

Lynch Interactive Corporation and Subsidiaries

*Consolidated Financial Statements as of
December 31, 2005 and 2004 and for the
Years Ended December 31, 2005, 2004 and 2003, and
Independent Auditors' Report*

LYNCH INTERACTIVE CORPORATION AND SUBSIDIARIES

TABLE OF CONTENTS	
	Page
INDEPENDENT AUDITORS' REPORT	1
CONSOLIDATED FINANCIAL STATEMENTS AS OF DECEMBER 31, 2005 AND 2004 AND FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003	
Balance Sheets	2
Statements of Operations	4
Statements of Changes in Stockholders' Equity	5
Statements of Cash Flows	6
Notes to Financial Statements	7 - 21

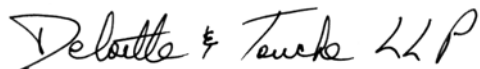
INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Stockholders of
Lynch Interactive Corporation
Rye, New York

We have audited the accompanying consolidated balance sheets of Lynch Interactive Corporation and subsidiaries (the "Company") as of December 31, 2005 and 2004, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2005. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We did not audit the financial statements of Cuba City Telephone Exchange Company and Belmont Telephone Company (consolidated subsidiaries) for the year ended December 31, 2005, which statements reflect total assets and total revenues constituting 2% and 2%, respectively, of the related consolidated totals for that year. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for Cuba City Telephone Exchange Company and Belmont Telephone Company for the year ended December 31, 2005, is based solely on the report of such other auditors.

We conducted our audit in accordance with standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit also includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Lynch Interactive Corporation and subsidiaries as of December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America.



May 2, 2006

LYNCH INTERACTIVE CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(in thousands)

	December 31,	
	2004	2005
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 27,214	\$ 32,001
Receivables, less allowances of \$260 and \$430, respectively	8,225	9,151
Material and supplies	2,314	2,236
Prepaid expenses and other current assets	1,685	1,517
Total current assets	39,438	44,905
Property, plant and equipment:		
Land	983	1,116
Buildings and improvements	17,640	19,687
Machinery and equipment	216,429	232,732
	235,052	253,535
Accumulated depreciation	(114,724)	(131,066)
	120,328	122,469
Excess of cost over fair value of net assets acquired, net (goodwill)	60,042	60,378
Other intangibles	10,026	15,666
Investments in and advances to affiliated entities	12,340	16,255
Other assets	14,906	15,843
	60,042	60,378
Total assets	\$ 257,080	\$ 275,516

See accompanying Notes to Consolidated Financial Statements.

LYNCH INTERACTIVE CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(in thousands)

	December 31,	
	2004	2005
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Notes payable to banks	\$ 4,793	\$ 12,633
Trade accounts payable	4,326	2,639
Accrued interest payable	825	1,140
Accrued liabilities	11,238	14,025
Current maturities of long-term debt	14,364	41,740
Total current liabilities	35,546	72,177
Long-term debt	154,602	135,709
Deferred income taxes	17,549	19,010
Other liabilities	3,268	2,882
Total liabilities	210,965	229,778
Minority interests	11,543	11,766
Commitments and contingencies (Note 11)		
Shareholders' equity		
Common stock, \$0.01 par value-10,000,000 shares authorized; 28,247.66 and 26,637.50 issued; 27,579.51 and 25,827.35 outstanding	--	--
Additional paid-in capital	21,406	16,586
Retained earnings	13,735	18,036
Accumulated other comprehensive income	1,588	1,890
Treasury stock, 668.15 and 810.15 shares, at cost	(2,157)	(2,540)
	34,572	33,972
Total liabilities and shareholders' equity	\$ 257,080	\$ 275,516

See accompanying Notes to Consolidated Financial Statements.

LYNCH INTERACTIVE CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except share and per share data)

	Years Ended December 31,		
	2003	2004	2005
Revenues	\$ 85,392	\$ 87,794	\$ 93,665
Operating costs:			
Cost of revenue, excluding depreciation	29,460	29,992	34,266
General and administrative costs at operations	12,693	13,800	14,668
Unallocated corporate costs	4,529	6,401	7,858
Depreciation and amortization	20,282	21,870	21,803
Gain on sale of burglar alarm customers	--	--	(1,063)
Operating profit	18,428	15,731	16,133
Other income (expense):			
Investment income	1,120	1,289	2,180
Interest expense	(11,864)	(11,204)	(12,472)
Equity in earnings of affiliated companies	2,280	3,564	3,613
Gain on sale of investments in Sunshine PCS	3,919	185	-
	(4,545)	(6,166)	(6,679)
Income before income taxes and minority interests	13,883	9,565	9,454
Provision for income taxes	(4,968)	(3,078)	(2,827)
Minority interests	(1,525)	(2,021)	(2,326)
Net income	\$ 7,390	\$ 4,466	\$ 4,301
Basic and diluted weighted average shares outstanding	27,857.43	27,694.66	27,396.50
Basic and diluted earnings (loss) per share:			
Net income per share	\$ 265.28	\$ 161.26	\$ 156.99

See accompanying Notes to Consolidated Financial Statements.

LYNCH INTERACTIVE CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(in thousands, except share data)

	Shares of Common Stock Out- standing	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Total
Balance at January 1, 2003	27,926.51	\$ 0	\$ 21,406	\$ 1,879	\$ 534	\$ (1,187)	\$ 22,632
Net income for the period	--	--	--	7,390	--	--	7,390
Unrealized gain on available for sale securities, net	--	--	--	--	322	--	322
Reclassification adjustment	--	--	--	--	(170)	--	(170)
Comprehensive income	--	--	--	--	--	--	7,542
Purchase of Treasury Stock	(127.00)	--	--	--	--	(287)	(287)
Balance at December 31, 2003	27,799.51	0	21,406	9,269	686	(1,474)	29,887
Net income for the period	--	--	--	4,466	--	--	4,466
Unrealized gain on available for sale securities, net	--	--	--	--	902	--	902
Reclassification adjustment	--	--	--	--	--	--	--
Comprehensive income	--	--	--	--	--	--	5,368
Purchase of Treasury Stock	(220.00)	--	--	--	--	(683)	(683)
Balance at December 31, 2004	27,579.51	0	21,406	13,735	1,588	(2,157)	34,572
Net income for the period	--	--	--	4,301	--	--	4,301
Unrealized gain on available for sale securities, net	--	--	--	--	619	--	619
Reclassification adjustment	--	--	--	--	(317)	--	(317)
Comprehensive income	--	--	--	--	--	--	4,603
Acquisition of shares to effectuate reverse stock split	(1,610.16)	--	(4,820)	--	--	--	(4,820)
Purchase of Treasury Stock	(142.00)	--	--	--	--	(383)	(383)
Balance at December 31, 2005	25,827.35	\$ 0	\$ 16,586	\$ 18,036	\$ 1,890	\$ (2,540)	\$ 33,972

See accompanying Notes to Consolidated Financial Statements.

LYNCH INTERACTIVE CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Years Ended December 31,		
	2003	2004	2005
OPERATING ACTIVITIES			
Net income	\$ 7,390	\$ 4,466	\$ 4,301
Depreciation and amortization	20,282	21,870	21,803
Minority interests	1,525	2,021	2,326
Equity in earnings of affiliated companies	(2,280)	(3,564)	(3,613)
Distribution received from affiliates	1,500	1,229	5,259
Gain on sale of burglar alarm customers	--	--	(1,063)
Gain on sale of investment in Sunshine PCS	(3,919)	(185)	--
Gain on sale of securities	(171)	--	(481)
Deferred income taxes	8,869	1,598	(2,939)
Changes in operating assets and liabilities, net of effects of acquisitions:			
Trade accounts receivable (increase) decrease	733	5	(346)
Trade accounts payable and accrued liabilities increase (decrease)	(4,219)	1,779	2,522
Other	893	(660)	(54)
Net cash provided by operating activities	<u>30,603</u>	<u>28,559</u>	<u>27,715</u>
INVESTING ACTIVITIES			
Acquisitions (net of debt assumed and cash equivalents acquired)	--	(377)	(23,358)
Capital expenditures	(22,740)	(16,468)	(10,211)
Acquisition of subscriber lists	(372)	(305)	(27)
Investment in affiliated companies	--	(4,688)	(62)
Acquisition of spectrum licenses	(617)	(49)	(500)
Proceeds from sale of burglar alarm customers	--	--	2,605
Proceeds from sale of investment in Sunshine PCS	7,587	244	--
Proceeds from sale of securities	285	2	657
Other	(382)	776	390
Net cash used in investing activities	<u>(16,239)</u>	<u>(20,865)</u>	<u>(30,506)</u>
FINANCING ACTIVITIES			
Issuance of long-term debt	11,772	5,973	23,612
Payments to reduce long-term debt	(12,610)	(13,345)	(16,568)
Borrowing related to lines of credit	5,269	8,886	14,306
Repayments related to lines of credit	(14,695)	(7,549)	(6,466)
Acquisition of shares to effectuate reverse stock split	--	--	(4,820)
Purchase of Treasury stock	(287)	(683)	(383)
Other	(613)	(318)	(2,103)
Net cash provided by (used in) financing activities	<u>(11,164)</u>	<u>(7,036)</u>	<u>7,578</u>
Net increase (decrease) in cash and cash equivalents	3,200	658	4,787
Cash and cash equivalents at beginning of year	23,356	26,556	27,214
Cash and cash equivalents at end of year	<u>\$ 26,556</u>	<u>\$ 27,214</u>	<u>\$ 32,001</u>
SUPPLEMENTAL DISCLOSURES			
Cash paid during the year for:			
Interest	\$ 11,947	\$ 11,096	\$ 12,065
Income tax payments (refunds)	800	(1,328)	3,620
Non cash transactions:			
Purchase of plant and equipment included in payables or accruals at year-end	2,189	1,608	322
Receipt of MCI stock	--	--	214
Fixed assets acquired under capital leases	--	--	1,445

See accompanying Notes to Consolidated Financial Statements.

LYNCH INTERACTIVE CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2005

1. Accounting and Reporting Policies

Organization

Lynch Interactive Corporation, (the "Company" or "Interactive") was formed on September 1, 1999, when Lynch Corporation ("Lynch") distributed 100 percent of the outstanding shares of common stock of Interactive, its wholly owned subsidiary, to the then holders of record of Lynch's common stock, in the form of a tax-free distribution.

On October 31, 2005, the Company's shareholders approved an amendment to the Corporation's Restated Certificate of Incorporation to effect a 1-for-100 reverse stock split. The purpose of the reverse split was to reduce shareholders of record below 300, allowing the Corporation to delist from the American Stock Exchange and deregister its shares under the Securities Exchange Act of 1934. As a result of the reverse split, holders of less than 100 shares became entitled to receive \$29.9352 for each pre-split share in lieu of a fractional share. On November 10, 2005 the American Stock Exchange, in keeping with its policies, suspended the Corporation's shares from trading, and such shares began trading in the Pink Sheets® under the symbol "LICT". On December 22, 2005, the Company provided approximately \$4.8 million to its transfer agent for distribution to holders of less than one full (post-split) share of its common stock, par value \$0.01 per share. This amount represents approximately 160,000 pre-split shares being cashed out in the 1-for-100 reverse stock split. All disclosures of the number of common shares and earnings per share have been adjusted retroactively for the 1-for -100 reverse stock split that became effective November 10, 2005.

Basis of Presentation

The accompanying consolidated financial statements represent the accounts of Interactive and its majority owned subsidiaries which primarily consists of its telephone (81%-100% owned), cable television (100% owned) and security (63.6% owned) subsidiaries. All material intercompany transactions and balances have been eliminated. Investments in affiliates in which the Company does not have a majority voting control but has the ability to significantly influence financial and operating policies are accounted for in accordance with the equity method. The Company accounts for the following affiliated companies on the equity basis of accounting:

- Coronet Communications Company (20% owned),
- Capital Communications Company, Inc. (49% of common equity owned and 100% of convertible preferred owned, when converted, equals 50% of all equity),
- KMG Holdings Group, Inc. (37% owned from May 2004),
- Two cellular telephone providers in New Mexico, both 33% owned,
- Two cellular partnerships in California resulting from the acquisition of Cal-Ore (see Note 2) (25% and 17% owned at Dec. 31, 2005).
- Telecommunications operations in North Dakota, Iowa and New York (5% to 14% owned through partnerships).

The Company's telephone subsidiaries are public utilities that are regulated by both the Federal Communications Commission (FCC) and various state commissions. These subsidiaries follow the

accounting prescribed by the Uniform System of Accounts of the FCC and the state commissions and Statement of Financial Accounting Standards (SFAS) No. 71, "Accounting for the Effects of Certain Types of Regulation." Where applicable, this accounting recognizes the economic effects of rate regulation by recording costs and a return on investment as such amounts are recovered through rates authorized by regulatory authorities.

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that effect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Reclassifications

Certain amounts within the consolidated statements of cash flows for the years ended December 31, 2004 and 2003 have been reclassified to conform to the December 31, 2005 presentation. Distributions received from affiliates, which had been reflected within investing activities in 2003 and 2004 are reported within operating activities in 2005.

Cash and Cash Equivalents

Cash equivalents consist of highly liquid investment with a maturity of three months or less when purchased.

Concentration of Credit Risk

Financial instruments, which potentially subject the Company to concentrations of credit risk, consist principally of cash and cash equivalents. Management believes the financial risks associated with these financial instruments are minimal.

At December 31, 2005, cash invested in United States Treasury money market funds which are not federally insured, totaled \$23.3 million. Of the \$8.7 million of cash invested in bank deposit accounts, approximately \$6.4 million exceeded the \$100,000 Federal Deposit Insurance Corporation (FDIC) limits per financial institution.

Marketable Securities

Marketable securities, included in other assets, consist principally of publicly traded common stocks. At December 31, 2004 and 2005, Interactive's investment in marketable securities, which had carrying values of \$3.9 million and \$4.4 million, respectively, were entirely classified as available-for-sale. Such carrying values include Interactive's 4.8% investment in Hector Communications (AMEX:HCT) valued at \$3.6 million and \$4.1 million at December 31, 2004 and 2005, respectively. Available-for-sale securities are stated at fair value with unrealized gains or losses included in equity as a component of comprehensive income (loss). Unrealized (losses) gains on available-for-sale securities were (\$0.4 million), \$1.4 million and \$0.9 million for the years ended December 31, 2003, 2004 and 2005, respectively and have been included in the Consolidated Statements of Shareholder's Equity, as "Accumulated other comprehensive income."

The cost of marketable securities sold is determined on the specific identification method. Realized gains included in investment income were \$0.3 million, \$-- million and \$0.5 million for the years ended December 31, 2003, 2004 and 2005, respectively.

Investment income - Patronage

CoBank, from which the Company has loans totaling \$59.2 million at December 31, 2005, is a cooperative, owned and controlled by its customers. Each customer borrowing from the bank shares in the bank's net income through payment of patronage refunds. Approximately 30-40% of patronage refunds are received in cash, with the balance in CoBank stock. Patronage stock is redeemable at its face value for cash after the related debt is paid off. Total patronage refunds were \$0.4 million, \$0.8 million and \$0.5 million in 2003, 2004 and 2005, respectively and were included as investment income in the Company's consolidated statement of operations. The Company cannot predict what patronage refunds might be in future years.

Fair Value of Financial Instruments

Cash and cash equivalents, trade accounts receivable, short-term borrowings, trade accounts payable and accrued liabilities are carried at cost which approximates fair value due to the short-term maturity of these instruments. The carrying amount of the Company's borrowings under its revolving line of credit approximates fair value, as the obligations bear interest at a floating rate. The fair value of other long-term obligations approximates carrying value based on borrowing rates for similar instruments.

Accounts Receivable

Accounts receivable are recorded at the invoiced amount and do not bear interest. The allowance for doubtful accounts is the Company's best estimate of the amount of probable credit losses in the Company's existing accounts receivable. The Company establishes an allowance for doubtful accounts based upon factors surrounding the credit risk of specific customers, historical trends, and other information. Receivable balances are reviewed on an aged basis and account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is doubtful. Due to dispersed geographic nature of the Company operations and residential nature of its customers, no customer accounts for a significant amount of the Company's receivable balances, other than from the National Exchange Carrier Association discussed below.

Property, Plant and Equipment

Property, plant and equipment are recorded at cost and include expenditures for additions and major improvements and, for our regulated telephone companies, include an allowance for funds used during construction (AFUDC). Maintenance and repairs are charged to operations as incurred. Depreciation of telephone plant is computed on the straight-line method using class or overall group rates acceptable to regulatory authorities. Depreciation of non-telephone property is computed on the straight-line method over the estimated useful lives of the assets. Depreciable lives for the Company's telephone and non-telephone properties, excluding land, range from 19 to 45 years for building, 3 to 50 years for machinery and equipment and 2 to 50 years for other assets. For income tax purposes, accelerated depreciation methods are used. Depreciation expense for 2003, 2004 and 2005 was \$19.5 million, \$20.0 million and \$20.6 million, respectively.

When a portion of the Company's depreciable property, plant and equipment relating to its telephone operations business is retired, the gross carrying value of the assets, including cost of disposal and net of any salvage value, is charged to accumulated depreciation, in accordance with regulated accounting procedures.

Goodwill and other Intangible Assets

The Company tests goodwill and other intangible assets with indefinite lives for impairment using the two-step process prescribed in SFAS No. 142 Goodwill and Other Intangible Assets. The first step is a screen for potential impairment, in which we determine the fair value for each reporting unit. We estimate the fair value of each reporting unit based on a number of subjective factors, including: (a) appropriate weighting of valuation approaches (income approach, market approach and comparable public company approach), (b) estimates of our future cost structure, (c) discount rates for our estimated cash flows, (d) selection of

peer group companies for the public company approach, (e) required level of working capital, (f) assumed terminal value and (g) time horizon of cash flow forecasts.

If such tests indicate potential impairment, then a second step measures the amount of impairment, if any. The Company performed its annual impairment tests of goodwill as of October 1, 2004 and 2005 and determined that in 2004 and 2005, \$0.5 million and \$0.3 million, respectively, of goodwill was considered impaired and was charged to income as amortization expense.

In addition to goodwill, intangible assets with indefinite lives include cellular licenses, with a carrying value of \$4.9 million and \$5.4 million at December 31, 2004 and 2005 respectively. At December 31, 2004, Interactive recorded a \$0.7 million impairment of its investment in certain 10 MHz spectrum, which is included in amortization expense. This impairment was based on a February 2005 FCC auction for similar spectrum in which the price per MHz of population was materially lower than the price paid by Interactive for this spectrum.

The Company's subscriber lists and related rights are generally amortized over a 10 to 15-year life. Such intangible assets had a gross value of \$7.9 million and \$11.5 million and accumulated amortization of \$3.6 million and \$2.9 million at December 31, 2004 and 2005, respectively. Amortization expense was \$0.7 million, \$0.6 million and \$0.7 million for the years ended December 31, 2003, 2004 and 2005 respectively and is estimated to be between \$0.8 and \$0.7 million annually for the next five years.

Impairment of Long-lived Assets

Long-lived assets, such as property, plant, and equipment, and purchased intangibles subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell, and depreciation ceases.

Revenues

Telephone service revenue is primarily derived from regulated local, intrastate and interstate access services and is recognized as services are provided. Revenues for our cost-based companies are generally derived from the Company's cost for providing services.

Local access revenue comes from providing local telephone exchange services and is billed to end users in accordance with tariffs approved by each state's Public Utilities Commission. Local access revenue is predominantly billed in advance and such advance billings are initially deferred and recognized as revenue when earned.

Revenue that is billed in arrears includes most intrastate and interstate network access services, nonrecurring local services and long distance services. The earned but unbilled portion of this revenue is recognized as revenue in the period that the services are provided.

Revenue from intrastate access is based on tariffs approved by each state's Public Utilities Commission. Revenue from interstate access is derived from settlements with the National Exchange Carrier Association (NECA). NECA was created by the FCC to administer interstate access rates and revenue pooling on behalf of small local exchange carriers who elect to participate in a pooling environment. Interstate settlements, including amounts received under Universal Service Funds, are determined based on the Company's cost of providing interstate telecommunications service, including investments in specific types of infrastructure and operating expenses and taxes.

Other businesses revenues include the Company's internet, CLEC, wireless, long-distance, cable and security operations all of which are recognized as services are provided.

Alarm system installation revenues, sales revenues on equipment upgrades and direct incremental costs of installations and sales are deferred for residential customers with monitoring services contracts. Revenues from monitoring contracts are recognized in the period such services are provided.

Deferred alarm system installation revenues are recognized over the expected life of the monitoring contracts of the customer for residential and commercial customers. Deferred costs in excess of deferred revenue are recognized over the initial contract term, typically three years. To the extent deferred costs are less than or equal to deferred revenues, such costs are recognized over the estimated life of the customer.

Earnings (Loss) Per Share

Basic earnings (loss) per common share amounts are based on the average number of common shares outstanding during each period, excluding the dilutive effects of options, warrants, and convertible securities. Diluted earnings per share reflect the effect, where dilutive, of options, warrants and convertible securities, using the treasury stock and if converted methods as applicable. Earnings per share in previous periods have been restated to reflect the one-for-one hundred reverse stock split.

Comprehensive Income

In accordance with SFAS No. 130, "Reporting Comprehensive Income" unrealized gains or losses, net of tax, on the Registrant's available-for-sale securities are included as a separate component of Shareholder Equity included in other comprehensive income (loss).

Minority Interest

The Company consolidates certain subsidiaries that are less than 100% owned. The portion of such subsidiaries not owned by the Company is shown as Minority Interests in the Consolidated Statements of Operations, Balance Sheets and Cash Flow.

Issuance of Stock by Subsidiary and Investees

Changes in the Company's equity in a subsidiary or an investee caused by issuances of the subsidiary's or investees' stock are accounted for as gains or losses where such issuance is not part of a broader reorganization.

Recently Issued Accounting Pronouncements

In March 2005, the FASB issued Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations" ("FIN 47"), which clarifies that conditional asset retirement obligations are within the scope of SFAS No. 143, "Accounting for Asset Retirement Obligations." FIN 47 requires the Company to recognize a liability for the fair value of conditional asset retirement obligations if the fair value of the liability can be reasonably estimated. FIN 47 is effective for the year ended December 31, 2005 and has been adopted by the Company in the fourth quarter of 2005. The Company evaluated the impact of FIN 47 on its businesses and determined that the impact was immaterial.

In May 2005, the FASB issued SFAS 154, "Accounting Changes and Error Corrections". SFAS 154 eliminates the requirement in APB Opinion No. 20, "Accounting Changes", to include the cumulative effect of changes in accounting principle in the income statement in the period of change. Instead, to enhance the comparability of prior period financial statements, SFAS 154 requires that changes in accounting principle be retrospectively applied. Under the retrospective application, the new accounting principle is applied as of the beginning of the first period presented as if that principle had always been used. Adoption of SFAS 154 is required for accounting changes and corrections of errors made in the fiscal

year beginning after December 15, 2005. The Company will adopt this new accounting standard on January 1, 2006.

2. Acquisitions and Dispositions

On August 29, 2005, the Company acquired 100% of the stock of California-Oregon Telecommunications Company (“Cal-Ore”) located in Dorris, California for \$21.5 million including \$0.4 million of acquisition costs. The accompanying consolidated Statements of Operations include results of operations for Cal-Ore since the date of the acquisition. The acquisition was financed with the issuance of \$21.2 million of bank debt and unsecured notes. Cal-Ore is the incumbent service provider for 850 square miles along the Northern California border with Oregon with approximately 2,500 access lines, Cal-Ore’s other businesses include an internet service provider, a Competitive Local Exchange Carrier (“CLEC”) that is planning to provide services in the surrounding area and minority interests in certain cellular partnerships. The allocation of the total purchase price of Cal-Ore at the date of acquisition is as follows (in thousands):

Cash	\$ 1,713
Other Assets	1,892
Plant and Equipment	9,855
Other investments	5,396
Goodwill	501
Other intangibles	6,808
Current liability	(275)
Deferred taxes	(4,438)
	<u>\$ 21,452</u>

The excess of the total purchase price over the fair value of the net identifiable assets acquired was approximately \$7.3 million of which \$6.5 million was allocated to subscriber lists and related rights which are subject to amortization, and \$0.5 million was allocated to goodwill. All such excess costs are not expected to be deductible for tax purposes.

On March 18, 2005, a subsidiary of the Company, Central Telcom Services, LLC, acquired certain cable television assets from Precis Communications, LLC, for a purchase price of \$3.5 million. The system has 2,411 cable subscribers located in Sanpete and Sevier Counties, Utah. The allocation of the purchase price included \$2.9 million to property, plant and equipment, \$0.1 million to goodwill and \$0.5 million to franchise rights and subscriber lists included in other intangible assets in the Consolidated Balance Sheet. Such franchise rights and subscriber lists are subject to amortization. All such amounts are expected to be deductible for tax purposes.

On July 29, 2005, a subsidiary of the Company closed on the sale of approximately 62% of its burglar alarm customers to an investment group for approximately \$2.6 million, net of holdbacks and fees, resulting in a \$1.1 million gain on the sale included in cost of revenue. The proceeds were used to retire debt.

On April 30, 2004, the Company acquired a 37% interest in an entity (KMG) whose principal asset consist of a \$6.0 million subordinated note and a 17% equity interest in Lynch Telephone Corporation, a 83% owned subsidiary of the Company. The remaining 63% ownership of KMG is held by the management of Western New Mexico Telephone Company, Inc. The Company issued a \$4.5 million, 8.5% five-year amortizing subordinated note and assumed an additional \$0.5 million note from the seller to acquire such interest. See Note 14, Subsequent Events.

3. Wireless Communications Services

On December 31, 2003, Sunshine PCS Corporation (“Sunshine”), in which the Company owned preferred stock and warrants to purchase common stock, sold its three PCS licenses to Cingular Wireless for \$13.75

million in cash. As part of this sale, Interactive received \$7.2 million in exchange for all its preferred stock in Sunshine and \$0.4 million for its warrants, resulting in a pre-tax gain of \$3.9 million. Due to the ongoing lawsuit in which Interactive and Sunshine are defendants (see Note 11), Cingular would not complete the sale without indemnification from losses that could result from an adverse ruling. As a result, Interactive agreed to provide Cingular an indemnification for up to \$8 million of losses that Cingular might incur in the event of an adverse ruling. Interactive considers it highly unlikely that Cingular will incur losses, however, in accordance with the provisions of FIN 45, the Company recorded an immaterial liability which represented the Company's best estimate of the fair value of such indemnification.

At December 31, 2004 as part of the Company's annual test for impairment of intangible assets with indefinite lives, Interactive recorded a \$0.7 million impairment of its investments in certain 10 MHz PCS licenses in Logan, UT and Las Cruces, NM. The impairment was based on a February 2005 FCC auction for similar spectrum in which the price per MHz of population was materially lower than the price paid by the Company.

In February 2005, Lynch 3G participated in Auction 58 for PCS Spectrum and was high bidder for two licenses, Marquette, MI and Klamath Falls, OR, for a total cost of \$0.5 million which is included in Other Intangibles in the Consolidated Balance Sheet.

4. Investments in Affiliated Companies

Interactive has equity investments in both broadcasting and telecommunications companies.

Summarized financial information for broadcasting companies accounted for by the equity method as of and for the years ended December 31, is as follows:

	Broadcasting Combined	
	2004	2005
Current assets	\$ 6,896	\$ 4,075
Property, plant & equipment, intangibles & other	9,558	10,905
Total Assets	\$ 16,454	\$ 14,980
Current liabilities	\$ 3,383	\$ 12,254
Long term liabilities	16,751	7,397
Equity	(3,680)	(4,671)
Total liabilities & equity	\$ 16,454	\$ 14,980
Revenues	\$ 14,007	\$ 11,718
Gross profit	\$ 4,965	\$ 2,825
Net income (loss)	\$ 1,246	\$ (1,000)

A wholly owned subsidiary of the Company has a 20% investment in Coronet Communications Company ("Coronet"), which operates television station WHBF-TV, a CBS affiliate in Rock Island, Illinois. A second wholly owned subsidiary of the Company has a 49% investment in Capital Communications Company, Inc. ("Capital"), which operates television station WOI-TV, an ABC affiliate in Des Moines, Iowa. At December 31, 2004 and 2005, the investment in Coronet was carried at a negative \$0.6 million and a negative \$0.7 million, respectively, due to the subsidiary's guarantee of \$3.8 million of Coronet's third party debt. The guarantee is in effect for the duration of the loan which expires on December 31, 2010 and would be payable if the equity investee fails to make such payment in accordance with the terms of the loan. Long-term debt of Coronet, at December 31, 2005, totaled \$9.6 million payable quarterly through December 31, 2010 to a third party lender.

At December 31, 2004 and 2005, the investment in Capital is carried at zero as its share of net losses recognized to date have exceeded its net investment and the Company has no further commitment to Capital. The Company's shares in Capital have been pledged as security for Capital's long term debt.

Summarized financial information for telecommunications companies which includes the cellular telephone providers, spectrum license holders, and other telecommunication operations accounted for by the equity method as of and for the years ended December 31, is as follows:

	Telecommunications Combined	
	2004	2005
Current assets	\$ 36,080	\$ 25,327
Property, plant & equipment, intangibles & other	33,087	45,242
Total Assets	\$ 69,167	\$ 70,569
Current liabilities	\$ 22,745	\$ 8,638
Long term liabilities	5,900	4,926
Equity	40,522	57,005
Total liabilities & equity	\$ 69,167	\$ 70,569
Revenues	\$ 53,751	\$ 63,800
Gross profit	\$ 25,618	\$ 28,671
Net income	\$ 15,247	\$ 15,724

Interactive owns a one-third interest in two cellular telephone providers in New Mexico: New Mexico RSA #3 and RSA #5. The Company's net investment in these partnerships was \$6.5 million and \$4.8 million at December 31, 2004 and 2005, respectively and included in Investment in and Advances to Affiliates.

As part of the Cal-Ore acquisition, Interactive owns a 25% partnership interest in a cellular telephone provider in northern California, California RSA #2. As of December 31, 2005, the net investment in the partnership was valued at \$2.0 million. Also as part of the Cal-Ore acquisition, Interactive acquired a 17% partnership interest in another cellular telephone provider in northern California, California RSA #1. Cal-Ore was in the process of selling such interest at the acquisition date and it was valued based on the proceeds of the sale (See Note 14, Subsequent Events).

Undistributed earnings of companies accounted for using the equity method that are included in consolidated retained earnings are \$3.1 million and \$2.3 million at December 31, 2004 and 2005, respectively.

5. Notes Payable to Banks and Long-term Debt

The Company's long term debt facilities contain covenants that restrict the distribution of cash and other net assets between subsidiaries or to the parent company. Long-term debt represents borrowings by specific entities, which are subsidiaries of Interactive.

	December 31,	
	2004	2005
	<i>(in thousands)</i>	
Long-term debt consists of (all interest rates are at December 31, 2005):		
Rural Electrification Administration (REA) and Rural Telephone Bank (RTB) notes payable in equal quarterly installments through 2027 at fixed interest rates ranging from 2% to 7.5% (5.1% weighted average), secured by assets of the telephone companies of \$150 million	\$ 57,129	\$ 52,018
Bank credit facilities utilized by certain telephone and telephone holding companies through 2017, \$7.3 million at fixed interest rates averaging 8.3% and \$70.5 million at variable interest rates averaging 7.6%	70,402	77,775
Unsecured notes issued in connection with acquisitions through 2008, all at fixed interest rates averaging 9.2% (primarily held by management of telephone company's)	38,983	45,619
Other	2,452	2,037
	168,966	177,449
Current maturities	(14,364)	(41,740)
	<u>\$ 154,602</u>	<u>\$ 135,709</u>

REA debt of \$8.0 million which bears interest at 2% has been reduced by a purchase price adjustment of \$1.7 million to discount the debt to an imputed interest rate of 5%. Such discount is being amortized into interest expense based on the effective interest method over the remaining life of the notes.

Interactive maintains a short-term line of credit facility totaling \$10.0 million, on December 31, 2005. Borrowings under this facility were \$1.1 million and \$8.3 million at December 31, 2004 and 2005, respectively. Borrowings outstanding under this facility and other lines of credit are classified as notes payable in the consolidated balance sheet. During 2005, the average balance of notes payable outstanding was \$4.1 million, the highest amount outstanding was \$8.3 million and the average interest rate was 7.0%.

In general, the long-term debt facilities are secured by substantially all of the Company's property, plant and equipment, receivables and common stock of certain subsidiaries and contain certain covenants restricting distributions to Lynch Interactive. At December 31, 2005, the Company is in compliance with all covenants. At December 31, 2004 and 2005, substantially all the subsidiaries' net assets are restricted from distribution to Lynch Interactive.

Aggregate principal maturities of long-term debt at December 31, 2005 for each of the next five years are as follows: 2006--\$41.7 million, 2007--\$26.4 million, 2008--\$19.7 million, 2009--\$19.5 million, 2010--\$15.0 million, and the remaining \$55.0 million thereafter.

The Company has a need for resources primarily to fund its ongoing litigation as well as future long-term growth initiatives. The Company considers various alternative long-term financing sources: debt, equity, or sale of an investment asset. At December 31, 2005, the Company has a \$27.3 million working capital deficiency primarily due to the \$41.7 million of debt maturing in 2006. The Company is in the process of renegotiating or refinancing \$27.3 million of debt facilities that mature over the next twelve months, of which \$21.3 million is due to management of the telephone companies when they were acquired. In addition, the Company is actively searching for a larger facility to replace its \$10 million line of credit facility. The efforts are currently in various stages of completeness. While management expects to obtain adequate financing resources to enable the Company to meet its obligations, there is no assurance that such can be readily obtained or at reasonable costs.

6. Related Party Transactions

Interactive leases its corporate headquarters from an affiliate of its Chairman. The lease was renewed in December 2002 for five years and calls for an annual payment of \$103,000 including utilities, subject to escalation. In addition, expenses relating to administrative support, transportation (includes charges for a leased airplane), and communications (approximately \$98,000, \$102,000 and \$92,000 for the years ended December 31, 2003, 2004 and 2005, respectively) are paid to an affiliate of its Chairman. See Note 3 for additional references to related party transactions.

In addition, the defendants in the Taylor False Claims Act lawsuit have not yet agreed among themselves as to the share of litigation costs (including settlement costs or judgment amounts) each defendant should ultimately bear. One other defendant, affiliated with our Chairman, thus far has funded approximately \$3 million of the legal costs not directly attributable to any particular defendant (joint defense costs). It is currently unclear to what extent that defendant (or any other defendant) may seek to obtain reimbursement from the Company for part or all of their defense, settlement or judgment costs. The Company has not reserved any amounts for additional defense, settlement or judgment costs. See Note 11 – Commitments and Contingencies.

At December 31, 2004 and 2005, assets of \$15.2 million and \$23.3 million, which are classified as cash and cash equivalents, are invested in United States Treasury money market funds for which affiliates of the Company's Chairman serve as investment managers to the respective funds.

7. Shareholder's Equity

In 1999, Interactive's Board of Directors authorized the purchase of up to 2,000 shares of its common stock. Through December 31, 2005, 810.15 shares have been purchased at an average investment of \$3,135 per share, including 142 shares in 2005 for an average investment of \$2,698 per share. Subsequent to year-end, the Company has purchased an additional 356 shares at an average investment of \$2,171 per share. All share amounts have been revised for the reverse stock split, see Note 1.

8. Income Taxes

Interactive files a consolidated income tax return with its subsidiaries for federal income tax purposes. Certain entities file separate state and local income tax returns, while others file on a combined or consolidated basis.

Deferred income taxes for 2004 and 2005 are provided for the temporary differences between the financial reporting bases and the tax bases of the Company's assets and liabilities. Cumulative temporary differences at December 31, 2004 and 2005 are as follows:

	2004 Deferred Tax		2005 Deferred Tax	
	Asset	Liability	Asset	Liability
	<i>(in thousands)</i>			
Fixed assets revalued under purchase				
accounting and tax over book depreciation	\$ --	\$ 11,029	\$ --	\$ 11,976
Discount on long term debt	--	488	--	411
Unrealized gains on marketable securities	--	1,827	--	1,985
Partnership tax losses in excess of book losses	1,863	2,669	1,863	3,256
Other reserves and accruals	--	1,536	--	1,382
Other	1,216	--	--	--
Total deferred income taxes	3,079	17,549	1,863	19,010
Valuation Allowance	(3,079)	--	(1,863)	--
	\$ --	\$ 17,549	\$ --	\$ 19,010

Due to uncertainty regarding its realization, a valuation allowance of approximately \$1.9 million exists against certain reserves for impairment.

The provision (benefit) for income taxes is summarized as follows:

	2003	2004	2005
	<i>(in thousands)</i>		
Current payable taxes:			
Federal	\$ (4,775)	\$ 831	\$ 4,150
State and local	874	649	1,616
	(3,901)	1,480	5,766
Deferred taxes:			
Federal	8,529	1,470	(2,522)
State and local	340	128	(417)
	8,869	1,598	(2,939)
	<u>\$ 4,968</u>	<u>\$ 3,078</u>	<u>\$ 2,827</u>

A reconciliation of the provision (benefit) for income taxes and the amount computed by applying the statutory federal income tax rate to income before income taxes and minority interest:

	2003	2004	2005
	<i>(in thousands)</i>		
Tax at statutory rate	\$ 4,720	\$ 2,847	\$ 2,760
Increases (decreases):			
State and local taxes, net of federal benefit	801	513	791
Other	(553)	(282)	(724)
	<u>\$ 4,968</u>	<u>\$ 3,078</u>	<u>\$ 2,827</u>

9. Accumulated Other Comprehensive Income

Balances of accumulated other comprehensive income, net of tax, which consists of unrealized gains (losses) on available for sale securities at December 31, 2004 and 2005 are as follows:

	Unrealized Gain (Loss)	Tax Effect	Net
	<i>(in thousands)</i>		
Balance at December 31, 2003	\$ 1,040	\$ (354)	\$ 686
Change in unrealized gains (losses), net	1,370	(468)	902
Balance at December 31, 2004	2,410	(822)	1,588
Change in unrealized gains (losses), net	940	(321)	619
Reclassification in adjustment	(481)	164	(317)
Balance at December 31, 2005	<u>\$ 2,869</u>	<u>\$ (979)</u>	<u>\$ 1,890</u>

10. Employee Benefit Plans

Interactive maintains several defined contribution plans at its telephone subsidiaries and corporate office. Interactive's contributions under these plans, which vary by subsidiary, are based primarily on the financial performance of the business units and employee compensation. Total expense of these plans was \$1.1 million, \$1.2 million and \$1.1 million for 2003, 2004 and 2005, respectively.

The Company has a Principal Executive Bonus Plan that has been approved by the shareholders, for which \$1.3 million, \$0.3 million and \$0.3 million were recorded in 2003, 2004, and 2005, respectively.

In addition, three of the Company's telephone subsidiaries participate in a multi-employer defined benefit plan, which is administrated by a telephone industry association. Under this plan accumulated benefits and

plan assets are not determined or allocated separately by individual employees. Accordingly, such data is not currently available. Total expenses of these plans were \$0.1 million, \$0.2 million and \$0.3 million for 2003, 2004 and 2005, respectively.

11. Commitments and Contingencies

Leases.

The Company leases certain land, buildings, computer equipment, computer software, and network services equipment under non-cancelable operating leases that expire in various years through 2028. Terms of the lease, including renewal options and escalation clauses, vary by lease. When determining the term of a lease, the Company includes renewal options that are reasonably assured. Rental expense under operating leases was \$0.5 million, \$0.3 million and \$0.3 million for years ended December 31, 2003, 2004 and 2005 respectively. Minimum lease payments due under non-cancelable operating leases at December 31, 2005 are as follows: \$0.3 million in 2006; \$0.3 million in 2007; \$0.2 million in 2008; \$0.2 million in 2009, \$0.1 million in 2010 and \$0.1 million thereafter.

Litigation.

False Claims Act Litigation.

Interactive and several other parties, including Interactive's Chairman of the Board, have been named as defendants in a lawsuit originally brought by Rufus C. Taylor, III ("Taylor" or the "relator") under the so-called "qui tam" provisions of the federal False Claims Act in the United States District Court for the District of Columbia. The complaint was filed under seal in February 2001 and, at the initiative of one of the defendants, the seal was lifted in January 2002. Under the False Claims Act, a private plaintiff called a relator may file a civil action on the U.S. government's behalf against another party for violation of the statute. In return, the relator receives a statutory bounty from the government's litigation proceeds if he is successful.

The main allegation in the case is that the defendants participated in the creation of "sham" bidding entities that allegedly defrauded the federal Treasury by improperly participating in certain Federal Communications Commission ("FCC") spectrum auctions restricted to small businesses, as well as obtaining "bidding credits" in other spectrum auctions allocated to "small" and "very small" businesses. While the complaint seeks to recover an unspecified amount of damages, which would be subject to mandatory trebling under the statute, a report prepared for the relator in February 2005 alleges damages of approximately \$91 million in respect of "bidding credits", approximately \$70 million in respect of government "financing" and approximately \$206 million in respect of subsequent resales of licenses, in each case prior to trebling. The liability is alleged to be joint and several.

Interactive was formally served with the complaint in July 2002. In September 2002, the defendants filed two motions with the United States District Court for the District of Columbia: a motion to dismiss the lawsuit; and a motion to transfer the action to the Southern District of New York. In September 2003, the court granted Interactive's motion to transfer the action. A scheduling conference was held in February 2004, at which time the judge approved a scheduling order and discovery commenced. In July 2004, the judge denied in part and granted in part defendants' motion to dismiss. In September 2004, the court issued a ruling denying defendants' motion to refer issues in the action to the FCC.

In December 2004, the defendants filed a motion in the United States District Court for the District of Columbia to compel the FCC to provide certain information subpoenaed by defendants to enable them to conduct their defense. This motion was denied in May 2005 and defendants appealed. In February 2006, the defendants and the FCC reached an agreement granting defendants discovery of certain documents and other evidentiary materials. Factual discovery against defendants is substantially complete and both Taylor and the defendants have moved for summary judgment on a variety of grounds. In November 2005, with respect to one such motion for partial summary judgment on the issue of damages based on resales of licenses, the court ruled that such damages were not allowed under the False Claims Act. Initially, in 2001, the Department of Justice notified the court that it would not intervene in the case. However, in response to the judge's above-described November 2005 ruling, the DOJ recently, in March 2006, petitioned to be

allowed to intervene. The case had been tentatively scheduled for trial in June 2006 but any trial may be delayed due to the government's intervention petition and related issues.

Defense costs incurred to date have been, and are expected to continue to be, material. Interactive does not have any insurance to cover its costs of defending or settling this lawsuit or for any adverse judgment resulting from it. Interactive does have a directors and officers liability policy but the primary insurer denied coverage under the policy. Interactive and that insurer recently filed lawsuits against each other on the issue of coverage under the policy, which lawsuits were settled in April 2006 without material payments by or to the Company. Interactive and its excess D&O insurers also have filed lawsuits against each other on the issue of coverage under their policies. Interactive's lawsuit in Connecticut against the excess insurers seeks a declaration that they are liable on their policies. The excess insurers' lawsuit in New York seeks a declaration that they are not liable on their policies because of alleged late notice and other reasons. Interactive intends to bring a timely motion to dismiss the excess insurers' New York lawsuit; however, the outcome of these lawsuits cannot be predicted. Also in April 2006, Interactive notified its current D&O carriers of the new claims brought by the government. The outcome of these remaining insurance claims cannot be predicted and, as a result, any coverage to be provided to any director or officer of Interactive under any policy is unclear at this time.

While Interactive believes it has meritorious defenses and has contested the case vigorously, it and the other defendants are involved in serious settlement negotiations in order to avoid the further costs and uncertainties associated with a trial and possible subsequent appeals. It is anticipated that any such settlement would have a substantial adverse effect on the Corporation, its consolidated financial statements and impair its growth potential. While management believes that it could raise additional debt and/or equity and that it could also sell assets to satisfy such a potential settlement, there is no assurance that such a plan could be accomplished. Further, the defendants have not agreed among themselves as to the share of litigation costs (including settlement costs or judgment amounts) each defendant should ultimately bear. One other defendant, affiliated with our Chairman, thus far has funded approximately \$3 million of the legal costs not directly attributable to any particular defendant (joint defense costs). It is currently unclear to what extent that defendant (or any other defendant) may seek to obtain reimbursement from the Company for part or all of their defense, settlement, or judgment costs. The Company will accrue a liability in accordance with SFAS No. 5, when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. In view of the inherent difficulty of predicting the outcome of any settlement, particularly given the substantial alleged damages and the number of defendants involved, the Company cannot predict what the eventual loss or range of loss could be, and as a result, the Company has not reserved any amounts for additional defense, settlement or judgment costs in connection with this case.

Also see "History of Lynch's "C Block Activities" below.

Also see Note 3 – Wireless Communication Services with regards to a potential indemnification obligation of the Company.

History of Lynch's "C Block" Activities.

As part of the Omnibus Budget Resolution of 1993, Congress authorized the FCC to employ competitive bidding procedures to select among mutually exclusive applicants for certain spectrum licenses. Initially the FCC was directed to include as licensees, among others, small businesses, African Americans, Native Americans, Asian Americans, and women. As a result, the FCC conducted auctions beginning in 1995 to allocate spectrum in a competitive manner, including the "C Block" auction (Auction 5) in 1995 and 1996 which was restricted to small businesses. Interactive was a participating investor and/or service provider to various entities in this "C Block" auction. These entities were initially put together to include, among others, women, African Americans, Native Americans and Asian Americans. As a result of changing legal standards, the FCC modified its rules to include only small businesses in the "C Block" auction, and these same individuals/entities were qualified as small businesses and remained eligible as bidders. By December 18, 1995, Interactive (through its predecessor Lynch Corporation) had investments in five entities that participated in the FCC auction for broadband PCS "C Block" spectrum. When the auction closed, on May

6, 1996, these five entities, on a combined basis, were the highest bidders for thirty-one 30 MHz licenses at a gross cost of \$288.2 million. These entities were credited with \$72 million of "bidding credits", and accordingly their net cost for licenses won was \$216.2 million. The federal government provided "financing" for 90% of the cost of these licenses, or \$194.6 million. Interactive's investments in these entities totaled \$21 million.

Events during and subsequent to Auction 5 made financing the build-out for these licenses through the capital markets much more difficult than originally anticipated. In April 1997, for a variety of reasons including being able to obtain some economies of scale in such areas as financing, the five entities Interactive had backed were merged into Fortunet Communications, Inc. The FCC, in partial response to the bankruptcy of Nextwave and others, promoted a plan for refinancing the "C Block" licenses. In 1997, many of the license holders from Auction 5, including Fortunet, petitioned the FCC for relief in order to afford these small businesses the opportunity to more realistically restructure and build out their systems. The President of Fortunet, Karen Johnson, participated in an FCC-sponsored forum on this issue in June 1997. The response from the FCC, which was announced in September 1997 and modified in March 1998, afforded license holders four options. One of these options was the resumption of debt payments, which had been suspended earlier in 1997 for all license holders. Another option, amnesty, was to return all licenses and forgo any amounts deposited in exchange for forgiveness of the FCC debt. Other options included: disaggregation, splitting a 30 MHz license into two 15 MHz licenses and forgoing 50% of the amount deposited; and prepayment, return of certain licenses and utilization of 70% of the amount deposited to acquire other licenses, with the other 30% of the deposits to be forfeited.

In June 1998, Fortunet elected to apply its eligible credits relating to its original down payment to the purchase of three licenses for 15 MHz of PCS spectrum in Tallahassee, Panama City and Ocala, Florida. Consistent with the FCC-promulgated disaggregation alternative, Fortunet surrendered all of its remaining licenses and forfeited 30% of its original down payment in full satisfaction of its government obligations, including forgiveness of all accrued interest. Accordingly, Fortunet retained 15 MHz of spectrum in the three Florida markets covering a population of approximately 962,000 at a net auction cost of \$15.8 million. As a result of this FCC process, disaggregation resulted in a reduction of the "bidding credits" to \$5.3 million. Fortunet also lost \$6.0 million of its down payment. As a result of this decision, during 1997, Interactive recorded a \$7.0 million write down of its investment in Fortunet.

In April 1999, the FCC completed a reauction of all the "C Block" licenses that were surrendered, including the 15 MHz of spectrum that Fortunet returned to the FCC in June 1998 in respect of the Tallahassee, Panama City and Ocala, Florida markets. In that reauction, the successful bidders paid a total of \$2.7 million for those three 15 MHz licenses returned by Fortunet, versus the \$15.8 million paid by Fortunet. As a result of this auction, Interactive recorded a further write down of its investment of \$15.4 million, including capitalized costs, to reflect the amount bid for the similar licenses in the reauction.

In February 2000, Fortunet merged with Sunshine PCS Corporation, which by way of a spin-off from Lynch Interactive became a public company. It traded under the symbol SUNPA.

In December 2003, Sunshine, after appropriate corporate and regulatory steps, sold its three 15 MHz licenses to Cingular Wireless for \$13.75 million. Interactive received \$7.6 million as its share of the sale proceeds versus its cash investment of \$21.9 million initially invested in the original five entities in 1996.

Other Litigation.

In addition to the litigation described above, Interactive is a party to routine litigation incidental to its business. Based on information currently available, Interactive believes that none of this ordinary routine litigation, either individually or in the aggregate, will have a material effect on its financial condition and results of operations.

12. Quarterly Results of Operations (Unaudited)

	2004-Three Months Ended			
	March 31	June 30	Sept. 30	Dec. 31
	<i>(in thousands, except per share amounts)</i>			
Revenues	\$ 21,401	\$ 21,141	\$ 22,865	\$ 22,387
Operating profit	4,888	3,227	5,087	2,529
Net Income	1,603	384	1,542	937
Basic and diluted earnings per share:	\$ 57.73	\$ 13.84	\$ 55.71	\$ 33.95

	2005-Three Months Ended			
	March 31	June 30	Sept. 30	Dec. 31
	<i>(in thousands, except per share amounts)</i>			
Revenues	\$ 21,618	\$ 22,471	\$ 24,159	\$ 25,417
Operating profit	3,258	2,945	6,546	3,384
Net Income	695	213	2,526	867
Basic and diluted earnings per share:	\$ 25.24	\$ 7.74	\$ 91.78	\$ 31.99

13. Segment Information

The Company is engaged in one business segment: multimedia.

14. Subsequent Events

President Bush's final Budget for Fiscal Year 2006 established the process and terms to implement the dissolution of the Rural Telephone Bank ("RTB"). Under RTB's By-Laws, on dissolution, the holders of its Class B and Class C stock will be paid the par value of their stock. As of December 31, 2004 and 2005, the total par value of RTB Class B and Class C stock at the Company's subsidiaries was \$13.7 million. The net book value and tax basis of this stock, at that date, was \$1.2 million. The Company executed the necessary documents related to dissolution of the RTB in the first quarter of 2006 and payments to the stock holders are expected in the second quarter of 2006. The gain to be recognized is currently uncertain due to negotiations by federal and state regulatory authorities to recover some portions of the dissolution through future revenue reduction.

In January 2006, the Company acquired the remaining 63% minority interest in KMG that it had not acquired in the April 2004 acquisition (See Note 2) for approximately \$9.4 million in notes to the sellers. KMG's principal assets consist of a \$6.0 million subordinated note and a 17% equity interest in Lynch Telephone Corporation.

In January 2006, the Company sold 80,000 shares of Hector Communications Common Stock for \$2.3 million, resulting in a pre-tax gain of approximately \$1.6 million.

In January 2006, the Company received \$1.0 million as a fee for providing services to a third party in an auction for spectrum in 1997. The fee was contingent and became payable in January 2006 based on the successful sale of such licenses. Such gain will be included in first quarter 2006 net income. Additional service provider fees have been held in escrow and will be recorded in income when and if they are received in cash.

In February 2006, Cal-Ore completed the sale of its 17% interest in a cellular partnership. The sale was anticipated in the purchase price allocation and no gain or loss will be recognized for financial statement purposes.