
LYNCH INTERACTIVE CORPORATION

Quarterly Report for period ended June 30, 2006

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LYNCH INTERACTIVE CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share amounts)

	June 30,	December	June 30,
	2006	31,	2005
	(Unaudited)	(Audited)	(Unaudited)
ASSETS			
Current assets:			
Cash and cash equivalents	\$ 46,453	\$ 32,001	\$ 27,741
Receivables, less allowances of \$448, \$430 and \$245, respectively	9,468	9,151	8,340
Material and supplies	2,618	2,236	2,647
Prepaid expenses and other current assets	1,510	1,517	993
Total current assets	60,049	44,905	39,721
Property, plant and equipment:			
Land	1,116	1,116	983
Buildings and improvements	19,742	19,687	17,757
Machinery and equipment	237,858	232,732	221,692
	258,716	253,535	240,432
Accumulated depreciation	(141,298)	(131,066)	(123,098)
	117,418	122,469	117,334
Excess of cost over fair value of net assets acquired, net (goodwill)			
	60,709	60,378	60,501
Other intangibles	15,569	15,666	10,690
Investments in and advances to affiliated entities	8,325	16,255	11,003
Other assets	13,097	15,843	15,518
Total assets	\$ 275,167	\$ 275,516	\$ 254,767

See accompanying Notes to Condensed Consolidated Financial Statements.

LYNCH INTERACTIVE CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share amounts)

	June 30, 2006	December 31, 2005	June 30, 2005
	(Unaudited)	(Audited)	(Unaudited)
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current liabilities:			
Notes payable to banks	\$ 11,057	\$ 12,633	\$ 8,419
Trade accounts payable	2,294	2,639	2,874
Accrued interest payable	779	1,140	847
Accrued litigation settlement	26,899	549	1,791
Accrued liabilities	8,755	13,476	11,177
Current maturities of long-term debt	53,077	41,740	25,068
Total current liabilities	102,861	72,177	50,176
Long-term debt	119,410	135,709	138,660
Deferred income taxes	19,649	19,010	15,872
Other liabilities	4,646	2,882	3,463
Total liabilities	246,566	229,778	208,171
Minority interests	2,829	11,766	11,250
Commitments and contingencies			
Shareholders' equity			
Common stock, \$0.0001 par value-10,000,000 shares authorized; 26,637.50, 26,637.50 and 28,247.66 issued; 25,286.35, 25,827.35 and 27,522.51 outstanding	--	--	--
Additional paid-in capital	16,586	16,586	21,406
Retained earnings	11,913	18,036	14,643
Accumulated other comprehensive income	933	1,890	1,633
Treasury stock, 1,351.15, 810.15, and 725.15 shares, at cost	(3,660)	(2,540)	(2,336)
Total shareholders' equity	25,772	33,972	35,346
Total liabilities and shareholders' equity	\$ 275,167	\$ 275,516	\$ 254,767

See accompanying Notes to Condensed Consolidated Financial Statements.

LYNCH INTERACTIVE CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(in thousands, except per share data)

	Three Months Ended		Six Months Ended	
	June 30,		June 30	
	2006	2005	2006	2005
Revenues	\$ 24,667	\$ 22,471	\$ 49,755	\$ 44,089
Costs and expenses:				
Cost of revenue, excluding depreciation	8,865	8,095	17,333	15,746
General and administrative costs at operations	3,675	3,343	7,577	6,766
Corporate office expenses	765	1,136	1,680	2,026
False Claims Act litigation and settlement	26,443	1,607	27,596	2,808
Depreciation and amortization	5,629	5,346	11,361	10,541
Total Expense	<u>45,377</u>	<u>19,527</u>	<u>65,547</u>	<u>37,887</u>
Operating profit (loss)	(20,710)	2,944	(15,792)	6,202
Other income (expense):				
Investment income	493	191	1,392	984
Interest expense	(3,599)	(2,949)	(7,131)	(5,772)
Equity in earnings of affiliated companies	900	841	1,792	1,552
Gains on sale of investments and other assets	10,527	--	12,353	--
	<u>8,321</u>	<u>(1,917)</u>	<u>8,406</u>	<u>(3,236)</u>
Income (loss) before income taxes and minority	(12,389)	1,027	(7,386)	2,966
Income tax (provision) benefit	3,841	(330)	2023	(1,097)
Minority interests	(388)	(484)	(760)	(961)
Net income (loss)	<u>\$ (8,936)</u>	<u>\$ 213</u>	<u>\$ (6,123)</u>	<u>\$ 908</u>
Basic and diluted weighted average shares	25,388.85	27,522.51	25,518.64	27,530.65
Basic and diluted earnings (loss) per share	\$ (351.97)	\$ 7.74	\$ (239.94)	\$ 32.98

See accompanying Notes to Condensed Consolidated Financial Statements.

LYNCH INTERACTIVE CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(Unaudited)
(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 December 31, 2005	25,827.35	\$ 0	\$ 16,586	\$ 18,036	\$ 1,890	\$ (2,540)	\$ 33,972
Net income for the period	--	--	--	(6,123)	--	--	(6,123)
Unrealized gain on available for sale securities, net	--	--	--	--	272	--	272
Reclass adjustment Comprehensive income					(1,229)		(1,229)
Purchase of Treasury Stock	(541,00)	--	--	--	--	(1,120)	(1,120)
Balance at June 30, 2006	25,286.35	\$ 0	\$ 16,586	\$ 11,913	\$ 933	\$ (3,660)	\$25,772

See accompanying Notes to Condensed Consolidated Financial Statements.

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

	Six Months Ended	
	June 30,	
	2006	2005
Operating activities:		
Net income (loss)	\$ (6,123)	\$ 908
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	11,361	10,541
Equity in earnings of affiliated companies	(1,792)	(1,552)
Distributions received from affiliated companies	1,059	2,973
Gains on sale of investments and other assests	(12,353)	---
Minority interests	760	961
Changes in operating assets and liabilities:		
Receivables	(317)	5
Accounts payable and accrued liabilities	(5,336)	(2,288)
Accrued litigation and settlement costs	26,350	453
Other	(1,859)	(286)
Net cash provided by operating activities	11,750	11,715
Investing activities:		
Capital expenditures	(5,980)	(4,205)
Acquisition of businesses	(9,373)	(3,594)
Proceeds from sale of investments and other assets	16,160	---
Acquisition of spectrum	---	(500)
Proceeds from the sale of an affiliate	3,429	---
Other	110	155
Net cash provided by (used in) investing activities	4,346	(8,144)
Financing activities:		
Proceeds from the issuance of long term debt	9,906	2,412
Repayments of long term debt	(8,364)	(7,650)
Net proceeds (repayment) on lines of credit	(1,576)	3,626
Purchase of treasury stock	(1,120)	(179)
Distributions to partners	(490)	(1,253)
Net cash used in financing activities	(1,644)	(3,044)
Net increase in cash and cash equivalents	14,452	527
Cash and cash equivalents at beginning of period	32,001	27,214
Cash and cash equivalents at end of period	\$ 46,453	\$ 27,741
Cash paid for:		
Interest expense	\$ 7,007	\$ 5,669
Income taxes	\$ 1,497	\$ 1,353

See accompanying Notes to Condensed Consolidated Financial Statements.

LYNCH INTERACTIVE CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

A. Basis of Presentation

Lynch Interactive Corporation (“Interactive” or the “Company”) consolidates the operating results of its subsidiaries (81%-100% owned at June 30, 2006, December 31, 2005 and June 30, 2005). 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 management decisions, 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 at June 30, 2006, December 31, 2005 and June 30, 2005), Capital Communications Company, Inc. (49% owned at June 30, 2006, December 31, 2005 and June 30, 2005; we note, however, that Interactive owns a convertible preferred stock which, if converted, would increase its ownership in Capital Communications to 50%), two cellular partnership operations in New Mexico (both 33% owned at June 30, 2006, December 31, 2005 and June 30, 2005), cellular partnership in California (25% owned at June 30, 2006 and December 31, 2005), KMG Holdings Group (37% owned since May 2004, 100% owned since January 2006) and telecommunications operations in North Dakota, Iowa and New York (5% to 14% owned).

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information. Accordingly, they are not audited and do not include all of the information and footnotes required for complete financial statements. These consolidated financial statements and footnotes should be read in conjunction with the consolidated financial statements and notes thereto included in the Company’s annual report for the year ended December 31, 2005. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and six month periods ended June 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. 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 affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

B. Recently Issued Accounting Pronouncements

No new accounting standards were issued during the quarter which are expected to impact the Company.

C. Acquisitions and Dispositions

On January 11, 2006, the Company acquired the 17% minority interest in Lynch Telephone Corporation from the management of Western New Mexico Telephone Company Inc. To effectuate the transaction, the Company acquired the remaining 63% interest in an entity (KMG) that it had previously acquired a 37% interest in April 2004. KMG’s principal asset consists of a \$6.0 million subordinated note and the 17% equity interest in Lynch Telephone Corporation. The Company issued \$9.4 million of 8.0% five-year subordinated notes to acquire such interest. The preliminary allocation of the purchase price includes \$0.6 million to goodwill and intangible assets, which is not expected to be deductible for income tax purposes.

On February 16, 2006, Cal-Ore completed the sale of its 17% interest in a cellular partnership. The sale was anticipated in the purchase price allocation.

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.

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.

D. 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 three and six months ended June 30, 2006 and 2005 and as of December 31, 2005, is as follows:

	Broadcasting Combined		
	June 30, 2006	December 31, 2005	June 30, 2005
	<i>(in thousands)</i>		
Current assets	\$ 3,681	\$ 4,075	\$ 4,183
Property, plant & equipment, intangibles & other	10,108	10,905	10,463
Total Assets	\$ 13,789	\$ 14,980	\$ 14,646
Current liabilities	\$ 2,473	\$ 12,254	\$ 2,256
Long term liabilities	16,821	7,397	16,231
Equity	(5,505)	(4,671)	(3,841)
Total liabilities & equity	\$ 13,789	\$ 14,980	\$ 14,646
<u>Three Months Ended</u>			
Revenues	\$ 3,030		\$ 2,972
Gross profit	893		807
Net income	(199)		(72)
<u>Six Months Ended</u>			
Revenues	\$ 6,065		\$ 6,028
Gross profit	1,754		1,557
Net income	(465)		(171)

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 June 30, 2006, December 31, 2005 and June 30, 2005, the investment in Coronet was carried at a negative \$0.8 million, \$0.7 million and \$0.6 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 June 30, 2006, totaled \$9.6 million payable quarterly through December 31, 2010 to a third party lender.

At June 30, 2006, December 31, 2005 and June 30, 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 three and six months ended June 30, 2006 and 2005 and as of December 31, 2005 is as follows (in thousands):

	Telecommunications Combined		
	June 30, 2006	December 31, 2005	June 30, 2005
	<i>(in thousands)</i>		
Current assets	\$ 16,636	\$ 25,327	\$ 33,256
Property, plant & equipment, intangibles & other	40,074	45,242	34,900
Total Assets	\$ 56,710	\$ 70,569	\$ 68,156
Current liabilities	\$ 8,256	\$ 8,638	\$ 22,941
Long term liabilities	7,452	4,926	6,002
Equity	41,002	57,005	39,213
Total liabilities & equity	\$ 56,710	\$ 70,569	\$ 68,156
<u>Three Months Ended</u>			
Revenues	\$ 17,963		\$ 15,229
Gross profit	8,339		6,920
Net income	4,232		4,005
<u>Six Months Ended</u>			
Revenues	\$ 34,116		\$ 29,998
Gross Profit	16,301		13,406
Net Income	8,615		7,645

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 \$5.4 million, \$4.8 million and \$4.9 million at June 30, 2006, December 31, 2005 and June 30, 2005, respectively and included in Investment in and advances to affiliated entities.

As part of the August 29, 2005 acquisition of Cal-Ore, Interactive owns a 25% partnership interest in a cellular telephone provider in northern California, California RSA #2. As of June 30, 2006, 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 which was sold in February 2006 (See Note C).

E. Indebtedness

Borrowings under the Company's \$10 million short-term line of credit facility, were \$7.2 million, \$8.3 million and \$4.3 at June 30, 2006, December 31, 2005 and June 30, 2005, respectively. In order to finance the July 2006 settlement of the Federal False Claim Act litigation, see Note I, such line of credit was increased from \$10 million to \$30 million. The expansion of the line was supported by a letter of credit by the Company's Chairman of The Board. The entire line expires on December 15, 2006. In addition, Interactive has a margin loan secured by its investments in available-for-sale securities of \$0.5 million and \$1.3 million at June 30, 2006 and December 31, 2005, respectively. Borrowing under both the line of credit facility and the margin loan are included in Notes payable to banks. Long-term debt consists of (all interest rates are at June 30, 2006) (in thousands):

	June 30, 2006	December 31, 2005	June 30, 2005
Rural Electrification Administration (“REA”) and Rural Telephone Bank (“RTB”) notes payable due quarterly through 2027 at fixed interest rates ranging from 2% to 7.5%. (5.1% weighted average, secured by assets of the telephone companies with a net book value of \$150 million)	\$ 49,957	\$ 52,018	\$ 55,211
Bank Credit facilities utilized by certain telephone and telephone holding companies due through 2017, \$4.1 million at fixed interest rates averaging 8.4% and \$69.2 million at variable interest rates averaging 8.4%.	73,261	77,775	68,347
Unsecured notes issued in connection with acquisitions through 2011, at fixed interest rates averaging 8.9%	46,964	45,619	38,419
Other	2,305	2,037	1,751
	172,487	177,449	163,728
Current maturities	(53,077)	(41,740)	(25,068)
	<u>\$ 119,410</u>	<u>\$ 135,709</u>	<u>\$ 138,660</u>

In January 2006, the Company issued \$9.4 million of 8.0% five-year subordinated notes to acquire the remaining 63% interest in KMG (see Note C). In addition, a \$6.0 million subordinated note owed to KMG prior to the acquisition was eliminated.

F. Gains on sales of investments and other assets

The Budget for Fiscal Year 2006 for the United States of America established the process and terms to implement the dissolution of the Rural Telephone Bank (“RTB”). In the second quarter of 2006, on dissolution, the holders of its Class B and Class C stock were paid the par value of their stock, which totaled \$13.7 million and a pre-tax gain of \$10.5 million was recorded. Some portion of the gain, while not estimable at this time, may be subject to review by regulatory authorities who may require us to record a portion thereof as a regulatory liability.

In the 2006 six month period, the Company sold shares of Hector Communications for proceeds of \$2.5 million, resulting in a pre-tax gain of \$1.9 million.

G. Comprehensive Income

Other comprehensive income, net of tax, which consists of unrealized gains (losses) on available for sale securities, as of June 30, 2006 and 2005 are as follows (in thousands):

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2006	2005	2006	2005
Net income (loss)	\$ (8,936)	\$ 213	\$ (6,123)	\$ 908
Unrealized gains - pre tax	289	209	432	69
Unrealized gains - tax effect	(110)	(71)	(160)	(24)
Reclassification adjustment - pre tax	(36)	---	(1,862)	---
Reclassification adjustment - tax effect	11	---	633	---
Net other comprehensive income	154	138	(957)	45
Comprehensive income	\$ (8,782)	\$ 351	\$ (7,080)	\$ 953

H. Treasury Stock Purchases

During the six months ended June 30, 2006, the Company purchased 541 shares of its common stock for treasury at an average investment of \$2,072 per share.

I. Litigation

False Claims Act Litigation.

Interactive and several other parties, including Interactive's Chairman of the Board, were sued in a civil action originally brought by Rufus C. Taylor III (the "Relator") under the "qui tam" provisions of the federal False Claims Act in 2001. The complaint alleged that the defendants defrauded the United States Government (the "Government") by creating "sham" bidding entities to participate in certain Federal Communications Commission ("FCC") spectrum auctions restricted to small businesses and unfairly obtained bidding credits and favorable government financing in these and other spectrum auctions in the mid and late 1990's.

In March 2006, the United States Department of Justice ("DOJ") reversed its earlier 2001 decision not to intervene in the case and petitioned the federal courts to be allowed to intervene on the side of the Relator. In May 2006, a tentative settlement was reached pursuant to which the defendants agreed to pay the Government \$130 million, plus \$9 million to Relator's counsel as legal fees and expenses. In June 2006, the defendants reached a tentative agreement allocating the above-mentioned settlement amounts among themselves and, in July 2006, the definitive settlement agreements with the Government and the Relator were signed and approved by the federal judge hearing the case.

Interactive's share of the litigation and settlement amounted to approximately \$35 million of which \$10 million has been recorded as litigation costs, primarily over the period from 2004 through the settlement date. The incremental \$25 million has been paid from internal funds (\$5 million) and borrowings under Interactive's increased line of credit (\$20 million). In entering into the settlement agreements Interactive admitted no liability and the conduct giving rise to the case is expressly excluded as a basis for future administrative proceedings by the FCC.

The entire line of credit expires on December 15, 2006 and Interactive expects to re-finance such line through either (i) other financing transactions or (ii) sales of assets, or both.

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.

J. Related Party Transactions

At June 30, 2006, December 31, 2005, and June 30, 2005, assets of \$34.4 million, \$23.3 million and \$20.8 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 CEO serve as investment managers to the respective funds.

K. Subsequent Events

In July 2006, the Company acquired the 19% minority interest in its Wisconsin operations by paying \$0.25 million in cash and issuing \$0.75 million in 7.5% five-year notes to the sellers.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This discussion should be read together with the Consolidated Financial Statements of Interactive and the notes thereto.

RESULTS OF OPERATIONS

Overview

Interactive has grown primarily through the selective acquisition of rural local exchange carriers ("RLECs") and by offering additional services such as Internet service, alarm services, long distance service and competitive local exchange carrier ("CLEC") service. From 1989 through the current reporting period, Interactive (and its predecessor corporation) acquired fifteen telephone companies, whose operations range in size from approximately 800 to over 10,000 access lines. The Company's telephone operations are located in California, Iowa, Kansas, Michigan, New Hampshire, New Mexico, New York, North Dakota, Utah and Wisconsin.

The telecommunications industry in general and the RLECs that comprise Interactive's business face a number of economic or industry-wide issues and challenges.

- Regulatory- The Telecommunications Act of 1996 and other federal and state legislation and regulations have a significant impact on the industry and on rural carriers in particular. Interactive's telephone companies are all RLECs serving very high cost areas with a significant portion of their revenues being derived from federal or state support mechanisms, which are referred to as Universal Service Funds ("USF"). The revenues and margins of our RLEC subsidiaries are largely dependent on the continuation of such support mechanisms.
- Competition- The effects of competition from CLECs, wireless service, high speed cable, Voice Over Internet Protocol ("VoIP") and other internet providers is an industry-wide issue that is felt to varying degrees by our rural telephone companies.
- The economy- Unemployment, building starts, business bankruptcies and the overall health of the economy have a significant effect on demand for our services.
- Telecommunication bankruptcies- Interactive's telephone companies have significant, normal course of business receivables from interexchange carriers, such as MCI or Global Crossings who filed for bankruptcy and, as a result, have been written-off. Additional bankruptcies could have a significant effect on our financial condition. The Company recovered settlements from MCI in 2005.
- Market challenges- Our phone companies are required to comply with industry-wide initiatives such as local number portability and the requirements of the Communications Assistance for Law Enforcement Act ("CALEA") that are expensive to implement and that in some cases have limited demand in our markets.

Interactive generates cash and earns telecommunications revenues primarily from local network access, intrastate and interstate access revenue and from state and federal USF support mechanisms. Due to the

nature of the Company's regulated telephone operations, revenues and operating expenses are relatively stable period to period.

- Local Revenues - The number of access lines is the primary driver of local network access revenues. In addition, the ratio of business to residential lines, as well as the number of features subscribed to by customers are secondary drivers.
- Intrastate access revenues - Customer usage, primarily based on minutes of use, and the number of access lines are the primary drivers of intrastate access revenues since the Company's RLECs are on a "bill-and-keep" basis.
- National Exchange Carrier Association ("NECA") revenues - All of our RLECs participate in the NECA access pools. Interstate access revenues depend upon whether the RLEC has elected to be "cost-based" or has remained an "average schedule" carrier. The revenues of our ten cost-based carriers directly correlate to the rate-of-return on regulated net investment earned by the NECA access pools plus the amount of regulated operating expenses including taxes. The revenues of the Company's five average schedule subsidiaries correlate to usage based measurements such as access lines, interstate minutes-of-use, and the number and mileage of different types of circuits. The average schedule formulas are intended to be a proxy for cost-based recovery.
- USF subsidies - The primary drivers of USF subsidies are investments in specific types of infrastructure, as well as certain operating expenses and taxes of the Company. Interstate and intrastate USF subsidies are included in the respective interstate and intrastate access revenue captions in the breakdown of revenue and operating expenses which follows.
- Other business revenue - Interactive's companies also provide non-regulated telecommunications related services, including Internet access service, wireless and long distance resale service, in certain of its telephone service and adjacent areas. Interactive also provides and intends to provide more local telephone and other telecommunications service outside certain of its franchise areas by establishing CLEC or high speed data operations in selected nearby areas. In addition, certain of Interactive's companies have expanded into cable and security businesses in the areas in which they operate.
- Long Distance revenues are only retained by the Company if it is providing the long distance service to the end user customer as the toll provider. For unaffiliated IXCs who contract with Interactive for billing services, the Company provides billing services and receives an administrative handling fee.

The following are material opportunities, challenges and risks that Interactive's executives are currently focused on, as well as actions that are being taken to address the concerns:

- Universal Service Reform - The Federal-State Joint Board on Universal Service ("Joint Board") and the FCC have been considering several potential changes to USF support mechanisms for the last few years. This includes, but is not limited to, the method of how USF contributions would be collected. The Company participates with the RLEC industry in comments to the FCC regarding the potential impact to customers and RLECs in rural America due to changes to USF support mechanisms. Total USF support payments are material to the Company's financial results.
- Intercarrier Compensation and Access Charge Reform - The Company is actively participating in the RLEC industry's efforts to determine how intercarrier compensation and access charges should be modified without causing revenue losses for RLECs.
- Loss of Access Revenues from VoIP and wireless usage - The Company is experiencing revenue losses as usage transfers from landline service provided by the Company's subsidiaries to either VoIP or wireless services. VoIP traffic currently does not pay access charges or contribute to universal service. The FCC has several proceedings underway to

determine whether VoIP traffic should contribute for the use of the network and contribute to USF. The Company is participating in the RLEC industry efforts to have VoIP traffic contribute for use of the underlying network on which the VoIP call travels. To offset revenue losses from traditional voice services, Interactive is installing more broadband services and is exploring how to best incorporate VoIP into its business model.

- Intrastate revenue at our Michigan telephone company has been adversely affected by a state requirement to expand the local calling area. The Company filed and received approval in 2005 from the state commission to recover a portion of the revenue deficiency resulting from this change.

Settlement of Federal False Claims Act Litigation

In July, we, along with the other defendants, reached a settlement with the United States Government and Mr. Taylor regarding the False Claims Act litigation (See Note I and the Liquidity Section below).

Second quarter ended June 30, 2006 compared to 2005

The following is a breakdown of revenues and operating costs and expenses (in thousands):

	Three months ended June 30,		Increase (Decrease)
	2006	2005	
	(Unaudited)		
Revenues:			
Local access	\$ 3,297	\$ 2,986	\$ 311
Interstate access	11,451	10,237	1,214
Intrastate access	3,887	3,478	409
Other business	6,032	5,770	262
Total	24,667	22,471	2,196
Operating Cost and Expense:			
Cost of revenue, excluding depreciation	8,865	8,095	770
General and administrative costs at operations	3,675	3,343	332
Corporate office expenses	765	1,136	(371)
False Claims Act litigation and settlement	26,443	1,607	24,836
Depreciation and amortization	5,629	5,346	283
Total	45,377	19,527	25,850
Operating profit	\$ (20,710)	\$ 2,944	\$ (23,654)

Total revenues in 2006 increased \$2.2 million, or 9.8%, to \$24.7 million compared to \$22.5 million in 2005. The inclusion of Cal-Ore in 2006 added \$1.7 million to revenue, including \$0.2 million local access, \$0.8 million interstate access, \$0.3 million intrastate access and \$0.4 million other business. The following explanations do not include the contributions to revenue from Cal-Ore. Local access revenue was relatively unchanged resulting from a decrease in access lines (June 30, 2006 compared to June 30, 2005 down 2.3%) offset by the sale of additional services and features. The decrease in access lines is due to the increase in cell phone usage and reduction in second lines as customers switch from dial-up internet service to DSL. Interstate access revenue increased \$0.4 million in 2006 primarily due to a temporary increase in customer traffic in Utah. In addition, infrastructure development undertaken in 2002 and 2003, entitled the Company to increased network access primarily at the Haviland Telephone Company in Kansas. Intrastate network access revenue increased \$0.2 million due to a loss of toll revenue for dial-up access to the internet at our Michigan telephone company, the gradual phase-out of a New York pool for small carriers, and a reduction of minutes of use at several of our companies. Other business revenues decreased \$0.1 million due to the sale of alarm customers in 2005 offset by increased revenues from a March 2005 acquisition of cable television assets, as well as increased DSL penetration.

Total costs and expenses increased by \$25.9 million to \$45.4 million in 2006 primarily due to False Claims Act litigation and settlement costs of \$26.4 million in 2006 compared to \$1.6 million in litigation costs in 2005. The inclusion of Cal-Ore in 2006 added \$1.3 million to cost, including \$0.5 million in cost of revenue, \$0.3 million of General and Administrative costs and \$0.5 million of depreciation. The following explanations do not include the contributions to expense from Cal-Ore. Costs of revenue increased \$0.3 million, or 3.9%, primarily due to costs generated by growth in the cable television operations that were acquired in March 2005. General and administrative costs incurred at the operations were relatively unchanged. Corporate office expenses decreased \$0.4 million primarily due to 2005 expenses relating to going dark. Depreciation and amortization was unchanged.

As a result of the above, operating profit in 2006 decreased by \$23.7 million to a loss of \$20.7 million compared to 2005.

Adjusted operating profit

Adjusted operating profit is used by our management as a supplemental financial measure to evaluate the operating performance of our business that, when viewed with our GAAP results and the accompanying reconciliations, we believe provides a more complete understanding of factors and trends affecting our business than the GAAP results alone. We also regularly communicate our adjusted operating profit to the public through our earnings releases because it is the financial measure commonly used by analysts that cover the telecommunications industry and our investor base to evaluate our operating performance. In addition, we routinely use adjusted operating profit as a metric for valuing potential acquisitions. We understand that analysts and investors regularly rely on non-GAAP financial measures, such as adjusted operating profit, to provide a financial measure by which to compare a company's assessment of its operating performance against that of other companies in the same industry. This non-GAAP financial measure is helpful in more clearly reflecting the sales of our products and services, as well as highlighting trends in our core business that may not otherwise be apparent when relying solely on GAAP financial measures, because this non-GAAP financial measure eliminates from earnings financial items that have less bearing on our performance.

Interactive's management believes strongly in growing intrinsic value as a long-term prescription for managing an enterprises health. Our local management teams run their respective businesses as stand-alone, entrepreneurial units. We believe that adjusted operating profit is the clearest indicator of the cash flow generating ability and long-term health of such units. We value potential acquisitions on the same basis.

The term "adjusted operating profit" refers to, for any period, net income (loss) before all components of "Other income (expense)" (consisting of investment income, interest expense, equity in earnings of affiliates, gains and losses on disposition of or impairment of assets), income taxes, depreciation, amortization, minority interests and income or loss from discontinued operations.

Set forth below are descriptions of the financial items that have been excluded from net income (loss) to calculate adjusted operating profit and the material limitations associated with using this non-GAAP financial measure as compared to the use of the most directly comparable GAAP financial measure:

- The amount of interest expense we incur is significant and reduces the amount of funds otherwise available to use in our business and, therefore, is important for investors to consider. However, management does not consider the amount of interest expense when evaluating our core operating performance.
- Investment income is considered to be similar to interest expense. Although it is important for investors to consider, management does not consider the amount of investment income when evaluating our core operating performance.
- Management does not consider income tax expense when considering the profitability of our core operations. Nevertheless, the amount of taxes we are required to pay reduces the amount of funds otherwise available for use in our business and thus may be useful for an investor to consider.
- Depreciation and amortization are important for investors to consider, even though they are non-cash charges, because they represent generally the wear and tear on our property, plant and equipment, which produce our revenue. We do not believe these charges are indicative of our core operating performance.
- Income from equity investments relates to our proportionate share of income or loss from the entities in which we hold minority interests. We do not control these entities and, as such, do not believe the income we receive from such entities is indicative of our core operating performance.
- Minority interest in (income) loss of subsidiaries relates to our minority investors' proportionate share of income or losses in our non-wholly owned subsidiaries, which generated non-cash charges to our operating results. Operating results attributable to these minority investors' investments do not necessarily result in any actual benefit or detriment to us and, therefore, we believe it would be more helpful for an investor to exclude such items as being more reflective of our core operating performance.
- Gain or losses on the disposition of assets or impairment of investments may increase or decrease the cash available to us and thus may be important for an investor to consider. We are not in the business of acquiring or disposing of assets and, therefore, the effect of the dispositions of assets may not be comparable from year-to-year. We believe such gains or losses recorded on the disposition of an asset do not reflect the core operating performance of our business.

Management compensates for the above-described limitations of using a non-GAAP financial measure by using this non-GAAP financial measure only to supplement our GAAP results to provide a more complete understanding of the factors and trends affecting our business. Adjusted operating profit should not be considered to be a substitute for net income or (loss) as an indicator of the Company's operating performance.

The following table provides the components of Adjusted Operating Profit and reconciles it to net income:

	Three months ended June 30,		Increase (Decrease)
	2006	2005	
Adjusted operating profit from:			
Operating units	\$ 12,127	\$ 11,033	\$ 1,094
Corporate expense:			
False Claims Act litigation and settlement	(26,443)	(1,607)	(24,836)
Other	(765)	(1,136)	371
Total corporate expenses	(27,208)	(2,743)	(24,465)
Adjusted operating profit (loss)	\$ (15,081)	\$ 8,290	\$ (23,371)
Reconciliation to net income:			
Adjusted operating profit (loss)	\$ (15,081)	\$ 8,290	\$ (23,371)
Depreciation and amortization	(5,629)	(5,346)	(283)
Investment income	493	191	302
Interest expense	(3,599)	(2,949)	(650)
Equity in income of affiliates	900	841	59
Gain on sale of investments and other assets	10,527	-	10,527
Income tax	3,841	(330)	4,171
Minority interests	(388)	(484)	96
Net income	\$ (8,936)	\$ 213	\$ (9,149)

Other Income (Expense)

In 2006, investment income increased by \$0.3 million primarily due to higher cash balances.

Interest expense increased by \$0.7 million in 2006 compared to 2005 due primarily to the debt issued in conjunction with the Cal-Ore acquisition, higher borrowings on the Corporate line of credit, higher interest rates on variable rate borrowings, and partly offset by scheduled debt repayments.

Equity in earnings of affiliates in 2006 was relatively unchanged due to consistent high earnings at the Company's New Mexico cellular investments (RSA 3 and 5).

In 2006, the Company recognized a gain of \$10.5 million from the dissolution of the RTB.

Income Tax Provision

The income tax provision includes federal, as well as state and local taxes. The tax provision for 2006 and 2005, represent effective tax rates of 30.1% and 45.1%, respectively. The difference between these effective rates and the federal statutory rate is principally due to state income taxes, including the effect of earnings attributable to different state jurisdictions.

Minority Interests

Minority interests decreased earnings by \$0.4 million in 2006, as compared to \$0.5 million in 2005.

Net Income

Net loss in the second quarter of 2006, was \$8.9 million, or \$351.97 per share (basic and diluted), compared to net income last year of \$0.2 million, or \$7.74 per share (basic and diluted). The Company has no dilutive instruments outstanding.

Six months ended June 30, 2006 compared to 2005

The following is a breakdown of revenues and operating costs and expenses (in thousands):

	<u>Six months ended June 30,</u>		<u>Increase (Decrease)</u>
	<u>2006</u>	<u>2005</u>	
	(Unaudited)		
Revenues:			
Local access	\$ 6,505	\$ 5,844	\$ 661
Interstate access	23,041	19,932	3,109
Intrastate access	7,391	7,175	216
Other business	12,818	11,138	1,680
Total	<u>49,755</u>	<u>44,089</u>	<u>5,666</u>
Operating Cost and Expense:			
Cost of revenue, excluding depreciation	17,333	15,746	1,587
General and administrative costs at operations	7,577	6,766	811
Corporate office expenses	1,680	2,026	(346)
False Claims Act litigation and settlement	27,596	2,808	24,788
Depreciation and amortization	11,361	10,541	820
Total	<u>65,547</u>	<u>37,887</u>	<u>27,660</u>
Operating profit (loss)	<u>\$ (15,792)</u>	<u>\$ 6,202</u>	<u>\$ (21,994)</u>

Total revenues in 2006 increased \$5.7 million, or 12.9%, to \$49.8 million compared to \$44.1 million in 2005. The inclusion of Cal-Ore in 2006 added \$3.5 million to revenue, including \$0.4 million local access, \$1.8 million interstate access, \$0.7 million intrastate access and \$0.7 million other business. The following explanations do not include the contributions to revenue from Cal-Ore. Local access revenue increased \$0.3 decrease in access lines offset (June 30, 2006 compared to June 30, 2005 down 2.3%) by the sale of additional services and features. The decrease in access lines is due to the increase in cell phone usage and reduction in second lines as customers switch from dial-up internet service to DSL. Interstate access revenue increased \$1.3 million in 2006 primarily due to a temporary increase in customer traffic in Utah. In addition, infrastructure development undertaken in 2002 and 2003, entitled the Company to increased network access primarily at the Haviland Telephone Company in Kansas. Intrastate network access revenue decreased \$0.5 million due to a loss of toll revenue for dial-up access to the internet at our Michigan telephone company, the gradual phase-out of a New York pool for small carriers, and a reduction of minutes of use at several of our companies. Other business revenues increased \$1.0 million primarily due to the recognition of \$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 sale of such licenses. In addition, increased revenues from a March 2005 acquisition of cable television assets, as well as increased DSL penetration was offset by the reduction in alarm revenue due to the sale of alarm customers in 2005.

Total costs and expenses increased by \$25.0 million to \$65.5 million in 2006 primarily due to the False Claims Act litigation and settlement costs of \$27.6 million in 2006 compared to \$2.8 million of litigation costs in 2005. The inclusion of Cal-Ore in 2006 added \$2.7 million to cost, including \$0.9 million in cost of revenue, \$0.7 million of General and Administrative costs and \$1.0 million of depreciation. The following explanations do not include the contributions to expense from Cal-Ore. Costs of revenue increased \$0.6 million, or 4.1%, primarily due to costs generated by growth in the cable television operations that were acquired in March 2005. General and administrative costs incurred at the operations increased \$0.1 million. Corporate office expenses decreased \$0.3 million. Depreciation and amortization decreased \$0.3 million.

As a result of the above, operating profit in 2006 decreased by \$22.0 million to an operating loss of \$15.8 million compared to 2005.

Adjusted operating profit

The following table provides the components of Adjusted Operating Profit and reconciles it to net income:

	<u>Six months ended June 30,</u>		<u>Increase</u>
	<u>2006</u>	<u>2005</u>	<u>(Decrease)</u>
Adjusted operating profit from:			
Operating units	\$ 24,845	\$ 21,577	\$ 3,268
Corporate expense:			
False Claims Act litigation and settlement	(27,596)	(2,808)	(24,788)
Other	(1,680)	(2,026)	346
Total corporate expenses	(29,276)	(4,834)	(24,442)
Adjusted operating profit (loss)	<u>\$ (4,431)</u>	<u>\$ 16,743</u>	<u>\$ (21,174)</u>
Reconciliation to net income:			
Adjusted operating profit (loss)	\$ (4,431)	\$ 16,743	\$ (21,174)
Depreciation and amortization	(11,361)	(10,541)	(820)
Investment income	1,392	984	408
Interest expense	(7,131)	(5,772)	(1,359)
Equity in income of affiliates	1,792	1,552	240
Gain on sale of marketable securities	12,353	-	12,353
Income tax	2,023	(1,097)	3,120
Minority interests	(760)	(961)	201
Net income	<u>\$ (6,123)</u>	<u>\$ 908</u>	<u>\$ (7,031)</u>

Other Income (Expense)

In 2006, investment income increased by \$0.4 million primarily due to higher cash balances. The 2005 period included a \$0.1 million one time dividend from Iowa Network services.

Interest expense increased by \$1.4 million in 2006 compared to 2005 due primarily to the debt issued in conjunction with the Cal-Ore acquisition, higher borrowings on the Corporate line of credit, higher interest rates on variable rate borrowings, and partly offset by scheduled debt repayments.

Equity in earnings of affiliates in 2006 increased by \$0.2 million due to higher earnings at the Company's New Mexico cellular investments (RSA 3 and 5).

In 2006, the Company recognized a gain of \$10.5 million from the dissolution of the RTB. Some portion of the gain may be subject to review by regulatory authorities who may require us to record a portion thereof as a regulatory liability.

In the 2006 period, the Company sold 85,000 shares of the common stock of Hector Communications for \$2.4 million, resulting in a pre-tax gain of approximately \$1.8 million.

Income Tax Provision

The income tax provision includes federal, as well as state and local taxes. The tax provision for 2006 and 2005, represent effective tax rates of 25.0% and 45.5%, respectively. The difference between these effective rates and the federal statutory rate is principally due to state income taxes, including the effect of earnings attributable to different state jurisdictions.

Minority Interests

Minority interests decreased earnings by \$0.8 million in 2006, as compared to \$1.0 million in 2005.

Net Income

The net loss in the second quarter of 2006, was \$6.1 million, or \$239.94 per share (basic and diluted), compared to net income last year of \$0.9 million, or \$32.79 per share (basic and diluted). The Company has no dilutive instruments outstanding.

LIQUIDITY AND CAPITAL RESOURCES

Liquidity

The debt at each of Interactive's subsidiary companies contains restrictions on the amount of funds that can be transferred to their respective parent companies. Lynch Interactive Corporation, the parent company ("Parent Company") needs cash primarily to pay corporate expenses including the Federal False Claims Act litigation, federal income taxes and to invest in new opportunities, including spectrum licenses. The Parent Company receives cash to meet its obligations primarily through management fees charged to its subsidiaries, a tax sharing agreement with its subsidiaries, usage of a line of credit facility, and has obtained additional liquidity by refinancing certain subsidiary debt. In addition, the Parent Company considers various alternative long-term financing sources: debt, equity, or sale of investments and other assets.

As discussed in Note I, Litigation, the Company and other named defendants, including related parties, settled the Federal False Claims Act litigation case in July 2006. The Company's share of the cost and litigation expenses was approximately \$35 million of which \$10 million had been recorded as litigation costs, primarily over the period from 2004 through the settlement date. The Company funded its incremental outlay of \$25 million from internal sources and by borrowing \$20 million under a temporarily expanded short-term line of credit facility. Such facility had a maximum availability of \$10 million, of which \$2.8 million was available on June 30, 2006. The \$20 million increase in such line was supported by a letter of credit by our Chairman. The entire line bears interest at the prime rate and expires on December 15, 2006. In order to pay off such \$20 million short term loans and to fund long-term growth initiatives the Company is exploring its options including the sale of assets, the restructuring of existing debt and issuing equity. 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.

In addition to the short term line of credit facility, the Parent Company maintains a margin account secured by its holdings of Hector stock of which \$0.5 million was outstanding at June 30, 2006. At June 30, 2006, the Company has a \$42.8 million working capital deficiency primarily due to the \$53.1 million of debt maturing in the next twelve months. The Company is in the process of renegotiating or refinancing \$40.3 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.

The Company's RLECs and other businesses need cash to fund their current operations, as well as future long-term growth initiatives. Each RLEC and other business finances its cash needs with cash generated from operations, by utilizing existing borrowing capacity or by entering into new long-term debt agreements. New business acquisitions are generally financed with a combination of new long-term debt, secured by the acquired assets, as well as cash from the Parent. While management expects that both Parent and the operating subsidiaries will be able 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. The Company is obligated under long-term debt provisions and lease agreements to make certain cash payments over the term of the agreements. The following table summarizes, as of June 30, 2006 for the periods shown, these contractual obligations and certain other financing commitments from banks and other financial institutions that provide liquidity:

	Payments Due by Period (In thousands)				
	Total	Less than 1 year	1 – 3 years	4 – 5 years	After 5 years
Long-term debt (a)	\$ 172,487	\$ 53,077	\$ 33,073	\$ 41,118	\$ 45,219
Operating leases	1,038	305	402	231	100
Notes payable to banks	11,057	11,057	-	-	-
Guarantees	3,750	-	-	3,750	-
Total contractual cash obligations and commitments	\$188,332	\$64,439	\$33,475	\$45,099	\$45,319

(a) Does not include interest payments on debt.

A subsidiary of the Company has guaranteed \$3.8 million of an equity investees' total debt of \$9.6 million. 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.

At June 30, 2006, total debt (including notes payable to banks) was \$183.5 million, a decrease of \$6.5 million from December 31, 2005. At June 30, 2006, there was \$102.6 million of fixed interest rate debt outstanding averaging 7.0% and \$80.9 million of variable interest rate debt averaging 8.5%. The debt at fixed interest rates includes \$47.0 million of subordinated notes at interest rates averaging 8.9% issued to sellers as part of acquisitions. The long-term debt facilities at certain subsidiaries are secured by substantially all of such subsidiaries assets, while at other subsidiaries it is secured by the common stock of such subsidiaries. In addition, the debt facilities contain certain covenants restricting distribution to Lynch Interactive. At June 30, 2006 substantially all of the subsidiaries' net assets are restricted. Interactive has a high degree of financial leverage. As of June 30, 2006, the ratio of total debt to equity was 7.1 to 1. Certain subsidiaries also have high debt to equity ratios.

As of June 30, 2006, Interactive had current assets of \$60.0 million and current liabilities of \$102.9 million resulting in a working capital deficit of \$42.8 million compared to a deficit of \$27.3 million at December 31, 2005. The deficit in both periods was primarily due to the \$40.3 million of debt maturing in the next twelve months that the Company is in process of renegotiating or refinancing.

Sources and Uses of Cash

Cash at June 30, 2006, was \$46.5 million, an increase of \$14.5 million compared to December 31, 2005 primarily due to the receipt of \$13.7 million from the dissolution of the RTB. In the six months of 2006, net cash provided by operations of \$11.8 million was used to invest in plant and equipment and repay debt. The KMG acquisition in the first quarter of 2006 was financed with new borrowings.

Capital expenditures were \$5.9 million in the six months of 2006 compared to \$4.2 million in the 2005 period, which is predominantly spent at the RLECs and will be included in their rate bases for rate setting purposes. Capital expenditures in 2006 are expected to be approximately \$13 million, most of which will be added to the RLEC rate bases.

The Company has initiated an effort to monetize certain of its assets, including selling a portion or all of its investment in certain of its operating entities and equity investments. These initiatives may include the sale of certain telephone operations where growth opportunities are not readily apparent. There is no assurance that all or any part of this program can be effectuated on acceptable terms.

In May 2006, the Company's Board of Directors increased the shares of the Company's common stock authorized for purchase to 3,000. Through June 30, 2006, 1,351 shares had been purchased at an average investment of \$2,709 per share including 541 shares purchased in 2006 at an average investment of \$2,072 per share.

The Company has not paid any cash dividends since its inception in 1999 and does not expect to pay cash dividends on its common stock in the foreseeable future. Interactive currently intends to retain its earnings, if any, for use in its business. Further financing may limit or prohibit the payment of dividends.