

# ***LICT Corporation***

*Consolidated Financial Statements as of  
December 31, 2006 and 2005 and for the Years  
Ended December 31, 2006, 2005 and 2004  
and Independent Auditors' Report*

# LICT CORPORATION

## TABLE OF CONTENTS

	<b>Page</b>
Independent Auditors' Report	1
Consolidated Financial Statements as of December 31, 2006 and 2005 and for the years ended December 31, 2006, 2005 and 2004:	
Balance Sheets	2
Statements of Income	4
Statements of Changes in Stockholder's Equity	5
Statements of Cash Flows	6
Notes to Consolidated Financial Statements	7 - 19

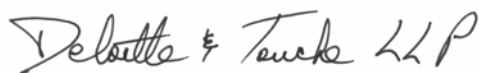
## INDEPENDENT AUDITORS' REPORT

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

We have audited the accompanying consolidated balance sheets of LICT Corporation and subsidiaries (the "Company") as of December 31, 2006 and 2005, and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2006. 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 audits. We did not audit the financial statements of Lynch Telephone North LLC and subsidiaries (consolidated subsidiaries) for the year ended December 31, 2006, which statements reflect total assets and total revenues constituting approximately 8% and 8%, respectively, of the related consolidated totals for that year as well as 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 approximately 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 Lynch Telephone North LLC and subsidiaries for the year ended December 31, 2006 and for Cuba City Telephone Exchange Company and Belmont Telephone Company for the year ended December 31, 2005, is based solely on the report of the other auditors.

We conducted our audits 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 LICT Corporation and subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006 in conformity with accounting principles generally accepted in the United States of America.



May 30, 2007

**LICT CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
*(in thousands)*

	<b>December 31,</b>	
	<b>2005</b>	<b>2006</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 32,001	\$ 41,445
Receivables, less allowances of \$430 and \$523, respectively	9,151	10,517
Material and supplies	2,236	2,505
Prepaid expenses and other current assets	1,517	1,794
Total current assets	44,905	56,261
Property, plant and equipment:		
Land	1,116	1,120
Buildings and improvements	19,687	19,062
Machinery and equipment	232,732	245,312
	253,535	265,494
Accumulated depreciation	(131,066)	(150,498)
	122,469	114,996
Excess of cost over fair value of net assets acquired, net (goodwill)	60,378	64,765
Other intangibles	15,666	9,149
Investments in and advances to affiliated entities	16,255	8,225
Other assets	15,843	10,103
	60,378	64,765
Total assets	\$ 275,516	\$ 263,499

*See accompanying Notes to Consolidated Financial Statements.*

**LICT CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
*(in thousands)*

	<b>December 31,</b>	
	<b>2005</b>	<b>2006</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Notes payable to banks	\$ 12,633	\$ 20,205
Trade accounts payable	2,639	4,017
Accrued interest payable	1,140	649
Accrued liabilities	14,025	14,159
Current maturities of long-term debt	41,740	27,254
Total current liabilities	72,177	66,284
Long-term debt	135,709	146,533
Deferred income taxes	19,010	11,458
Other liabilities	2,882	5,090
Total liabilities	229,778	229,365
Minority interests	11,766	2,191
Commitments and contingencies (Note 10)		
Shareholders' equity		
Common stock, \$0.01 par value-10,000,000 shares authorized; 28,247.66 and 26,637.50 issued; 25,827.35 and 25,210.35 outstanding	-	-
Additional paid-in capital	16,586	16,586
Retained earnings	18,036	19,230
Accumulated other comprehensive income (loss)	1,890	(16)
Treasury stock, 810.15 and 1,427.15 shares, at cost	(2,540)	(3,857)
	33,972	31,943
Total liabilities and shareholders' equity	\$ 275,516	\$ 263,499

*See accompanying Notes to Consolidated Financial Statements.*

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

	<b>Years Ended December 31,</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
Revenues	\$ 87,794	\$ 93,665	\$ 98,778
Operating costs:			
Cost of revenue, excluding depreciation	29,992	34,266	35,576
General and administrative costs at operations	13,800	14,668	15,139
Unallocated corporate costs	3,151	4,078	3,776
Litigation and settlement costs	3,250	3,780	27,849
Depreciation and amortization	21,870	21,803	21,895
Gain on sale of burglar alarm customers	-	(1,063)	-
Operating profit (loss)	15,731	16,133	(5,457)
Other income (expense):			
Investment income	1,289	1,700	2,500
Interest expense	(11,204)	(12,472)	(15,473)
Equity in earnings of affiliated companies	3,564	3,613	3,970
Gain on sale of investments	185	480	12,802
	(6,166)	(6,679)	3,799
Income (loss) before income taxes and minority interests	9,565	9,454	(1,658)
Provision for income taxes	(3,078)	(2,827)	4,381
Minority interests	(2,021)	(2,326)	(1,529)
Net income	\$ 4,466	\$ 4,301	\$ 1,194
Basic and diluted weighted average shares outstanding	27,694.66	27,396.50	25,376.00
Basic and diluted earnings per share:			
Net income per share	\$ 161.26	\$ 156.99	\$ 47.05

*See accompanying Notes to Consolidated Financial Statements.*

**LICT 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 (loss)	Treasury Stock	Total
Balance at January 1, 2004	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
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
Net income for the period	--	--	--	1,194	--	--	1,194
Unrealized gain on available for sale securities, net	--	--	--	--	327	--	327
Reclassification adjustment	--	--	--	--	(2,233)	--	(2,233)
Comprehensive income							(712)
Purchase of Treasury Stock	(617.00)	--	--	--	--	(1,317)	(1,317)
Balance at December 31, 2006	25,210.35	\$ 0	\$ 16,586	\$ 19,230	\$ (16)	\$ (3,857)	\$ 31,943

*See accompanying Notes to Consolidated Financial Statements.*

**LICT CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
*(in thousands)*

	<b>Years Ended December 31,</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
<b>OPERATING ACTIVITIES</b>			
Net income	\$ 4,466	\$ 4,301	\$ 1,194
Depreciation and amortization	21,870	21,803	21,895
Minority interests	2,021	2,326	1,529
Equity in earnings of affiliated companies	(3,564)	(3,613)	(3,970)
Distribution received from affiliates	1,229	5,259	4,473
Gain on sale of burglar alarm customers	--	(1,063)	--
Gain on sale of investments	(185)	(480)	(12,802)
Deferred income taxes	1,598	(2,939)	(4,529)
Changes in operating assets and liabilities, net of effects of acquisitions:			
Trade accounts receivable (increase) decrease	5	(346)	(1,242)
Trade accounts payable and accrued liabilities increase (decrease)	1,779	2,522	(1,450)
Other operating assets and liabilities	(127)	374	(545)
Other	(533)	(429)	(452)
Net cash provided by operating activities	<u>28,559</u>	<u>27,715</u>	<u>4,101</u>
<b>INVESTING ACTIVITIES</b>			
Acquisitions (net of debt assumed and cash equivalents acquired)	(377)	(23,358)	(10,400)
Capital expenditures	(16,468)	(10,211)	(13,162)
Acquisition of subscriber lists	(305)	(27)	--
Investment in affiliated companies	(4,688)	(62)	--
Proceeds from the sale of an affiliate	--	--	2,578
Acquisition of spectrum licenses	(49)	(500)	(485)
Proceeds from sale of burglar alarm customers	--	2,605	--
Proceeds from sale of investments	246	657	18,520
Other	776	390	792
Net cash used in investing activities	<u>(20,865)</u>	<u>(30,506)</u>	<u>(2,157)</u>
<b>FINANCING ACTIVITIES</b>			
Issuance of long-term debt	5,973	23,612	23,906
Payments to reduce long-term debt	(13,345)	(16,568)	(21,250)
Borrowing related to lines of credit	8,886	14,306	32,637
Repayments related to lines of credit	(7,549)	(6,466)	(25,065)
Acquisition of shares to effectuate reverse stock split	--	(4,820)	--
Purchase of Treasury stock	(683)	(383)	(1,317)
Distribution to Partners	(318)	(2,103)	(1,411)
Net cash provided by (used in) financing activities	<u>(7,036)</u>	<u>7,578</u>	<u>7,500</u>
Net increase in cash and cash equivalents	658	4,787	9,444
Cash and cash equivalents at beginning of year	26,556	27,214	32,001
Cash and cash equivalents at end of year	<u>\$ 27,214</u>	<u>\$ 32,001</u>	<u>\$ 41,445</u>

**SUPPLEMENTAL DISCLOSURES**

Cash paid during the year for:

Interest	\$ 11,096	\$ 12,065	\$ 15,582
Income tax payments (refunds)	(1,328)	3,620	2,976

Non cash transactions:

Purchase of plant and equipment included in payables or accruals at year-end	1,608	322	1,069
Receipt of MCI stock	--	214	--
Fixed assets acquired under capital leases	--	1,445	--

*See accompanying Notes to Consolidated Financial Statements.*

**LICT CORPORATION AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements**  
**December 31, 2006**

**1. Accounting and Reporting Policies**

**Organization**

LICT Corporation, (the “Company” or “LICT”) changed its name from Lynch Interactive Corporation by a shareholder vote in January 2007, which became effective in March 2007. LICT deregistered its shares with the Securities and Exchange Commission in 2005 and is no longer required to file periodic reports with the SEC. The Company trades on the Pink Sheets under the symbol LICT.

LICT subsidiaries operate in rural communities in ten states providing regulated and unregulated communications services including local telephone service, network access, transport, high speed and dial-up internet access, long-distance service, cable television, burglar alarm monitoring services and competitive local exchange carrier services (CLEC). The operating companies include Western New Mexico Telephone Company, Intercommunity Telephone Company, LLC in North Dakota, Cuba City Telephone Exchange Company and Belmont Telephone Company in Wisconsin, Bretton Woods Telephone Company in New Hampshire, J.B.N. Telephone Company, Inc. and Haviland Telephone Company, Inc. in Kansas, Upper Peninsula Telephone Corporation in Michigan, Central Scott Telephone Company in Iowa, Central Utah Telephone Inc. in Utah, Dunkirk and Fredonia Telephone Company in New York and California-Oregon Telecommunications in California (Cal-Ore).

**2005 reverse stock split**

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 LICT and its majority owned subsidiaries which primarily consists of its telephone (100% owned), cable television and internet services (100% owned) and burglar alarm (63.6% owned) subsidiaries. All material inter-company 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 method 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 through January 2006),

- Two cellular telephone providers in New Mexico, both 33% owned,
- Cellular partnership in California (25% owned).
- 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 of America 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.

### **Reclassification**

In 2005, the Company recorded a gain on the sale of a portion of its investment in Hector Communications (Hector), which was classified in investment income. During 2006, LICT sold the remaining investment in Hector at a gain and classified such gain, along with those described in Note 4, separately as "Gain on sale of investments". Consequently, the 2005 gain was reclassified to conform to the 2006 presentation.

### **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, 2006, cash invested in United States Treasury money market funds which are not federally insured, totaled \$31.0 million. Of the \$10.5 million of cash invested in bank deposit accounts, approximately \$7.8 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, 2005 and 2006, LICT's investment in marketable securities, which had carrying values of \$4.4 million and \$0.5 million, respectively, were entirely classified as available-for-sale. Such carrying values, at December 31, 2005, include LICT's 4.8% investment in Hector (AMEX:HCT) valued at \$4.1 million, which was sold in 2006. 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 gains (losses) on available-for-sale securities were \$1.4 million, \$0.9 million and less than (\$0.1 million) for the years ended December 31, 2004, 2005 and 2006, 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 from the sale of the Company's investment in Hector, included in gain on sale of investments, were \$0.5 million and \$3.4 million for the years ended December 31, 2005 and 2006, respectively.

### **Investment income - Patronage**

CoBank, from which the Company has loans totaling \$59.3 million at December 31, 2006, 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 \$0.8 million, \$0.5 million and \$0.6 million in 2004, 2005 and 2006, 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 15 to 40 years for building, 3 to 50 years for machinery and equipment and 3 to 25 years for other assets. For income tax purposes, accelerated depreciation methods are used. Depreciation expense for 2004, 2005 and 2006 was \$20.0 million, \$20.6 million and \$21.6 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, 2005 and 2006 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. The increase in the carrying amount of goodwill from December 31, 2005 to December 31, 2006 was entirely related to acquisitions and the finalization of the purchase price allocation from the August 2005 acquisition of California-Oregon Telecommunications Company ("Cal-Ore") (see Note 2 Acquisitions and Dispositions).

In addition to goodwill, intangible assets with indefinite lives include cellular licenses, with a carrying value of \$6.6 million and \$7.1 million at December 31, 2005 and 2006 respectively. At December 31, 2004, LICT 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 LICT 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 \$11.5 million and \$5.0 million and accumulated amortization of 2.9 million and \$3.0 million at December 31, 2005 and 2006, respectively. Amortization expense was \$0.6 million, \$0.7 million and \$0.2 million for the years ended December 31, 2004, 2005 and 2006 respectively and is estimated to be between \$0.4 and \$0.3 million annually for the next five years. The decrease in both the gross value and amortization expense in 2006 resulted from the finalization of the purchase price allocation related to the Cal-Ore acquisition (see Note 2).

### **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.

### **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.

## **2. Acquisitions and Dispositions**

On January 11, 2006, the Company acquired the 17% remaining 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. In April 2004, 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 the initial 37% interest. In 2006, the Company issued \$9.4 million of 8.0% five-year subordinated notes to acquire the remaining 63% ownership interest. The allocation of the purchase price includes \$0.2 million to goodwill, which is not expected to be deductible for income tax purposes.

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. The preliminary allocation of the purchase price includes \$0.5 million to goodwill.

In August 2006, a subsidiary of the Company, Central Telcom Services, LLC acquired certain CATV and cable modem assets for \$0.2 million. The system includes 352 CATV customers and 306 cable modem customers.

On August 29, 2005, the Company acquired 100% of the stock of 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. During 2006, the Company finalized the allocation of the purchase price as follows (in thousands):

Cash	\$ 1,713
Plant and Equipment	9,855
Goodwill	4,106
Investments in affiliated entities	5,748
Other assets	2,590
Current liability	(275)
Deferred taxes	(2,285)
	<u>\$ 21,452</u>

Although there were no adjustments to the total purchase price, the above allocation differed from the preliminary purchase price allocation recorded in 2005. The final adjustments made to the preliminary purchase price allocation included an increase of approximately \$0.4 million in investments in affiliated entities to reflect the final valuation of Cal-Ore's 17% interest in a cellular partnership, which was sold during 2006. The valuation of Cal-Ore's investment in Rural Telephone Bank ("RTB") stock was increased approximately \$0.7 million, included in other assets, to reflect actual amounts expected from the dissolution of the RTB (see Note 4). Consequently, no gains were recognized on such dispositions. Deferred taxes of approximately \$0.4 million were recorded associated with the increase in the investment in the cellular partnership and the RTB stock. Lastly, other intangible assets of approximately \$6.8 million, and associated deferred tax of \$2.5 million were reduced and reallocated to goodwill in recognition of the fact that Cal-Ore is a regulated entity. The final purchase price allocation of \$4.1 million to goodwill is not expected to be deductible for tax purposes.

On March 18, 2005, Central Telcom 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.

### 3. Wireless Communications Services

In September 2006, the Company was the high bidder for a license in Topeka, Kansas in the Advance Wireless Services Auction No. 66 for a cost of \$0.5 million and was included in Other Intangibles in the Consolidated Balance Sheet.

In February 2005, Lynch 3G participated in Auction 58 for PCS Spectrum and was the 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.

At December 31, 2004 as part of the Company's annual test for impairment of intangible assets with indefinite lives, LICT 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.

### 4. Gains on sales of investments

In the second quarter of 2006, the Rural Telephone Bank ("RTB") was dissolved based on the process and terms established in the Budget for fiscal year 2006 for the United States of America. Accordingly, the holders of its Class B and Class C stock were paid the par value of their stock, which totaled \$13.7 million for LICT's subsidiaries, resulting in a pre-tax gain of \$9.4 million. The Company's New York subsidiary deferred \$1.9 million of intrastate gain in accordance with a March 2006 New York State commission ruling. Management believes that, except for its New York subsidiary, amounts received upon the dissolution of the RTB will not need to be refunded to ratepayers. However, public service commissions in several states, where we do not have operations, have been reviewing the proper disposition of such RTB proceeds, but have reached no final conclusions. Therefore, some portion of the recorded gain, while not estimable at this time, may be subject to review by other regulatory authorities who may require us to record a portion thereof as a regulatory liability.

In 2005 and 2006, the Company sold all of its shares of Hector Communications for proceeds of \$0.7 million and \$4.5 million, respectively, resulting in pre-tax gains of \$0.5 million and \$3.4 million, respectively.

### 5. Investments in Affiliated Companies

LICT 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:

	<b>Broadcasting Combined</b>	
	<b>2005</b>	<b>2006</b>
Current assets	\$ 4,075	\$ 4,370
Property, plant & equipment, intangibles & other	10,905	8,617
Total Assets	\$ 14,980	\$ 12,987
Current liabilities	\$ 12,254	\$ 2,899
Long term liabilities	7,397	15,825
Equity	(4,671)	(5,737)
Total liabilities & equity	\$ 14,980	\$ 12,987
Revenues	\$ 11,718	\$ 12,653
Gross profit	\$ 2,825	\$ 3,836
Net income (loss)	\$ (1,000)	\$ (698)

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, 2005 and 2006, the investment in Coronet was carried at a negative \$0.7 million and a negative \$0.8 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, 2006, totaled \$9.5 million payable quarterly through December 31, 2010 to a third party lender.

At December 31, 2005 and 2006, the investment in Capital is carried at zero as the Company's 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:

	<b>Telecommunications Combined</b>	
	<b>2005</b>	<b>2006</b>
Current assets	\$ 25,327	\$ 14,781
Property, plant & equipment, intangibles & other	45,242	44,891
<b>Total Assets</b>	<b>\$ 70,569</b>	<b>\$ 59,672</b>
Current liabilities	\$ 8,638	\$ 8,678
Long term liabilities	4,926	10,144
Equity	57,005	40,850
<b>Total liabilities &amp; equity</b>	<b>\$ 70,569</b>	<b>\$ 59,672</b>
Revenues	\$ 63,800	\$ 73,933
Gross profit	\$ 28,671	\$ 32,906
Net income	\$ 15,724	\$ 17,357

LICT 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 \$4.8 million and \$5.1 million at December 31, 2005 and 2006, respectively and included in Investment in and Advances to Affiliates.

As part of the Cal-Ore acquisition, LICT owns a 25% partnership interest in a cellular telephone provider in northern California, California RSA #2. As of December 31, 2006, the net investment in the partnership was valued at \$2.2 million.

Undistributed earnings of companies accounted for using the equity method that are included in consolidated retained earnings are \$2.3 million and \$2.5 million at December 31, 2005 and 2006, respectively.

## 6. 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 LICT.

	<b>December 31,</b>	
	<b>2005</b>	<b>2006</b>
	<i>(in thousands)</i>	
Long-term debt consists of (all interest rates are at December 31, 2006):		
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% (5.2% weighted average), secured by assets of the telephone companies of \$150 million	\$ 52,018	\$ 47,869
Bank credit facilities utilized by certain telephone and telephone holding companies through 2017, \$73.9 million at fixed interest rates averaging 8.1% and \$2.4 million at variable interest rates averaging 7.7%	77,775	76,244
Unsecured notes issued in connection with acquisitions through 2008, \$37.8 million at fixed interest rates averaging 8.8% and \$9.7 million at variable interest rates averaging 9.1% (primarily held by management of telephone company's)	45,619	47,563
Other	2,037	2,111
	<u>177,449</u>	<u>173,787</u>
Current maturities	<u>(41,740)</u>	<u>(27,254)</u>
	<u>\$ 135,709</u>	<u>\$ 146,533</u>

REA debt of \$6.5 million which bears interest at 2% has been reduced by a purchase price adjustment of \$0.9 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.

In July 2006, in order to finance the agreement to reimburse the federal government in the "qui tam" litigation, see Note 12, the Company's short term line of credit facility 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, at no fee to LICT. In September 2006, in conjunction with the refinancing of certain subsidiaries, such line was reduced from \$30 million to \$20 million. The entire line, as well as the letter of credit from LICT's Chairman, expired on December 15, 2006 and was replaced by a \$17.5 million line of credit facility, which had \$0.4 million available as of December 31, 2006. Such line was scheduled to be reduced to \$15 million on June 30, 2007 and expire December 31, 2007. In April 2007, LICT reached an agreement with the lender to extend the maturity date of the credit facility, at the \$17.5 million level, until June 30, 2008.

Borrowings under LICT Corporation's, the parent company ("Parent Company"), short-term line of credit facilities, classified in notes payable to banks, were \$8.3 million and \$17.1 million at December 31, 2005 and 2006, respectively. In addition, the Parent Company had a margin loan secured by its investments in available-for-sale securities of \$1.3 million at December 31, 2005, that was repaid in 2006. Borrowing under both the line of credit facility and the margin loan are included in Notes payable to banks. During 2006, the average balance of notes payable outstanding was \$14.0 million, the highest amount outstanding was \$27.3 million and the average interest rate was 8.74%.

At December 31, 2006, the Company has a \$10.0 million working capital deficiency primarily due to the amounts included in Notes payable to banks and a \$12 million Term Loan, held by a subsidiary, which

comes due on June 30, 2007. Such subsidiary has the financial resources but does not currently have the liquidity to satisfy this loan, which is secured by the subsidiary's assets, but not guaranteed by the Parent Company. Management is currently working with the lender on several alternatives to satisfy this debt and it is confident that it will be able to repay or refinance this loan on terms that are acceptable to the lender, but there is no assurance that will be accomplished.

The debt at each of LICT's subsidiary companies contains restrictions on the amount of funds that can be transferred to the Parent Company. 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 general, the long-term debt facilities are secured by substantially all of property, plant and equipment, receivables and common stock of the subsidiaries that have incurred such indebtedness and contain certain covenants restricting distributions to LICT. At December 31, 2006, the Company is in compliance with all covenants.

Aggregate principal maturities of long-term debt at December 31, 2006 for each of the next five years are as follows: 2007--\$27.3 million, 2008--\$21.2 million, 2009--\$15.1 million, 2010--\$20.9 million, 2011--\$28.9 million, and the remaining \$60.4 million thereafter.

The Company has a need for resources in excess of its current facilities to fund its ongoing operations as well as future long-term growth initiatives. The Company is working on various alternative long-term financing sources: sale of operating assets, refinancing all of the Company's debt agreements, and/ or a rights offering to its shareholders. 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.

#### **7. Related Party Transactions**

LICT leases its corporate headquarters from an affiliate of its Chairman. The lease was renewed in October 2006 for four years and calls for an annual payment of \$113,000 including utilities, subject to escalation. In addition, expenses relating to administrative support, transportation (includes charges for a leased airplane), and communications (approximately \$102,000, \$92,000 and \$120,000 for the years ended December 31, 2004, 2005 and 2006, respectively) are paid to an affiliate of its Chairman. In addition, the expansion of LICT's line of credit facility from \$10 million to \$30 million in 2006 (see Note 6) was supported by a letter of credit from the company's chairman, at no cost to LICT.

At December 31, 2005 and 2006, assets of \$23.3 million and \$31.0 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.

#### **8. Shareholder's Equity**

LICT's Board of Directors authorized the purchase of up to 3,000 shares of its common stock. Through December 31, 2006, 1,427 shares have been purchased at an average investment of \$2,702 per share, including 617 shares purchased in 2006 for an average investment of \$2,135 per share.

## 9. Income Taxes

LICT 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 2005 and 2006 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, 2005 and 2006 are as follows:

	2005 Deferred Tax		2006 Deferred Tax	
	Asset	Liability	Asset	Liability
	<i>(in thousands)</i>			
Fixed assets revalued under purchase accounting and tax over book depreciation	\$ --	\$ 11,976	\$ --	\$ 6,883
Discount on long term debt	--	411	--	339
Unrealized gains on marketable securities	--	1,985	--	1,012
Partnership tax losses in excess of book losses	--	3,256	--	2,283
Other reserves and accruals	--	1,382	--	941
Other	--	--	--	--
Total deferred income taxes	--	19,010	--	11,458
Valuation Allowance	--	--	--	--
	\$ --	\$ 19,010	\$ --	\$ 11,458

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

	2004	2005	2006
	<i>(in thousands)</i>		
Current taxes:			
Federal	\$ 831	\$ 4,150	\$ 122
State and local	649	1,616	26
	1,480	5,766	148
Deferred taxes:			
Federal	1,470	(2,522)	(3,864)
State and local	128	(417)	(665)
	1,598	(2,939)	(4,529)
	\$ 3,078	\$ 2,827	\$ (4,381)

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:

	2004	2005	2006
	<i>(in thousands)</i>		
Tax at statutory rate	\$ 2,847	\$ 2,760	\$ (1,070)
Increases (decreases):			
State and local taxes, net of federal benefit	513	791	(540)
Reduction of tax reserves	--	--	(2,181)
Other	(282)	(724)	(590)
	\$ 3,078	\$ 2,827	\$ (4,381)

## 10. 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, 2005 and 2006 are as follows:

	<b>Unrealized Gain (Loss)</b>	<b>Tax Effect</b>	<b>Net</b>
	<i>(in thousands)</i>		
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	2,869	(979)	1,890
Change in unrealized gains (losses), net	502	(175)	327
Reclassification in adjustment	(3,396)	1,163	(2,233)
Balance at December 31, 2006	\$ (25)	\$ 9	\$ (16)

## 11. Employee Benefit Plans

LICT maintains several defined contribution plans at its telephone subsidiaries and corporate office. LIC T'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 \$1.2 million, \$1.1 million and \$1.1 million for 2004, 2005 and 2006, respectively.

The Company has a Principal Executive Bonus Plan that has been approved by the shareholders, for which \$0.3 million, \$0.3 million and \$0.3 million were recorded in 2004, 2005, and 2006, 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 \$0.2 million, \$0.3 million, and \$0.3 million for 2004, 2005 and 2006, respectively.

## 12. 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 \$0.3 million, \$0.3 million and \$0.4 million for years ended December 31, 2004, 2005 and 2006 respectively. Minimum lease payments due under non-cancelable operating leases at December 31, 2006 are as follows: \$0.4 million in 2007; \$0.3 million in 2008; \$0.3 million in 2009; \$0.3 million in 2010, \$0.2 million in 2011 and \$0.4 million thereafter. In addition, at December 31, 2006, LIC T has \$1.3 million in capital leases with minimum lease payments of \$0.4 million in 2007 and \$0.3 million in the following three years.

### *Litigation.*

#### False Claims Act Litigation.

LICT and several other parties, including LIC T'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 to obtain 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.

LICT’s share of the litigation and settlement amounted to approximately \$36 million of which \$10 million has been recorded as litigation costs, primarily over the period from 2004 through the settlement date. The incremental \$26 million has been paid from internal funds (\$6 million) and borrowings under LICT’s increased line of credit (\$20 million) (see Note 6). LICT agreed to reimburse the government in order to preserve its flexibility to pursue spectrum acquisitions and other opportunities before the FCC in the future. LICT admitted no liability and the conduct giving rise to the case is expressly excluded as a basis for future administrative proceedings by the FCC.

*Other Litigation.*

In addition to the litigation described above, LICT is a party to routine litigation incidental to its business. Based on information currently available, LICT 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.