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**LYNCH INTERACTIVE CORPORATION**

Quarterly Report for period ended September 30, 2006

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**LYNCH INTERACTIVE CORPORATION AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

(In thousands, except share amounts)

	<b>September 30, 2006</b>	<b>December 31, 2005</b>	<b>September 30, 2005</b>
	(Unaudited)	(Audited)	(Unaudited)
<b>ASSETS</b>			
Current assets:			
Cash and cash equivalents	\$ 40,805	\$ 32,001	\$ 32,951
Receivables, less allowances of \$475, \$430 and \$407, respectively	9,974	9,151	9,387
Material and supplies	2,994	2,236	896
Prepaid expenses and other current assets	2,614	1,517	1,510
Total current assets	56,387	44,905	46,744
Property, plant and equipment:			
Land	1,120	1,116	1,047
Buildings and improvements	19,045	19,687	20,039
Machinery and equipment	242,355	232,732	230,682
	262,520	253,535	251,768
Accumulated depreciation	(146,445)	(131,066)	(126,851))
	116,075	122,469	124,917
Excess of cost over fair value of net assets acquired, net (goodwill)			
	60,966	60,378	61,519
Other intangibles	16,130	15,666	792
Investments in and advances to affiliated entities	8,530	16,255	18,664
Other assets	11,584	15,843	17,557
Total assets	\$ 269,672	\$ 275,516	\$ 280,193

*See accompanying Notes to Condensed Consolidated Financial Statements.*

**LYNCH INTERACTIVE CORPORATION AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands, except share amounts)

	<b>September 30, 2006</b>	<b>December 31, 2005</b>	<b>September 30, 2005</b>
	(Unaudited)	(Audited)	(Unaudited)
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>			
Current liabilities:			
Notes payable to banks	\$ 22,017	\$ 12,633	\$ 8,288
Trade accounts payable	2,441	2,639	3,584
Accrued interest payable	692	1,140	1,121
Accrued litigation settlement	2,256	549	--
Accrued liabilities	12,585	13,476	11,888
Current maturities of long-term debt	40,735	41,740	27,055
Total current liabilities	80,726	72,177	51,936
Long-term debt	136,344	135,709	154,305
Deferred income taxes	18,334	19,010	20,173
Other liabilities	4,727	2,882	3,400
Total liabilities	240,131	229,778	229,814
Minority interests	2,396	11,766	11,822
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; 25,220.35, 25,827.35 and 27,522.51 outstanding	--	--	--
Additional paid-in capital	16,586	16,586	21,406
Retained earnings	14,243	18,036	17,169
Accumulated other comprehensive income	144	1,890	2,318
Treasury stock, 1,417.15, 810.15, and 725.15 shares, at cost	(3,828)	(2,540)	(2,336)
Total liabilities and shareholders' equity	\$269,672	\$ 275,516	\$ 280,193

*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)*

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Revenues	\$ 24,766	\$ 24,159	\$ 74,521	\$ 68,248
Costs and expenses:				
Cost of revenue, excluding depreciation	8,865	8,410	26,198	24,156
General and administrative costs at operations	3,620	3,508	11,197	10,274
Corporate office expenses	1,095	1,187	2,775	3,213
False Claims Act litigation and settlement	133	343	27,729	3,151
Depreciation and amortization	5,537	5,274	16,898	15,815
Gain on sale of burglar alarm customers	-	(1,110)	-	(1,110)
Total Expense	19,250	17,612	84,797	55,499
Operating profit (loss)	5,516	6,547	(10,276)	12,749
Other income (expense):				
Investment income	529	287	1,921	1,271
Interest expense	(4,085)	(3,215)	(11,216)	(8,987)
Equity in earnings of affiliated companies	1,018	861	2,810	2,413
Gains on sale of investments and other assets	1,332	--	13,685	--
	(1,206)	(2,067)	7,200	(5,303)
Income (loss) before income taxes and minority interests	4,310	4,480	(3,076)	7,446
Income tax (provision) benefit	(1,580)	(1,259)	443	(2,356)
Minority interests	(400)	(695)	(1,160)	(1,656)
Net income (loss)	\$ 2,330	\$ 2,526	\$ (3,793)	\$ 3,434
Basic and diluted weighted average shares outstanding	25,260	27,523	25,438	27,528
Basic and diluted earnings (loss) per share	\$ 92.24	\$ 91.78	\$ (149.11)	\$124.75

*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	--	--	--	(3,793)	--	--	(3,793)
Unrealized gain on available for sale securities, net	--	--	--	--	357	--	357
Reclass adjustment					(2,103)		(2,103)
Comprehensive income							(5,539)
Purchase of Treasury Stock	(607.00)	--	--	--	--	(1,288)	(1,288)
Balance at June 30, 2006	25,220.35	\$ 0	\$ 16,586	\$ (14,243)	\$ 144	\$ (3,828)	\$ 27,145

*See accompanying Notes to Condensed Consolidated Financial Statements.*

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

	<b>Nine Months Ended</b>	
	<b>September 30,</b>	
	<b>2006</b>	<b>2005</b>
<b>Operating activities:</b>		
Net income (loss)	\$ (3,793)	\$ 3,434
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	16,898	15,815
Equity in earnings of affiliated companies	(2,810)	(2,413)
Distributions received from affiliated companies	1,802	3,554
Gains on sale of investments and other assets	(13,685)	(1,110)
Minority interests	1,160	1,656
Changes in operating assets and liabilities:		
Receivables	(823)	621
Accounts payable and accrued liabilities	123	(2,533)
Other	(4,087)	(224)
Net cash provided by operating activities	(5,215)	18,800
<b>Investing activities:</b>		
Capital expenditures	(9,905)	(7,036)
Acquisition of businesses and minority interests	(10,570)	(22,697)
Proceeds from sale of investments and other assets	17,919	2,635
Acquisition of spectrum	(485)	(500)
Proceeds from the sale of an affiliate	3,531	---
Other	137	202
Net cash provided by (used in) investing activities	627	(27,396)
<b>Financing activities:</b>		
Proceeds from the issuance of long term debt	25,978	24,268
Repayments of long term debt	(19,845)	(11,874)
Net proceeds (repayment) on lines of credit	9,384	3,495
Purchase of treasury stock	(1,288)	(179)
Distributions to partners	(837)	(1,377)
Net cash used in financing activities	(13,392)	14,333
Net increase in cash and cash equivalents	8,804	5,737
Cash and cash equivalents at beginning of period	32,001	27,214
Cash and cash equivalents at end of period	\$ 40,792	\$ 32,951
<b>Cash paid for:</b>		
Interest expense	\$ 10,931	\$ 8,733
Income taxes	\$ 1,831	\$ 2,219

*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, which primarily consists of its telephone (100% owned, see Note C), cable television (100% owned) and security (63.6% owned) subsidiaries. All material intercompany transactions and balances have been eliminated. Investments in affiliates in which the Company does not have a majority voting control, but has the ability to significantly influence 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 September 30, 2006, December 31, 2005 and September 30, 2005), Capital Communications Company, Inc. (49% owned at September 30, 2006, December 31, 2005 and September 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 September 30, 2006, December 31, 2005 and September 30, 2005), cellular partnership in California (25% owned at September 30, 2006 and December 31, 2005), KMG Holdings Group (37% owned from May 2004, to January 2006, see Note C below) 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 nine month periods ended September 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

In July 2006, the Financial Accounting Standards Board (“FASB”) issued FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109” (“FIN 48”), which clarifies the accounting for uncertainty in income tax positions. This Interpretation requires that the Company recognize in its financial statements the impact of a tax position if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The provisions of FIN 48 are effective for the Company on January 1, 2007, with the cumulative effect of the change in accounting principle, if any, recorded as an adjustment to opening retained earnings. The Company is currently evaluating the impact of adopting FIN 48 on its financial position, cash flows, and results of operations.

In September 2006, the FASB issued SFAS No. 157, “Fair Value Measurements” (“SFAS 157”), which clarifies the definition of fair value, establishes guidelines for measuring fair value, and expands disclosures regarding fair value measurements. SFAS 157 does not require any new fair value measurements and eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS 157 will be effective for the Company on January 1, 2008. The Company is currently evaluating the impact of adopting SFAS 157 on its financial position, cash flows, and results of operations.

#### 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 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 and intangible assets.

In September 2006, the Company was high bidder for a license in Topeka, Kansas in the Advance Wireless Services Auction No.66 for a 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 nine months ended September 30, 2006 and 2005 and as of December 31, 2005, is as follows:

	<b>Broadcasting Combined</b>		
	<b>September 30, 2006</b>	<b>December 31, 2005</b>	<b>September 30, 2005</b>
	<i>(in thousands)</i>		
Current assets	\$ 3,785	\$ 4,075	\$ 4,025
Property, plant & equipment, intangibles & other	9,156	10,905	11,707
<b>Total Assets</b>	<b>\$ 12,941</b>	<b>\$ 14,980</b>	<b>\$ 15,732</b>
Current liabilities	\$ 2,713	\$ 12,254	\$ 2,828
Long term liabilities	16,138	7,397	17,036
Equity	(5,910)	(4,671)	(4,132)
<b>Total liabilities &amp; equity</b>	<b>\$ 12,941</b>	<b>\$ 14,980</b>	<b>\$ 15,732</b>
<b><u>Three Months Ended</u></b>			
Revenues	\$ 2,761		\$ 2,682
Gross profit	585		506
Net income	(405)		(291)
<b><u>Nine Months Ended</u></b>			
Revenues	\$ 8,826		\$ 8,710
Gross profit	2,339		2,063
Net income	(870)		(462)

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 September 30, 2006, December 31, 2005 and September 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 September 30, 2006, totaled \$9.6 million payable quarterly through December 31, 2010 to a third party lender.

At September 30, 2006, December 31, 2005 and September 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 nine months ended September 30, 2006 and 2005 and as of December 31, 2005 is as follows (in thousands):

	<b>Telecommunications Combined</b>		
	<b>September 30, 2006</b>	<b>December 31, 2005</b>	<b>September 30, 2005</b>
	<i>(in thousands)</i>		
Current assets	\$ 19,384	\$ 25,327	\$ 40,885
Property, plant & equipment, intangibles & other	44,740	45,242	44,384
<b>Total Assets</b>	<b>\$ 64,124</b>	<b>\$ 70,569</b>	<b>\$ 85,269</b>
Current liabilities	\$ 11,852	\$ 8,638	\$ 23,990
Long term liabilities	9,802	4,926	5,342
Equity	42,470	57,005	55,937
<b>Total liabilities &amp; equity</b>	<b>\$ 64,124</b>	<b>\$ 70,569</b>	<b>\$ 85,269</b>
<b><u>Three Months Ended</u></b>			
Revenues	\$ 21,123		\$ 14,973
Gross profit	10,004		7,301
Net income	5,406		3,792
<b><u>Nine Months Ended</u></b>			
Revenues	\$ 55,239		\$ 44,972
Gross Profit	26,304		20,708
Net Income	14,021		11,437

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 \$5.5 million, \$4.8 million and \$5.3 million at September 30, 2006, December 31, 2005 and September 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 September 30, 2006, the net investment in the partnership was valued at \$2.1 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. 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 nine month period, the Company sold shares of Hector Communications for proceeds of \$4.2 million, resulting in a pre-tax gain of \$3.2 million.

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 \$2.75 million, net of holdbacks and fees, resulting in a \$1.1 million gain on the sale. The proceeds were used to retire debt.

#### F. Indebtedness

In order to finance the July 2006 settlement of the Federal False Claim Act litigation, see Note I, the Company’s short term line of credit facility was increased from \$10 million to \$30 million. In September 2006 in conjunction with the refinancing of certain subsidiaries, such line was reduced from \$30 million to \$20 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. Borrowings under such short-term line of credit facility, were \$18.8 million, \$8.3 million and \$5.3 million at September 30, 2006, December 31, 2005 and September 30, 2005, respectively. In addition, Interactive had a margin loan secured by its investments in available-for-sale securities of \$0.5 million and \$1.3 million at December 31, 2005, that was repaid as of September 30, 2006. 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 September 30, 2006) (in thousands):

	<u>September 30,</u> <u>2006</u>	<u>December 31,</u> <u>2005</u>	<u>September 30,</u> <u>2005</u>
Rural Utilities Service (“RUS”) and) 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)	\$ 48,922	\$ 52,018	\$ 54,175
Bank Credit facilities utilized by certain telephone and telephone holding companies due through 2017, \$3.9 million at fixed interest rates averaging 8.4% and \$74.5 million at variable interest rates averaging 8.4%.	78,357	77,775	80,216
Unsecured notes issued in connection with acquisitions through 2011, \$37.9 million at fixed interest rates averaging 8.8% and \$9.7 million at variable rates averaging 9.1%	47,645	45,619	45,619
Other	2,155	2,037	1,350
	177,079	177,449	181,360
Current maturities	(40,735)	(41,740)	(27,055)
	<u>\$ 136,344</u>	<u>\$ 135,709</u>	<u>\$ 154,305</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.

In September 2006, the Company issued \$13.0 million of bank debt by refinancing three of its operating subsidiaries. The loan has variable interest rates, amortizes quarterly and matures in 2016. Proceeds of the loan will be used to retire approximately \$5.8 million of existing bank debt and the remainder to retire a portion of the Company's short term line of credit facility.

In conjunction with the RTB dissolution (see Note E), all outstanding RTB notes payable were transferred to the RUS.

In general, the long-term debt facilities are secured by substantially all of the Company's property, plant and equipment, receivables and common stock of certain subsidiaries and contain certain covenants restricting distributions to Lynch Interactive. At September 30, 2006, the Company is in compliance with all covenants. At September 30, 2006, December 31, 2005 and September 30, 2005, substantially all subsidiaries' net assets are restricted from distribution to Lynch Interactive.

#### G. Comprehensive Income

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

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Net income (loss)	\$ 2,330	\$ 2,526	\$ (3,793)	\$ 3,434
Unrealized gains - pre tax	144	1,082	576	1,151
Unrealized gains - tax effect	(59)	(356)	(219)	(380)
Reclassification adjustment - pre tax	(1,324)	(41)	(3,186)	(41)
Reclassification adjustment - tax effect	450	---	1,083	---
Net other comprehensive income	(789)	685	(1,746)	730
Comprehensive income	\$ 1,541	\$ 3,211	\$ (5,539)	\$ 4,164

#### H. Treasury Stock Purchases

During the nine months ended September 30, 2006, the Company purchased 607 shares of its common stock for treasury at an average investment of \$2,122 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 \$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 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 September 30, 2006, December 31, 2005, and September 30, 2005, assets of \$30.7 million, \$23.3 million and \$23.4 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.

### **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 2006, the Company 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).

### **Third quarter ended September 30, 2006 compared to 2005**

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

	Three months ended September 30,		Increase
	2006	2005	(Decrease)
	(Unaudited)		
Revenues:			
Local access	\$ 3,323	\$ 3,017	\$ 306
Interstate access	11,514	11,644	(130)
Intrastate access	4,045	3,846	199
Other business	5,884	5,652	232
Total	<u>24,766</u>	<u>24,159</u>	<u>607</u>
Operating Cost and Expense:			
Cost of revenue, excluding depreciation	8,865	8,410	455
General and administrative costs at operations	3,620	3,508	112
Corporate office expenses	1,095	1,187	(92)
False Claims Act litigation and settlement	133	343	(210)
Depreciation and amortization	5,537	5,274	263
Gain on sale of burglar alarm customers	--	(1,110)	1,110
Total	<u>19,250</u>	<u>17,612</u>	<u>1,638</u>
Operating profit	<u>\$ 5,516</u>	<u>\$ 6,547</u>	<u>\$ (1,031)</u>

Total revenues in 2006 increased \$0.6 million, or 2.5%, to \$24.8 million compared to \$24.2 million in 2005. The inclusion of Cal-Ore for the entire quarter compared to one month in 2005 added \$1.2 million to revenue, including \$0.1 million local access, \$0.6 million interstate access, \$0.3 million intrastate access and \$0.1 million other business. The following explanations do not include the contributions to revenue from Cal-Ore. Local access revenue increased \$0.2 million resulting from a decrease in access lines (September 30, 2006 compared to September 30, 2005 down 3.4%) offset by the sale of additional services and features and a rate increase in Michigan. 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 decreased \$0.8 million in 2006 primarily due to two 2005 revenue increases totaling approximately \$0.9 million; a retroactive adjustment of long-haul traffic and a prior period adjustment. 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 \$0.1 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 \$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 \$1.6 million to \$19.3 million in 2006. The inclusion of Cal-Ore in 2006 for two additional months added \$0.7 million to cost, including \$0.2 million in cost of revenue, \$0.2 million of General and Administrative costs and \$0.3 million of depreciation. The following explanations do not include the contributions to expense from Cal-Ore. Costs of revenue increased \$0.2 million, or 2.6%, 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 and litigation expenses decreased \$0.3 million primarily due to 2005 expenses relating to going dark and the end of the litigation in July 2006. Depreciation and amortization decreased by \$0.1 million.

As a result of the above, and a \$1.1 million gain on the sale of burglar alarm customers recognized in the 2005 third quarter, operating profit in 2006 decreased by \$1.0 million to \$5.5 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:

	<u>Three months ended September 30,</u>		Increase (Decrease)
	<u>2006</u>	<u>2005</u>	
Adjusted operating profit from:			
Operating units	\$ 12,281	\$ 12,241	\$ 40
Gain from sale of burglar alarm customers	--	1,110	(1,110)
Corporate expense:			
False Claims Act litigation	(133)	(343)	210
Other	(1,095)	(1,187)	92
Total corporate expenses	(1,228)	(1,530)	302
Adjusted operating profit (loss)	<u>\$ 11,053</u>	<u>\$ 11,821</u>	<u>\$ (768)</u>
<b>Reconciliation to net income:</b>			
Adjusted operating profit (loss)	\$ 11,053	\$ 11,821	\$ (768)
Depreciation and amortization	(5,537)	(5,274)	(263)
Investment income	529	287	242
Interest expense	(4,085)	(3,215)	(870)
Equity in income of affiliates	1,018	861	157
Gain on sale of investments and other assets	1,332	--	1,332
Income tax	(1,580)	(1,259)	(321)
Minority interests	(400)	(695)	295
Net income	<u>\$ 2,330</u>	<u>\$ 2,526</u>	<u>\$ (196)</u>

#### **Other Income (Expense)**

In 2006, investment income increased by \$0.2 million primarily due to higher cash balances.

Interest expense increased by \$0.9 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 \$0.2 million due to consistent high earnings at the Company's New Mexico cellular investments (RSA 3 and 5).

In the 2006 period, the Company sold 49,500 shares of the common stock of Hector Communications for \$1.8 million, resulting in a pre-tax gain of approximately \$1.3 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 40.3% and 30.3%, 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 \$0.7 million in 2005.

### **Net Income**

Net income in the third quarter of 2006, was \$2.3 million, or \$92.24 per share (basic and diluted), compared to net income last year of \$2.5 million, or \$91.78 per share (basic and diluted). The Company has no dilutive instruments outstanding.

### **Nine months ended September 30, 2006 compared to 2005**

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

	<u>Nine months ended September 30,</u>		Increase
	<u>2006</u>	<u>2005</u>	(Decrease)
	(Unaudited)		
Revenues:			
Local access	\$ 9,828	\$ 8,861	\$ 967
Interstate access	34,555	31,576	2,979
Intrastate access	11,436	11,021	415
Other business	18,702	16,790	1,912
Total	<u>74,521</u>	<u>68,248</u>	<u>6,273</u>
Operating Cost and Expense:			
Cost of revenue, excluding depreciation	\$ 26,198	24,156	\$ 2,042
General and administrative costs at operations	11,197	10,274	923
Corporate office expenses	2,775	3,213	(438)
False Claims Act litigation and settlement	27,729	3,151	24,578
Depreciation and amortization	16,898	15,815	1,083
Gain on sale of burglar alarm customers	--	(1,110)	1,110
Total	<u>84,797</u>	<u>55,499</u>	<u>29,298</u>
Operating profit (loss)	<u>\$ (10,276)</u>	<u>\$ 12,749</u>	<u>\$ (23,025)</u>

Total revenues in 2006 increased \$6.3 million, or 9.2%, to \$74.5 million compared to \$68.2 million in 2005. The inclusion of Cal-Ore in 2006 compared to one month in 2005 added \$4.7 million to revenue, including \$0.5 million local access, \$2.4 million interstate access, \$1.2 million intrastate access and \$0.5 million other business. The following explanations do not include the contributions to revenue from Cal-Ore. Local access revenue increased \$0.5 million resulting from a decrease in access lines (September 30, 2006 compared to September 30, 2005 down 3.4%) offset by the sale of additional services and features and a rate increase in Michigan. 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 \$0.5 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 \$0.8 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 \$1.4 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 \$29.3 million to \$84.8 million in 2006 primarily due to the False Claims Act litigation and settlement costs of \$27.7 million in 2006 compared to \$3.2 million of litigation costs in 2005. The inclusion of Cal-Ore in 2006 added \$3.3 million to cost, including \$1.1 million in cost of revenue, \$0.8 million of General and Administrative costs and \$1.4 million of depreciation. The following explanations do not include the contributions to expense from Cal-Ore. Costs of revenue increased \$0.9 million, or 3.8%, 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 \$0.4 million. Depreciation and amortization decreased \$0.3 million.

As a result of the above, and a \$1.1 million gain on the sale of burglar alarm customers recognized in 2005, operating profit in 2006 decreased by \$23.0 million to an operating loss of \$10.3 million.

### **Adjusted operating profit**

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

	<u>Nine months ended September 30,</u>		Increase
	<u>2006</u>	<u>2005</u>	<u>(Decrease)</u>
Adjusted operating profit from:			
Operating units	\$ 37,126	\$ 33,818	\$ 3,308
Gain from sale of burglar alarm customers	-	1,110	(1,110)
Corporate expense:			
False Claims Act litigation and settlement	(27,729)	(3,151)	(24,578)
Other	(2,775)	(3,213)	438
Total corporate expenses	<u>(30,504)</u>	<u>(6,364)</u>	<u>(24,140)</u>
Adjusted operating profit (loss)	<u>\$ 6,622</u>	<u>\$ 28,564</u>	<u>\$ (21,942)</u>
<b>Reconciliation to net income:</b>			
Adjusted operating profit (loss)	\$ 6,622	\$ 28,564	\$ (21,942)
Depreciation and amortization	(16,898)	(15,815)	(1,083)
Investment income	1,921	1,271	650
Interest expense	(11,216)	(8,987)	(2,229)
Equity in income of affiliates	2,810	2,413	397
Gain on sale of marketable securities	13,685	-	13,685
Income tax	443	(2,356)	2,799
Minority interests	(1,160)	(1,656)	496
Net income	<u>\$ (3,793)</u>	<u>\$ 3,434</u>	<u>\$ (7,227)</u>

### **Other Income (Expense)**

In 2006, investment income increased by \$0.7 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 \$2.2 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 \$0.4 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 136,500 shares of the common stock of Hector Communications for \$4.2 million, resulting in a pre-tax gain of approximately \$3.2 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 10.6% and 35.9%, 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. In addition, the litigation settlement is only deductible for federal purposes.

### **Minority Interests**

Minority interests decreased earnings by \$1.2 million in 2006, as compared to \$1.7 million in 2005.

### **Net Income**

The net loss in 2006 was \$3.8 million, or \$149.11 per share (basic and diluted), compared to net income last year of \$3.4 million, or \$124.75 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 on December 31, 2005, \$30 million after the temporary expansion in the line, and was reduced to \$20 million in September 2006 in conjunction with the refinancing of certain subsidiaries. At September 30, 2006, \$1.8 million was available under the line. 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 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.

At September 30, 2006, the Company has a \$24.3 million working capital deficiency primarily due to the \$40.7 million of debt maturing in the next twelve months. The Company is in the process of renegotiating or refinancing \$26.8 million of debt facilities that mature over the next twelve months, of which \$11.6 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 September 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)	\$ 177,079	\$ 40,735	\$ 34,644	\$ 50,096	\$ 51,604
Operating leases	942	300	370	172	100
Notes payable to banks	22,017	22,017	-	-	-
Guarantees	3,750	-	-	3,750	-
Total contractual cash obligations and commitments	\$ 203,788	\$ 63,052	\$ 35,014	\$ 54,018	\$ 51,704

(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 September 30, 2006, total debt (including notes payable to banks) was \$199.1 million, an increase of \$9.0 million from December 31, 2005. At September 30, 2006, there was \$92.2 million of fixed interest rate debt outstanding averaging 6.8% and \$106.9 million of variable interest rate debt averaging 8.5%. 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 September 30, 2006 substantially all of the subsidiaries' net assets are restricted. Interactive has a high degree of financial leverage. As of September 30, 2006, the ratio of total debt to equity was 7.3 to 1. Certain subsidiaries also have high debt to equity ratios.

### **Sources and Uses of Cash**

Cash at September 30, 2006, was \$40.8 million, an increase of \$8.8 million compared to December 31, 2005 primarily due to the receipt of \$13.7 million from the dissolution of the RTB. In the nine months of 2006, net cash used by operations of \$5.2 million consists of \$26 million used to pay the litigation and settlement offset by \$20.8 million generated by operations. The amount generated by operations 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 \$9.9 million in the nine months of 2006 compared to \$7.0 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 September 30, 2006, 1,417 shares had been purchased at an average investment of \$2,701 per share including 607 shares purchased in 2006 at an average investment of \$2,122 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.