SITESTAR CORP
Form 10QSB
November 14, 2005

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-QSB**

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

**For the quarterly period ended September 30, 2005**

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

For the transition period from ________________ to _______________

**000-27763**

(Commission file number)

**SITESTAR CORPORATION**

(Exact name of small business issuer as specified in its charter)

| **NEVADA** | **88-0397234** |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

**7109 Timberlake Road, Lynchburg, VA 24502**

(Address of principal executive offices)

**(434) 239-4272**

(Issuer's telephone number)

N/A

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

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ]

Indicate by check mark whether the registrant is a shell company (as defined by Rule 12b-2 of the Exchange Act). Yes [ ] No [X]

APPLICABLE ONLY TO CORPORATE ISSUERS

As of November 14, 2005, the issuer had 86,013,305 shares of common stock issued and outstanding.

Transitional Small Business Disclosure Format (check one): Yes [ ] No [X]

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**SITESTAR CORPORATION**

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PART I. FINANCIAL INFORMATION

**Item 1. Financial Statements**

**SITESTAR CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

**SEPTEMBER 30, 2005 AND DECEMBER 31, 2004**

**ASSETS**

| | 2005 (Unaudited) | 2004 (Audited) |
|---|---|---|
| CURRENT ASSETS | | |
| Cash and cash equivalents | $ 34,206 | $ 48,533 |
| Accounts receivable, net of allowance of $12,341 and $11,992 as of September 30, 2005 and December 31, 2004 respectively | 135,382 | 192,350 |
| Inventory | 116,593 | 106,388 |
| Total current assets | 286,181 | 347,271 |
| PROPERTY AND EQUIPMENT, net | 342,490 | 359,284 |
| CUSTOMER LIST, net of accumulated amortization of $2,592,879 and $2,335,566 as of September 30, 2005 and December 31, 2004 respectively | 1,593,395 | 421,659 |
| GOODWILL, net of impairment | 1,288,559 | 1,288,559 |
| OTHER ASSETS | 184,114 | 36,790 |

| | | | | |
|---|---|---|---|---|
| TOTAL ASSETS | $ | 3,694,739 | $ | 2,453,563 |

See the accompanying notes to the consolidated financial statements.

**SITESTAR CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS, Continued**

**SEPTEMBER 30, 2005 AND DECEMBER 31, 2004**

**LIABILITIES AND STOCKHOLDERS EQUITY**

| | 2005 (Unaudited) | 2004 (Audited) |
|---|---|---|
| CURRENT LIABILITIES | | |
| Accounts payable | $ 158,937 | $ 260,499 |
| Accrued expenses | 131,573 | 141,975 |
| Deferred revenue | 340,532 | 366,311 |
| Settlement of convertible debentures | - | 259,734 |
| Notes payable stockholders, current portion | 181,439 | 323,434 |
| Notes payable, current portion | 1,417,532 | 124,016 |
| Total current liabilities | 2,230,013 | 1,475,969 |
| NOTES PAYABLE STOCKHOLDERS, less current portion | 704,579 | 696,294 |
| NOTES PAYABLE, less current portion | 185,996 | 171,482 |
| TOTAL LIABILITIES | 3,120,588 | 2,343,745 |
| STOCKHOLDERS' EQUITY | | |
| Preferred Stock, $.001 par value, 10,000,000 shares authorized, 0 shares issued and outstanding | - | - |
| Common stock, $.001 par value, 300,000,000 shares authorized, 86,013,305 and 82,013,305 shares issued and outstanding on September 30, 2005 and December 31, 2004 respectively | 86,013 | 82,013 |
| Additional paid-in capital | 13,450,207 | 13,334,207 |

| | | | | |
|---|---|---|---|---|
| Treasury stock, $.001 par value, 6,218,305 and 6,218,305 common shares on September 30, 2005 and December 31, 2004 respectively | | (129,977) | | (129,977) |
| Accumulated deficit | | (12,832,092) | | (13,176,425) |
| Total stockholders equity | | 574,151 | | 109,818 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | $ | 3,694,739 | $ | 2,453,563 |

See the accompanying notes to the consolidated financial statements.

**SITESTAR CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF INCOME**

**FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2005 AND 2004**

**(UNAUDITED)**

| | | 2005 | 2004 |
|---|---|---|---|
| REVENUE | | | |
| Internet service revenue | $ | 780,793 $ | 724,106 |
| Retail revenue | | 37,615 | 63,742 |
| Development revenue | | - | 15,964 |
| TOTAL REVENUE | | 818,408 | 803,812 |
| COST OF REVENUE | | | |
| Cost of Internet service revenue | | 198,594 | 164,067 |
| Cost of retail revenue | | 30,481 | 42,805 |
| Cost of development revenue | | - | 13,069 |
| TOTAL COST OF REVENUE | | 229,075 | 219,941 |
| GROSS PROFIT | | 589,333 | 583,871 |
| OPERATING EXPENSES: | | | |
| Selling general and administrative expenses | | 427,704 | 371,718 |
| INCOME FROM OPERATIONS | | 161,629 | 212,153 |
| OTHER INCOME (EXPENSES) | | (45,105) | (56,102) |
| INCOME BEFORE INCOME TAXES | | 116,524 | 156,051 |
| INCOME TAXES | | - | - |
| NET INCOME | $ | 116,524 $ | 156,051 |

| | | | | |
|---|---|---|---|---|
| BASIC AND DILUTED EARNINGS PER SHARE | $ | 0.001 | $ | 0.001 |
| WEIGHTED AVERAGE SHARES OUTSTANDING - BASIC AND DILUTED | | 83,839,392 | | 109,739,142 |

See the accompanying notes to the consolidated financial statements.

**SITESTAR CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF INCOME**

**FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2005 AND 2004**

**(UNAUDITED)**

| | 2005 | 2004 |
|---|---|---|
| REVENUE | | |
| Internet service revenue | $ 2,281,068 | $ 2,067,132 |
| Retail revenue | 118,346 | 214,249 |
| Development revenue | - | 79,914 |
| TOTAL REVENUE | 2,399,414 | 2,361,295 |
| COST OF REVENUE | | |
| Cost of Internet service revenue | 575,413 | 701,163 |
| Cost of retail revenue | 68,103 | 161,458 |
| Cost of development revenue | - | 71,428 |
| TOTAL COST OF REVENUE | 643,516 | 934,049 |
| GROSS PROFIT | 1,755,898 | 1,427,246 |
| OPERATING EXPENSES: | | |
| Selling general and administrative expenses | 1,281,875 | 1,210,426 |
| INCOME FROM OPERATIONS | 474,023 | 216,820 |
| OTHER INCOME (EXPENSES) | (129,690) | (206,236) |
| INCOME BEFORE INCOME TAXES | 344,333 | 10,584 |
| INCOME TAXES | - | - |
| NET INCOME | $ 344,333 | $ 10,584 |
| BASIC AND DILUTED EARNINGS PER SHARE | $ 0.004 | $ (0.000) |

| | | |
|---|---|---|
| WEIGHTED AVERAGE SHARES OUTSTANDING - BASIC AND DILUTED | 82,628,690 | 108,432,357 |

See the accompanying notes to the consolidated financial statements.

**SITESTAR CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2005 AND 2004**

**(UNAUDITED)**

| | 2005 | 2004 |
|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | $ 344,333 | $ 10,584 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization expense | 349,099 | 342,797 |
| Bad debt expense | 348 | 198,828 |
| Contingent expense refinancing settlement | - | 36,000 |
| Gain on sale of assets | | (13,125) |
| (Increase) decrease in: | | |
| Accounts receivable | 3,729 | (195,832) |
| Accounts receivable, other | 52,891 | (61,739) |
| Inventory | (10,204) | 17,557 |
| Increase (decrease) in: | | |
| Accounts payable | (101,562) | 38,221 |
| Accrued expenses | (10,403) | 40,465 |
| Deferred revenue | (118,863) | (59,034) |
| Net cash provided by operating activities | 509,368 | 354,722 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchase of property and equipment | (7,315) | (512) |
| Purchase of customer list | (250,000) | - |
| Net cash (used in) investing activities | (257,315) | (512) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Net change in bank overdraft | - | 116,573 |
| Net proceeds from notes payable stockholders | 335,000 | 107,650 |
| Repayment of notes payable | (186,693) | (266,056) |
| Repayment of convertible debenture | (259,734) | (100,000) |
| Repayment of notes payable stockholders | (154,953) | (173,190) |

| | | | | |
|---|---|---|---|---|
| Net cash (used in) financing activities | | (266,380) | | (315,023) |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | | (14,327) | | 39,187 |
| CASH AND CASH EQUIVALENTS BEGINNING OF PERIOD | | 48,533 | | 47,864 |
| CASH AND CASH EQUIVALENTS -END OF PERIOD | $ | 34,206 | $ | 87,051 |

See the accompanying notes to the consolidated financial statements.

**SITESTAR CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2005 AND 2004 (continued)**

**(UNAUDITED)**

**SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:**

During the nine months ended September 30, 2005 and 2004, the Company paid no income taxes and interest of approximately $148,000 and $183,000, respectively.

**NON-CASH INVESTING AND FINANCING TRANSACTIONS:**

During the nine months ended September 30, 2005, the Company issued 4,000,000 shares of common stock to Frank and Julie Erhartic pursuant to a Debt Conversion Agreement dated August 19, 2005. The Agreement provides that Frank R. Erhartic, Jr. and Julie Erhartic accept four million shares of common stock of the Company as payment of $120,000, based on the market value of the shares at the date of issuance, of debt owed

by the Company to Frank R. Erhartic, Jr. and Julie Erhartic jointly. During the nine months ended September 30, 2004, the Company issued 8,145,995 shares of common stock. 4,000,000 shares of common stock valued at $79,999 were issued in connection with the Settlement Agreement described in note 3. In addition, related to the Settlement Agreement, interest accrued on the convertible debenture was removed and an increase in the contingent liability was recorded of $21,518. Also 4,145,995 shares were issued to Frank and Julie Erhartic as original Lynchburg.net shareholders pursuant to the purchase agreement dated November 11, 2000 whereby the Company purchased their shares of Lynchburg.net. The value of these additional shares issued was $165,840, based on the market value of the shares at the date of issuance and was recorded as additional goodwill in the accompanying consolidated financial statements. On December 31, 2004 the Company restated shares deducted from the issued and outstanding status for the year ended December 31, 2002 for shares not cancelled for the period then ended. Certain restricted shares were restated to the issued and outstanding status to more accurately reflect their status on December 31, 2004.

On June 30, 2004, the Company acquired 100% of the Internet-related assets of Virginia Link Internet and Network Management, Inc., a Virginia corporation, an Internet Service Provider located in Galax, Virginia, and Mount Airy Networks, LLC, a North Carolina limited liability company, an Internet Service Provider located in Mount Airy, North Carolina. The total purchase price was $226,314 representing the fair value of the assets acquired, less $50,000 for deferred revenues and less a 10% discount, for a purchase price of $176,314 which consisted of a non-interest bearing note payable over 30 months.

Effective August 31, 2004, the Company entered into a Definitive Agreement pursuant to which the Company sold the assets of Sitestar Applied Technologies (SAT), the software development division of Sitestar, to Thomas Albanese, the former manager of the SAT division. The assets are being used in a new company that is now doing business as Servatus Development, LLC. (Servatus). Under the terms of the agreement, Mr.

**SITESTAR CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2005 AND 2004 (continued)**

**(UNAUDITED)**

Albanese surrendered 1,460,796 shares of Sitestar stock. In addition, Sitestar is receiving 20% of the gross revenues of Servatus over a period of four years and is maintaining the perpetual rights to the crisis management system. Sitestar is providing office space, occupancy costs, and Internet Services.

The Company recognized a gain from this transaction of $17,895 in the current reporting period, representing the amount received over the recorded basis of the assets sold.

Exchange Computers, Inc. and Exis.net, Inc.

Effective November 22, 2004, the Company entered into a Definitive Agreement pursuant to which it acquired the Internet related assets of Exchange Computers, Inc. and Exis.net, Inc. Both are Virginia corporations. The transaction consists of the acquisition of the dial-up customers, the related Internet assets and non-compete agreements from the principal officers of the companies. The total purchase price was $216,187 representing the fair value of the assets acquired, less $66,187 for deferred revenues and less a 10% discount, for a net purchase price of $143,745 which consisted of a down payment of $30,000 with the balance to be paid by a non-interest bearing note payable over 12 months.

Idacomm, a wholly owned subsidiary of Idacorp

Effective September 16, 2005, the Company entered into a Definitive Agreement pursuant to which it acquired the Internet related assets of Idacomm, an Idaho corporation. The transaction consists of the acquisition of the dial-up customers, the related Internet assets and non-compete agreements from company. The total purchase price was $1,698,430 representing the fair value of the assets acquired, less $112,735 for deferred revenues and less a 10% discount, for a net purchase price of $1,545,304, which consisted of a down payment of $250,000 with the balance to be paid by a non-interest bearing note payable over 7 months.

During the nine months ended September 30, 2005, the Company issued 4,000,000 shares of common stock to Frank and Julie Erhartic pursuant to a Debt Conversion Agreement dated August 19, 2005. The Agreement provides that Frank R. Erhartic, Jr. and Julie Erhartic accept four million shares of common stock of the Company as payment of $120,000 of debt owed from the Company to Frank R. Erhartic, Jr. and Julie Erhartic jointly based on the market value of the shares at the date of issuance.

See the accompanying notes to the consolidated financial statements.

**SITESTAR CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

## NOTE 1 BASIS OF PRESENTATION

The unaudited Consolidated Financial Statements have been prepared by Sitestar Corporation (the Company or Sitestar ), pursuant to the rules and regulations of the Securities and Exchange Commission. The information furnished herein reflects all adjustments (consisting of normal recurring accruals and adjustments), which are, in the opinion of management, necessary to fairly present the operating results for the respective periods. Certain information and footnote disclosures normally present in annual consolidated financial statements prepared in accordance with generally accepted accounting principles have been omitted pursuant to such rules and regulations. These financial statements should be read in conjunction with the audited consolidated financial statements and footnotes for the year ended December 31, 2004 included in the Company s Annual Report on Form 10-KSB. The results of the nine and three months ended September 30, 2005 are not necessarily indicative of the results to be expected for the full year ending December 31, 2005.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As shown in the financial statements, as of September 30, 2005, the Company had a working capital deficit of $1,943,832. That condition raises substantial doubt about the Company s ability to continue as a going concern. The financial statements do not include any adjustments that might result from the outcome of this uncertainty. However, the Company believes that its existing cash, cash equivalents and cash flow from operations and its ability to obtain favorable financing will be sufficient to meet the Company s working capital and capital expenditure requirements for the next 12 months.

## NOTE 2 EARNINGS PER SHARE

The Financial Accounting Standards No. 128, "Accounting for Earnings Per Share" requires dual presentation of basic and diluted earnings per share on the face of the statements of operations and requires a reconciliation of the numerators and denominators of the basic and diluted earnings per share calculation. Basic earnings per share are calculated based on the weighted average number of shares of common stock outstanding during each period. Diluted income per share is computed using weighted average shares outstanding adjusted to reflect the dilutive effect of all potential common shares that were outstanding during the period.

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**SITESTAR CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

## NOTE 3 CONVERTIBLE DEBENTURE

On May 11, 2000, the Company issued two convertible debentures aggregating $500,000. The debentures bore interest at 12% per annum and were due on May 1, 2001. The debenture holders voluntarily decided to hold on to the debentures. The debentures were convertible into shares of the Company's common stock at a rate equal to the lowest of $.70 or 60% of the average of the three lowest closing bid prices for the Company's common stock during the 20 trading days immediately preceding the conversion date. In addition, the Company also issued three-year warrants to purchase an aggregate of 250,000 shares of common stock at an initial exercise price of $0.70 per share. Due to the preferential conversion feature of these debentures, the Company recognized a financing charge in 2000 of $242,857 (which represents the value of additional shares issuable upon conversion at the $.70 conversion price versus the number of shares issuable upon conversion at the market value at the date of issuance). In addition, the warrants issued in connection with these debentures were valued at $121,543 using the Black-Scholes model. Because these debentures were convertible on issuance, preferential conversion costs were expensed immediately and the value of the warrant was recognized as financing costs over the term of the debentures.

On August 14, 2000, the Company issued two additional convertible debentures aggregating $500,000 to the holders of the above-mentioned debentures on the same terms described above, except that such convertible debentures had a due date of August 14, 2001. In connection with these debentures, the Company recognized a financing charge in 2000 in connection with the preferential conversion feature of $333,333 and valued the 250,000 warrants issued in connection with these debentures at $13,332 using the Black-Scholes model. Because these debentures were convertible on issuance, the preferential conversion costs were expensed immediately and the value of the warrant was recognized as a financing cost over the term of the debentures.

During the year ended December 31, 2002, the holders of the debentures converted $12,200 of principal and $9,000 of accrued interest into 1,218,255 and 1,500,000, respectively, shares of the Company s common stock. In addition, during the year ended December 31, 2002, the Company repaid $325,000 of these debentures in cash.

On a cumulative basis through December 31, 2002, the holders of the debentures converted $525,588 of principal and $99,820 of accrued interest into 14,319,156 and 5,176,352, respectively, shares of the Company s common stock. Also as of December 31, 2002, the Company repaid $335,000 of these debentures in cash. On December 31, 2002, New Millennium Capital Partners II, LLC and AJW Partners, LLC (the Convertible Debenture Holders ) filed a complaint against the Company, its former officers and its current officers at the Supreme Court of the State of New York.

**SITESTAR CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 3 CONVERTIBLE DEBENTURE, Continued**

The complaint alleged that the Company and the officers breached their contractual and fiduciary duties. The original dispute arose over a significant payment issued by the conversion of stock that was neither applied to the principal or interest balance by the holders. Effective January 31, 2004 the Company entered into a Settlement Agreement and Mutual Release (the Agreement ) with the Convertible Debenture Holders whereby all legal action regarding the convertible debentures held by the Convertible Debenture Holders was dismissed. The Settlement Agreement is an exhibit to Form 8-K filed with the Securities and Exchange Commission dated February 23, 2004.

The terms of the Agreement included a cash payment of $100,000 to the Convertible Debenture Holders plus the issuance of 4,000,000 shares of the Company s common stock at a conversion price of $.02 per share. The Agreement limited the number of shares the Convertible Debenture Holders could have sold in any calendar month to 500,000 shares, beginning in May 2004. In exchange, the Company agreed to guarantee an average price of $.08 per share for the stock that sold. To the extent that there was a differential between the actual selling price and the guaranteed selling price, the Company was obligated to pay the differential to the Convertible Debenture Holders within thirty days of receiving a request for payment. The request for payment could only be made between January 1, 2005 and February 28, 2005.

As a result of signing the Agreement, the Company recognized a contingent liability of $220,000 as of December 31, 2003, representing management s estimate of the potential additional payment that could have been required under the terms of the Agreement related to the stock price guarantee. Demand for payment, per the terms of the settlement agreement, was made for the gross up balance on January 11, 2005 for $259,793. The Company settled this amount in cash on February 28, 2005 after receiving a corrected demand of $259,734 on February 1, 2005.

**NOTE 4 COMMON STOCK**

During the nine months ended September 30, 2005, the Company issued 4,000,000 shares of common stock to Frank and Julie Erhartic pursuant to a Debt Conversion Agreement dated August 19, 2005. The Agreement provides that Frank R. Erhartic, Jr. and Julie Erhartic accept four million shares of common stock of the Company as payment of $120,000, based on the market value of the shares at the date of issuance, of debt owed

by the Company to Frank R. Erhartic, Jr. and Julie Erhartic jointly. During the nine months ended September 30, 2004, the Company issued 8,145,995 shares of common stock. 4,000,000 shares of common stock were issued in connection with the Settlement



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**SITESTAR CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 4 COMMON STOCK, Continued**

Agreement described in note 3. An additional 4,145,995 shares were issued to Frank and Julie Erhartic as original Lynchburg.net shareholders pursuant to the purchase agreement dated November 11, 2000 whereby the Company purchased their shares of Lynchburg.net. The value of these additional shares issued was $165,840, based on the market value of the shares at the date of issuance and was recorded as additional goodwill in the accompanying consolidated financial statements.

**NOTE 5 SEGMENT INFORMATION**

The Company has four business units that have separate management and reporting infrastructures offering different products and services. The business units have been aggregated into four reportable segments: Corporate, Internet, Development and Retail. The Corporate group is the holding company and oversees the operating of the other business units. The Corporate group also arranges financing for the entire organization. The Internet group provides Internet access to customers in the Martinsville, Galax, Virginia Beach, Shenandoah Valley and Lynchburg, Virginia, Mt. Airy, North Carolina, Idaho, Washington, Utah, Nevada and Arizona areas. The Development group provides customer software programming to companies, principally in the manufacturing industries. (See Note 8) The Retail group operates a retail computer store in Lynchburg, Virginia and in Mt. Airy, North Carolina, as well as, providing toner cartridge remanufacturing services in Lynchburg, Virginia (http://www.recharge.net).

The Company evaluates the performance of its operating segments based on income from operations before income taxes, accounting changes, non-recurring items, and interest income and expense.

Summarized financial information concerning the Company's reportable segments is shown in the following table for the three months ended September 30, 2005 and 2004:

September 30, 2005

| | Corporate | Internet | Development | Retail | Consolidated |
|---|---|---|---|---|---|
| Revenue | $ - | $ 780,793 | $ - | $ 37,615 | $ 818,408 |
| Operating income (loss) | (8,399) | 182,804 | - - | (12,776) | 161,629 |

| | | | | | |
|---|---|---|---|---|---|
| Depreciation and amortization | - | 147,346 | - | 709 | 148,055 |
| Interest expense | - | 49,471 | - | - | 49,471 |
| Intangible assets | - | 3,066,068 | - | - | 3,066,068 |
| Total assets | - | 3,596,700 | - | 98,039 | 3,694,739 |

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**SITESTAR CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 5 SEGMENT INFORMATION, continued**

September 30, 2004

| | Corporate | Internet | Development | Retail | Consolidated |
|---|---|---|---|---|---|
| Revenue | $ - | $ 724,106 | $ 15,964 | $ 63,742 | $ 803,812 |
| Operating Income (loss) | (10,632) | 219,391 | 2,895 | 499 | 212,153 |
| Depreciation and amortization | - | 126,125 | - | 1,076 | 127,201 |
| Interest expense | (1,973) | (63,254) | - | - | (65,227) |
| Intangible assets | - | 1,729,180 | - | - | 1,729,180 |
| Total assets | - | 2,311,760 | - | 89,755 | 2,401,515 |

Summarized financial information concerning the Company's reportable segments is shown in the following table for the nine months ended September 30, 2005 and 2004:

September 30, 2005

| | Corporate | Internet | Development | Retail | Consolidated |
|---|---|---|---|---|---|
| Revenue | $ - | $ 2,281,068 | $ - | $ 118,346 | $ 2,399,414 |
| Operating income (loss) | (51,523) | 536,024 | - | (10,478) | 474,023 |
| Depreciation and amortization | - | 346,973 | - - | 2,126 | 349,099 |
| Interest expense | - | 147,585 | - | - | 147,585 |
| Intangible assets | - | 3,066,068 | - | - | 3,066,068 |
| Total assets | - | 3,596,700 | - | 98,039 | 3,694,739 |

**SITESTAR CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 5 SEGMENT INFORMATION, continued**

September 30, 2004

| | Corporate | Internet | Development | Retail | Consolidated |
|---|---|---|---|---|---|
| Revenue | $ - | $ 2,067,132 | $ 79,914 | $ 214,249 | $ 2,361,295 |
| Operating Income (loss) | (61,611) | 281,148 | 8,486 | (11,203) | 216,820 |
| Depreciation and amortization | - | 339,571 | - | 3,226 | 342,797 |
| Interest expense | (15,802) | (167,559) | - | - | (183,361) |
| Intangible assets | - | 1,729,180 | - | - | 1,729,180 |
| Total assets | - | 2,311,760 | - | 89,755 | 2,401,515 |

**NOTE 6 RECENTLY ISSUED ACCOUNTING PROUNCEMENTS**

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. This Statement establishes standards for the classification and measurement of certain financial instruments with characteristics of both liabilities and equity. The Statement also includes required disclosure for financial instruments within its scope. The Statement was effective for instruments entered into or modified after May 31, 2003 and otherwise was effective as of January 1, 2004, except for mandatory redeemable financial instruments. For certain mandatory redeemable financial instruments, the statement will be effective as of January 1, 2005. The effective date has been deferred indefinitely for certain other types of mandatory redeemable financial instruments. The Company currently does not have any financial instruments that are within the scope of this statement.

On December 16, 2004, the Financial Accounting Standards Board ("FASB") published Statement of Financial Accounting Standards No. 123 (Revised 2004), Share-Based Payment ("SFAS 123R"). SFAS 123R requires that compensation cost related to share-based payment transactions be recognized in the financial statements. Share-based payment transactions within the scope of SFAS 123R include stock options, restricted stock plans, performance-based awards, stock appreciation rights, and employee share purchase plans. The provisions of SFAS 123R are effective for small business issuers as of the first interim period that begins after December 15, 2005. Accordingly, the Company will implement the revised standard in the fourth quarter of fiscal year 2005. Currently, the Company accounts for its share-based payment transactions under the

**SITESTAR CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

## NOTE 6 RECENTLY ISSUED ACCOUNTING PROUNCEMENTS

provisions of APB 25, which does not necessarily require the recognition of compensation cost in the financial statements. Management is assessing the implications of this revised standard, which may materially impact the Company's results of operations in the fourth quarter of fiscal year 2005 and thereafter.

## NOTE 7 ACQUISITIONS

Virginia Link Internet and Network Management, Inc. and Mount Airy Networks, LLC

On June 30, 2004, the Company acquired 100% of the Internet-related assets of Virginia Link Internet and Network Management, Inc., a Virginia corporation, an Internet Service Provider located in Galax, Virginia, and Mount Airy Networks, LLC, a North Carolina limited liability company, an Internet Service Provider located in Mount Airy, North Carolina. The total purchase price was $226,314 representing the fair value of the assets acquired, less $50,000 for deferred revenues and less a 10% discount, for a purchase price of $176,314 which consisted of a non-interest bearing note payable over 30 months.

The transaction was accounted for by the purchase method of accounting. Accordingly, the purchase price was allocated to the assets acquired based on the estimated fair values at the date of acquisition. The excess of the purchase price over the estimated fair value of tangible assets acquired was attributed to the customer list and non-compete agreement, which are being amortized over the estimated three-year life and contractual three-year life, respectively. The value of the customer list was determined by multiplying the current market value per customer times the number of customers purchased at the time of the acquisition.

The fair value of assets acquired is summarized as follows:

| | |
|---|---|
| Equipment | $ 42,689 |
| Customer list | 159,625 |
| Non-compete agreement | 24,000 |
| Deferred revenue | (50,000) |

| | |
|---|---|
| Purchase price | $ 176,314 |
| | ======== |

Since the acquisition of Virginia Link Internet and Network Management, Inc. and Mount Airy Networks, LLC was consummated on June 30, 2004, there are results of operations of these companies for the nine months ended September 30, 2005 included in the accompanying September 30, 2005 consolidated financial statements.

**SITESTAR CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 7 ACQUISITIONS, continued**

The following table presents the unaudited pro forma condensed statement of operations for the nine months ended September 30, 2005 and 2004 and reflects the results of operations of the Company as if the acquisition of Virginia Link and Network Management, Inc. and Mount Airy Networks, LLC had been effective January 1, 2004. The pro forma amounts are not necessarily indicative of the combined results of operations had the acquisitions been effective as of that date, or of the anticipated results of operations, due to cost reductions and operating efficiencies that are expected as a result of the acquisitions.

| | 2005 | 2004 |
|---|---|---|
| Net sales | $ 2,399,414 | $ 2,475,832 |
| Gross profit | 1,755,898 | 1,516,507 |
| Selling, general and administrative | | |
| expenses | 1,281,875 | 1,251,641 |
| Net income | $ 344,333 | $ 52,099 |
| Basic income per share | $ 0.004 | $ 0.00 |

Exchange Computers, Inc. and Exis.net, Inc.

Effective November 22, 2004, the Company entered into a Definitive Agreement pursuant to which it acquired the Internet related assets of Exchange Computers, Inc. and Exis.net, Inc.. Both are Virginia corporations. The transaction consists of the acquisition of the dial-up customers, the related Internet assets and non-compete agreements from the principal officers of the companies. The total purchase price was $216,187 representing the fair value of the assets acquired, less $66,187 for deferred revenues and less a 10% discount, for a net purchase price of $143,745 which consisted of a down payment of $30,000 with the balance to be paid by a non-interest bearing note payable over 12 months.

The transaction was accounted for by the purchase method of accounting. Accordingly, the purchase price was allocated to the assets acquired based on the estimated fair values at the date of acquisition. The excess of the purchase price over the estimated fair value of tangible assets acquired was attributed to the customer list and non-compete agreement, which are being amortized over the estimated three-year life and contractual three-year life, respectively. The value of the customer list was determined by multiplying the current market value per customer times the number of customers purchased at the time of the acquisition.

**SITESTAR CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 7 ACQUISITIONS, continued**

The fair value of assets acquired is summarized as follows:

| | |
|---|---|
| Equipment | $ 59,755 |
| Accounts receivable | 2,284 |
| Customer list | 69,706 |
| Non-compete agreement | 12,000 |
| Purchase price | $ 143,745 |
| | ======== |

Because the acquisition of Exchange Computers, Inc. and Exis.net, Inc. was consummated on November 22, 2004, there are results of operations of these companies for the nine months ended September 30, 2005 included in the accompanying September 30, 2005 and 2004 consolidated financial statements.

The following table presents the unaudited pro forma condensed statement of operations for the nine months ended September 30, 2005 and 2004 and reflects the results of operations of the Company as if the acquisition of Exchange Computers, Inc. and Exis.net, Inc. had been effective January 1, 2004. The pro forma amounts are not necessarily indicative of the combined results of operations had the acquisitions been effective as of that date, or of the anticipated results of operations, due to cost reductions and operating efficiencies that are expected as a result of the acquisitions.

| | 2005 | 2004 |
|---|---|---|
| Net sales | $ 2,399,414 | $ 2,614,319 |
| Gross profit | 1,755,898 | 1,563,968 |
| Selling, general and administrative expenses | 1,281,875 | 1,287,136 |
| Net income | $ 344,333 | $ 65,536 |
| Basic income per share | $ 0.004 | $ 0.00 |

Idacomm, a wholly owned subsidiary of Idacorp

Effective September 16, 2005, the Company entered into a Definitive Agreement pursuant to which it acquired the Internet related assets of Idacomm, an Idaho corporation. The transaction consists of the acquisition of the dial-up customers, the related Internet assets and non-compete agreements from company. The total purchase price was $1,698,430 representing the fair value of the assets acquired, less $112,735 for deferred

**SITESTAR CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 7 ACQUISITIONS, continued**

revenues and less a 10% discount, for a net purchase price of $1,545,304 which consisted of a down payment of $250,000 with the balance to be paid by a non-interest bearing note payable over 7 months.

The transaction was accounted for by the purchase method of accounting. Accordingly, the purchase price was allocated to the assets acquired based on the estimated fair values at the date of acquisition. The excess of the purchase price over the estimated fair value of tangible assets acquired was attributed to the customer list and non-compete agreement, which are being amortized over the estimated three-year life and contractual three-year life, respectively. The value of the customer list was determined by multiplying the current market value per customer times the number of customers purchased at the time of the acquisition.

The fair value of assets acquired is summarized as follows:

| | |
|---|---|
| Equipment | $ 50,000 |
| Accounts receivable | 13,990 |
| Customer list | 1,316,314 |
| Non-compete agreement | 165,000 |
| Purchase price | $ 1,545,304 |
| | ======== |

Because the acquisition of Idacomm was consummated on September 16, 2005, there are no results of operations of these companies for the nine months ended September 30, 2005 included in the accompanying September 30, 2005 and 2004 consolidated financial statements.

The following table presents the unaudited pro forma condensed statement of operations for the nine months ended September 30, 2005 and 2004 and reflects the results of operations of the Company as if the acquisition of Idacomm had been effective January 1, 2004. The pro forma amounts are not necessarily indicative of the combined results of operations had the acquisitions been effective as of that date, or of the anticipated results of operations, due to cost reductions and operating efficiencies that are expected as a result of the acquisitions.

**SITESTAR CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 7 ACQUISITIONS, continued**

| | 2005 | 2004 |
|---|---|---|
| Net sales | $ 4,094,725 | $ 4,147,530 |
| Gross profit | 3,246,451 | 2,997,481 |
| Selling, general and administrative expenses | 1,658,101 | 1,633,681 |
| Net income | $ 1,423,667 | $ 1,117,175 |
| Basic income per share | $ 0.02 | $ 0.01 |

**NOTE 8 SALE OF ASSETS**

Effective August 31, 2004, the Company entered into a Definitive Agreement pursuant to which the Company sold the assets of Sitestar Applied Technologies (SAT), the software development division of Sitestar to Thomas Albanese, the former manager of the SAT division, purchased the assets. The assets are being used in a new company doing business as Servatus Development, LLC (Servatus). Under the terms of the Agreement, Mr. Albanese surrendered 1,460,796 shares of Sitestar stock. In addition, Sitestar will receive 20% of the gross revenues of Servatus over a period of four years and will maintain the perpetual rights to the crisis management system. Sitestar will provide office space, occupancy costs, and Internet services for one year. The Company recognized a gain from this transaction of $17,895 in the current reporting period, representing the excess of the value of the common stock received over the recorded basis of the assets sold.

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

General

The following discussion and analysis should be read in conjunction with our consolidated financial statements and related footnotes for the year ended December 31, 2004 included in the Annual Report on Form 10-KSB. The discussion of results, causes and trends should not be construed to imply any conclusion that such results or trends will necessarily continue in the future.

Overview

The Company is a national Internet Service Provider and Computer Services company offering a broad range of services to business and residential customers. The Company serves primarily markets in Mid Atlantic and Northwestern states. In November 2003, the Company announced the launch of the national dial-up Internet service that made service available to thousands of cities throughout the United States. This expanded service was enhanced with the acquisition of the Idacomm customer base, features web acceleration, e-mail acceleration and pop-up ad blocking. Spam and virus filtering are also included. The Company s national Internet service is marketed under the brand name SurfWithUs.net to differentiate national marketing method. The Company utilizes its own infrastructure as well as affiliations that allow it to expand its network and services to most of the United States.

The products and services that the Company provides include:

- Internet access services;
- Web acceleration services;
- Web design and programming services;
- Web hosting services;
- End-to-end e-commerce solutions;
- Online marketing consulting;
- Toner and ink cartridge remanufacturing services; and
- Computer programming and consulting services.

The Company s Internet Service Provider (ISP) division has five sites of operation (http://www.sitestar.net, http://www.lynchburg.net, http://www.advi.net, http://www.valink.com and http://www.exis.net). These are located in Martinsville, Galax, Virginia Beach, Shenandoah Valley and Lynchburg, Virginia, Mt. Airy, North

Carolina, Idaho, Washington, Utah, Nevada and Arizona areas. The Company provides both narrow-band (dial-up) services and broadband services (ISDN, DSL, satellite, cable and wireless) utilizing its own infrastructure and affiliations to provide services to thousands of service locations throughout the United States.

The Company s web design, web hosting and related services provide a way to help businesses market their products and services over the Internet. Through its computer sales and service division http://www.computersbydesign.com), the Company sells and manufactures computer systems, computer hardware, computer software, networking services, repair services and toner and ink cartridge remanufacturing services from the office locations noted above. The Company is a factory authorized service center for many national-brand computer equipment companies. The Company s toner and ink cartridge remanufacturing service (http://www.recharge.net) takes empty toner cartridges and remanufactures them to provide savings to customers over buying brand new cartridges. This service is available locally and nationwide.

The Company s computer programming and consulting services help companies automate their businesses. The Company sold the assets of the programming division on August 31, 2004 while retaining the rights to the new product that automates certain functions of crisis centers throughout the nation.

RESULTS OF OPERATIONS

The following tables show financial data for the nine months ended September 30, 2005 and 2004. Operating results for any period are not necessarily indicative of results for any future period.

| | For the nine months ended September 30, 2005 (unaudited) | | | | |
|---|---|---|---|---|---|
| | Corporate | Internet | Development | Retail | Total |
| Revenue | $ - | $2,281,068 | $ - | $118,346 | $2,399,414 |
| Cost of revenue | - | 575,413 | - | 68,103 | 643,516 |
| Gross profit | - | 1,705,655 | - | 50,243 | 1,755,898 |
| Operating expenses | 51,523 | 1,169,631 | - | 60,721 | 1,281,875 |
| Income (loss) from Operations | (51,523) | 536,024 | | (10,478) | 474,023 |
| Other income | - | (129,690) | - | - | (129,690) |

| | | | | | |
|---|---|---|---|---|---|
| (expense) | | | | | |
| | ______ | ______ | ______ | ______ | ___ |
| Net income | | | | | |
| (loss) | $(51,523) | $406,334 | - | $(10,478) | $344,333 |
| | ======= | ======= | ======= | ====== | ======= |
| EBITDA(1) | $(51,523) | $900,892 | $ - | $(8,352) | $841,017 |

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| | For the nine months ended September 30, 2004 (unaudited) | | | | |
|---|---|---|---|---|---|
| | Corporate | Internet | Development | Retail | Total |
| Revenue | $ - | $2,067,132 | $ 79,914 | $214,249 | $2,361,295 |
| Cost of revenue | - | 701,163 | 71,428 | 161,458 | 934,049 |
| Gross profit | - | 1,365,969 | 8,486 | 52,791 | 1,427,246 |
| Operating expenses | 61,611 | 1,084,821 | - | 63,994 | 1,210,426 |
| Income (loss) from Operations | (61,611) | 281,148 | 8,486 | (11,203) | 216,820 |
| Other income (expense) | (51,802) | (154,434) | - | - | (206,236) |
| Net income (loss) | $(113,413) | $126,714 | 8,486 | $(11,203) | $10,584 |
| EBITDA(1) | $(97,611) | $633,844 | $ 8,486 | $(7,977) | $536,742 |

(1) EBITDA (earnings before interest, taxes, depreciation and amortization) consists of revenue less cost of revenue and operating expense. EBITDA is provided because it is a measure commonly used by investors to analyze and compare companies on the basis of operating performance. EBITDA is presented to enhance an understanding of the Company s operating results and is not intended to represent cash flows or results of operations in accordance with GAAP for the periods indicated. EBITDA is not a measurement under GAAP and is not necessarily comparable with similarly titled measures for other companies. See Liquidity and Capital Resources section for further discussion of cash generated from operations.

NINE MONTHS ENDED SEPTEMBER 30, 2005 COMPARED TO SEPTEMBER 30, 2004 (Unaudited)

REVENUE. Revenue for the nine months ended September 30, 2005 increased by $38,119 or 1.6% from $2,361,295 for the nine months ended September 30, 2004 to $2,399,414 for the same period in 2005. Internet sales increased $213,936 or 10.3% from $2,067,132 for the nine months ended September 30, 2004 to $2,281,068 for the same period in 2005. Internet sales increased due to the addition of Internet customers from the

asset acquisitions of Virginia Link Internet and Network Management, Inc., Mount Airy Networks, LLC, Exchange Computers, Inc., Exis.net, Inc., and Idacomm. These acquisitions, for the nine months ended September 30, 2005, yielded approximately $426,000 in additional net revenues. While the Company continues to sign up new customers, the trend is moving towards growth in broadband Internet connections and more choices for consumers resulting in net a decline in excess of growth for dial-up customers. To insure continued strength in revenue growth the Company s strategy is to continue to consummate acquisitions of Internet Service Providers. Offsetting this increase in Internet sales in part, retail sales decreased $95,903 or 44.8% for the nine months ended September 30, 2005 from $214,249 for the nine months ended September 30, 2004 to $118,346 for the same period in 2005. Decreases in retail sales of new equipment reflect competition from large retail establishments and the change in focus of this division. The Company is focusing more on providing professional computer service and repair which carries lower volume of revenue but a higher profit margin.

COST OF REVENUE. Costs of revenue for the nine months ended September 30, 2005 decreased by $290,533 or 31.1% from $934,049 for the nine months ended September 30, 2004 to $643,516 for the same period in 2005. Internet cost of revenue decreased $125,750 or 17.9% from $701,163 for the nine months ended September 30, 2004 to $575,413 for the same period in 2005. This decrease is primarily due to decreases in telecommunication expenses. More favorable contracts have been negotiated resulting in efficient use of network capacity for a savings of $191,257 or 32.8% from $583,186 for the nine months ended September 30, 2004 to $391,929 for the same period in 2005.

OPERATING EXPENSES. Operating expenses for the nine months ended September 30, 2005 increased $71,449 or 5.9% from $1,210,426 for the nine months ended September 30, 2004 to $1,281,875 for the same period in 2005. Bad debts increased $142,947 or 71.9% from $198,828 for the nine months ended September 30, 2004 to $341,775 for the same period in 2005. This was offset in part by decreases in administrative wages and insurance expense. Administrative wages decreased $65,185 or 19.8% from $328,478 for the nine months ended September 30, 2004 to $263,293 for the same period in 2005. Insurance expense decreased $21,804 or 50.2% from $43,392 for the nine months ended September 30, 2004 to $21,588 for the same period in 2005. Corporate expenses of $51,523 for the nine months ended September 30, 2005 consisted primarily of professional fees. Corporate expenses of $61,611 for the nine months ended September 30, 2004 consisted primarily of professional fees.

GAIN ON SALE OF ASSETS. A gain was recognized on the sale of the assets of Sitestar Applied Technologies, Inc. from Servatus LLC of $17,895 for the nine months ended September 30, 2005. This represents, per the Definitive Agreement, 20% of the gross revenue of Servatus, LLC for the nine months ended September 30, 2005. This is an increase of $9,409 over the net income generated by Sitestar Applied Technologies, Inc. for the same period in 2004.

INTEREST EXPENSE. Interest expense for the nine months ended September 30, 2005 decreased by $35,776 or 19.5% from $183,361 for the nine months ended September 30, 2004 to $147,585 for the same period in 2005. This decrease is a result of reducing principal loan balances and negotiations of more favorable interest rates on loan renewals.

SEPTEMBER 30, 2005 (Unaudited) COMPARED TO DECEMBER 31, 2004 (Audited)

BALANCE SHEET. Net accounts receivable decreased by $56,968 or 29.6% on September 30, 2005 from $192,350 on December 31, 2004 to $135,382 on September 30, 2005. The primary reason for this decrease is the collection of refundable credits from telecommunications suppliers included in net accounts receivable on December 31, 2004 of $52,891. Inventory increased by $10,205 or 9.6% on September 30, 2005 from $106,388 on December 31, 2004 to $116,593 on September 30, 2005. This increase is primarily a result of the acquisition of used equipment in bulk for resale. Accounts payable decreased $101,562 or 39.0% on September 30, 2005 from $260,499 on December 31, 2004 to $158,937 on September 30, 2005. This decrease reflects the Company s improved cash flow. Accrued expenses decreased $10,402 or 7.3% from $141,975 on December 31, 2004 to $131,573 on September 30, 2005. Deferred revenue decreased $25,779 or 7.0% from $366,311 on December 31, 2004 to $340,532 on September 30, 2005 representing customer accounts that have been prepaid. The current portion of long-term debt payable to shareholders, decreased by $141,995 or 44.0% on September 30, 2005 from $323,434 on December 31, 2004 to $181,439 on September 30, 2005. The current portion of long-term debt payable, increased by $1,293,516 on September 30, 2005 from $124,016 on December 31, 2004 to $1,417,532 on September 30, 2005. The increase is primarily due to financing the purchase of the Idacomm customer base which is all classified as current. The long-term portion of notes payable, including notes payable to shareholders, increased by $22,799 or 2.6% on September 30, 2005 from $867,776 on December 31, 2004 to $890,575 on September 30, 2005.

LIQUIDITY AND CAPITAL RESOURCES

For the nine months ended September 30, 2005, the Company generated EBITDA (earnings before interest, taxes, depreciation and amortization) at the Company s operating subsidiary level of $900,892, which consists of revenue less cost of revenue and operation expenses. This amount was offset in part by EBITDA at the corporate level of $(51,523). EBITDA is provided because it is a measure commonly used by investors to analyze and compare companies on the basis of operating performance. The Company applied EBITDA from operations of $841,017 to reduce the principal balances on notes payable in addition to funding operations for the nine months ended September 30, 2005.

On May 11, 2000, the Company issued two convertible debentures aggregating $500,000.

The debentures bore interest at 12% per annum and were due on May 1, 2001. The debentures were convertible into shares of the Company s common stock at a rate equal to the lowest of $.70 or 60% of the average of the three lowest closing bid prices for the Company s common stock during the 20 trading days immediately preceding the conversion date. In addition, the Company also issued three-year warrants to purchase an aggregate of 250,000 shares of common stock at an initial exercise price of $0.77 per share. Due to the preferential conversion feature of these debentures, the Company recognized a financing charge in 2000 of $242,857 (which represents the value of additional shares issuable upon conversion at the $.70 conversion price versus the number of shares issuable upon conversion at the market value at the date of issuance). In addition, the warrants issued in connection with these debentures were valued at $121,543 using the Black-Scholes model. Since these debentures were convertible on issuance, preferential conversion costs were expensed immediately and the value of the warrant was recognized as financing costs over the term of the debentures.

On August 14, 2000, the Company issued two additional convertible debentures aggregating $500,000 to the holders of the above-mentioned debentures for the same terms described above, except with a due date of August 14, 2001. In connection with these debentures, the Company recognized a financing charge in 2000 in connection with the preferential conversion feature of $333,333 and valued the 250,000 warrants issued in connection with these debentures at $13,332 using the Black-Scholes model. Since these debentures were convertible on issuance, the preferential conversion costs were expensed immediately and the value of the options was recognized as financing costs over the term of the debentures.

During the year ended December 31, 2002, the holders of the debentures converted $12,200 of principal and $9,000 of accrued interest into 1,218,255 and 1,500,000, respectively, shares of the Company s common stock. In addition, during the year ended December 31, 2002, the Company repaid $325,000 of these debentures in cash.

On a cumulative basis through December 31, 2002, the holders of the debentures converted $525,588 of principal and $99,820 of accrued interest into 14,319,156 and 5,176,352, respectively, shares of the Company s common stock. Also as of December 31, 2002, the Company repaid $335,000 of these debentures in cash.

On December 31, 2002, New Millennium Capital Partners II, LLC and AJW Partners, LLC (the Convertible Debenture Holders ) filed a complaint against the Company, its former officers and its current officers at the Supreme Court of the State of New York. The complaint alleged the Company and the officers breached their contractual and fiduciary duties. This proceeding was a dispute over the amount owed on the convertible

Effective January 31, 2004 the Company entered into a Settlement Agreement and Mutual Release (the Agreement ) with the Convertible Debenture Holders whereby all legal action regarding the convertible debentures held by the Convertible Debenture Holders will be dismissed. The Settlement Agreement is an exhibit to Form 8-K filed with the Securities and Exchange Commission dated February 23, 2004.

The terms of the Agreement included a cash payment of $100,000 plus the issuance of 4,000,000 shares of the Company s common stock at a conversion price of $.02 per share. The Agreement limited the number of shares the Convertible Debenture Holders could have sold in any calendar month to 500,000 shares, beginning in May 2004. In exchange, the Company agreed to guarantee an average price of $.08 per share for the stock that sold. To the extent that there was a differential between the actual selling price and the guaranteed selling price, the Company was obligated to pay the differential to the Convertible Debenture Holders within thirty days of receiving a request for payment. However, the request for payment could have only been made between January 1, 2005 and February 28, 2005.

As a result of signing the Agreement, the Company had recognized a contingent liability of $220,000 as of December 31, 2003, representing management s estimate of the potential additional payment that may have been required under the terms of the Agreement related to the stock price guarantee. Demand for payment, per the terms of the settlement agreement, was made for the gross up balance on January 11, 2005 for $259,734. The Company settled this amount in cash on February 28, 2005.

Sales of Internet services, which are not automatically processed via credit card or bank account drafts, have been the Company s highest exposure to collection risk. To help offset this exposure, the Company has added a late payment fee to encourage timely payments by customers. Another effort to improve customer billing and collections was

the implementation of a uniform manual invoice-processing fee, which also helps speed up the billing and collections process.

The aging of accounts receivable as of September 30, 2005 and December 31, 2004 is as shown:

| | 2005 | | 2004 | |
|---|---|---|---|---|
| Current | $ 37,314 | 27 % | $ 54,677 | 29 % |
| 30 < 60 | 65,662 | 49 % | 108,087 | 56 % |
| 60 + | 32,406 | 24 % | 29,586 | 15 % |
| Total | $ 135,382 | 100 % | $ 192,350 | 100 % |

The Company believes that the existing cash, cash equivalents, and cash flow from operations and the Company s ability to obtain favorable financing will be sufficient to meet the working capital and capital expenditure requirements for at least the next 12 months. If such sources of financing are insufficient or unavailable, or if the Company experiences shortfalls in anticipated revenue or increases in anticipated expenses, the



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Company may need to slow down or stop the acquisition of Internet Service Providers and reduce the marketing and development efforts. Any of these events could harm the Company s business, financial condition or results of operations.

OFF BALANCE SHEET TRANSACTIONS

The Company is not a party to any off balance sheet transactions.

Forward-looking statements

This report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Stockholders are cautioned that all forward-looking statements involve risks and uncertainty, including without limitation, the Company s ability to expand the customer base, make strategic acquisitions, general market conditions, and competition and pricing. Although the Company believes the assumptions underlying the forward-looking statements contained herein are reasonable, any of the assumptions could be inaccurate, and therefore, there can be no assurance that the forward-looking statements contained in the report will prove to be accurate.

CRITICAL ACCOUNTING POLICY AND ESTIMATES

The Company s Management s Discussion and Analysis of Financial Condition and Results of Operations section discusses its condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America as promulgated by the Public Company Accounting Oversight Board. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. On an ongoing basis, management evaluates its estimates and judgments, including those related to revenue recognition, accrued expenses, financing operations, and contingencies and litigation. Management bases its estimates and judgments on historical experience and on various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions and conditions. The most significant accounting estimates inherent in the preparation of the Company s financial statements include estimates as to the appropriate carrying value of certain assets and liabilities which are not readily apparent from other sources. These accounting policies are described at relevant sections in this discussion and analysis and in the condensed consolidated financial statements included in this quarterly report.

Item 3. Controls and Procedures

Evaluation of disclosure controls and procedures

The term disclosure controls and procedures is defined in Rules 13(a)-15e and 15(d) 15(e) of the Securities Exchange Act of 1934, as amended (the Exchange Act). The Company s principal executive officer and principal financial officer have evaluated the effectiveness of its disclosure controls and procedures as of September 30, 2005. They have concluded that, as of September 30, 2005, the Company s disclosures were effective to ensure that:

(1)

That information required to be disclosed by the Company in reports that it files or submits under the act is recorded, processed, summarized and reported, within the time periods specified in the Commission s rules and forms, and

(2)

Controls and procedures are designed by the Company to ensure that information required to be disclosed by Sitestar Corporation in the reports it files or submits under the Act is accumulated and communicated to the issuer s management including the principal executive and principal financial officer or persons performing similar functions, as appropriate to allow timely decisions regarding financial disclosure.

This term refers to the controls and procedures of a Company that are designed to ensure that information required to be disclosed by a Company in the reports that it files under the Exchange Act is recorded, processed, summarized and reported within the required time periods. The Company s principal executive officer and principal financial officer have evaluated the effectiveness of its disclosure controls and procedures as of the end of the period covered by this quarterly report. They have concluded that, as of September 30, 2005, the Company s disclosure and procedures were effective in ensuring that required information will be disclosed on a timely basis in its reports filed under the Exchange Act.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

None.

Item 2. Unregistered Sales of Equity Securities and use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

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

None.

Item 5. Other Information

None

Item 6. Exhibits

(a) The following are filed as exhibits to this form 10-QSB:

31.1

Certification of President Pursuant to the Securities Exchange Act of 1934, Rules 13a-14 and 15d-14, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2

Certification of Chief Financial Officer Pursuant to the Securities Exchange Act of 1934, Rules 13a-14 and 15d-14, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

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Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURES

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

SITESTAR CORPORATION

Date: November 14, 2005

By: /s/ Frank Erhartic, Jr.

Frank Erhartic, Jr.

President, Chief Executive Officer

(Principal Executive Officer and

Principal Accounting Officer)

Date: November 14, 2005

By: /s/ Daniel A. Judd.

Daniel A. Judd

Chief Financial Officer

(Principal Financial Officer)