FSB Community Bankshares Inc
Form 10-Q
November 14, 2011

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

FORM 10-Q

x Quarterly Report Pursuant To Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended September 30, 2011

OR

o Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from _______________ to ______________________

Commission File No. 001-52751

FSB Community Bankshares, Inc.
(Exact name of registrant as specified in its charter)

United States	74-3164710
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
45 South Main Street, Fairport, New York	14450
(Address of Principal Executive Offices)	Zip Code

(585) 223-9080
(Registrant's telephone number)

N/A
(Former name or former address, if changed since last report)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
YES x NO o.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one)

Large accelerated filer	o	Accelerated filer	o
Non-accelerated filer	o	Smaller reporting company	x
(Do not check if smaller reporting company)			

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES o NO x

As of November 14, 2011 there were 1,785,000 shares of the Registrant's common stock, par value $0.10 per share, outstanding, 946,050 of which were held by FSB Community Bankshares, MHC, the Registrant's mutual holding company.

FSB Community Bankshares, Inc.
FORM 10-Q

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Part I. Financial Information

Item 1. Consolidated Financial Statements

FSB COMMUNITY BANKSHARES, INC.

Consolidated Balance Sheets
September 30, 2011 and December 31, 2010 (unaudited)
(Dollars in thousands, except share data)

	September 30, 2011	December 31, 2010
Assets		
Cash and due from banks	$733	$561
Interest-earning demand deposits	11,092	7,273
Cash and Cash Equivalents	11,825	7,834
Securities available for sale	60,340	72,634
Securities held to maturity (fair value 2011 $7,333; 2010 $7,305)	7,096	7,183
Investment in FHLB stock	1,404	1,513
Loans held for sale	1,688	342
Loans receivable, net of allowance for loan losses (2011 $406; 2010 $384)	121,384	114,477
Bank owned life insurance	3,235	3,144
Accrued interest receivable	776	888
Premises and equipment, net	3,203	2,705
Prepaid FDIC premium	470	579
Other assets	1,142	1,108
Total Assets	$212,563	$212,407
Liabilities & Stockholders' Equity		
Deposits:		
Non-interest-bearing	$4,092	$3,705
Interest-bearing	160,386	158,701
Total Deposits	164,478	162,406
Borrowings	24,191	26,732
Advances from borrowers for taxes and insurance	975	1,926
Official bank checks	1,380	363
Other liabilities	650	488
Total Liabilities	191,674	191,915
Stockholders' Equity		
Preferred Stock- no par value- 1,000,000 shares authorized; no shares issued and outstanding	-	-
Common Stock- $0.10 par value – 10,000,000 shares authorized; 1,785,000 shares issued and outstanding	179	179

Additional paid-in-capital	7,265	7,269
Retained earnings	13,533	13,537
Accumulated other comprehensive income	446	67
Unearned ESOP shares – at cost	(534)	(560)
Total Stockholders' Equity	20,889	20,492
Total Liabilities and Stockholders' Equity	$212,563	$212,407

See accompanying notes to consolidated financial statements

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FSB COMMUNITY BANKSHARES, INC.

Consolidated Statements of Income
Three Months Ended September 30, 2011 and 2010 (unaudited)
(Dollars in thousands, except per share data)

	2011	2010
Interest and Dividend Income		
Loans	$1,555	$1,614
Securities – taxable	219	285
Securities – tax exempt	14	3
Mortgage-backed securities	195	218
Other	2	7
Total Interest and Dividend Income	1,985	2,127
Interest expense		
Deposits	456	590
Borrowings	223	293
Total Interest Expense	679	883
Net Interest Income	1,306	1,244
Provision for Loan Losses	7	8
Net Interest Income After Provision for Loan Losses	1,299	1,236
Other Income		
Service fees	53	56
Fee income	36	10
Realized gain on sale of securities	111	95
Increase in cash surrender value of bank owned life insurance	30	34
Realized gain on sale of loans	100	155
Mortgage fee income	70	59
Other	26	33
Total Other Income	426	442
Other Expense		
Salaries and employee benefits	983	894
Occupancy expense	192	151
Data processing costs	33	27
Advertising	44	39
Equipment expense	140	107
Electronic banking	24	22
Directors' fees	31	30
Mortgage fees and taxes	93	61
FDIC premium expense	(23)	58
Other expense	187	168
Total Other Expenses	1,704	1,557

Income Before Income Taxes	21	121
Provision (Benefit) for Income Taxes	(5)	29
Net Income	$26	$92
Earnings per common share – basic and diluted	$0.02	$0.05

See accompanying notes to consolidated financial statements

FSB COMMUNITY BANKSHARES, INC.

Consolidated Statements of Income
Nine months Ended September 30, 2011 and 2010 (unaudited)
(Dollars in thousands, except per share data)

	2011	2010
Interest and Dividend Income		
Loans	$4,599	$4,809
Securities – taxable	726	1,124
Securities – tax exempt	38	3
Mortgage-backed securities	650	634
Other	6	12
Total Interest and Dividend Income	6,019	6,582
Interest expense		
Deposits	1,422	1,978
Borrowings	676	973
Total Interest Expense	2,098	2,951
Net Interest Income	3,921	3,631
Provision for Loan Losses	22	14
Net Interest Income After Provision for Loan Losses	3,899	3,617
Other Income		
Service fees	141	173
Fee income	45	36
Realized gain on sale of securities	135	87
Realized loss on sale of real estate owned	-	(5)
Increase in cash surrender value of bank owned life insurance	91	99
Realized gain on sale of loans	225	238
Mortgage fee income	166	141
Other	94	94
Total Other Income	897	863
Other Expense		
Salaries and employee benefits	2,666	2,308
Occupancy expense	548	450
Data processing costs	82	70
Advertising	141	133
Equipment expense	380	314
Electronic banking	70	59
Directors' fees	98	85
Mortgage fees and taxes	185	178
FDIC premium expense	121	174
Other expense	568	523
Total Other Expenses	4,859	4,294

Income (Loss) Before Income Taxes	(63)	186
Provision (Benefit) for Income Taxes	(59)	26
Net Income (Loss)	$(4)	$160
Earnings (Loss) per common share – basic and diluted	$(0.00)	$0.09

See accompanying notes to consolidated financial statements

FSB COMMUNITY BANKSHARES, INC.

Consolidated Statements of Stockholders' Equity
Nine months Ended September 30, 2011 and 2010 (unaudited)
(Dollars in thousands)

	Common Stock	Additional Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Unearned ESOP Shares	Total
Balance – January 1, 2010	$179	$7,275	$13,317	$ 174	$(595)	$20,350
Comprehensive income:						
Net income	-	-	160	-	-	160
Change in net unrealized gain on securities available for sale, net of reclassification adjustment and taxes	-	-	-	364	-	364
Total Comprehensive Income						524
ESOP shares committed to be released (2,624 shares)	-	(4)	-	-	27	23
Balance – September 30, 2010	$179	$7,271	$13,477	$ 538	$(568)	$20,897
Balance – January 1, 2011	$179	$7,269	$13,537	$ 67	$(560)	$20,492
Comprehensive income:						
Net loss	-	-	(4)	-	-	(4)
Change in net unrealized gain on securities available for sale, net of reclassification adjustment and taxes	-	-	-	379	-	379
Total Comprehensive Income						375
ESOP shares committed to be released (2,624 shares)	-	(4)	-	-	26	22
Balance – September 30, 2011	$179	$7,265	$13,533	$ 446	$(534)	$20,889

See accompanying notes to consolidated financial statements

FSB COMMUNITY BANKSHARES, INC.

Consolidated Statements of Cash Flows
Nine months Ended September 30, 2011 and 2010 (unaudited)
(Dollars in thousands)

	2011	2010
Cash Flows From Operating Activities		
Net income (loss)	$(4)	$160
Adjustments to reconcile net income (loss) to net cash provided by (used by) operating activities:		
Net amortization of premiums and discounts on investments	565	743
Gain on sale of securities available for sale	(135)	(97)
Loss on sale of securities held to maturity	-	10
Gain on sale of loans	(225)	(238)
Proceeds from loans sold	2,706	7,377
Loans originated for sale	(3,827)	(7,834)
Amortization of net deferred loan origination costs	8	23
Amortization of premium on FHLB advances	150	-
Depreciation and amortization	305	238
Provision for loan losses	22	14
Expense related to ESOP	22	23
Deferred income tax (benefit) expense	(75)	1
Earnings on investment in bank owned life insurance	(91)	(99)
Decrease in accrued interest receivable	112	147
Decrease in prepaid FDIC premium	109	162
Decrease (increase) in other assets	(34)	271
Decrease in other liabilities	43	29
Loss on sale of real estate owned	-	5
Net Cash Provided By (Used By) Operating Activities	(349)	935
Cash Flows From Investing Activities		
Purchases of securities available for sale	(35,078)	(80,230)
Proceeds from maturities and calls of securities available for sale	38,108	71,800
Proceeds from sales of securities available for sale	3,024	3,188
Proceeds from principal paydowns on securities available for sale	6,394	5,494
Purchases of securities held to maturity	(434)	(510)
Proceeds from sales of securities held to maturity	-	686
Proceeds from principal paydowns on securities held to maturity	510	387
Net decrease (increase) in loans	(6,937)	2,387
Redemption of FHLB stock	109	278
Proceeds from sales of foreclosed real estate	-	74
Purchase of premises and equipment	(803)	(216)
Net Cash Provided By Investing Activities	4,893	3,338
Cash Flows From Financing Activities		
Net increase in deposits	2,072	5,839
Proceeds from borrowings	4,000	13,238
Repayments on borrowings	(6,691)	(19,028)

Net decrease in advances from borrowers for taxes and insurance	(951)	(1,106)
Net increase in official bank checks	1,017	1,449
Net Cash Provided By (Used By) Financing Activities	(553)	392
Net Increase in Cash and Cash Equivalents	3,991	4,665
Cash and Cash Equivalents- Beginning	7,834	5,965
Cash and Cash Equivalents- Ending	$11,825	$10,630
Supplementary Cash Flows Information		
Interest paid	$2,108	$3,002
Income taxes paid	$-	$-

See accompanying notes to consolidated financial statements

Notes to Consolidated Financial Statements

Note 1-Basis of Presentation

The accompanying unaudited consolidated financial statements of FSB Community Bankshares, Inc. and its wholly owned subsidiary Fairport Savings Bank (collectively, the “Company”) have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and the applicable instructions to Form 10-Q and Regulation S-X. Accordingly, they do not include all of the information and footnotes necessary for a complete presentation of consolidated financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. In the opinion of management, all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation have been included.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) 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 financial statements and the reported amounts of revenues and expenses during the reported periods. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant changes in the near term relate to the determination of the allowance for loan losses, the evaluation of other-than-temporary impairment of investment securities, and the valuation of deferred tax assets. For additional information and disclosures required under GAAP, reference is made to the Company’s Annual Report on Form 10-K for the period ended December 31, 2010 (the “Form 10-K”) filed with the Securities and Exchange Commission (“SEC”) on March 31, 2011.

The unaudited consolidated financial statements and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” should be read in conjunction with the Company’s audited consolidated financial statements for the year ended December 31, 2010, included in the Form 10-K filed with the SEC on March 31, 2011.

Operating results for the three and nine months ended September 30, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011.

The consolidated financial statements at September 30, 2011 and December 31, 2010 and for the three and nine months ended September 30, 2011 and 2010 include the accounts of the Company, Fairport Savings Bank (the “Bank”) and the Bank’s wholly-owned subsidiary, Oakleaf Services Corporation (“Oakleaf”). All inter-company balances and transactions have been eliminated in consolidation. Certain amounts from prior periods may have been reclassified, when necessary, to conform to current period presentation. Such reclassifications had no impact on net income (loss) or stockholders’ equity.

The Company has evaluated subsequent events through the date these consolidated financial statements were issued. On October 26, 2011 the Bank opened its fifth full service branch location in Perinton, NY.

Note 2-Fair Value Measurement and Disclosure

Management uses its best judgment in estimating the fair value of the Company’s financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates herein are not necessarily indicative of the amounts the Company could have realized in a sale transaction on the dates indicated. The estimated fair value amounts have been measured as of their respective reporting dates and have not been re-evaluated or updated for purposes of these consolidated financial statements subsequent to those respective dates. As such, the estimated fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported at each reporting date.

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Note 2--Fair Value Measurement and Disclosure (Continued)

A fair value hierarchy that prioritizes the inputs to valuation methods is used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are as follows:

Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical unrestricted assets or liabilities.

Level 2: Quoted prices in markets that are not active, or inputs that are observable either directly or indirectly, for substantially the full term of the asset or liability.

Level 3: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e. supported with little or no market activity).

An asset or liability's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

For assets measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy used are as follows at September 30, 2011 and at December 31, 2010:

September 30, 2011 Securities Available for Sale: (In Thousands)	Total	Level 1	Level 2	Level 3
U.S. Government and agency obligations	$ 27,042	$ -	$ 27,042	$ -
Mortgage-backed securities - residential	29,779	-	29,779	-
SBA pools	3,519	-	3,519	-
Total Available for Sale Securities	$ 60,340	$ -	$ 60,340	$ -

December 31, 2010 Securities Available for Sale: (In Thousands)	Total	Level 1	Level 2	Level 3
U.S. Government and agency obligations	$ 39,336	$ 8,014	$ 31,322	$ -
Mortgage-backed securities - residential	29,361	1,673	27,688	-
SBA pools	3,937	-	3,937	-
Total Available for Sale Securities	$ 72,634	$ 9,687	$ 62,947	$ -

There was one mortgage-backed security for $1.7 million transferred out of level 1 securities available for sale to level 2 securities available for sale during the nine months ended September 30, 2011, as a result of the lack of availability of observable market data used in the securities' pricing obtained through independent pricing services or dealer market participants. There were six U.S. Government and agency obligations for $8.0 million called during the nine months ended September 30, 2011 that were measured as level 1 securities available for sale at December 31, 2010. No assets or liabilities have been measured on a non-recurring basis at or for the nine months ended September 30, 2011 or at or for the year ended December 31, 2010.

Accounting guidance requires disclosure of fair value information about financial instruments, whether or not recognized in the consolidated balance sheets, for which it is practicable to estimate that value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the defined fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument. Certain assets and liabilities are excluded from the disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company.

Note 2--Fair Value Measurement and Disclosure (Continued)

The following methods and assumptions were used by the Company in estimating its fair value disclosures for financial instruments at September 30, 2011 and December 31, 2010:

Cash, Due from Banks, and Interest-Earning Demand Deposits

The carrying amounts of these assets approximate their fair values.

Investment Securities

The fair value of securities available for sale (carried at fair value) and held to maturity (carried at amortized cost) are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level 1), or matrix pricing (Level 2), which is a mathematical technique used widely in the banking industry to value debt securities without relying exclusively on quoted market prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted prices. For certain securities which are not traded in active markets or are subject to transfer restrictions, valuations are adjusted to reflect illiquidity and/or non-transferability, and such adjustments are based on observable market based assumptions (Level 3). In the absence of such evidence, management's best estimate is used. Management's best estimate consists of both internal and external support on certain Level 3 investments. Internal cash flow models using a present value formula that includes assumptions market participants would use along with indicative exit pricing obtained from broker/dealers (where available) are used to support fair values of certain Level 3 investments. The Company had no Level 3 investment securities at September 30, 2011 or at December 31, 2010.

Investment in FHLB Stock

The carrying value of Federal Home Loan Bank ("FHLB") stock approximates its fair value based on the restricted nature of the FHLB stock.

Loans

The fair values of loans held to maturity are estimated using discounted cash flow analyses, using market rates at the balance sheet date that reflect the credit and interest rate-risk inherent in the loans. Projected future cash flows are calculated based upon contractual maturity or call dates, projected repayments and prepayments of principal. Generally, for variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values.

Mortgage loans held for sale in the secondary market are carried at the lower of cost or fair value. Separate determinations of fair value for residential and commercial loans are made on an aggregate basis. Fair value is determined based solely on the effect of changes in secondary market interest rates and yield requirements from the commitment date to the date of the financial statements. Realized gains and losses on sales are computed using the specific identification method.

Accrued Interest Receivable and Payable

The carrying amount of accrued interest receivable and payable approximates fair value.

Deposits

The fair values disclosed for demand deposits (e.g., NOW accounts, non-interest checking, regular savings and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). The carrying amounts for variable-rate certificates of deposit approximate their fair values at the reporting date. Fair values for fixed rate certificates of deposit are estimated using a discounted cash flow calculation that applies market interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.

Note 2--Fair Value Measurement and Disclosure (Continued)

Borrowings

The fair values of FHLB borrowings are estimated using discounted cash flow analyses, based on the quoted rates for new FHLB advances with similar credit risk characteristics, terms and remaining maturity.

Off-Balance Sheet Instruments

The fair values for off-balance sheet financial instruments (lending commitments and lines of credit) are estimated using the fees currently charged to enter into similar agreements, taking into account market interest rates, the remaining terms and present credit worthiness of the counterparties. Such fees were not material at September 30, 2011 and December 31, 2010.

The carrying amounts and estimated fair values of the Company's financial instruments at September 30, 2011 and December 31, 2010 are as follows:

	September 30, 2011		December 31, 2010	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(In Thousands)			
Financial assets:				
Cash and due from banks	$733	$733	$561	$561
Interest-earning demand deposits	11,092	11,092	7,273	7,273
Securities available for sale	60,340	60,340	72,634	72,634
Securities held to maturity	7,096	7,333	7,183	7,305
Investment in FHLB stock	1,404	1,404	1,513	1,513
Loans held for sale	1,688	1,688	342	342
Loans, net	121,384	128,473	114,477	116,350
Accrued interest receivable	776	776	888	888
Financial liabilities:				
Deposits	164,478	163,648	162,406	161,165
Borrowings	24,191	22,695	26,732	25,107
Accrued interest payable	58	58	68	68
Off-balance sheet instruments:				
Commitments to extend credit	-	-	-	-

Note 3 - Securities

The amortized cost and estimated fair value of securities with gross unrealized gains and losses at September 30, 2011 and at December 31, 2010 are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
		(In Thousands)		
September 30, 2011:				
Available for Sale:				
U.S. Government and agency obligations	$26,909	$152	$(19)	$27,042
Mortgage-backed securities - residential	29,263	519	(3)	29,779
SBA pools	3,492	27	-	3,519
	$59,664	$698	$(22)	$60,340
Held to Maturity:				
Mortgage-backed securities-residential	$4,405	$162	$-	$4,567
State and Municipal securities	2,691	75	-	2,766
	$7,096	$237	$-	$7,333
December 31, 2010:				
Available for Sale:				
U.S. Government and agency obligations	$39,764	$32	$(460)	$39,336
Mortgage-backed securities - residential	28,882	539	(60)	29,361
SBA pools	3,886	51	-	3,937
	$72,532	$622	$(520)	$72,634
Held to Maturity:				
Mortgage-backed securities – residential	$4,918	$182	$-	$5,100
State and Municipal securities	2,265	-	(60)	2,205
	$7,183	$182	$(60)	$7,305

Mortgage-backed securities consist of securities that are issued by Fannie Mae (“FNMA”), Freddie Mac (“FHLMC”), Ginnie Mae (“GNMA”), and Federal Farm Credit Bank (“FFCB”) and are collateralized by residential mortgages.

The amortized cost and estimated fair value by contractual maturity of debt securities at September 30, 2011 are shown below. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations.

Note 3 – Securities (continued)

	Available for Sale		Held to Maturity	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
	(In Thousands)		(In Thousands)	
Due in one year or less	$-	$-	$-	$-
Due after one year through five years	2,500	2,531	1,177	1,197
Due after five years through ten years	11,893	11,979	1,514	1,569
Due after ten years	12,516	12,532	-	-
Mortgage-backed securities – residential	29,263	29,779	4,405	4,567
SBA pools	3,492	3,519	-	-
	$59,664	$60,340	$7,096	$7,333

For the nine months ended September 30, 2011 there was a $24,000 gross realized gain on sale of mortgage-backed securities available for sale resulting from proceeds of $1.4 million and a $111,000 gross realized gain on sale of U.S. government agency securities available for sale resulting from proceeds of $1.6 million. For the nine months ended September 30, 2010 there was a $10,000 gross realized loss on sale of mortgage-backed securities held to maturity resulting from proceeds of $686,000, a $2,000 gross realized gain on sale of FHLMC common stock available for sale resulting from proceeds of $11,000, and a $95,000 gross realized gain on sale of U.S. government agency securities available for sale resulting from proceeds of $3.2 million. In accordance with accounting guidance, the Company was able to sell securities classified as held to maturity after the Company had already collected a substantial portion (at least 85%) of the principal outstanding at acquisition due either to prepayments or to scheduled principal and interest payments on the debt securities.

No securities were pledged to secure public deposits or for any other purpose required or permitted by law at September 30, 2011 or at December 31, 2010.

The following table shows gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2011 and December 31, 2010:

Note 3 – Securities (continued)

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
			(In Thousands)			
September 30, 2011:						
Available for Sale						
U.S. Government and agency obligations	$3,537	$6	$3,360	$13	$6,897	$19
Mortgaged-backed securities - residential	2,144	3	-	-	2,144	3
Held to Maturity						
State and Municipal securities	-	-	-	-	-	-
	$5,681	$9	$3,360	$13	$9,041	$22
December 31, 2010:						
Available for Sale						
U.S. Government and agency obligations	$24,757	$460	$-	$-	$24,757	$460
Mortgaged-backed securities - residential	8,387	60	-	-	8,387	60
Held to Maturity						
State and Municipal securities	1,875	60	-	-	1,875	60
	$35,019	$580	$-	$-	$35,019	$580

Management evaluates securities for other-than-temporary impairment at least quarterly, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than the amortized cost basis, (2) the financial condition of the issuer (and guarantor, if any) and adverse conditions specifically related to the security, industry or geographic area, (3) failure of the issuer of the security to make scheduled interest or principal payments, (4) any changes to the rating of a security by a rating agency, (5) the presence of credit enhancements, if any, including the guarantee of the federal government or any of its agencies, and (6) whether the Company intends to sell or more likely than not be required to sell the debt securities. In the nine month period ended September 30, 2011 and the year ended December 31, 2010, the Company did not record an other-than-temporary impairment charge.

At September 30, 2011, four U.S. Government and agency securities and two mortgage-backed securities were in a continuous unrealized loss position for less than twelve months. At September 30, 2011, four U.S. Government agency securities were in a continuous unrealized loss position for twelve months or more. The U.S. Government and agency securities and mortgage-backed securities were issued by U.S. government sponsored agencies. All are paying in accordance with their terms with no deferrals of interest or defaults. Because the decline in fair value is attributable to changes in interest rates, not credit quality, and because management does not intend to sell and will more than likely not be required to sell these securities prior to recovery or maturity, no declines are deemed to be other-than-temporary.

Note 4 – Loans and The Allowance for Loan Losses

Net loans at September 30, 2011 and December 31, 2010 consist of the following:

	2011	2010
	(In Thousands)	
Real estate loans:		
Secured by one-to-four residential	$ 107,804	$ 102,295
Home equity lines of credit	9,073	8,900
Secured by multifamily residential	1,355	1,165
Construction	966	652
Commercial	2,143	1,395
Other	75	73
Total Loans	121,416	114,480
Net deferred loan origination costs	374	381
Allowance for loan losses	(406)	(384)
Net Loans	$ 121,384	$ 114,477

An analysis of activity in the allowance for loan losses for the nine months ended September 30, 2011 and 2010 is as follows:

	2011	2010
Balance at January 1	$ 384	$ 368
Provision for loan losses	22	13
Loans charged-off	-	-
Recoveries	-	-
Balance at September 30	$ 406	$ 381

The loan portfolio is segmented into commercial and consumer loans. Commercial loans consist of commercial real estate. Consumer loans consist of the following classes: residential real estate, construction, home equity lines of credit, and other consumer.

The Bank's primary lending activity is the origination of one-to-four residential real estate mortgage loans. At September 30, 2011, $107.8 million, or 88.8%, of the total loan portfolio consisted of one-to-four residential real estate mortgage loans compared to $102.3 million, or 89.4%, of the total loan portfolio at December 31, 2010. The Bank offers fixed-rate and adjustable-rate residential real estate mortgage loans with maturities of up to 30 years and maximum loan amounts generally of up to $750,000.

The Bank currently offers fixed-rate conventional mortgage loans with terms of up to 30 years that are fully amortizing with monthly loan payments, and adjustable-rate mortgage loans that provide an initial fixed interest rate for one, three, five, seven or ten years and that amortize over a period of up to 30 years. The Bank originates fixed-rate mortgage loans with terms of less than 15 years, but at rates applicable to 15-year loans. The Bank originates fixed-rate bi-weekly mortgage loans with terms of up to 30 years that are fully amortizing with bi-weekly loan payments, and "interest only" loans where the borrower pays interest for an initial period (ten years) after which the loan converts to a fully amortizing loan.

Note 4 – Loans and The Allowance for Loan Losses (continued)

Management actively monitors the interest rate risk position to determine the desired level of investment in fixed-rate mortgages. Depending on market interest rates and the Bank's capital and liquidity position, all newly originated longer term fixed-rate residential mortgage loans may be retained, or, all or a portion of such loans may be sold in the secondary mortgage market to government sponsored entities such as Freddie Mac or other purchasers.

The Bank originates residential, first mortgage loans with the assistance of computer-based underwriting engines licensed from Fannie Mae and/or Freddie Mac. Appraisals of real estate collateral are contracted directly with independent appraisers and not through appraisal management companies. The Bank's appraisal management policy and procedure is in accordance with all rules and best practice guidance from the Bank's primary regulator. Credit scoring, using FICO, is employed in the ultimate judgmental credit decision by the Bank's underwriting staff. The Bank does not use third party contract underwriting services. Residential mortgage loans include fixed and variable interest rate loans secured by one to four family homes generally located in Monroe, Ontario, and Wayne counties of New York State. The Bank's ability to be repaid on such loans is closely linked to the economic and real estate market conditions in this region. Underwriting policies generally adhere to Fannie Mae and Freddie Mac guidelines for loan requests of conforming and non-conforming amounts. In deciding whether to originate each residential mortgage, the Bank considers the qualifications of the borrower as well as the value of the underlying property.

Adjustable-rate mortgage loans generally present different credit risks than fixed-rate mortgage loans primarily because the underlying debt service payments of the borrowers increase as interest rates increase, thereby increasing the potential for default. Interest-only loans present different credit risks than fully amortizing loans, as the principal balance of the loan does not decrease during the interest-only period. As a result, the Bank's exposure to loss of principal in the event of default does not decrease during this period.

The Bank offers home equity lines of credit, which are primarily secured by a second mortgage on one-to-four-family residences. At September 30, 2011, home equity lines of credit totaled $9.1 million, or 7.5%, of total loans receivable compared to $8.9 million, or 7.7%, of total loans receivable at December 31, 2010.

The underwriting standards for home equity lines of credit include a determination of the applicant's credit history, an assessment of the applicant's ability to meet existing obligations, the value of the collateral securing the loan, and payments on the proposed loan. The combined loan-to-value ratio (first and second mortgage liens) for home equity lines of credit is generally limited to 90%. The Company originates home equity lines of credit without application fees or borrower-paid closing costs. Home equity lines of credit are offered with adjustable-rates of interest indexed to the prime rate, as reported in The Wall Street Journal.

Multi-family residential loans generally are secured by rental properties. Multi-family real estate loans are offered with fixed and adjustable interest rates. Loans secured by multi-family real estate totaled $1.4 million, or 1.1%, of the total loan portfolio at September 30, 2011, compared to $1.2 million, or 1.0%, of the total loan portfolio at December 31, 2010. Multi-family real estate loans are originated for terms of up to 20 years. Adjustable-rate multi-family real estate loans are tied to the average yield on U.S. Treasury securities, subject to periodic and lifetime limitations on interest rate changes.

Loans secured by multi-family real estate generally involve a greater degree of credit risk than one-to four-family residential mortgage loans and carry larger loan balances. This increased credit risk is a result of several factors including: the concentration of principal in a limited number of loans and borrowers, the effects of general economic conditions on income producing properties, and the increased difficulty of evaluating and monitoring these types of loans. Furthermore, the repayment of loans secured by multi-family real estate typically depends upon the successful operation of the real estate property securing the loans. If the cash flow from the project is reduced, the borrower's ability to repay the loan may be impaired.

Note 4 – Loans and The Allowance for Loan Losses (continued)

The Bank originates construction loans for the purchase of developed lots and for the construction of single-family residences. At September 30, 2011, construction loans totaled $966,000, or 0.8%, of total loans receivable compared to $652,000, or 0.6%, at December 31, 2010. At September 30, 2011, the additional unadvanced portion of these construction loans totaled $299,000 compared to $357,000 of additional unadvanced portion of construction loans at December 31, 2010. Construction loans are offered to individuals for the construction of their personal residences by a qualified builder.

Before making a commitment to fund a construction loan, we require an appraisal of the property by an independent licensed appraiser. We generally also review and inspect each property before disbursement of funds during the term of the construction loan.

Construction financing generally involves greater credit risk than long-term financing on improved, owner-occupied real estate. Risk of loss on a construction loan depends largely upon the accuracy of the initial estimate of the value of the property at completion of construction compared to the estimated cost (including interest) of construction and other assumptions. If the estimate of construction cost proves to be inaccurate, we may be required to advance additional funds beyond the amount originally committed in order to protect the value of the property. Moreover, if the estimated value of the completed project proves to be inaccurate, the borrower may hold a property with a value that is insufficient to assure full repayment of the loan.

Commercial real estate loans are secured by office buildings, mixed use properties, places of worship, and other commercial properties. At September 30, 2011, $2.1 million, or 1.7%, of our total loan portfolio consisted of commercial real estate loans compared to $1.4 million, or 1.2%, of our total loan portfolio at December 31, 2010.

The Company generally originates adjustable-rate commercial real estate loans with maximum terms of up to 15 years. The maximum loan-to-value ratio of commercial real estate loans is 70%.

Loans secured by commercial real estate generally are larger than one-to-four-family residential loans and involve greater credit risk. Commercial real estate loans often involve large loan balances to single borrowers or groups of related borrowers. Repayment of these loans depends to a large degree on the results of operations and management of the properties securing the loans or the businesses conducted on such property, and may be affected to a greater extent by adverse conditions in the real estate market or the economy in general. Accordingly, the nature of these loans makes them more difficult for management to monitor and evaluate.

The Company offers a variety of other loans secured by property other than real estate. At September 30, 2011, these other loans totaled $75,000, or 0.1%, of the total loan portfolio compared to other loans totaling $73,000, or 0.1%, of the total loan portfolio at December 31, 2010. These loans include automobile, passbook, overdraft protection and unsecured loans. Due to the relative immateriality of other loans, the Company’s risk associated with these loans is not considered significant.

Note 4 – Loans and The Allowance for Loan Losses (continued)

The following table sets forth the allowance for loan losses allocated by loan class and the activity in our allowance for loan losses for the three months ended September 30, 2011. The allowance for loan losses allocated to each class is not necessarily indicative of future losses in any particular class and does not restrict the use of the allowance to absorb losses in other classes.

	Secured by 1-4 family residential	Secured by multifamily residential	Construction	Commercial (In thousands)	Home Equity	Other/ Unallocated	Total
Allowance for Loan Losses:							
Beginning Balance June 30, 2011	$277	$8	$1	$20	$45	$48	$399
Charge Offs	-	-	-	-	-	-	-
Recoveries	-	-	-	-	-	-	-
Provisions	6	2	4	1	3	(9)	7
Ending Balance September 30, 2011 (1)	$283	$10	$5	$21	$48	$39	$406

(1)All Loans are collectively evaluated for impairment.

The following table sets forth the allowance for loan losses allocated by loan class and the activity in our allowance for loan losses for the nine months ended September 30, 2011. The allowance for loan losses allocated to each class is not necessarily indicative of future losses in any particular class and does not restrict the use of the allowance to absorb losses in other classes.

	Secured by 1-4 family residential	Secured by multifamily residential	Construction	Commercial (In thousands)	Home Equity	Other/ Unallocated	Total
Allowance for Loan Losses:							
Beginning Balance December 31, 2010	$242	$9	$3	$14	$55	$61	$384
Charge Offs	-	-	-	-	-	-	-
Recoveries	-	-	-	-	-	-	-
Provisions	41	1	2	7	(7)	(22)	22
Ending Balance September 30, 2011 (1)	$283	$10	$5	$21	$48	$39	$406

(1)All Loans are collectively evaluated for impairment.

The Bank's policies, consistent with regulatory guidelines, provide for the classification of loans that are considered to be of lesser quality as substandard, doubtful, or loss assets. An asset is considered substandard if it is inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Substandard assets include those assets characterized by the distinct possibility that we will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful have all of the weaknesses inherent in those classified as substandard with the added characteristic that the weaknesses present make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable. Assets (or portions of assets) classified as loss are those considered uncollectible and of such little value that their continuance as assets is not warranted. Assets that do not expose us to risk sufficient to warrant classification in one of the aforementioned categories, but which possess potential weaknesses that deserve our close attention, are required to be designated as special mention. All other assets are categorized as pass.

Note 4 – Loans and The Allowance for Loan Losses (continued)

When the Bank classifies assets as either pass, special mention, substandard, or doubtful, we allocate a portion of the related general loss allowances to such assets as we deem prudent. The allowance for loan losses is the amount estimated by management as necessary to absorb credit losses incurred in the loan portfolio that are both probable and reasonably estimable at the balance sheet date. Our determination as to the classification of our assets and the amount of our loss allowances are subject to review by the Bank's principal federal regulator, which prior to July 21, 2011 was the Office of Thrift Supervision and was succeeded by the Office of the Comptroller of the Currency (OCC), which can require that we establish additional loss allowances. We regularly review our asset portfolio to determine whether any assets require classification in accordance with applicable regulations.

At and for the nine and twelve months ended September 30, 2011 and December 31, 2010, respectively, there were no loans considered to be impaired. At September 30, 2011 and December 31, 2010 we had no troubled debt restructurings.

The following table presents the risk category of loans by class at September 30, 2011:

(In thousands)	Pass	Special Mention	Substandard	Doubtful	Total
One-to-four residential	$107,426	-	$378	-	$107,804
Home equity lines of credit	9,049	-	24	-	9,073
Multi-family residential	1,355	-	-	-	1,355
Construction	966	-	-	-	966
Commercial	2,143	-	-	-	2,143
Other loans	75	-	-	-	75
Total	$121,014	-	$402	-	$121,416

The following table presents the risk category of loans by class at December 31, 2010:

(In thousands)	Pass	Special Mention	Substandard	Doubtful	Total
One-to-four residential	$102,238	-	$57	-	$102,295
Home equity lines of credit	8,784	-	116	-	8,900
Multi-family residential	1,165	-	-	-	1,165
Construction	652	-	-	-	652
Commercial	1,395	-	-	-	1,395
Other loans	73	-	-	-	73
Total	$114,307	-	$173	-	$114,480

The Bank had $325,000 in nonaccrual loans, comprised of one one-to-four residential property, and no foreclosed assets at September 30, 2011, and no nonaccrual loans or foreclosed assets at December 31, 2010. There were no loans that were past due 90 days or more and still accruing interest at September 30, 2011 and December 31, 2010. Interest on non-accrual loans that would have been earned if loans were accruing interest was $18,093 for the nine months ended September 30, 2011 and $1,176 for the nine months ended September 30, 2010.

Note 4 – Loans and The Allowance for Loan Losses (continued)

Delinquent Loans. The following table sets forth an analysis of the age of the loan delinquencies by type and by amount past due as of September 30, 2011 and December 31, 2010.

	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Current	Total Loans Receivable
			(Dollars in thousands)			
At September 30, 2011						
Real estate loans:						
One-to-four residential	$-	$53	$325	$378	$107,426	$107,804
Home equity lines of credit	24	-	-	24	9,049	9,073
Multi-family residential	-	-	-	-	1,355	1,355
Construction	-	-	-	-	966	966
Commercial	-	-	-	-	2,143	2,143
Other loans	-	-	-	-	75	75
Total	$24	$53	$325	$402	$121,014	$121,416
At December 31, 2010						
Real estate loans:						
One-to-four residential	$57	$-	$-	$57	$102,238	$102,295
Home equity lines of credit	116	-	-	116	8,784	8,900
Multi-family residential	-	-	-	-	1,165	1,165
Construction	-	-	-	-	652	652
Commercial	-	-	-	-	1,395	1,395
Other loans	-	-	-	-	73	73
Total	$173	$-	$-	$173	$114,307	$114,480

Note 5 - Federal Home Loan Bank of New York Stock

Federal law requires a member institution of the Federal Home Loan Bank (FHLB) System to hold stock of its district FHLB according to a predetermined formula. This restricted stock is carried at cost.

Management evaluates the FHLB stock for impairment on a quarterly basis. Management's determination of whether this investment is impaired is based on its assessment of the ultimate recoverability of its cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of cost is influenced by criteria such as (1) the significance of the decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and the length of time this situation has persisted, (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB, and (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the FHLB.

No impairment charges were recorded related to the FHLB stock for the nine month periods ended September 30, 2011 and 2010.

Note 6 – Comprehensive Income

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

The components of other comprehensive income and related tax effects for the three and nine months ended September 30, 2011 and 2010 are as follows:

	For the Three Months Ended September 30,		For the Nine months Ended September 30,	
	2011	2010	2011	2010
	(In Thousands)		(In Thousands)	
Unrealized holding gain on available for sale securities	$408	$118	$709	$649
Reclassification adjustment for realized gain included in net income	(111)	(95)	(135)	(97)
Net Unrealized Gain	297	23	574	552
Tax effect	101	9	195	188
Net of tax amount	$196	$14	$379	$364

Note 7 - Earnings Per Common Share

Basic earnings per common share are calculated by dividing net income by the weighted-average number of common shares outstanding during the period. The Company has not granted any restricted stock awards or stock options and had no potentially dilutive common stock equivalents. Unallocated common shares held by the ESOP are not included in the weighted-average number of common shares outstanding for purposes of calculating earnings per common share until they are committed to be released. The weighted average common shares outstanding were 1,731,646 for the three months ended September 30, 2011, 1,730,778 for the nine months ended September 30, 2011, 1,728,148 for the three months ended September 30, 2010 and 1,727,280 for the nine months ended September 30, 2010.

Note 8 - Recent Accounting Pronouncements

Accounting Standards Update No. 2011-05: Comprehensive Income (Topic 220) – Presentation of Comprehensive Income

The objective of this Update is to improve the comparability, consistency, and the transparency of financial reporting and to increase the prominence of items reported in other comprehensive income. To increase the prominence of items reported in other comprehensive income and to facilitate convergence of U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS), the Financial Accounting Standards Board (FASB) decided to eliminate the option to present components of other comprehensive income as part of the statement of changes in stockholders' equity, among other amendments in this Update.

The amendments require that all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In the two-statement approach, the first statement should present total net income and its components followed consecutively by a second statement that should present total other comprehensive income, the components of other comprehensive income, and total of comprehensive income.

Note 8 - Recent Accounting Pronouncements (continued)

The amendments in this Update should be applied retrospectively. For public entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Management does not expect the adoption of this statement to have a material impact on the Company's consolidated financial statements.

Accounting Standards Update No. 2011-04: Fair Value Measurement (Topic 820) – Amendments to Achieve Common Fair Value Measurement and Disclosures Requirements in U.S. GAAP and IFRS

The amendments of this Update are the result of work by the FASB and the International Accounting Standard Board (IASB) to develop common requirements for measuring fair value and for disclosing information about fair value measurements in accordance with GAAP and IFRS. Consequently, the amendments change the wording used to describe many of the requirements in GAAP for measuring fair value and for disclosing information about fair value measurements. The amendments include the following requirements:

Those that clarify the FASB's intent about the application of existing fair value measurement and disclosure requirements including:
Application of the highest and best use and valuation premise concepts;
Measuring the fair value of an instrument classified in a reporting entity's shareholders' equity; and
Clarifying disclosure requirements of quantitative information about the unobservable inputs used in a fair value measurement that is categorized within Level 3 of the fair value hierarchy.

Those that change a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements including:
Measuring the fair value of financial instruments that are managed within a portfolio;
Application of premiums and discounts in a fair value measurement; and
Expanding disclosure requirements about Level 3 fair value measurements, use of nonfinancial assets in a way that differs from the asset's highest and best use and categorization by level of fair value hierarchy for items that are not measured at fair value in the statement of position but for which the fair value is required to be disclosed.

The amendments in this Update are to be applied prospectively. For public entities, the amendments are effective during interim and annual periods beginning after December 15, 2011. Management does not expect the adoption of this statement to have a material impact on the Company's consolidated financial statements.

Accounting Standard Update 2011-02: Receivables (Topic 310) – A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring

The FASB has issued this Update to clarify the accounting principles applied to loan modifications, as defined by FASB Accounting Standards Codification (ASC) Subtopic 310-40, Receivables – Troubled Debt Restructurings by Creditors. This guidance was prompted by the increased volume in loan modifications prompted by the recent economic downturn. The Update clarifies guidance on a creditor's evaluation of whether or not a concession has been granted, with an emphasis on evaluating all aspects of the modification rather than a focus on specific criteria, such as the effective interest rate test, to determine a concession. The Update goes on to provide guidance on specific types of modifications such as changes in the interest rate of the borrowing, and insignificant delays in payments, as well as guidance on the creditor's evaluation of whether or not a debtor is experiencing financial difficulties.

Note 8 - Recent Accounting Pronouncements (continued)

For public entities, the amendments in the Update are effective for the first interim or annual periods beginning on or after June 15, 2011, and should be applied retrospectively to the beginning of the annual period of adoption. The adoption of this statement did not have a material impact on the Company's consolidated financial statements.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

General

Throughout the Management's Discussion and Analysis ("MD&A"), the term "the Company" refers to the consolidated entity of FSB Community Bankshares, Inc., Fairport Savings Bank, and Oakleaf Services Corporation, a wholly owned subsidiary of Fairport Savings Bank. At September 30, 2011, FSB Community Bankshares, MHC the Company's mutual holding company parent, held 946,050 shares, or 53.0%, of the Company's common stock, engaged in no significant activities, and was not included in the consolidated financial statements or MD&A.

Forward Looking Statements

This Quarterly Report contains forward-looking statements, within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements are subject to certain risks and uncertainties, including, among other things, changes in general economic conditions, either nationally or in our market areas, that are worse than expected; competition among depository and other financial institutions; inflation and changes in the interest rate environment that reduce our margins or reduce the fair value of financial instruments; adverse changes in the securities markets; changes in laws or government regulations or policies affecting financial institutions, including changes in regulatory fees and capital requirements; our ability to enter new markets successfully and capitalize on growth opportunities; our ability to successfully integrate acquired entities, if any; changes in consumer spending, borrowing and savings habits; changes in accounting policies and practices, as may be adopted by the bank regulatory agencies, the Financial Accounting Standards Board, the Securities and Exchange Commission and the Public Company Accounting Oversight Board; changes in our organization, compensation and benefit plans; changes in our financial condition or results of operations that reduce capital available to pay dividends; and changes in the financial condition or future prospects of issuers of securities that we own, that could cause actual results to differ materially from historical earnings and those presently anticipated or projected. The Company wishes to caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made. The Company wishes to advise readers that the factors listed above could affect the Company's financial performance and could cause the Company's actual results for future periods to differ materially from any opinions or statements expressed with respect to future periods in any current statements.

The Company does not undertake, and specifically declines any obligation, to publicly release the results of any revisions that may be made to any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

Critical Accounting Policies

The most significant accounting policies followed by the Company are presented in Note 1 to the consolidated financial statements included in the Company's Annual Report filed on Form 10-K with the Securities and Exchange Commission on March 31, 2011. These policies, along with the disclosures presented in the other consolidated financial statement notes and in this discussion, provide information on how significant assets and liabilities are valued in the consolidated financial statements and how those values are determined. Based on the valuation techniques used and the sensitivity of consolidated financial statement amounts to the methods, assumptions and estimates underlying those amounts, management has identified the determination of the allowance for loan losses, the evaluation of investment securities for other-than-temporary impairment and the valuation and recoverability of deferred tax assets to be the accounting areas that require the most subjective and complex judgments, and as such could be the most subject to revision as new information becomes available.

Allowance for Loan Losses. The allowance for loan losses is the amount estimated by management as necessary to absorb credit losses incurred in the loan portfolio that are both probable and reasonably estimable at the balance sheet date. The amount of the allowance is based on significant estimates, and the ultimate losses may vary from such estimates as more information becomes available or conditions change. The methodology for determining the allowance for loan losses is considered a critical accounting policy by management due to the high degree of judgment involved, the subjectivity of the assumptions used and the potential for changes in the economic environment that could result in changes to the amount of the recorded allowance for loan losses.

As a substantial percentage of our loan portfolio is collateralized by real estate, appraisals of the underlying value of property securing loans are critical in determining the amount of the allowance required for specific loans. Assumptions are instrumental in determining the value of properties. Overly optimistic assumptions or negative changes to assumptions could significantly affect the valuation of a property securing a loan and the related allowance. Management carefully reviews the assumptions supporting such appraisals to determine that the resulting values reasonably reflect amounts realizable on the related loans.

Management performs a quarterly evaluation of the adequacy of the allowance for loan losses. We consider a variety of factors in establishing this estimate including, but not limited to, current economic conditions, delinquency statistics, geographic concentrations, the adequacy of the underlying collateral, the financial strength of the borrower, results of internal loan reviews, and other relevant factors. This evaluation is inherently subjective as it requires material estimates by management that may be susceptible to significant change based on changes in economic and real estate market conditions. Various banking regulators, as an integral part of their examination process, also review the allowance for loan losses. Such regulators may require, based on their judgments about information available to them at the time of their examination, that certain loan balances be charged off or require that adjustments be made to the allowance for loan losses when their credit evaluations differ from those of management. Additionally, the allowance for loan losses is determined, in part, by the composition and size of the loan portfolio which represents the largest asset type on the consolidated balance sheet.

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

Actual loan losses may be significantly more than the allowance we have established which could have a material negative effect on our financial results.

Other-than-temporary impairment. When the fair value of a held to maturity or available for sale security is less than its amortized cost basis, an assessment is made at the balance sheet date as to whether other-than-temporary impairment (OTTI) is present.

The Company considers numerous factors when determining whether a potential OTTI exists and the period over which the debt security is expected to recover. The principal factors considered are (1) the length of time and the extent to which the fair value has been less than the amortized cost basis, (2) the financial condition of the issuer (and guarantor, if any) and adverse conditions specifically related to the security, industry or geographic area, (3) failure of the issuer of the security to make scheduled interest or principal payments, (4) any changes to the rating of a security by a rating agency, and (5) the presence of credit enhancements, if any, including the guarantee of the federal government or any of its agencies.

For debt securities, OTTI is considered to have occurred if (1) the Company intends to sell the security, (2) it is more likely than not the Company will be required to sell the security before recovery of its amortized cost basis, or (3) if the present value of expected cash flows is not sufficient to recover the entire amortized cost basis.

In determining whether OTTI has occurred for equity securities, the Company considers the applicable factors described above and the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

For debt securities, credit-related OTTI is recognized in income while noncredit-related OTTI on securities not expected to be sold is recognized in other comprehensive income (loss). Credit-related OTTI is measured as the difference between the present value of an impaired security's expected cash flows and its amortized cost basis. Noncredit-related OTTI is measured as the difference between the fair value of the security and its amortized costs less any credit-related losses recognized. For securities classified as held to maturity, the amount of OTTI recognized in other comprehensive income (loss) is accreted to the credit-adjusted expected cash flow amounts of the securities over future periods. For equity securities, the entire amount of OTTI is recognized in income.

Deferred Tax Assets. Deferred tax assets and liabilities represent the future tax return consequences of temporary differences, which will either be taxable or deductible when the assets and liabilities are recovered or settled. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion of the deferred tax assets will not be realized. Deferred tax assets and liabilities are reflected at income tax rates applicable to the period in which the deferred tax assets and liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

Comparison of Financial Condition at September 30, 2011 and December 31, 2010

Total Assets. Total assets increased by $156,000, or 0.1%, to $212.6 million at September 30, 2011 from $212.4 million at December 31, 2010. The modest increase in total assets primarily reflects increases in cash and cash equivalents, net loans receivable, loans held for sale, and premises and equipment, partially offset by decreases in securities available for sale, prepaid FDIC premium, accrued interest receivable and FHLB stock.

Total securities decreased by $12.4 million, or 15.5%, to $67.4 million at September 30, 2011 from $79.8 million at December 31, 2010. The decrease in securities was a result of a $12.3 million, or 16.9%, decrease in securities classified as available for sale to $60.3 million at September 30, 2011 from $72.6 million at December 31, 2010 and an $87,000, or 1.2%, decrease in securities classified as held to maturity to $7.1 million at September 30, 2011 from $7.2 million at December 31, 2010. The $12.3 million decrease in securities classified as available for sale was attributable to maturities and calls of $38.1 million of U.S. government agency securities, $2.9 million in sales of securities, and $6.9 million in principal repayments received and amortization, partially offset by the purchase of $27.0 million of U.S. government agency securities and $8.0 million of mortgage-backed securities, and a $574,000 increase in the fair value of securities classified as available for sale.

Securities classified as held to maturity decreased $87,000 as a result of $521,000 in principal repayments and amortization, partially offset by purchases of $434,000 of State and Municipal bonds. All securities purchased in 2011, with the exception of State and Municipal bonds classified as held to maturity, have been classified as available for sale to provide a portfolio of marketable securities for liquidity as an alternative to borrowings. The Company has reviewed its investment securities portfolio for the nine months ended September 30, 2011, and has determined that no other-than-temporary impairment exists in the portfolio at September 30, 2011.

Net loans receivable increased $6.9 million, or 6.0%, to $121.4 million at September 30, 2011 from $114.5 million at December 31, 2010. The Bank originated $26.2 million of residential mortgage loans, sold $3.8 million in the secondary market and brokered $5.7 million of long-term fixed rate conventional mortgage loans and FHA mortgage loans as a balance sheet management strategy in the first nine months of 2011 to reduce interest rate risk in a potentially rising interest rate environment. The Bank sold these loans at a gain of $225,000 which was recorded in other income in the first nine months of 2011. The Bank ended September 30, 2011 with $17.8 million in mortgage loans sold and will realize servicing income on these loans as long as these loans have outstanding balances. In the current interest rate environment we intend to continue to sell a portion of our fixed-rate residential mortgage loans on a servicing-retained basis resulting in additional loan servicing income, as well as selling the majority of FHA mortgage loans originated on a servicing-released basis.

Cash and cash equivalents, primarily interest-earning deposits at the Federal Reserve Bank of New York and Federal Home Loan Bank of New York, increased by $4.0 million, or 50.9%, to $11.8 million at September 30, 2011 from $7.8 million at December 31, 2010. The Bank continues to maintain a strong liquidity position, retaining excess cash and cash equivalent balances that will allow the Bank to capitalize on investment and lending opportunities that may arise in future periods.

Loans held for sale increased $1.4 million, or 393.6%, to $1.7 million at September 30, 2011 from $342,000 at December 31, 2010. The $1.7 million in loans held for sale at September 30, 2011 is comprised of FHA mortgage loans and fixed rate conventional loans originated and closed by the Bank in the third quarter of 2011 that have been committed for sale in the secondary market and will be delivered and sold in the fourth quarter of 2011.

The credit quality of the Bank's loan portfolio remains solid. At September 30, 2011 the Bank had net loans receivable of $121.4 million, with $325,000 in non-performing loans comprised of one one-to-four residential property compared to net loans receivable of $114.5 million at December 31, 2010, with no non-performing loans. At September 30, 2011 and December 31, 2010 we had no foreclosed real estate owned or troubled debt restructurings. Management continues to actively monitor the performance of the loan portfolio during these difficult economic times. Credit quality continues to be the highest priority when underwriting loans. Subjective judgments about a borrower's ability to repay and the value of any underlying collateral are made prior to approving a loan. We believe our stringent underwriting standards have directly resulted in our significantly low level of non-accruing loans and non-performing loans.

Premises and equipment increased by $498,000, or 18.4%, to $3.2 million at September 30, 2011 from $2.7 million at December 31, 2010. The increase was mainly due to the purchase of furniture and fixtures, office equipment, computer hardware, and building and leasehold improvements held in the construction in process account until the opening of the Perinton branch which opened in October 2011. Premises and equipment are recorded at cost and are generally depreciated by the straight-line method over the estimated useful lives of the assets. Furniture and equipment are generally depreciated over a useful life of three to seven years, and leasehold improvements over the shorter of the useful life or the term of the lease.

Prepaid FDIC premium decreased by $109,000, or 18.8%, to $470,000 at September 30, 2011 from $579,000 at December 31, 2010. The Federal Deposit Insurance Corporation adopted a final rule pursuant to which all insured depository institutions were required to prepay their estimated assessments for the fourth quarter of 2009, and for all of 2010, 2011 and 2012. Under the rule, this pre-payment of approximately $793,000 to the Bank was due on December 31, 2009. We will continue to amortize this premium paid on a quarterly basis through December 31, 2012.

Accrued interest receivable decreased $112,000, or 12.6%, to $776,000 at September 30, 2011 from $888,000 at December 31, 2010. The decrease was due primarily to a lower balance and lower yield in total securities at

September 30, 2011 compared to December 31, 2010.

Investment in FHLB stock decreased by $109,000, or 7.2%, to $1.4 million at September 30, 2011 from $1.5 million at December 30, 2011 due to stock redemptions. The FHLB requires members to purchase and redeem stock based on the level of borrowings.

Liabilities. Total deposits increased by $2.1 million, or 1.3%, to $164.5 million at September 30, 2011 from $162.4 million at December 31, 2010. The $2.1 million increase consisted of core deposit growth of $1.7 million including increases in non-interest bearing checking, interest-bearing checking, and savings accounts, and $374,000 in non-core deposit growth consisting of IRA's and Certificates of Deposits. The Company's deposit costs have decreased as market interest rates have remained at historically low levels.

Official Bank checks increased $1.0 million, or 280.2%, to $1.4 million at September 30, 2011 from $400,000 at December 31, 2010. The $1.0 million increase is due to school tax bill checks outstanding at September 30, 2011.

Borrowings, consisting of Federal Home Loan Bank ("FHLB") advances, decreased by $2.5 million, or 9.5%, to $24.2 million at September 30, 2011 from $26.7 million at December 31, 2010. The decrease of $2.5 million in the first nine months of 2011 included $6.7 million in maturities and principal payments of FHLB fixed rate borrowings, $4.0 million in new FHLB fixed rate borrowings, and $150,000 in amortization of deferred premium expense.

In July 2010, the Company restructured a portion of its FHLB advances by repaying $13.2 million of existing borrowings and replacing these borrowings with $13.2 million of new, lower cost FHLB advances. This transaction resulted in $638,000 in prepayment penalties that have been deferred and are recognized in interest expense as an adjustment to the cost of the Company's new borrowings in future periods. At September 30, 2011 there was $397,000 remaining in deferred premium expense on total FHLB borrowings.

Stockholders' Equity. Total stockholders' equity increased by $397,000, or 1.9%, to $20.9 million at September 30, 2011 from $20.5 million at December 31, 2010. There was an increase of $379,000 in accumulated other comprehensive income, and a $22,000 increase in committed ESOP shares, partially offset by a net loss of $4,000. At September 30, 2011 the Bank was considered well capitalized, which is the highest standard of capital rating as defined by the Bank's regulators.

Non-Performing Assets. At September 30, 2011 the Company had $325,000 in loans classified as non-performing compared to no loans classified as non-performing at December 31, 2010. For both periods ended September 30, 2011 and December 31, 2010 the Company had no foreclosed assets. At September 30, 2011, management has evaluated the Bank's loan loss reserve and believes it is adequate based on the quality of the current loan portfolio. The increase in one-to-four-family real estate mortgage loans classified as substandard was the cause for the shift of a portion of the allowance from unallocated to allocated to one-to-four-family residential real estate mortgage loans in the allowance for loan losses. At September 30, 2011, there were no other assets that are not disclosed as classified or special mention, where known information about possible credit problems of borrowers caused us to have serious doubts as to the ability of the borrowers to comply with the present loan repayment terms and which may result in impairment or disclosure of such loans in the future.

Average balances and yields. The following tables set forth average balance sheets, average yields and costs, and certain other information at and for the periods indicated. All average balances are daily average balances. Non-accrual loans were included in the computation of average balances, where applicable, but have been reflected in the table as loans carrying a zero yield. The yields set forth below include the effect of deferred fees, discounts and premiums that are amortized or accreted to interest income. Yields have been annualized.

	For the Three months Ended September 30,					
	2011			2010		
	Average Balance	Interest Income/Expense	Yield/ Cost	Average Balance	Interest Income/Expense	Yield/ Cost
	(Dollars in thousands)					
Interest-earning assets:						
Loans	$120,912	$ 1,555	5.14%	$117,871	$ 1,614	5.48%
Securities - taxable	40,357	219	2.17	49,769	285	2.29
Mortgage-backed securities	33,002	195	2.36	28,493	218	3.06
Securities - tax exempt (1)	2,693	21	3.12	433	4	3.70
Other	5,872	2	0.14 %	13,088	7	0.21
Total interest-earning assets	202,836	1,992	3.93	209,654	2,128	4.06
Non-interest-earning assets	8,847					

					1,007,625			
Issuance of options and warrants for services				5,849,585				5,849,585
Deferred employee stock option compensation				607,885		(607,885)		
Amortization of deferred employee stock option compensation						1,120,278		1,120,278
Issuance of common stock in settlement of debt to directors and related parties	4,840,077	48,402		2,371,637				2,420,039
Net Loss							(23,998,734)	(23,998,734)
Balance June 30, 2001	**41,344,467**	**$ 413,445**	**$ (7,973)**	**$ 92,293,370**	**$**	**(713,275)**	**$ (90,120,925)**	**$ 1,864,642**
Issuance of Common stock with warrants in private placement	6,980,643	69,807		1,903,943				1,973,750
Issuance of Common stock for services	2,976,068	29,760		1,169,241				1,199,001
Issuance of options and warrants for services				1,877,937				1,877,937
Cancellation of unearned options to former employees				(140,802)		140,802		
Amortization of deferred employee stock option compensation						548,550		548,550
Issuance of common stock and warrants in settlement of debt to related parties and	7,492,996	74,930		2,663,728				2,738,658

strategic vendors							
Sale of Common stock to certain Officers and Directors in private placement	2,000,000	20,000		980,000			1,000,000
Issuance of Common stock upon exercise of options	13,334	133		3,867	4,000		
Net Loss						(11,249,387)	(11,249,387)
Balance, June 30, 2002	**60,807,508**	**$ 608,075**	**$ (7,973)**	**$ 100,751,284**	**$ (23,923)**	**$ (101,370,312)**	**$ (42,849)**

The accompanying notes are an integral part of these Consolidated Financial Statements.

mPHASE TECHNOLOGIES, INC.
CONSOLIDATED STATEMENT OF CHANGES IN
SHAREHOLDERS EQUITY (DEFICIT)
FOR THE PERIOD FROM INCEPTION (OCTOBER 2, 1996)
TO JUNE 30, 1997 AND FOR EACH OF THE TWELVE YEARS
IN THE PERIOD ENDED JUNE 30, 2009

	Common Stock Shares	Par Value 0.01	Treasury Stock	Additional Paid-In Capital	Deferred Compensation	Accumulated Deficit	Total Stockholders Equity (Deficit)
Balance, June 30, 2002	**60,807,508**	**$ 608,075**	**$ (7,973)**	**$ 100,751,284**	**$ (23,923)**	**$ (101,370,312)**	**$ (42,849)**
Issuance of Common stock with warrants in private placement, net of Cash offering costs of $124,687	4,296,680	42,967		1,121,351			1,164,318
Issuance of Common stock for services	426,000	4,260		107,985			112,245
Issuance of options and warrants for services				274,100			274,100
Amortization of deferred employee stock option compensations					23,923		23,923
Issuance of common stock and warrants in settlement of debt to related parties and strategic vendors	5,923,333	59,233		1,826,329			1,885,562
Net Loss						(6,,646,185)	(6,646,185)
Balance, June 30, 2003	**71,453,521**	**$ 714,535**	**$ (7,973)**	**$ 104,081,049**	**$ 0**	**$ (108,016,497)**	**$ (3,228,886)**
Issuance of common stock with warrants in private placement, net of cash offering costs of $313,200	15,177,973	151,779		4,322,934			4,474,713
Issuance of common stock for services	924,667	9,247		238,153			247,400
Issuance of options and warrants for services				1,067,393			1,067,393
Issuance of common stock pursuant to exercise of warrants	1,233,334	12,333		304,467			316,800
Issuance of common stock and warrants in settlement of debt to related parties and strategic vendors	110,467	1,105		1,962,099			1,963,204
Net Loss						(7,758,586)	(7,758,586)
Balance, June 30, 2004	**88,899,962**	**$ 888,999**	**$ (7,973)**	**$ 111,976,095**	**$ 0**	**$ (115,775,083)**	**$ (2,917,962)**

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SHAREHOLDERS EQUITY (DEFICIT)
FOR THE PERIOD FROM INCEPTION (OCTOBER 2, 1996)
TO JUNE 30, 1997 AND FOR EACH OF THE TWELVE YEARS IN THE PERIOD ENDED JUNE 30, 2009

	Common Stock Shares	Par Value 0.01	Treasury Stock	Additional Paid-In Capital	Accumulated Deficit	Total Stockholders Equity (Deficit)
Balance, June 30, 2004	**88,899,962**	**$ 888,999**	**$ (7,973)**	**$ 111,976,095**	**$ (115,775,083)**	**$ (2,917,962)**
Issuance of Shares in Private Placement	39,853,661	398,535		6,888,553		7,287,088
Issuance of in connection with exercise of warrants	3,637,954	36,380		644,229		680,609
Conversion of Debt to Common stock and warrants	3,895,171	38,952		1,174,134		1,213,086
Options Awarded to Consultants				2,191,043		2,191,043
Options Awarded to Officers				625,290		625,290
Issuance of shares to Officers and consultants for services	1,151,000	11,510		322,500		334,010
Exercise of cashless warrants	4,949,684	49,499		(49,499)		
Exercise of warrants by officers	1,770,400	17,704				17,704
Reparation of Private Placement Offering	891,000	8,910		176,811		185,721
Net Loss					(11,234,324)	(11,234,324)
Balance June 30, 2005	**145,048,832**	**$ 1,450,489**	**$ (7,973)**	**$ 123.949,156**	**$ (127,009,407)**	**$ (1,617,735)**
Issuance of common stock pursuant to the exercise of warrants, net of cash expenses of $108,000	15,720,120	157,201		2,850,523		3,007,724
Issuance of common stock with warrants in private placements, net of cash expenses of $674,567	72,786,897	727,868		9,329,781		10,057,649
Issuance of common stock for services	11,500,000	115,000		2,324,000		2,439,000
Conversion of related party and strategic vendor debts to common stock and warrants	3,331,864	33,319		556,681		590,000
Stock options awarded to consultants, employees and officers				3,837,423		3,837,423
Issuance of additional shares and warrants to effect revised pricing on previous private offering charged to	29,848,271	298,483		5,232,021		5,530,504

expense										
Net loss									(24,450,650)	(24,450,650)
Balance, June 30, 2006	**278,235,984**	**$**	**2,782,360**	**$**	**(7,973)**	**$**	**148,079,585**	**$**	**(151,460,057) $**	**(606,085)**

The accompanying notes are an integral part of these Consolidated Financial Statements.

mPHASE TECHNOLOGIES, INC.
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SHAREHOLDERS EQUITY (DEFICIT)
FOR THE PERIOD FROM INCEPTION (OCTOBER 2, 1996)
TO JUNE 30, 1997 AND FOR EACH OF THE TWELVE YEARS IN THE PERIOD ENDED JUNE 30, 2009

	Shares	$.01 Par Value	Treasury Stock	Additional Paid in Capital	Deferred Compensation	Accumulated Deficit	Total Shareholders (Deficit) Equity
Balance June 30, 2006	**278,235,984**	**$ 2,782,360**	**$ (7,973)**	**$ 148,079,585**		**$ (151,460,057)**	**$ (606,085)**
Issuance of common stock pursuant to the exercise of warrants (net of cash expenses of $150,000)	14,740,669	$ 147,406		$ 1,922,261			$ 2,069,667
Issuance of common stock in private placements, (net of cash expenses of $216,134)	47,958,060	$ 479,581		$ 5,711,788			$ 6,191,369
Issuance of common stock for services	18,172,983	$ 181,730		$ 2,486,885	$ (627,250)		$ 2,041,365
Conversion of related party and strategic vendor debt to common stock	6,073,728	$ 60,737		$ 930,972			$ 991,709
Issuance of additional shares and warrants to effect repricing	22,664,580	$ 226,646		$ 1,647,374			$ 1,874,020
Stock options awarded to employees and officers				$ 1,321,853			$ 1,321,853
Deferred stock compensation					$ 213,166		$ 213,166
Net Loss						$ (16,851,562)	$ (16,851,562)
Balance June 30, 2007	**387,846,004**	**$ 3,878,460**	**$ (7,973)**	**$ 162,100,718**	**$ (414,084)**	**$ (168,311,619)**	**$ (2,754,498)**

The accompanying notes are an integral part of these Consolidated Financial Statements.

mPHASE TECHNOLOGIES, INC.
CONSOLIDATED STATEMENT OF CHANGES IN
SHAREHOLDERS EQUITY (DEFICIT)
FOR THE PERIOD FROM INCEPTION (OCTOBER 2, 1996)
TO JUNE 30, 1997 AND FOR EACH OF THE TWELVE YEARS IN THE PERIOD ENDED JUNE 30, 2009

	Shares	$.01 Par Value	Treasury Stock	Additional Paid in Capital	Deferred Compensation	Accumulated Deficit	Total Shareholders (Deficit) Equity
Balance June 30, 2007	387,846,004	$3,878,460	($7,973)	$162,100,718	($414,084)	($168,311,619)	($2,754,498)
Issuance of common stock in private placements net of $116,253 offering cost	24,600,000	$246,000		$898,247			$1,144,247

Exercise of Warrants net of Offering Cost $72,222	11,111,113	$111,111		$538,889			$650,000
Common shares in settlement of accrued expenses	1,019,200	$10,192		$89,808			$100,000
Issuance of additional shares effect repricing	4,663,741	$46,637		$345,401			$392,038
Stock options/ warrants awarded to employees and investors				$85,682			$85,682
Stock based compensation	1,000,000	10,000		$90,192			$100,192
Amortization of deferred stock compensation							$414,084
Investment in Granita				$514,000			$514,000
Conversion of debt	4,904,942	$49,050		$192,073			$241,123
Cost related to convertible debt financing	5,250,000	$52,500		$212,500			$265,000
Net Loss						($3,956,721)	($3,956,721)
Balance June,30, 2008	440,395,000	$4,403,950	($7,973)	$165,067,510	($414,084)	($172,268,340)	($2,804,853)

The accompanying notes are an integral part of these consolidated financial statements.

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mPHASE TECHNOLOGIES, INC.
CONSOLIDATED STATEMENT OF CHANGES IN
SHAREHOLDERS EQUITY (DEFICIT)
FOR THE PERIOD FROM INCEPTION (OCTOBER 2, 1996)
TO JUNE 30, 1997 AND FOR EACH OF THE TWELVE YEARS IN THE PERIOD ENDED JUNE 30, 2009

	Shares	$.01 Par Value	Treasury Stock	Additional Paid in Capital	Accumulated Deficit	Total Shareholders (Deficit) Equity
Balance June 30, 2008	440,395,000	$4,403,950	($7,973)	$165,067,510	($172,268,340)	($2,804,853)
Issuance of common stock in private placements net of offering cost ($80,000)	72,333,333	$723,333		($3,333)		$720,000
Issuance of additional shares effect repricing	19,522,000	$195,220		$236,952		$432,172
Stock options/ warrants awarded to employees and investors				$4,071,348		$4,071,348
Stock based compensation	61,750,000	$617,500		$2,908,115		$3,525,615
Vendor settlements	(1,926,470)	($19,265)		$19,265		$0
Beneficial Conversion feature of Notes Payable, including $914,060 on Officers' Notes Payable				$1,028,560		$1,028,560
Forgiveness of related party debt				$19,336		$19,336
Conversion of debt securities and interest	278,346,019	$2,783,459		$519,874		$3,303,333
Net Loss					($15,529,677)	($15,529,677)
Balance June 30, 2009	870,419,882	$8,704,198	($7,973)	$173,867,627	($187,798,019)	($5,234,168)

The accompanying notes are an integral part of these consolidated financial statements.

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mPHASE TECHNOLOGIES, INC.

(A Development Stage Company)
Consolidated Statements of Cash Flows

		Fiscal Year Ended		October 2, 1996 (Date of Inception)
	June 30, 2007	June 30, 2008	June 30, 2009	To June 30, 2009
Cash Flow From Operating Activities:				
Net Loss	($16,851,562)	($3,956,721)	($15,529,677)	($187,798,017)
Adjustments to reconcile net loss to net cash used in operating activities:				
Depreciation and amortization	218,237	246,355	117,943	7,400,300
(Gain) loss on debt extinguishments			(165,154)	(937,370)
Non-cash charges relating to issuance of common stock, common stock options and warrants	3,363,218	185,874	7,596,963	70,217,431
Reparation charges	1,874,020	392,038	432,172	8,228,734
Derivative Value and Debt Discount charges		(1,188,597)	3,199,854	2,011,257
Write off of Granita Inventory/ Sovereign Investment		505,910	110,000	615,910
Other non cash charges including amortization of deferred compensation and beneficial conversion interest expense	213,166	414,084	1,028,560	2,043,625
Changes in assets and liabilities:				
Accounts receivable	104,276	(2,039)	(42,065)	381,811
Inventories	(344,640)	0		(510,471)
Prepaid expenses and Other current assets	(325,808)	320,703	(31,754)	(72,575)
Other				906,535
Accounts payable, Accrued expenses, Deferred revenue	2,084,440	(746,694)	275,321	8,309,881
Due to/from related parties				
Microphase / Janifast//Lintel	73,742	(249,835)	131,824	5,509,887
Officers and Other	528,100	427,597	276,104	1,711,357
Net cash used in operating activities	**($9,062,811)**	**($3,651,325)**	**($2,599,909)**	**($81,981,704)**
Cash Flow from Investing Activities:				
Payments related to patents and licensing rights		-		(450,780)
Purchase of fixed assets	(114,480)	(61,832)	(8,173)	(3,287,560)
Investment in Sovereign		(110,000)		(110,000)
Net Cash (used) in investing activities	**($114,480)**	**($171,832)**	**($8,173)**	**($3,848,340)**
Cash Flow from Financing Activities:				
Proceeds from issuance of common stock, exercises warrants and finders fees, net	7,761,037	2,294,247	720,000	82,698,879
Payments of short term notes	(241,418)	(379,848)		(1,281,552)
Advances from Microphase				347,840
Issuance of Other Debt		154,000	112,500	266,500
Net Proceeds (Repayment) from notes payable related parties	321,000	(116,962)	60,187	234,516

Proceeds under securities purchase agreements		1,350,000	1,800,000	3,150,000
Sale of minority interest in Granita subsidiary		514,000		514,000
Net cash provided by financing activities	**$7,840,619**	**$3,815,437**	**$2,692,687**	**$85,930,183**
Net increase (decrease) in cash	**($1,336,672)**	**($7,720)**	**$84,605**	**$100,138**
period	$1,359,925	$23,253	$15,533	0
CASH AND CASH EQUIVALENTS, end of period	**$23,253**	**$15,533**	**$100,138**	**$100,138**

The accompanying notes are an integral part of these consolidated financial statements.

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mPHASE TECHNOLOGIES, INC.

(A DEVELOPMENT STAGE COMPANY)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2009

1. ORGANIZATION AND NATURE OF BUSINESS

mPhase, a New Jersey corporation founded in 1996, is a publicly-held company with over 19,000 shareholders and approximately 870 million shares of common stock outstanding. The Company s common stock is traded on the Over the Counter Bulletin Board under the ticker symbol XDSL.

The Company is in the development stage and historically has focused much of its efforts in the commercial deployment of its TV+ products for delivery of broadcast IPTV, and DSL component products which include POTS splitters. Beginning in 2004, the Company added a new line of power cell batteries and electronic sensors (magnetometers) being developed through the use of Nanotechnology. Since mPhase is in the development stage, the accompanying consolidated financial statements should not be regarded as typical for normal operating periods.

The Company has recently shifted its primary business focus to the development of battery technology and using the science of nanotechnology has developed a battery that has a significantly longer shelf life prior to activation than conventional batteries. In addition, such battery product, unlike conventional batteries, is capable of being disposed of after use without harm to the environment.

On April 17, 2007, the Company announced that it had formed AlwaysReady, Inc., a New Jersey Corporation, as a new wholly-owned subsidiary. The Company plans to transfer all of its nanotechnology assets and appropriate liabilities to such company so as to separate its nanotechnology product line from its IPTV product. Management and staff of AlwaysReady Inc have been hired, however, during the fiscal years ended June 30, 2008 and 2009 the Company funded all the operations of Always Ready, Inc and no assets or liabilities have been transferred.

On June 20, 2007, the Company announced the formation of a new subsidiary, Granita Media, Inc. (Granita), a Delaware corporation, to promote and develop its IPTV product line including targeted advertising, and middleware solution. Capitalization of Granita amounted to $514,000 of equity, provided by employees and independent investors. During FYE June 30, 2008, related assets and liabilities were transferred to Granita and its results consolidated into the these financial statements. Additional funding was to have been arranged from outside institutional financing and potentially involve the sale of up to 10% of the common stock of Granita with mPhase retaining 90% of the stock of Granita. Owing to very challenging conditions in the capital markets, Granita was unable to raise funds necessary to operate as a self sufficient enterprise and fund the additional software development necessary for a targeted advertising enhancement capability of its TV+ solution. In order to conserve financial resources, all employees of Granita were either terminated or had resigned by December 31, 2007. (see also footnote #6)

We are headquartered in Norwalk, Connecticut with offices in Little Falls, and Newark NJ. mPhase shares common office space with Microphase Corporation, a privately held company in which the CEO of the company owns a minority interest. Microphase is a leader in the field of radio frequency and filtering technologies within the defense and telecommunications industry. It has been in operation for over 50 years and has supported mPhase with engineering, administrative and financial resources.

mPHASE TECHNOLOGIES, INC.

(A DEVELOPMENT STAGE COMPANY)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2009

2. LOSSES DURING THE DEVELOPMENT STAGE AND MANAGEMENT S PLANS

Through June 30, 2009, the Company incurred development stage losses totaling approximately $188 million and at June 30, 2009 had a working capital deficit of $3,991,645. Funding in our tradition capital markets was difficult during FYE 2008.and 2009.

Alternatively the Company was able to enter into Convertible Debt arrangements with independent investors to provide liquidity and capital resources during the year. Such arrangements have provided the Company with cash in the amount of $1,350,000 and $1,800,000 during FYE 2008 and 2009 respectively. These arrangements will likely provide much of the working capital anticipated to be needed during the next FYE (See Footnote #8). In addition and from time to time during FYE 2008 and 2009, the Company raised necessary working capital via bridge loans from officers and private placements of equity. Such loans have subsequently been repaid (see notes payable to officers).

The Company is currently focused upon development and commercialization of its Always Ready battery product developed using the science of nanotechnology. The Company believes that such battery has a much longer shelf life than conventional batteries and will have significant commercial and military applications. To conserve financial resources, the Company has suspended development of its magnetometer sensor devices and all activities all activity related to its IPTV business. It is unsure whether any intellectual property related to those operations will have significant value.

The Company s ability to continue as a going concern and its future success is dependent upon its ability to raise capital in the near term to: (1) satisfy its current obligations, (2) continue its research and development efforts, and (3) successfully develop, market and sell its products. The Company believes that it will be able to complete the necessary steps in order to meet its cash flow requirements throughout fiscal 2010 and continue its development and commercialization efforts.

However, there can be no assurance that mPhase will generate sufficient revenues to provide positive cash flows from operations or that sufficient capital will be available, when required, to permit the Company to realize its plans. The accompanying consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of mPhase, it s wholly-owned and majority owned subsidiaries. Significant inter-company accounts and transactions have been eliminated in consolidation.

USE OF ESTIMATES

The preparation of financial statements in conformity with generally accepted accounting principles 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 financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

RECLASSIFICATIONS

Certain reclassifications have been made in the prior period consolidated financial statements to conform to the current period presentation.

STOCK BASED COMPENSATION

On July 1, 2005, the Company adopted the provisions of Financial Accounting Standards Board Statement No. 123R, *Share-Based Payment* (SFAS 123R). SFAS 123R revised SFAS 123, Accounting for Stock Based Compensation and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees. SFAS 123R requires companies to measure and recognize compensation expense for all employee stock-based payments at fair value over the service period underlying the arrangement. Therefore, the Company is now required to record the grant-date fair value of its stock-based payments (i.e., stock options and other equity-based compensation) in the statement of operations. Effective, July 1,2005, the Company adopted FAS 123R using the modified prospective method, and has recorded as an expense the fair value of all stock based grants to employees after such date The Company has not restated its operating results for any prior fiscal year end or quarter.

PROPERTY AND EQUIPMENT

Property and equipment is recorded at cost. Depreciation is provided on the straight-line method over the estimated useful lives of three to five years.

REVENUE RECOGNITION

As required, mPhase has adopted the Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition in Financial Statements, which provides guidelines on applying generally accepted accounting principles to revenue recognition based on the interpretations and practices of the SEC. The Company recognizes revenue on its research grant contract upon delivery of milestones defined in the contract, at the fixed predetermined price under the contract in which payment is reasonably expected as enumerated in SAB104.

RESEARCH AND DEVELOPMENT

Research and Development cost are charged to operations when incurred. The amounts charged to expense for the years ended 2007, 2008, 2009 and inception to date were, $6,393,215, $988,091, $1,255,665 and $60,216,673 respectively.

PATENTS AND LICENSES

Patents and licenses are capitalized when mPhase determines there will be a future benefit derived from such assets, and are stated at cost. Amortization is computed using the straight-line method over the estimated useful life of the asset, generally five years.

Amortization expense was, $36,439, $51,140 and $0 for the years ended June 30, 2007, 2008, and 2009, respectively. As of June 30, 2008, the book value of such assets has been fully amortized.

INVENTORIES

The Company uses the First In First Out method (FIFO) to account for inventory which is carried at cost. As of June 30, 2007, inventory consisted primarily of component parts being assembled on location in anticipation of deployment of specific IPTV systems. Appropriate reserves have been taken to assure that the cost of such inventory does not exceed the value of the underlying contract. During the year ended June 30, 2008, the Company determined that the value of inventory related to IPTV had been impaired and charged to earnings all associated amounts ($505,910).

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - (Continued)

LONG-LIVED ASSETS

In August 2001, the FASB issued Statement No. 144 Accounting for the Impairment or Disposal of Long-Lived Assets, which became effective for the Company July 1, 2002 for the fiscal years ended June 30, 2005, June 30, 2006 thru June 30, 2009. The Company assesses long-term assets for impairment under SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. Under SFAS No. 144, the Company reviews long-term assets for impairment whenever events or circumstances indicate that the carrying amount of those assets may not be recoverable. The Company also assesses these assets for impairment based on their estimated future cash flows. During the fiscal year ended June 30, 2009, the Company wrote-down the value of its investment of a 10% interest in Soverign Corporation from $110,000 to $0.

REPARATION EXPENSE

As an incentive for additional equity contributions, the Company will from time to time, adjust the cost of past private purchases of common stock through the issuance of additional shares in such magnitude as to reduce an investors cost to an average price that more closely approximates current market value. The market value of additional shares issued without cash investment is charged to Reparation Expense, which is included in Other Expenses. Reparations expenses have amounted to, $1,874,020, $392,038, $432,172 and $8,167,734 for the years ended 2007, 2008, 2009 and inception to date, respectively.

LOSS PER COMMON SHARE, BASIC AND DILUTED

mPhase accounts for net loss per common share in accordance with the provisions of SFAS No. 128, Earnings per Share (EPS). SFAS No. 128 requires the disclosure of 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 earnings of the entity. Common equivalent shares have been excluded from the computation of diluted EPS since their effect is anti-dilutive. In accordance with SFAS No. 128, "Earnings Per Share," Basic loss per share is computed by dividing net loss by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share is computed by dividing net loss adjusted for income or loss that would result from the assumed conversion of potential common shares from contracts that may be settled in stock or cash by the weighted average number of shares of common stock, common stock equivalents and potentially dilutive securities outstanding during each period. The Company had 141,081,646 warrants and 145,293,000 options outstanding at June 30, 2009 and convertible debentures convertible into approximately the Company's common stock based upon the conversion terms at June 30, 2009. The inclusion of the warrants and potential common shares to be issued in connection with convertible debt have anti-dilutive effect on diluted loss per share and have been omitted in such computation.

BUSINESS CONCENTRATIONS AND CREDIT RISK

To date the Company s products have been sold to a limited number of customers, primarily in the telecommunications and defense industry. The Company had revenue from two customers of 48% and 22% during the fiscal year ended June 30, 2007. During the year ended the June 30, 2008 and 2009 all revenue is attributable to research contracts with the US Army

Throughout the year, cash may exceed FDIC insured limits. The Company maintains cash balances at financial institutions. The balances are insured by the Federal Deposit Insurance Corporation up to $250,000. Cash balances exceeded FDIC insured limits at times throughout the years ended June 30, 2008 and 2009.

Debt Discounts

Costs incurred with parties who are providing the actual long-term financing, which generally may include the value of warrants, fair value of the derivative conversion feature, or the intrinsic value of beneficial conversion features associated with the underlying debt, are reflected as a debt discount. These costs and discounts are generally amortized over the life of the related debt.

Derivative Financial Instruments

Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended and EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock" require all derivatives to be recorded on the balance sheet at fair value. The beneficial conversion features of the convertible debentures are embedded derivatives and are separately valued and accounted for on our balance sheet with changes in fair value recognized during the period of change as a separate component of other income/expense. Fair values for exchange-traded securities and derivatives are based on quoted market prices. The pricing model we use for determining fair value of our derivatives is the Black-Scholes Pricing Model. Valuations derived from this model are subject to ongoing internal and external verification and review. The model uses market-sourced inputs such as interest rates and stock price volatilities. Selection of these inputs involves management's judgment and may impact net income.

Income Taxes

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. At June 30, 2009, the Company had a full valuation allowance against its deferred tax assets.

Estimated Fair Value of Financial Instruments

The Company's financial instruments include cash, accounts payable, long term debt, line of credit, convertible debt and due to related parties. Management believes the estimated fair value of cash, accounts payable and debt instruments at June 30, 2009 approximate their carrying value as reflected in the balance sheets due to the short-term nature of these instruments or the use of market interest rates for debt instruments. Fair value of due to related parties cannot be determined due to lack of similar instruments available to the Company.

3. SUPPLEMENTAL CASH FLOW INFORMATION

For the FYE June 30,	2007	2008	2009
Non Cash Investing and Financing Activities:			
Interest Paid (net interest income)	$ 18,310	$ 214,878	$ 20,054
Assumption of Sovereign Debt		$ 110,000	$ 0
Stock issued (canceled) in settlement of accrued expenses		$ 100,000	$ (175,000)
Vendor debt into equity	$ 991,709	$ 0	$ 0
Conversion of related party obligations to notes payable			$ 1,068,338
Convertible Debt issued for Notes Receivable		$ 2,000,000	$ 2,800,000
Conversion of Convertible Debt and Related Expenses		$ 241,123	$ 3,303,333
Forgiveness of related party debt.	$ -	$ -	$ 19,336
Reversal of accrued expenses in settlement of litigation with Magpie Telecom Insiders, Inc.			$ 175,000

During the year ended June 30, 2009, the Company wrote down the value of its investment in a 10% interest in Sovereign Corporation from $110,000 to $0.

4. PROPERTY AND EQUIPMENT

Property and equipment, at cost, consist of the following:

	2008	2009
Research Equipment	$ 505,905	$ 36,452
Office and Marketing	224,998	87,352
Gross Cost	730,903	123,804
Less Accumulated Depreciation	(581,485)	(84,156)
Net Property and Equipment	$ 149,418	$ 39,648

Depreciation expense for the years ended June 30, 2007, 2008 and 2009 was $218,237, $246,355 and $115,144 respectively, of which, $124,382, $101,024 and $81,168 respectively, relates to research laboratory and testing equipment included in research and development expense.

5. ACCRUED EXPENSES

Accrued expenses consist of the following:

	2008	2009
Finders Fees	$ 160,000	$ 160,000
Other Expenses	$ 228,444	$ 322,388
Total	$ 388,444	$ 482,388

6. GRANITA MEDIA

Effective July 1, 2007, the Company formed Granita Media, Inc. to separate its IPTV business and facilitate the raising of capital. Pursuant to an arrangement with 4 employees of mPhase, such employees were terminated from mPhase as of July 1, 2007 and became employees of Granita Media Inc and invested solely in the common stock of Granita Media Inc. Under the arrangement, each of the 4 employees were required to invest $125,000 in exchange for an aggregate 2% equity interest in Granitia Media, Inc with mPhase continuing to own 98% of the Company. The 4 employees contributed a total of $339,000 of the total $500,000 equity investment required from them and raised from third party investors another $175,000 for a total of $514,000 Granita Media has 19,000,000 shares of common stock outstanding of which 18,000,000 was owned by mPhase Technology and 1,000,000 is being held for issuance the 4 employees and the third party investors pending an agreement among such persons of the allocation of such shares.

Under the terms of the arrangement between mPhase and the 4 employees, such employees were authorized to sell up to 7.99% of additional equity in the Company for a total of not less than $2,000,000 of additional capital by December 31, 2007. As noted above, the employees raised a total of $175,000 of outside capital only and pursuant to the arrangement, such employees either resigned or were terminated by mPhase together with several lower level employees of Granita. A dispute has arisen between Granita Media and one of the former employees with respect to a sum of approximately $176,000 included in short term loans. It is the Company s position that such sums were voluntarily advanced to fund operating expenses after July 1, 2007. Since the 4 employee / officers of Granita Media were required to cover operating expenses of Granita Media after July 1, 2007 through equity investments either directly or from third parties, the Company has taken the position that such amount nor any related interest and fees are not owed to the employee. In addition, the Company has substantial rights of offset for unpaid rent with respect to the portion of its Little Falls office occupied by Granita Media after July 1, 2007. Granita Meida, Inc. ceased operations in December of 2007.

7. SHORT TERM NOTES PAYABLE

Short term debt is comprised of the following:

	June 30, 2008	June 30, 2009
Note payable to Granita Employee (See note #6)	$ 175,820	$ 175,820
Note payable to law firm bearing 8% interest, originally monthly installments of $5,000 per month commencing in June 2002 and continuing through December 1, 2003 with a final payment of principal plus accrued interest due at maturity on December 31, 2003, this note was in arrears as of June 30, 2004 and the company negotiated a new settlement arrangement as of August 31, 2004. Under such settlement agreement, the Company made a $100,000 cash payment and gave a cashless warrant to purchase $150,000 worth of common stock valued at $.25 per share. In addition, the Company agreed to pay $25,000 on each of December 1, 2004, March 1, 2005, June 1, 2005, September 1, 2005 and $50,000 on December 1, 2005. Thereafter, the Company was obligated to pay $25,000 on each of March 1, 2006, June 1, 2006, September 1, 2006 with a final payment of $75,000 on December 1, 2006 ($10,000 paid in 2008). The Company is currently in default.	$ 65,000	$ 65,000
Total Short Term Notes	$ 240,820	$ 240,820

8. STOCKHOLDERS EQUITY

mPhase initially authorized capital of 50,000,000 shares of common stock with no par value. On February 23, 2000, the Board of Directors proposed and on May 22, 2000 the shareholders approved an increase in the authorized capital to 150,000,000 shares of common stock. On June 15, 2004, a Special Meeting of Shareholders of the Company approved a proposal by the Company to amend the Company s Certificate of Incorporation under New Jersey law to increase the authorized shares of common stock from 150 million to 250 million shares and change the par value of all shares of common stock from no par to $0.01 par stock.. Effective, June, 2005 and June 2006, and June 2008, the Company received authorization to increase the number of authorized shares to 500 million, 900 million and 2 billion, respectively. On April 25, 2009 The Board of Directors, subject to shareholder approval, approved an increase in shares of common stock to 3 billion shares.

During the Fiscal Year Ending June 30, 2009 the following transactions impacted stockholders equity

Private Placements

During the quarter ended September 30, 2008, the Company issued 4,000,000 shares of its common stock at $.05 per share in private placements generating net proceeds of $180,000. Related to this transaction was the issuance of 3,862,000 shares as reparations shares to effect repricing, costing an estimated $216,689.

During the quarter ended December 31, 2009 there were no private placements.

During the quarter ended March 31, 2009, the Company issued 35,000,000 shares of its common stock at $.01 per share in private placements generating net proceeds of $315,000. Related to this transaction was the issuance of 7,660,000 shares as reparations shares to effect repricing, costing an estimated $99,483.

During the quarter ended June 30,2009, the Company issued 33,333,333 shares of its common stock at $.075 per share in private placements generating net proceeds of $225,000 net of $25,000 of finders fees. Related to this transaction was the issuance of 8,000,000 shares as reparations shares to effect repricing, costing an estimated $116,000.

Stock Based Compensation

During the three months ended September 30, 2008, the Company issued 5 year options to purchase 104,675,000 shares of common stock at $.05 per share. The value of such options was estimated to be $4,071,613 using the Black Scholes method, a volatility of 80% and an interest free rate of 3%. In addition, 61,750,000 shares of common stock valued at $3,520,215 were issued to employees and consultants. (See note 3).

Conversion of debt securities

During the FYE June 30, 2009, $3,303,333 of debt and accrued interest was converted into 278,346,019 shares of common stock. Included in this amount is $112,500 of notes payable to a related party which were sold to an investor for $112,500 cash and subsequently converted into 15,000,000 shares of the Company s common stock valued at 1.6 cents per share resulting in beneficial conversion of $114,500. Also included is the conversion of short term investor debt (face value $54,000), related interest and settlement expenses in the aggregate amount of 57,375.

All other debt converted involved long term convertible debentures which are discussed below.:

Long Term Convertible Debentures / Note Receivable / Debt Discount and related Interest

The Company has entered into five separate convertible debt arrangements with independent investors.

General

The economic substance of convertible debt arrangements entered into beginning December 2007 was to provide the Company with needed liquidity to supplement the private equity markets.

The form of the transaction may involve the following:

The receipt of cash

The issuance of a note payable from mPhase.

The issuance of a note receivable due to mPhase

A Securities Purchase Agreement

The note payable contains conversion features which permit the holder to convert debt into equity. Such debt is eligible to be converted into the Company s common stock immediately, thus requiring the recording of the entire liability upfront. Finally, to encourage conversion, a discount from market value was offered.

The aggregate amount of notes payable exceeded the amount of cash received. As Consideration for this difference the Company took back a secured Note Receivable. Security is generally liquid investments of the investor.

The note receivable provides a commitment to fund mPhase. The notes are secured and collateralized and carry terms which are different from the related note payable and no right of offset exist.

A summary of our arrangement is as follows:

Arrangement #1 (Golden Gate Investors)

In December, 2007, the Company received proceeds of $500,000 under a Securities Purchase Agreement. This transaction involves three related agreements: 1) A Securities Purchase Agreement, dated as of December 11, 2007, which may under certain circumstances permitted the Company to draw up to $6.0 of funds; 2) A Convertible Debenture in the amount of $1.5 million, with an interest rate of 7 ¼% and a maturity date of December 11, 2010 and 3) A Secured Note Receivable in the amount of $1.0 million, with an interest rate of 8 ¼ % and a maturity date of February 1, 2011 due from the same parties who are the holders of the Convertible Debentures. In March of 2009, by mutual consent of the parties, the Securities Purchase Agreement was terminated. Total draws under this facility were $1.5 million.

During FYE 2009, $1,365,000 of such debt was converted into 74,368,943 shares of common stock and the Company received a total of $950,000 under the provisions of the related note receivable. As of June 30, 2009 all notes receivable had been paid and all debt converted. No further obligations exist by either party.

Arrangement #2 (St.George Investments, LLC)

In February 2008, the Company entered into a Convertible Debenture transaction which involved the receipt of $500,000 cash, a note payable of $550,000 and the issuance of 3,250,000 shares of stock. The relative fair value of the shares was $105,000. The terms of the debenture provide for a 7.5% interest rate, a due date of February 2012 and conversion privileges equal to 75% of the average of the three lowest prices over the 20 day period prior to conversion.

During FYE 2009, $614,209 of such debt and related interest was converted into 60,536,482 shares of common stock. As of June 30, 2009 all debt had been converted and no further obligation exist by either party

Arrangement #3 (JMJ Financial, Inc.)

In April, 2008, the Company received proceeds of $300,000 under a Securities Purchase Agreement. This transaction involves three related agreements: 1) A Securities Purchase Agreement which may under certain circumstances permit the Company to draw up to $1,000,000 of funds; 2) Two Convertible Debentures totaling $1,450,000, with a one time interest factor of 12% ($132,000) and a maturity date of March 25, 2011 and 3) A Secured Note Receivable in the amount of $1.0 million, with a one time interest factor of 13.2 % and maturity dates of March 25, 2012 due from the same parties who are the holders of the Convertible Debentures. The Note Receivable is collateralized by $1 million of Blue Chip Stocks.

Conversion of outstanding debentures into common shares is at the option of the holder. The number of shares into which this debenture can be converted is equal to the dollar amount of the debenture divided by 75% of the lowest trade price during the 20 day trading period prior to conversion.

During FYE 2009, $964,250 of such debt and related interest was converted into 100,951,309 shares of common stock. In addition, the Company received $650,000 cash payments of the note receivable. As of June 30, 2009 the face value of the note receivable was $350,000 plus interest of $132,000 and the note payable was $527,750 plus interest of $132,000 and an FMV adjustment of $115,801.

Arrangement #4 (JMJ Financial, Inc.)

On December 31, 2008, the Company entered into a second agreement with JMJ Financial. This transaction involves; 1) A Convertible Debenture in the amount of $1.1 million, plus a one time interest factor of 12% ($132,000) and a maturity date of December 31, 2011 and 2) A Secured Note Receivable in the amount of $1.0 million, plus a one time interest factor of 13.2 % ($132,000) and maturity date of December 31, 2012 due from the same parties who are the holders of the Convertible Debentures. Conversion of outstanding debentures into common shares is at the option of the holder. The number of shares into which this debenture can be converted is equal to the dollar amount of the debenture divided by 75% of the lowest trade price during the 20 day trading period prior to conversion.

During FYE 2009 no cash was exchange nor was any debt converted relative to this agreement. (See Subsequent Events). The FMV addition to this debt as of FYE 2009 was $307,899

Arrangement #5 (LaJolla Cove Investors, Inc.)

On Sept 11, 2008, the Company received proceeds of $200,000 under a Securities Purchase Agreement. This transaction involves three related agreements: 1) A Securities Purchase Agreement which may under certain circumstances permit the Company to draw up to $2,000,000 of funds; 2) A Convertible Debenture totaling $2,000,000, with an interest rate of 7 1/4% and a maturity date of September 30, 2011 and 3) A Secured Note Receivable in the amount of $1,800,000, with an interest rate of 8 1/4% and maturity dates of September 30, 2011 due from the same parties who are the holders of the Convertible Debentures. In addition, the holder of the debenture is related to the holder in Arrangement #1.Conversion of outstanding debentures into common shares is similar to the terms of Arrangement #1. As of FYE 2009, $190,000 of debt was converted into 21,714,285 shares of common stock. On June 30, 2009 the note receivable balance was $1,800,000, the note payable was $1,810,000 and the FMV addition $387,228.

Arrangement #5 (JMJ Financial, Inc.-See Subsequent Events)

On August 19, 2009, the Company received proceeds of $250,000 in connection with a third agreement with JMJ Financial. This transaction involves 1) a Convertible Debenture in the amount of $1,870,000, plus a one time interest factor of 12% ($224,400) and a maturity date of August 10, 2012 and 2) A Secured Note Receivable in the amount of $1,700,000 plus a one time interest factor of 13.2% ($224,400) and a maturity date of August 10, 2012 due from the same parties who are the holders of the Convertible Debenture. Conversion of outstanding into common shares is at the option of the holder. The number of shares into which this debenture can be converted is equal to the dollar amount of the debenture divided by 75% of the lowest trade price during the 20 day trading period prior to conversion..

Arrangement #6 (JMJ Financial, Inc.-See Subsequent Events)

On September 30, 2009, the Company expects to receive a total of $150,000 of proceeds in connection with a fourth agreement with JMJ Financial. This transaction involves 1) One Convertible Debentures in the amount of $1,200,000 plus a one time interest factor of 12% ($144,100) and a maturity date of September 23,2012 and (2) A Secured Note in the amount of $1,100,000 plus a one time interest rate factor of 13.1%($144,100 each) and a maturity date of September, 2012 due from the same parties who are the holders of the Convertible Debenture. Conversion of outstanding into common shares is at the option of the holder. The number of shares into which this debenture can be converted is equal to the dollar amount of the debenture divided by 75% of the lowest trade price during the 20 day trading period prior to conversion. The Company has also received a commitment from JMJ Financial to enter into a second convertible debenture on identical terms not later than 60 days from September 23, 2009.

During the Fiscal Year Ending June 30, 2009 the following transactions impacted stockholders equity

Private Placements

During the quarter ended September 30, 2008, the Company issued 4,000,000 shares of its common stock at $.05 per share in private placements generating net proceeds of $180,000. Related to this transaction was the issuance of 3,862,000 shares as reparation shares to effect repricing, costing an estimated $216,689.

No Private Placements occurred in the quarter ending December 31, 2008.

During the quarter ended March 31, 2009, the Company issued 35,000,000 shares of its common stock at $.01 per share in private placements generating net proceeds of $315,000. Related to this transaction was the issuance of 7,660,000 shares as reparations shares to effect repricing, costing an estimated $99,483

During the quarter ended June 30, 2009, the Company issued 33,333,333 shares of its common stock at $.0075 per share in private placements generating net proceeds of $225,000. Related to this transaction were reparation costs of $75,340.

Exercise of Warrants

NONE

Other Equity

During the year months ended, June 30, 2008, the Company issued 1,000,000 shares of stock, 110,000 of options to purchase common stock valued at $100,192 to individuals. In addition, it issued 4,663,741 shares of common stock valued at $392,038 to reflect re-pricing agreements, 1,109,200 shares were issued to pay for finders fees valued at $100,000 and issued 5,250,000 shares of common stock valued at $265,000 in connection with debt financing arrangement (see convertible debt below) The fair value of shares issued was estimated as of the date of grant using the Black-Scholes pricing model, based on the following weighted average assumptions: annual expected return of 0%, annual volatility of ranging between 70 -79 %, based on a risk-free interest rate of 2.25% and expected option life of 5 years.

During the years ended June 30, 2008 and 2009 the Company reevaluated warrants to purchase 13,104,168 shares at fixed prices ranging from $.05 to $.14 per share originally issued during Fiscal Year Ended June 30, 2008 pursuant to EITF-0019, such reevaluation was to review if the Company should record an additional Derivative Liability which would be recordable if the other convertible instruments the Company has outstanding; primarily the Convertible Debentures discussed above; would limit or prevent the Company from honoring the conversion of these fixed price warrants during their contract term. The Company determined it unnecessary to record an additional Derivative Liability at June 30, 2008 and 2009.

Convertible Debt Short Term

Long Term Convertible Debentures / Note Receivable / Debt Discount

SEE NOTES RELATED TO CURRENT YEAR

During fiscal years ended June 30, 2008 and June 30, 2009 the Company entered into 5 convertible debt arrangements with independent investors. These transactions are intended to provide liquidity and capital to the Company and are summarized below.

Arrangement #1 (Golden Gate Investors)

In December, 2007, the Company received proceeds of $500,000 under a Securities Purchase Agreement. This transaction involves three related agreements: 1) A Securities Purchase Agreement, dated as of December 11, 2007, which may under certain circumstances permitted the Company to draw up to $6.0 of funds; 2) A Convertible Debenture in the amount of $1.5 million, with an interest rate of 7 ¼% and a maturity date of December 11, 2010 and 3) A Secured Note Receivable in the amount of $1.0 million, with an interest rate of 8 ¼% and a maturity date of February 1, 2011 due from the same parties who are the holders of the Convertible Debentures. In March of 2009, by mutual consent of the parties, the Securities Purchase Agreement was terminated. Total draws under this facility were $1.5 million. Conversion of the outstanding debenture into common shares is at the option of the holder. The number of shares into which this debenture was converted is equal to the dollar amount of the debenture divided by the lesser of $.35 per share or 80% of the 3 lowest Volume Weighted Average Prices during the 20 day trading period prior to conversion. At the time of the transaction (December 11, 2007) the derivative value of the conversion feature was calculated to be $1,678,471. On June 30, 2008, given the decrease in the Company s stock price, this value had decreased to $322,636. As of June 30, 2009 all of the related debt had been converted and no derivative value balance remained. This has resulted in an increase in earnings for the year of $322,636. In addition, the transaction resulted in a note discount of $1.5 million which has been amortized as expense. During the year ended June 30, 2009, amortization of debt discount amounted to $1,122,649.

During the fiscal year ended June 30, 2009, $1,365,000 of such debt was converted into 74,368,943 shares of common stock and the Company received a total of $950,000 under the provisions of the related Note Receivable.

Arrangement #2 (St.George Investments, LLC)

In February 2008, the Company entered into a Convertible Debenture transaction which involved the receipt of $500,000 cash, a note payable of $550,000 and the issuance of 3,250,000 shares of stock. The relative fair value of the shares was $105,000. The terms of the debenture provide for a 7.5% interest rate, a due date of February 2012 and conversion privileges equal to 75% of the average of the three lowest prices over the 20 day period prior to conversion. The derivative value of the embedded conversion feature was estimated to be $581,428 on the date of issuance. On June 30, 2008, the derivative value was $142,593 and on June 30, 2009 such value was $0 since the entire debt has been converted. The cost of the shares issued and related debt discount is being amortized to expense over the life of the debenture. In the event of default under the note payable the holder is entitled to certain compensatory fees. During the period ended June 30, 2009, amortization of debt discount amounted to $502,083.

During the fiscal year ended June 30, 2009, $614,209 of such debt plus accrued interest was converted into 60,536,582 shares of common stock.

Arrangement #3 (JMJ Financial, Inc.)

In April, 2008, the Company received proceeds of $300,000 under a Securities Purchase Agreement. This transaction involves three related agreements: 1) A Securities Purchase Agreement which may under certain circumstances permit the Company to draw up to $1,000,000 of funds; 2) Two Convertible Debentures totaling $1,450,000, with a one time interest factor of 12% ($132,000) and a maturity date of March 25, 2011 and 3) A Secured Note Receivable in the amount of $1.0 million, with a one time interest factor of 13.2 % and maturity dates of March 25, 2012 due from the same parties who are the holders of the Convertible Debentures. Conversion of outstanding debentures into common shares is at the option of the holder. The number of shares into which the debentures can be converted is equal to the dollar amount of the debenture divided by 75% of the 3 lowest Volume Weighted Average Prices during the 20 day trading period prior to conversion. An amendment of December 31, 2008 allowed one conversion of $200,000 of principal to be converted into common stock at the rate of 70% of the three lowest volume weighted average prices during the 20 day period prior to conversion and reduced the conversion price from 80% to 75% for future conversions.

During the fiscal year ended June 30, 2009, $964,250 of such debt and accrued interest was converted into 100,951,309 shares of common stock.

At the time of the transaction the embedded conversion feature of this security was calculated to be $2,493,212. On June 30, 2008, this value had decreased to $284,922. On June 30, 2009, such value had increased to $444,552, creating a non-cash expense for the twelve month period of $159,630. In addition, the transaction resulted in a note discount which is being amortized as expense over the life of the loan. During the twelve month period ended June 30, 2009, amortization of debt discount amounted to $1,007,097.

Payments received under the Note Receivable for the fiscal year ended June 30, 2009, have totaled $650,000. The Note Receivable is collateralized by $1 million of Blue Chip Stocks.

Arrangement #4 (JMJ Financial, Inc.)

On December 31, 2008, the Company entered into a second agreement with JMJ Financial. This transaction involves; 1) A Convertible Debenture in the amount of $1.1 million, plus a one time interest factor of 12% ($132,000) and a maturity date of December 31, 2011 and 2) A Secured Note Receivable in the amount of $1.0 million, plus a one time interest factor of 13.2 % ($132,000) and maturity date of December 31, 2012 due from the same parties who are the holders of the Convertible Debentures. No cash was exchanged relative to this agreement.

During the years ended June 30, 2008 and 2009 the Company reevaluated warrants to purchase 11,711,112 shares at fixed prices ranging from $.05 to $.14 per share originally issued during Fiscal Year Ended June 30, 2008 pursuant to EITF-0019, such reevaluation was to review if the Company should record an additional Derivative Liability which would be recordable if the other convertible instruments the Company has outstanding; primarily the Convertible Debentures discussed above; would limit or prevent the Company from honoring the conversion of these fixed price warrants during their contract term. The Company determined it unnecessary to record an additional Derivative Liability at June 30, 2008 and 2009.

Arrangement #5 (LaJolla Cove Investors, Inc.)

On Sept 11, 2008, the Company received proceeds of $200,000 under a Securities Purchase Agreement. This transaction involves three related agreements: 1) A Securities Purchase Agreement which may under certain circumstances permit the Company to draw up to $2,000,000 of funds; 2) A Convertible Debenture totaling $2,000,000, with an interest rate of 7 1/4% and a maturity date of September 30, 2011 and 3) A Secured Note Receivable in the amount of $1,800,000, with an interest rate of 8 1/4% and maturity dates of September 30, 2011 due from the same parties who are the holders of the Convertible Debentures. In addition, the holder of the debenture is related to the holder in Arrangement #1.

Conversion of outstanding debentures into common shares is similar to the terms of Arrangement #1. At the time of the transaction (September 11, 2008) the embedded conversion feature of this security was calculated to be $859,756.

On June 30, 2009, this value had increased to $1,080,343, creating a non-cash expense to earnings for the twelve month period of $220,587. In addition, the transaction resulted in a note discount which is being amortized as expense over the life of the loan. During the twelve month period ended June 30, 2009, amortization of debt discount amounted to $285,320. During the twelve months ended June 30, 2009 the holder converted $19,000 of principal into 27,214,285 shares of common stock.

STOCK INCENTIVE PLANS

A summary of the stock option activity for the years ended June 30, 2007, 2008 and 2009 pursuant to the terms of both plans, which include incentive stock options and non-qualified stock options, is set forth on the below:

	Number of Options		Weighed Average Exercise Price
Outstanding at June 30, 2007	45,893,000	$	0.25
Granted	85,000	$	0.15
Exercised	0		0
Cancelled/Expired	0		0
Outstanding at June 30, 2008	45,978,000	$	0.25
Granted	104,675,000		0.05
Exercised	0		0
Cancelled/Expired	(5,360,000)		(0.25)
Outstanding at June 30, 2009	145,293,000	$	0.11

The fair value of options granted in fiscal year ended June 30, 2008 and 2009 was estimated as of the date of grant using the Black-Scholes stock option pricing model, based on the following weighted average assumptions: annual expected return of 0%, an average life of 5 years, annual volatility of 71% and 80.3% and a risk-free interest rate 2.25% and 3.0%in the years 2008 and 2009 respectively.

The following summarizes information about stock options outstanding at June 30, 2009:

RANGE OF EXERCISE PRICE	NUMBER OUTSTANDING	WEIGHTED AVERAGE REMAINING CONTRACTUAL LIFE	WEIGHTED AVERAGE EXERCISE PRICE	NUMBER EXERCISABLE	WEIGHTED AVERAGE EXERCISE PRICE
$.13 - $.45	40,618,000	1.4 years	$.25	40,618,000	$.25
$.05	104,675,000	4.3 years	$.05	104,675,000	$.05
Totals				145,293,000	$.11

During The fiscal year ended June 30, 2009 the Company issued no warrants and 5,064,859 warrants expired.

During The fiscal year ended June 30, 2008 the Company issued 13,104,168 of warrants at exercises prices ranging from $.05 to $0.15 and 5,271,740 warrants expired. In addition the Company received a total of $650,000 (net of fees) through the exercise of 11,111,113 warrants.

As of June 30, 2009 and 2008 warrants covering 141,081,646 and 146,146,505 shares remain outstanding with a weighted average exercise price of $ 0.23 and $0.21 respectively.

The following summarizes information about warrants outstanding at June 30, 2009:

RANGE OF EXERCISE PRICE	NUMBER OUTSTANDING	WEIGHTED AVERAGE REMAINING CONTRACTUAL LIFE	WEIGHTED AVERAGE EXERCISE PRICE	NUMBER EXERCISABLE	WEIGHTED AVERAGE EXERCISE PRICE
$.21 - $.50	89,633,400	1.5 years	$.27	89,633,400	$.27
$.05-20	51,488,246	3.8 years	$.17	51,488,246	$.17
Totals				141,081,646	$.23

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9. RELATED PARTY TRANSACTIONS

Mr. Durando, the President and CEO of mPhase together with Mr. Ergul own a controlling interest and are officers of Janifast Limited. Mr. Durando and Mr. Dotoli are officers of Microphase Corporation. Mr. Ergul, retired as the chairman of the board of mPhase in Nov 2007, owns a controlling interest and is a director of Microphase Corporation,

Mr. Abraham Biderman was employed until September 30, 2003 by our former investment-banking firm Lipper & Company. During the fiscal year ended June 30 2007, Mr. Biderman s current firm Eagle Advisers, Inc. has acted as a finder of money in connection with finder s fees of $520,000, as well as addition administrative and occupancy charges of $43,400. In 2008, Mr Biderman was paid $188,472 of finders fees.

In addition, at various points during fiscal year ended June 30, 2009, Messrs. Durando, Dotoli and Smiley provided no additional net bridge loans to the Company.

As of June 30, 2009, bridge loans outstanding including accrued interest thereon from Mr. Smiley, equaled $1,332,400. Additionally, accrued interest totaling $133,592 was owed to the Officers and is included in accrued expenses at June 30, 2009. All of the foregoing promissory notes are payable on demand. As of June 30, 2009 Mr. Durando and Mr. Dotoli are owed unpaid compensation plus accrued interest thereon at 12% per annum equal to $617,420 and $ 450,756 respectively.

In April 2009 the Board of Directors authorized the right for the officers to convert such loans plus accrued interest thereon, at any time for the next five years providing such shares are issued, outstanding and available, at a conversion price of $.0075; such price comparable to private placements during the period. The Company recorded beneficial conversion interest expense of $914,060 during the year ended June 30, 2009 on the conversion feature based upon principle at the commitment date and accrued interest through June 30, 2009. The officers notes plus accrued interest is convertible into approximately 195,465,654 shares of the Company s common stock based upon the conversion terms at June 30, 2009.

JANIFAST

During the year ended June 30, 2000, mPhase advanced money to Janifast Limited, which is owned by U.S. Janifast Holdings, Ltd, a related party of which three directors of mPhase are significant shareholders, in connection with the manufacturing of POTS Splitter shelves and DSL component products. As of June 30, 2000 the amount advanced to Janifast was approximately $1,106,000, which is included in production advances-related parties on the accompanying balance sheet. There were no such advances during the years ended June 30, 2002 and 2003. Pursuant to debt conversion agreements between the Company and Janifast, for the year ended June 30, 2001 Janifast received 1,200,000 shares of mPhase common stock canceling liabilities of $600,000, and for the year ended June 30, 2002 Janifast received 3,450,000 shares of mPhase common stock and 1,200,000 warrants to purchase mPhase common stock for the cancellation of $720,000 of liabilities, as discussed in Note 10. During the year ended June 30, 2003 Janifast was issued 1,500,000 shares of mPhase common stock in connection with the cancellation of $360,000 of outstanding liabilities of mPhase, the value of which was based upon the price of the Company s common stock on the effective date of settlement. No gain or loss was recognized in connection with conversions by Janifast for fiscal 2003. During the years ended June 30, 2003, 2004 and 2005 and the period from inception (October 2, 1996) to June 30, 2005, there has been $174,959, $2,771,925, 1,536,494 and $15,001,105, respectively, of invoices for products and services have been charged to inventory or expense and is included in operating expenses in the accompanying statements of operations. Effective December 30, 2004, Janifast Ltd. agreed to convert $200,000 of accounts payable into common stock of the Company at $.20 per share plus a 5 year warrant for a like amount of shares at $.25 per share.

During the year ended June 30, 2007, Janifast agreed to converted $108,000 of debt into 830,000 shares of common stock and received 769,231 additional shares of stock as reparations.

In March of 2009, Janifast Ltd. ceased operations owing to its financial condition and the global downturn in the capital markets.

MICROPHASE

The Company leases office space from Microphase at both its Norwalk and Little Falls location. Current rental expense is $3,000 and $2,245 per month at Norwalk and Little Falls respectively. In addition, Microphase provides certain research and development services and shares administrative personnel from time to time. During the year ended June 30, 2009, Microphase Corporation charged the Company $150,000 for project management fees, $36,000 for rent and $16,773 for administrative expenses. Additionally, in July 2009 Microphase Corporation converted $200,000 of accounts payable into 26,666,667 shares of the Company s common stock at $.0075 per share. Such price was determined based upon the price of private placements of equity by the Company during such period.

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9. RELATED PARTY TRANSACTIONS - ***(continued)***

On August 30, 2004, the Company paid $100,000 in cash to Piper Rudnick LLP, outside legal counsel in the Company as part of a renegotiated settlement agreement that was originally effective as of March 31, 2002. The Company was in arrears with respect to payments due under the original settlement agreement and as part of the renegotiated agreement agreed to make the following payments:

a. $25,000 on each of December 1, 2004, March 2005, June 1, 2005, September 1, 2005 and a $50,000 payment on December 1, 2005. Thereafter the Company is obligated to pay $25,000 on each of March 1, 2006, June 1 2006, and September 1, 2006 with a final payment of $75,000 of December 1, 2006.

b. The Company also delivered a 5 year cashless warrant to purchase $150,000 worth of common stock at $.25 per share.

The warrant was valued pursuant to EITF 96-18, the ascribed value of the warrant minus the debt cancelled resulting loss of $40,500.

As of June 30, 2004, Mr. Smiley and Microphase each agreed to extend to July 25, 2005, the maturity on their 12% convertible promissory notes in the principal amount of $100,000 and $180,000 respectively.

Additionally at June 30, 2004, Mr. Durando was owed $300,000 by the Company as evidenced by a non-interest bearing promissory note that was repaid in July 2004. As of June 30, 2004 a total of $55,000 in the aggregate was due to Mr. Durando and Mr. Dotoli for unpaid compensation.

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

During the fiscal year ended June 30, 2005, Mr. Dotoli and Mr. Smiley, the COO, and CFO and General Counsel of the Company respectively, each lent the Company $75,000. Mr. Dotoli was repaid, the principal amount of such loan, in cash in January, 2005 and Mr. Smiley converted his $75,000 loan into 375,000 shares of common stock of the Company plus a 5 year warrant to purchase a like amount of shares at $.25 per share. In addition, Mr. Smiley converted $9,975 of accrued interest into 49,875 shares of common stock plus a 5 year warrant to purchase a like amount of shares at $.25 per share. Finally Mr. Smiley received 25,000 additional shares of common stock as a market adjustment to his equity investment of $25,000 on August 30, 2004. Mr. Dotoli cancelled $3,750 of accrued and unpaid interest from August 15, 2004 through January 15, 2004 into 375,000 shares of common stock pursuant to the terms of a portion of a warrant that was exercised at $.01 per share previously given by the Company to Mr. Dotoli in exchange for and cancellation of unpaid compensation. On January 15, 2004, Mr. Smiley was awarded 425,000 shares of common stock as additional compensation.

In July of 2005, Mr. Smiley was repaid a loan of $35,000, without interest made to the Company in June of 2005. In the three month period ended September 30, 2005, Mr. Durando and Mr. Smiley lent the Company $50,000 and $100,000, respectively, which was repaid by the Company, without interest in October of 2005.

The Following Summaries Compensation to Related Parties for the Fiscal Year Ended June 30, 2007

	Durando	Dotoli	Ergul	Biderman	Smiley	Guerino	Lawrence	Janifast	Microphase	TOTAL RELATED
Consulting / Salary	$ 393,600	$ 282,000			$ 200,000					$ 875,600
Directors Stipend and Interest	$ 7,500	$ 7,538	$ 3,750	$ 3,750	$ 8,550	$ 3,750	$ 3,750			$ 38,588
Rent									$ 60,000	$ 60,000
R&D									$ 236,492	$ 236,492
Finders Fees (including common shares)				$ 520,000						$ 520,000
Cost of Sales and SG&A								$ 110,912	$ 36,342	$ 147,254
Reparations and Stock Based Compensation	$ 1,044,000	$ 555,000	$ 201,000	$ 16,800	$ 306,250	$ 14,700		$ 138,462		$ 2,276,212
Totals	**$ 1,445,100**	**$ 844,538**	**$ 204,750**	**$ 540,550**	**$ 514,800**	**$ 18,450**	**$ 3,750**	**$ 249,374**	**$ 332,834**	**$ 4,154,146**
PacketPort.com legal expense										**$ 611,807**
Total expense to related parties										**$ 4,765,953**

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The Following Summaries Compensation to Related Parties for the Fiscal Year Ended June 30, 2008

	Durando	Dotoli	Biderman	Smiley	Microphase	TOTAL RELATED
Consulting / Salary	$ 393,600	$ 282,000		$ 200,000		$ 875,600
Interest	$ 19,490	$ 4,156		$ 18,752		$ 42,398
Rent					$ 60,000	$ 60,000
R&D					$ 28,151	$ 28,151
Finders Fees			$ 188,472			$ 188,472
Cost of Sales and SG&A					$ 30,089	$ 30,089
Totals	**$ 413,090**	**$ 286,156**	**$ 188,472**	**$ 218,752**	**$ 118,240**	**$ 1,224,710**

Summary of compensation to related parties for the Fiscal Year Ended June 30, 2009

	Durando	Dotoli	Smiley	Biderman	Microphase	Total
Consulting / Salary	$ 275,718	$ 229,000	$ 182,292			$ 687,010
Interest	$ 61,473	$ 62,514	$ 21,048			$ 145,035
Rent					$ 36,000	$ 36,000
G&A					$ 16,773	$ 16,773
R&D					$ 150,000	$ 150,000
Finders Fees				$ 80,000		$ 80,000
Stock based compensation (shares issued)*	$ 1,541,700	$ 913,600	$ 571,000	$ 228,400		$ 3,254,700
Stock based compensation (options issued)**	$ 1,944,912	$ 1,166,747	$ 700,168	$ 77,746		$ 3,889,823
Total compensation	$ 3,823,803	$ 2,372,061	$ 1,474,508	$ 386,196	$ 202,773	$ 8,259,341
Common stock issued*	27,000,000	16,000,000	10,000,000	4,000,000		57,000,000
Options issued (5 years @ 5 cents)**	50,000,000	30,000,000	18,000,000	2,000,000		100,000,000

Amounts due to Officers For the year ended June 30, 2008

	RON DURANDO	GUS DOTOLI	MARTIN SMILEY	TOTAL
NOTES PAYABLE OFFICERS				
BALANCE 6/30/07	$ 85,000	$ 75,000	$ 161,000	$ 321,000
July 2007 Advances (Payments)	$ (30,000)	$ (75,000)		$ (105,000)
August 2007 Advances (Payments)	$ 35,000	$ 75,100	$ 35,000	$ 145,100
Sept 2007 Advances (Payments)	$ 110,000			$ 110,000
Assumption of Note Payable- Sovereign	$ 110,000			$ 110,000
Oct 2007 Advances (Payments)	$ 25,000	$ 25,000	$ 25,000	$ 75,000
Nov 2007 Advances (Payments)	$ 76,000	$ 36,000	$ 11,000	$ 123,000
Dec 2007 Advances (Payments)	$ 25,000	$ 0	$ 0	$ 25,000
Transferred to Deferred Comp	$ (148,000)	$ (123,500)		$ (271,500)
Jan 2008 Advances (Payments)	$ 2,000	$ 32,000		$ 34,000
Feb 2008 Advances (Payments)	$ 0	$ 55,000	$ 72,038	$ 127,038
Mar 2008 Advances (Payments)	$ (180,000)	$ (47,500)	$ (40,000)	$ (267,500)
April 2008 Advances (Payments)	$ (110,000)	$ (52,100)	$ (45,000)	$ (207,100)
May 2008 Advances (Payments)			$ (15,000)	$ (15,000)
June 2008 Advances (Payments)				
BALANCE Notes Payable Officers	**$ 0**	**$ 0**	**$ 204,038**	**$ 204,038**
Deferred Compensation	**$ 278,000**	**$ 323,500**		**$ 601,500**

Due To Officers								
BALANCE 6/30/07	$	188,400	$	75,500			$	263,900
Consulting Fee Earned -1st Qtr	$	98,400	$	70,500			$	168,900
Consulting Fees Paid - 1st Qtr	$	(39,500)	$	(32,500)			$	(72,000)
Consulting Fee Earned - 2nd Qtr	$	98,400	$	70,500			$	168,900
Consulting Fees Paid - 2nd Qtr	$	(10,000)	$	(10,000)			$	(20,000)
Consulting Fee Earned - 3rd Qtr	$	98,400	$	70,500			$	168,900
Consulting Fees Paid - 3rd Qtr	$	(12,000)	$	(8,500)			$	(20,500)
Consulting Fee Earned - 4th Qtr	$	98,400	$	70,500			$	168,900
Consulting Fees Paid - 4th Qtr	$	(221,510)	$	(204,244)			$	(425,754)
Balance Due to Officers	**$**	**298,990**	**$**	**102,256**			**$**	**401,246**
Interest Payable	**$**	**0**	**$**	**0**	**$**	**18,751**	**$**	**18,751**
Totals Payable to Officers	**$**	**576,990**	**$**	**425,756**	**$**	**222,789**	**$**	**1,225,535**

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Equity Conversions of Debt and Other Financial Instruments with Related Parties

Janifast:		**2006**		**2007**	**2008**	**2009**
Number of shares		950,000		830,769		
Number of warrants		950,000		0		
Amount converted to equity	$	171,000	$	108,000		
Microphase Corporation:						
Number of shares		2,050,000		0		
Number of warrants		2,050,000		0		
Amount converted to equity	$	369,000	$	0		
Strategic Vendor Conversions:						
Number of shares		331,864		5,242,959		
Number of warrants		277,778		0		
Amount converted to equity	$	50,000	$	1,996,561		
Officers						
Number of shares		0		0		
Number of warrants (A)		0		0		
Amount converted to equity	$	0	$	0		
Total Related Party Conversions:						
Number of shares		3,331,864		6,073,728	NONE	NONE
Number of warrants		3,277,778		0		
Amount converted to equity	$	590,000	$	2,104,561		

NOTE 10 - INCOME TAXES

The accompanying consolidated balance sheet includes the following components of deferred taxes under the liability method:

		2008		2009
Deferred Tax Liabilities				
Property and equipment		-		-
Accrued expenses		-		-
		-		-
Deferred Tax Assets				
Net operating loss carryforward	$	35,081,500	$	38,223,650
Accrued expenses		-		-
		35,081,500		38,223,650
Net Deferred Tax Asset		35,081,500		38,223,650
Valuation allowance		(35,081,500)		(38,223,650)
	$	-	$	-

At June 30, 2009 the Company has federal net operating loss carryforwards of approximately $96.5 million and $93.4 million to offset future federal and state income taxes respectively, which expire at various times from 2016 through 2029. The federal net operating loss carryforwards may be subject to the separate return loss limitation rules and IRC section 382 limitations due to changes in ownership. The Company has assessed the evidence of its forecasted future operations against the potential likelihood of the realization of the deferred tax assets to make the determination that the Company will not utilize these carryforwards and has recorded a valuation allowance against the net deferred tax asset.

The Company has a loss of $3,956,721 in 2008 and $15,529,677 in 2009. Deferred income taxes relate principally to the use of net operating loss carryforwards, these can differ from computations based upon book losses for the use for tax purposes of accelerated depreciation methods and the difference in the book and tax basis of certain stock based compensation.

The provision for income taxes from continuing operations differs from taxes that would result from applying Federal statutory rates because of the following:

	Year ended June 30,			
	2008		2009	
	Amount	Percent	Amount	Percent
Taxes at Federal Statutory Rate	$ (1,345,285)	(34.0%)	$ (5,280,090)	(34.0)%
State Taxes Net of Federal Tax Benefit	(221,970)	(5.61%)	(871,215)	(5.61)%
Utilization of NOL	-	-	-	-
Tax Credits	-	-	-	-
Valuation Allowance	1,493,785	37.8%	3,142,150	20.2%
Other-non deductible stock based compensation-restricted shares and unexercised options	73,470	1.9%	3,009,155	19.4%
	$ -	-	$ -	-

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11. COMMITMENTS AND CONTINGENCIES

COMMITMENTS

The Company has a lease obligation for the rental of office space in Little Falls New Jersey until May 1, 2010. The annual obligation under such lease requires rent of $2,245 per month ($21,600 annually) for the year beginning June 1, 2009 and ending May 1, 2010.

mPhase has entered into various agreements with Georgia Tech Research ("GTRC") and its affiliate, Georgia Tech Applied Research Corporation, ("GTARC"), pursuant to which the Company receives technical assistance in developing the commercialization of its Digital Video and Data Delivery System. The amount incurred by the Company for GTRC technical assistance with respect to its research and development activities during the years ended, 2007, 2008 and 2009 totaled $0, $0 and $0 respectively, and $13,539,952 from the period from inception through June 30, 2009.

12. FAIR VALUE MEASUREMENTS

Effective July 1, 2008, we adopted Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS 157), which provides a framework for measuring fair value under GAAP. SFAS 157 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. SFAS 157 requires that valuation techniques maximize the use of observable inputs and minimize the use of unobservable inputs. SFAS 157 also establishes a fair value hierarchy, which prioritizes the valuation inputs into three broad levels.

Financial assets and liabilities valued using level 1 inputs are based on unadjusted quoted market prices within active markets. Financial assets and liabilities valued using level 2 inputs are based primarily on quoted prices for similar assets or liabilities in active or inactive markets. For certain long-term debt, the fair value was based on present value techniques using inputs derived principally or corroborated from market data. Financial assets and liabilities using level 3 inputs were primarily valued using management s assumptions about the assumptions market participants would utilize in pricing the asset or liability. Valuation techniques utilized to determine fair value are consistently applied.

The table below presents a reconciliation for liabilities measured at fair value on a recurring basis at June 30, 2009 and 2008:

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3) Derivative Liability June 30, 2009	June 30, 2008
Balance at July 1, 2008	$ 750,151	$ 0
Increase in Derivative Liability	184,242	2,384,849
Debt discounts	1,446,423	(1,634,698)

Balance at June 30, 2009	$	2,380,816	$	750,151

Financial instruments are considered Level 3 when their values are determined using pricing models, discounted cash flow methodologies or similar techniques and at least one significant model assumption or input is input is unobservable. Level 3 financial instruments also include those for which the determination of fair value requires significant management judgment or estimation.

13. SUBSEQUENT EVENTS:

On August 19, 2009, the Company received proceeds of $250,000 in connection with a third agreement with JMJ Financial. This transaction involves 1) a Convertible Debenture in the amount of $1,870,000, plus a one time interest factor of 12% ($224,400) and a maturity date of August 10, 2012 and 2) A Secured Note Receivable in the amount of $1,700,000 plus a one time interest factor of 13.2% ($224,400) and a maturity date of August 10, 2012 due from the same parties who are the holders of the Convertible Debenture. Conversion of outstanding into common shares is at the option of the holder. The number of shares into which this debenture can be converted is equal to the dollar amount of the debenture divided by 75% of the lowest trade price during the 20 day trading period prior to conversion.

On September 30, 2009, the Company expects to receive a total of $150,000 of proceeds in connection with a fourth agreement with JMJ Financial. This transaction involves 1) A Convertible Debenture in the amount of $1,200,000 plus a one time interest factor of 12% ($144,000) and a maturity date of September 23, 2012 and (2) A Secured Note in the amount of $1,100,000 plus a one time interest rate factor of 13.2%($144,000 each) and a maturity date of September 23, 2012 due from the same parties who are the holders of the Convertible Debentures. Conversion of outstanding into common shares is at the option of the holder. The number of shares into which this debenture can be converted is equal to the dollar amount of the debenture divided by 75% of the lowest trade price during the 20 day trading period prior to conversion. The Company has received a commitment from JMJ Financial to enter into an identical financing not later than 60 days from September 23, 2009.

In July of 2009 Microphase Corporation converted $200,000 of Accounts Payable into 26,666,667 shares of the Company s common stock at $.0075 per share. The price was the same price and common stock offered in equity private placements during such period.

On October 7, 2009, the Company paid Messrs. Durando, Dotoli and Smiley $45,000,$45,000 and $25,000 respectively in reduction of amounts owed to them by the Company for unpaid compensation and bridge loans.

SCHEDULE II

ITEM 14B. VALUATION AND QUALIFYING ACCOUNTS

No material Accounts exists.

SIGNATURES

Pursuant to the requirements of the Section 13 or 15(d) 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.

mPHASE TECHNOLOGIES, INC.

Dated: October 7, 2009

By: /s/ RONALD A. DURANDO

Ronald A. Durando
President, CEO

Pursuant to the requirements of the Securities and Exchange Act of 1934, this report has been signed by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Ronald A. Durando, Chief Executive Officer, Director	October 7, 2009
Gustave T. Dotoli, Chief Operating Officer, Director	October 7, 2009
Martin S. Smiley, EVP, Chief Financial Officer, and General Counsel, Director	October 7, 2009
Anthony Guerino, Director	October 7, 2009
Abraham Biderman, Director	October 7, 2009
Victor Lawrence, Director	October 7, 2009