidated financial position at any future date or the combined financial results of the Company, Caerus and WQN for any future period.

VoIP, Inc
Pro Forma Condensed Combined Statement of Operations (Unaudited)
Six Months Ended June 30, 2005

	VoIP, Inc	Caerus, Inc	WQN, Inc	Adjustments	Consolidated
Revenues	$ 2,445,796	6,639,756	$ 15,583,367	$ -	$ 24,668,919
Cost of sales	1,933,103	8,477,915	14,931,037	-	25,342,055
Gross profit	512,693	(1,838,159)	652,330	-	(673,136)
Operating expenses	5,396,076	2,718,729	2,769,889	1,695,599	12,580,293
Loss from continuing operations before income taxes	(4,883,383)	(4,556,888)	(2,117,559)	(1,695,599)	(13,253,429)
Interest expense	82,103	386,838		321,600	790,541
Loss before income taxes and results of discontinued operations	(4,965,486)	(4,943,726)	(2,117,559)	(2,017,199)	(14,043,970)
Provision for income taxes	-	-	-	-	-
Net loss before discontinued operations	(4,965,486)	(4,943,726)	(2,117,559)	(2,017,199)	(14,043,970)
Loss from discontinued operations, net of income taxes	(126,016)	-	-	-	(126,016)
Net Loss	$ (5,091,502)	$ (4,943,726)	$ (2,117,559)	$ (2,017,199)	$ (14,169,986)
Basic and diluted loss per share:					
Loss before discontinued operations					$ (0.52)
Loss from discontinued operations, net of income taxes					(0.01)
Net Loss					$ (0.53)
Weighted average number of shares outstanding					26,940,458

The accompanying notes are an integral part of this pro forma condensed combined statement of operations.

18

VoIP, Inc
Pro Forma Condensed Combined Statement of Operations (Unaudited)
Three Months Ended June 30, 2005

	VoIP, Inc	Caerus, Inc	WQN, Inc	Adjustments	Consolidated
Revenues	$ 1,439,685	1,642,363	$ 7,975,629	$ -	$ 11,057,677
Cost of sales	935,214	2,120,198	7,605,626	-	10,661,038
Gross profit	504,471	(477,835)	370,003	-	396,639
Operating expenses	3,850,854	1,103,606	1,543,488	703,489	7,201,437
Loss from continuing operations before income taxes	(3,346,383)	(1,581,441)	(1,173,485)	(703,489)	(6,804,798)
Interest expense	67,825	146,756		160,800	375,381
Loss before income taxes and results of discontinued operations	(3,414,208)	(1,728,197)	(1,173,485)	(864,289)	(7,180,179)
Provision for income taxes	-	-	-	-	-
Net loss before discontinued operations	(3,414,208)	(1,728,197)	(1,173,485)	(864,289)	(7,180,179)
Loss from discontinued operations, net of income taxes	(121,896)	-	-	-	(121,896)
Net Loss	$ (3,536,104)	$ (1,728,197)	$ (1,173,485)	$ (864,289)	$ (7,302,075)
Basic and diluted loss per share:					
Loss before discontinued operations					$ (0.24)
Loss from discontinued operations, net of income taxes					-
Net Loss					$ (0.24)
Weighted average number of shares outstanding					30,012,632

The accompanying notes are an integral part of this pro forma condensed combined statement of operations.

19

VoIP, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED PRO FORMA CONDENSED COMBINED FINANCIAL STATEMENTS

(1) Basis of Presentation

The historical financial information for the Company, Caerus and WQN for the three and six months ended June 30, 2005 has been derived from each company's respective historical consolidated financial statements.

(2) VoIP, Inc. and Caerus, Inc. Merger

On June 1, 2005, the Company and Caerus announced the closing of the Merger of Volo with and into Caerus, with Caerus as the surviving corporation. The Merger was completed pursuant to the Merger Agreement through the conversion of all of Caerus' outstanding capital stock into 16,434,470 shares of common stock, par value $0.001, of the Company.

(3) On October 6, 2005, the Company purchased substantially all of the assets of WQN's VoIP business. Such assets consist of WQN's properties and infrastructure for its services platform for both retail and wholesale voice over internet business.

(4) Pro Forma Statements of Operations Adjustments

Adjustments to the pro forma Statements of Operations represent amortization of intangible assets and interest expense related to convertible debt recorded in connection with the acquisitions.

20

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

General

The following discussion should be read in conjunction with the unaudited consolidated financial statements and the notes thereto and the other financial information appearing elsewhere in this Form 10-Q. Certain statements contained in this Form 10-Q and other written material and oral statements made from time to time by us do not relate strictly to historical or current facts. As such, they are considered "forward-looking statements" that provide current expectations or forecasts of future events. Such statements are typically characterized by terminology such as "believe," "anticipate," "should," "intend," "plan," "will," "expect," "estimate," "project," "strategy," and “may,” and similar expressions. Our forward-looking statements generally relate to the prospects for future sales of our products, the success of our marketing activities, and the success of our strategic corporate relationships. These statements are based upon assumptions and assessments made by our management in light of its experience and its perception of historical trends, current conditions, expected future developments and other factors our management believes to be appropriate. These forward-looking statements are subject to a number of risks and uncertainties, including the following: our ability to achieve profitable operations and to maintain sufficient cash to operate our business and meet our liquidity requirements; our ability to obtain financing, if required, on terms acceptable to it, if at all; the success of our research and development activities; competitive developments affecting our current products; our ability to successfully attract strategic partners and to market both new and existing products; exposure to lawsuits and regulatory proceedings; our ability to protect our intellectual property; governmental laws and regulations affecting operations; our ability to identify and complete diversification opportunities; and the impact of acquisitions, divestitures, restructurings, product withdrawals and other unusual items. A further list and description of these risks, uncertainties and other matters can be found elsewhere in our Form 10-KSB for the year ended December 31, 2005. Except as required by applicable law, we undertake no obligation to update any forward-looking statements, whether as a result of new information, future events or otherwise.

Restatement of Financial Statements

On October 31, 2006, we concluded that our consolidated financial statements for the three and six months ended June 30, 2006 understated other income and warrant liabilities, and overstated net loss and additional paid-in capital. On May 22, 2006, we repriced a portion of our outstanding warrants to $0.78 per share, triggering contractual “favored nations” price ratchets on a number of our existing convertible debt and warrant agreements, reducing their effective conversion and exercise prices to $0.78 per share. The effect was to increase the number of our fully diluted shares of common stock to approximately 129 million, relative to our authorized 100 million common shares. Our total warrants then outstanding were approximately 28 million. Emerging Issues Task Force Issue No. 00-19 (“EITF 00-19”) states that in this instance, asset or liability classification of the warrants is required (as opposed to permanent equity classification). Our original June 30, 2006 consolidated financial statements only reflected this asset or liability accounting treatment for our warrants issued in January and February 2006. However, as a result of the May 2006 warrant repricing, we should have given this treatment to all of our outstanding warrants. We therefore restated our consolidated financial statements for the three and six months ended June 30, 2006. Adjustments to (i) increase the fair value warrant liability; (ii) decrease additional paid-in capital; and (iii) increase other income and decrease net loss aggregated $4,323,999, $5,271,659, and $947,660, respectively, for the six months ended June 30, 2006.

The following tables set forth the impact of this restatement on certain amounts previously reported in our consolidated financial statements as of and for the three and six months ended June 30, 2006.

Statement of Operations Data	Six Months Ended June 30, 2006	Three Months Ended June 30, 2006

	Previously Reported	Restated	Previously Reported	Restated
Change in fair value liability for warrants	$ (2,424,502)	$ (3,372,162)	$ (3,705,780)	$ (4,653,440)
Net loss	(19,946,393)	(18,998,733)	(6,139,359)	(5,191,699)
Net loss per common share	(0.29)	(0.28)	(0.09)	(0.07)

Balance Sheet Data	As of June 30, 2006	
	Previously Reported	Restated
Fair value liability for warrants	$ 1,871,889	$ 6,195,888
Additional paid-in capital	76,989,626	71,717,967
Accumulated deficit	(54,746,493)	(53,798,833)

Financial Summary

Balance Sheet Data:	June 30, 2006 (Restated)	December 31, 2005
Goodwill and other intangible assets	$ 36,683,014	$ 38,404,271
Total assets	49,760,228	56,244,161
Notes and loans payable, current	11,907,161	11,085,034
Total liabilities	31,768,585	27,018,241
Shareholders' equity	17,991,643	29,225,920

	Six Months Ended June 30		Three Months Ended June 30	
Statement of Operations Data:	2006 (Restated)	2005	2006 (Restated)	2005
Revenues	$ 18,998,290	$ 2,445,796	$ 9,003,742	$ 1,439,685
Operating expenses	16,119,884	5,396,076	7,006,697	3,850,854
Loss from continuing operations	(16,508,772)	(4,883,383)	(6,776,552)	(3,346,383)
Loss from discontinued operations	(968,261)	(126,016)	(21,782)	(121,896)
Net loss	(18,998,733)	(5,091,502)	(5,191,699)	(3,536,104)
Net loss per share	(0.28)	(0.19)	(0.07)	(0.12)

Comparability of Results

The comparability of our results of operations is greatly impacted by the acquisition in May 2005 of Caerus and by the purchase in October 2005 of substantially all of the VoIP-related assets and business of WQN. The following table presents our pro forma results of operations for the six and three months ended June 30, 2005, assuming these business combinations had occurred at the beginning of 2005.

	Six Months Ended June 30, 2005	Three Months Ended June 30, 2005
Revenues	$ 24,668,919	$ 11,057,677
Cost of sales	25,342,055	10,661,038
Operating expenses	12,580,293	7,201,437
Net loss	(14,169,986)	(7,302,075)
Net loss per share	(0.53)	(0.24)

Revenues

Our consolidated revenues for the six months ended June 30, 2006 and 2005 were $19.0 million and $2.4 million, respectively. Our consolidated net loss was $19.9 million ($0.29 per share) for the six months ended June 30, 2006 as compared to a net loss of $5.1 million ($0.19 per share) for the six months ended June 30, 2005. The increases in our revenues and net loss from the 2005 to 2006 period reflect the inclusion of the results of Caerus and the VoIP business of WQN from the dates of their acquisitions. Revenues for the six months ended June 30, 2006 include approximately $4.0 million and $14.8 million in revenues generated by the acquired Caerus and WQN businesses, respectively. Substantially all of the Caerus revenues for this 2006 period (which represent 21% of our consolidated revenues for this period) were generated by one customer. Our results for this 2006 period include operating losses of $6.7 million generated by Caerus' operations and $452,807 attributable to the business formerly owned by WQN.

Our consolidated revenues for the three months ended June 30, 2006 and 2005 were $9.0 million and $1.4 million, respectively. Our consolidated net loss was $6.1 million ($0.09 per share) for the three months ended June 30, 2006 as compared to a net loss of $3.5 million ($0.12 per share) for the three months ended June 30, 2005. The increases in our revenues and net loss from the 2005 to 2006 period reflect the inclusion of the results of Caerus and the VoIP business of WQN from the dates of their acquisitions. Revenues for the three months ended June 30, 2006 include approximately $1.9 million and $7.0 million in revenues generated by the acquired Caerus and WQN businesses, respectively. Substantially all of the Caerus revenues for this 2006 period (which represent 21% of our consolidated revenues for this period) were generated by one customer. Our 2006 results include operating losses of $2.6 million generated by Caerus' operations and $159,385 attributable to the business formerly owned by WQN.

Expenses

Consolidated operating expenses were $16.1 million and $ 5.4 million for the six months ended June 30, 2006 and 2005, respectively. Compensation and related expenses accounted for $5.4 million of the increase from 2005. Professional legal and consulting expenses increased by $2.6 million, due primarily to the litigation discussed in NOTE L to our consolidated financial statements. Depreciation and amortization increased $2.5 million, due primarily to amortization of intangible assets relating to the acquisition of Caerus and WQN assets. Interest expense also increased from $82,103 to $3.5 million, due to our increased level of debt used to finance our operations and the purchase of Caerus and WQN assets. Financing expenses were $1.4 million for the six months ended June 30, 2006 due to capital raising efforts.

Consolidated operating expenses were $7.0 million and $3.9 million for the three months ended June 30, 2006 and 2005, respectively. Compensation and related expenses accounted for $3.3 million of the increase from 2005. Professional legal and consulting expenses increased by approximately $543,000, due primarily to the litigation discussed in Note L to our consolidated financial statements. Depreciation and amortization increased $1.0 million, due primarily to amortization of intangible assets relating to the acquisition of Caerus and WQN assets. Commissions and fees paid to third parties decreased by approximately $855,000, because the comparable period of 2005 included expenses related to the Caerus acquisition. General and administrative expenses decreased by approximately $827,000, due primarily to a $397,821 noncash gain related to a litigation settlement discussed in NOTE K to our consolidated financial statements. Interest expense increased from $67,825 to $2.0 million, due to our increased level

of debt used to finance our operations, and for the purchase of Caerus and WQN assets. Financing expenses were $1.0 million for the three months ended June 30, 2006, due to our capital raising efforts.

In accordance with SFAS No. 142, we are required to periodically evaluate the carrying value of our goodwill and other intangible assets. During the six months ended June 30, 2006, we recognized impairment expense of $839,101 related to goodwill recorded for our hardware sales business segment, and included in our reported loss from discontinued operations. If in the future the remaining carrying value of our goodwill exceeds its fair market value, we may be required to record an additional impairment charge in our statement of operations. Such an impairment charge could have a significant adverse impact on both our operating results and financial condition. If the traded market price of our common stock continues to decline, or our future revenue does not increase coincident with amounts previously projected and utilized to determine the fair value of our goodwill and other intangible assets, a material goodwill impairment charge in the third quarter of 2006 is likely.

We did not have sufficient authorized and unissued common shares to satisfy the related warrant obligations associated with convertible notes issued in January and February 2006 on the dates the warrants were issued. Therefore, in accordance with Emerging Issues Task Force Issues 00-19 ("EITF 00-19"), the value of the January and February 2006 warrants at their issuance dates was recorded as a debt discount and a liability on our consolidated balance sheet. This liability was marked to market at March 31, 2006, resulting in a $1,281,278 increase in the liability and a corresponding charge to earnings for the three months ended March 31, 2006. In May 2006, we repriced a portion of our outstanding warrants to $0.78 per share, triggering contractual "favored nations" price ratchets on a number of our existing convertible debt and warrant agreements, bringing their effective conversion and exercise prices down to $0.78 per share. The effect of this was to increase the number of our fully diluted shares of common stock to approximately 129 million, relative to our currently-authorized 100 million common shares. At that time then, in accordance with EITF 00-19, we reclassified all of our remaining outstanding warrants from additional paid-in capital to warrant liability on our consolidate balance sheet. At June 30, 2006 this liability was again marked to market, resulting in a credit to operations of $4,653,440 for the three months ended June 30, 2006. Future changes in the market value of these warrants may have a material effect on our operating results.

Discontinued Operations

On April 19, 2006, the Company sold its wholly-owned subsidiary DTNet Technologies to the Company's former Chief Operating Officer (the "Purchaser"), pursuant to a stock purchase agreement. The consideration for the sale consisted primarily of (1) the return for cancellation of warrants to purchase 200,000 shares of the Company's common stock held by the Purchaser; and (2) the return for cancellation of 200,000 shares of the Company's common stock held by the Purchaser. Because DTNet Technologies' operations were the primary component of the Company's hardware sales business segment, the Company recorded an impairment charge of $839,101 in its statement of operations for the three months ended June 30, 2006. The remaining $198,000 of goodwill for this segment approximated the excess of the sales proceeds received over DTNet Technologies' carrying value (excluding goodwill) and was written off in conjunction with the sale of DTNet Technologies.

The following summarizes the results of DTNet Technologies' operations for the six and three months ended June 30, 2006 (through the April 19, 2006 date of sale) and 2005, classified as discontinued operations for all periods presented.

	Six Months Ended June 30		Three Months Ended June 30	
	2006	2005	2006	2005
Revenues	$ 421,722	$ 866,446	$ 54,724	$ 470,088
Cost of sales	326,127	671,903	43,391	368,697
Gross profit	95,595	194,543	11,333	101,391
Compensation and benefits	116,985	186,578	27,958	101,971
Other operating expenses*	946,871	133,981	5,157	121,316
Net loss	$ (968,261)	$ (126,016)	$ (21,782)	$ (121,896)

*Includes $839,101 impairment of goodwill recorded in March, 2006.

Assets

Total assets at June 30, 2006 were $49.8 million, down from $56.2 million at December 31, 2005. This decrease in assets is due primarily to increased depreciation, amortization and impairment related to the tangible and intangible assets. Goodwill and other intangible assets comprised 74% of our consolidated total assets at June 30, 2006, attributable primarily to the acquisitions of Caerus and WQN assets.

Results by Segment

Comparison of Six Months Ended June 30, 2006 and 2005

Our results by business segment for the six months ended June 30, 2006 and 2005 are as follows:

	Telecommunication Services	Hardware Sales	Calling Cards	Corporate	Consolidated
2006:					
Revenues	$ 8,776,545	$ 191,496	$ 10,030,249	$ -	$ 18,998,290
Gross profit (loss)	(640,546)	64,239	187,419	-	(388,888)
Operating expenses	5,974,755	12,096	223,114	9,909,919	16,119,884
Profit (loss) from continuing operations	(6,615,301)	52,143	(35,695)	(9,909,919)	(16,508,772)
Other expense	608,931	-	-	912,769	1,521,700
Loss from discontinued operations	-	-	-	(968,261)	(968,261)
Net income (loss)	$ (7,224,232)	$ 52,143	$ (35,695)	$ (11,790,949)	$ (18,998,733)
2005:					
Revenues	$ 1,542,112	$ 903,684	$ -	$ -	$ 2,445,796
Gross profit (loss)	(31,933)	544,626	-	-	512,693
Operating expenses	2,329,951	42,545	-	3,023,580	5,396,076
Profit (loss) from continuing operations	(2,361,884)	502,081	-	(3,023,580)	(4,883,383)
Other expense	53,446	-	-	28,657	82,103
Loss from discontinued operations	-	-	-	(126,016)	(126,016)
Net income (loss)	$ (2,415,330)	$ 502,081	$ -	$ (3,178,253)	$ (5,091,502)

Telecommunication Services Segment:

Telecommunication services revenues increased from $1.5 million for the six months ended June 30, 2005 to $8.8 million for the six months ended June 30, 2006. The net loss from this segment also increased from $2.4 million to $7.2 million. These increases are attributable almost entirely to the Caerus and WQN acquisitions.

The negative gross profit for this segment of $640,546 in the first six months of 2006 reflects variable costs paid to third party vendors that exceeded the revenues we charged to terminate the calls of our customers. Positive margins on our network traffic will require us to increase the overall volume of traffic handled by our network by growing our customer base, and lower the average cost per minute we pay for call termination through: (a) negotiating more favorable pricing; (b) expanding our selection of third party vendors; and (c) improving our routing process and technology to ensure we are using the lowest cost route available to us to terminate each call.

Operating expenses in the first six months of 2006 for this segment rose to $6.0 million, and include compensation and benefits expenses of $1.3 million, and depreciation and amortization aggregating $2.5 million. Other expense, consisting primarily of interest expense, increased due to debt assumed with the Caerus acquisition.

Hardware Sales Segment:

Hardware sales revenues decreased from $903,684 in the six months ended June 30, 2005 to $191,496 in the comparable period of 2006. The decrease is attributed to the sale of DTNet Technologies in April 2006, whose revenues for both periods have been included in our reported loss from discontinued operations.

On April 19, 2006, the Company sold its wholly-owned subsidiary, DTNet Technologies. However, because DTNet Technologies' operations were the primary component of the Company's hardware sales business segment, the Company recorded an impairment charge of $839,101 in its statement of operations for the three months ended June 30, 2006, which was included in our reported loss from discontinued operations.

Calling Card Sales Segment:

Calling cards revenues are all related to the WQN asset acquisition, which occurred in the fourth quarter of 2005. Revenues from this segment amounted to $10.0 million for the first six months of 2006. Given the wholesale nature of this business segment, its gross margin is inherently small, typically averaging 2%, more or less. This segment had a net loss of $35,695 for the six months ended June 30, 2006.

Comparison of Three Months Ended June 30, 2006 and 2005

Our results by business segment for the three months ended June 30, 2006 and 2005 are as follows:

	Telecommunication Services	Hardware Sales	Calling Cards	Corporate	Consolidated
2006:					
Revenues	$ 4,143,998	$ 123,643	$ 4,736,101	$ -	$ 9,003,742
Gross profit (loss)	87,642	55,081	87,422	-	230,145
Operating expenses	2,581,615	2,374	96,524	4,326,184	7,006,697
Profit (loss) from continuing operations	(2,493,973)	52,707	(9,102)	(4,326,184)	(6,776,552)
Other expense	283,571	-	-	(1,890,206)	(1,606,635)
Loss from discontinued operations	-	-	-	(21,782)	(21,782)
Net income (loss)	$ (2,777,544)	$ 52,707	$ (9,102)	$	