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LYNCH INTERACTIVE CORP  
Form 10-Q  
August 15, 2005

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SECURITIES & EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-Q  
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(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2005  
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or

TRANSITION REPORT PURSUANT TO SECTION 13 OF 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File No. 1-15097  
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LYNCH INTERACTIVE CORPORATION

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(Exact name of Registrant as specified in its charter)

Delaware

06-1458056

State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

401 Theodore Fremd Avenue, Rye, New York

10580

(Address of principal executive offices)

(Zip Code)

(914) 921-8821

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Registrant's telephone number, including area code

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes /X/ No / /

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes / / No /X/

Indicate the number of shares outstanding of each of the Registrant's classes of Common Stock, as of the latest practical date.

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| Class<br>-----                  | Outstanding at July 31, 2005<br>----- |
|---------------------------------|---------------------------------------|
| Common Stock, \$.0001 par value | 2,752,251                             |

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

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

|  | JUNE 30,<br>2005     | DECEMBER 31,<br>2004 | JUN<br>20        |
|--|----------------------|----------------------|------------------|
|  | -----<br>(Unaudited) | -----<br>(Audited)   | -----<br>(Unaud) |
| <b>ASSETS</b>  |                      |                      |                  |
| Current assets:  |                      |                      |                  |
| Cash and cash equivalents  | \$ 27,741            | \$ 27,214            | \$ 25,93         |
| Receivables, less allowances of \$245, \$260 and \$291,<br>respectively  | 8,340                | 8,225                | 8,45             |
| Material and supplies  | 2,647                | 2,314                | 3,24             |
| Prepaid expenses and other current assets                                | 993                  | 1,685                | 3,01             |
|  | -----                | -----                | -----            |
| Total current assets   | 39,721               | 39,438               | 40,63            |
| Property, plant and equipment:   |                      |                      |                  |
| Land   | 983                  | 983                  | 1,11             |
| Buildings and improvements   | 17,757               | 17,640               | 17,55            |
| Machinery and equipment  | 221,692              | 216,429              | 214,40           |
|  | -----                | -----                | -----            |
|  | 240,432              | 235,052              | 233,07           |
| Accumulated depreciation   | (123,098)            | (114,724)            | (111,67          |
|  | -----                | -----                | -----            |
|  | 117,334              | 120,328              | 121,40           |
| Excess of cost over fair value of net assets<br>acquired, net (goodwill) |                      |                      |                  |
|  | 60,501               | 60,042               | 60,58            |
| Other intangibles  | 10,690               | 10,026               | 10,95            |
| Investments in and advances to affiliated entities                       | 11,003               | 12,340               | 10,52            |
| Other assets   | 15,518               | 14,906               | 13,42            |
|  | -----                | -----                | -----            |
| Total assets   | \$ 254,767           | \$ 257,080           | \$ 257,52        |
|  | =====                | =====                | =====            |

See accompanying Notes to Condensed Consolidated Financial Statements.

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|   | June 30,<br>2005     | December<br>2004   |
|---|----------------------|--------------------|
|   | -----<br>(Unaudited) | -----<br>(Audited) |
| LIABILITIES AND SHAREHOLDERS' EQUITY  |                      |                    |
| Current liabilities:  |                      |                    |
| Notes payable to banks  | \$ 8,419             | \$ 4,7             |
| Trade accounts payable  | 2,874                | 4,3                |
| Accrued interest payable  | 847                  | 8                  |
| Accrued liabilities   | 12,968               | 11,2               |
| Current maturities of long-term debt  | 25,068               | 14,3               |
|   | -----                | -----              |
| Total current liabilities   | 50,176               | 35,5               |
| Long-term debt  | 138,660              | 154,6              |
| Deferred income taxes   | 15,872               | 17,5               |
| Other liabilities   | 3,463                | 3,2                |
|   | -----                | -----              |
| Total liabilities   | 208,171              | 210,9              |
| Minority interests  | 11,250               | 11,5               |
| Commitments and contingencies   |                      |                    |
| Shareholders' equity  |                      |                    |
| Common stock, \$0.0001 par value-10,000,000<br>shares authorized; 2,824,766 issued;<br>2,752,251, 2,757,951 and 2,771,751 outstanding | --                   | --                 |
| Additional paid-in capital  | 21,406               | 21,4               |
| Retained earnings   | 14,643               | 13,7               |
| Accumulated other comprehensive income  | 1,633                | 1,5                |
| Treasury stock, 72,515, 66,815 and 53,015<br>shares, at cost  | (2,336)              | (2,1               |
|   | -----                | -----              |
| Total shareholders' equity  | 35,346               | 34,5               |
|   | -----                | -----              |
| Total liabilities and shareholders' equity  | \$ 254,767           | \$ 257,0           |
|   | =====                | =====              |

See accompanying Notes to Condensed Consolidated Financial Statements.

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|   | THREE MONTHS ENDED<br>JUNE 30, |           | SIX MONTHS ENDED<br>JUNE 30, |
|---|--------------------------------|-----------|------------------------------|
|   | 2005                           | 2004      | 2005                         |
| Revenues  | \$ 22,471                      | \$ 21,087 | \$ 44,089                    |
| Costs and expenses:                                   |                                |           |                              |
| Cost of revenue, excluding depreciation               | 8,095                          | 7,407     | 15,746                       |
| General and administrative costs at operations        | 3,343                          | 3,253     | 6,766                        |
| Corporate office expenses                             | 2,742                          | 2,273     | 4,834                        |
| Depreciation and amortization                         | 5,346                          | 4,927     | 10,541                       |
| Total Expense   | 19,526                         | 17,860    | 37,887                       |
| Operating profit                                      | 2,945                          | 3,227     | 6,202                        |
| Other income (expense):                               |                                |           |                              |
| Investment income                                     | 191                            | 82        | 984                          |
| Interest expense                                      | (2,950)                        | (2,851)   | (5,772)                      |
| Equity in earnings of affiliated companies            | 841                            | 886       | 1,552                        |
|   | (1,918)                        | (1,883)   | (3,236)                      |
| Income before income taxes and minority interests     | 1,027                          | 1,344     | 2,966                        |
| Provision for income taxes                            | (330)                          | (473)     | (1,097)                      |
| Minority interests                                    | (484)                          | (487)     | (961)                        |
| Net income  | \$ 213                         | \$ 384    | \$ 908                       |
| Basic and diluted weighted average shares outstanding | 2,752                          | 2,774     | 2,753                        |
| Basic and diluted earnings per share                  | \$ 0.08                        | \$ 0.14   | \$ 0.33                      |

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

ADDITIONAL

ACCUMULATED  
OTHER

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|  | STOCK OUT-<br>STANDING | COMMON<br>STOCK | PAID-IN<br>CAPITAL | RETAINED<br>EARNINGS | COMPREHENSIVE<br>INCOME |
|--|------------------------|-----------------|--------------------|----------------------|-------------------------|
| Balance at December 31, 2004                             | 2,757,951              | \$ 0            | \$ 21,406          | \$13,735             | \$ 1,588                |
| Net income for the period                                | --                     | --              | --                 | 908                  | --                      |
| Unrealized loss on available<br>for sale securities, net | --                     | --              | --                 | --                   | 45                      |
| Comprehensive income                                     |                        |                 |                    |                      |                         |
| Purchase of Treasury Stock                               | (5,700)                | --              | --                 | --                   | --                      |
| Balance at June 30, 2005                                 | 2,752,251              | \$ 0            | \$ 21,406          | \$14,643             | \$ 1,633                |

See accompanying Notes to Condensed Consolidated Financial Statements.

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

|  | SIX MONTHS ENDED<br>JUNE 30, |          |
|--|------------------------------|----------|
|  | 2005                         | 2004     |
| OPERATING ACTIVITIES:  |                              |          |
| Net Income   | \$ 908                       | \$ 1,987 |
| Adjustments to reconcile net income to net cash provided<br>by operating activities: |                              |          |
| Depreciation and amortization  | 10,541                       | 10,148   |
| Equity in earnings of affiliated companies   | (1,552)                      | (1,598)  |
| Distributions received from affiliated companies                                     | 2,973                        | 879      |
| Minority interests   | 961                          | 944      |
| Changes in operating assets and liabilities:   |                              |          |
| Receivables  | 5                            | (226)    |
| Accounts payable and accrued liabilities   | (1,835)                      | (368)    |
| Other  | (286)                        | (2,112)  |
| Net cash provided by operating activities  | 11,715                       | 9,654    |
| INVESTING ACTIVITIES:  |                              |          |
| Capital expenditures   | (4,205)                      | (6,307)  |

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|  |           |           |
|--|-----------|-----------|
| Acquisition of business                              | (3,594)   | (4,877)   |
| Acquisition of spectrum                              | (500)     | --        |
| Investment in and advances to affiliated entities    | (62)      | (63)      |
| Other  | 217       | (367)     |
|  | -----     | -----     |
| Net cash used in investing activities                | (8,144)   | (11,614)  |
|  | -----     | -----     |
| FINANCING ACTIVITIES:                                |           |           |
| Issuance of long term debt                           | 2,412     | 5,599     |
| Repayments of long term debt                         | (7,650)   | (6,702)   |
| Net proceeds on lines of credit                      | 3,626     | 2,994     |
| Purchase of treasury stock                           | (179)     | (237)     |
| Distributions to partners                            | (1,253)   | (318)     |
|  | -----     | -----     |
| Net cash provided by (used in) financing activities  | (3,044)   | 1,336     |
|  | -----     | -----     |
| Net increase (decrease) in cash and cash equivalents | 527       | (624)     |
| Cash and cash equivalents at beginning of period     | 27,214    | 26,556    |
|  | -----     | -----     |
| Cash and cash equivalents at end of period           | \$ 27,741 | \$ 25,932 |
|  | =====     | =====     |
| Cash paid for:                                       |           |           |
| Interest expense                                     | \$ 5,669  | \$ 5,509  |
|  | =====     | =====     |
| Income taxes   | \$ 1,353  | \$ 1,703  |
|  | =====     | =====     |

See accompanying Notes to Condensed Consolidated Financial Statements.

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LYNCH INTERACTIVE CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

A. BASIS OF PRESENTATION

Lynch Interactive Corporation ("Interactive" or the "Company") consolidates the operating results of its subsidiaries (81%-100% owned at June 30, 2005, December 31, 2004 and June 30, 2004). All material intercompany transactions and balances have been eliminated. Investments in affiliates in which the Company does not have a majority voting control, but has the ability to significantly influence management decisions, are accounted for in accordance with the equity method. The Company accounts for the following affiliated companies on the equity basis of accounting: Coronet Communications Company (20% owned at June 30, 2005, December 31, 2004 and June 30, 2004), Capital Communications Company, Inc. (49% owned at June 30, 2005, December 31, 2004 and June 30, 2004; in addition, Interactive owns a convertible preferred stock which, if converted, would increase its ownership in Capital Communications to 50%), two cellular partnership operations in New Mexico (both 33% owned at June 30, 2005, December 31, 2004 and June 30, 2004), KMG Holdings Group (37% owned since May 2004) and telecommunications operations in North Dakota, Iowa and New York (5% to 14% owned).

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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 and with the instructions to Form 10-Q and Articles 10 and 11 of Regulation S-X. Accordingly, they are not audited and do not include all of the information and footnotes required for complete financial statements. The consolidated financial statements and footnotes included in this Form 10-Q should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2004. 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 six month period ended June 30, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005. 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. Certain prior period amounts in the accompanying consolidated financial statements have been reclassified to conform to current period presentation.

### B. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In June 2004, the Emerging Issues Task Force ("EITF") issued EITF No. 03-01, "The Meaning Of Other-Than-Temporary Impairment And Its Application To Certain Investments". EITF 03-01 includes new guidance for evaluating and recording impairment losses on debt and equity investments, as well as new disclosure requirements for investments that are deemed to be temporarily impaired. The provisions of EITF 03-01 were initially effective for reporting periods beginning after June 15, 2004, while the disclosure requirements for debt and equity securities accounted for under SFAS 115, "Accounting For Certain Investments In Debt And Equity Securities", are effective for annual periods ending after December 15, 2003. In September 2004, the FASB delayed the effective date for the measurement and recognition guidance of EITF 03-01. The Company will evaluate the effect of adopting the recognition and measurement guidance when the final consensus is reached.

In May 2005, the FASB issued SFAS 154, "Accounting Changes and Error Corrections". SFAS 154 eliminates the requirement in APB Opinion No. 20, "Accounting Changes", to include the cumulative effect of changes in accounting principle in the income statement in the period of change. Instead, to enhance the comparability of prior period financial statements, SFAS 154 requires that changes in accounting principle be retrospectively applied. Under the retrospective application, the new accounting principle is applied as of the beginning of the first period presented as if that principle had always been used. Adoption of SFAS 154 is required for accounting changes and corrections of errors made in the fiscal year beginning after December 15, 2005.

In December 2004, the FASB issued SFAS No.153, "Exchanges of Nonmonetary Assets", which eliminates the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. SFAS No.153 will be effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The Company does not believe the adoption of SFAS No.153 will have a material impact on its consolidated financial statements.



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In December 2004, the FASB issued SFAS No.123(R), "Share-Based Payment", which establishes standards for transactions in which an entity exchanges its equity instruments for goods or services. This standard requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. This eliminates the exception to account for such awards using the intrinsic method previously allowable under APB Opinion No.25. SFAS No.123(R) will be effective in the first quarter of 2006. The Company does not believe that the adoption of SFAS No.123(R) will have a material impact on its consolidated financial statements.

In March 2005, the FASB issued Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations" ("FIN 47"), which clarifies that conditional asset retirement obligations are within the scope of SFAS No. 143, "Accounting for Asset Retirement Obligations." FIN 47 requires the Company to recognize a liability for the fair value of conditional asset retirement obligations if the fair value of the liability can be reasonably estimated. The Company does not believe that the adoption of FIN 47 will have a material impact on its financial statements.

### C. ACQUISITIONS AND DISPOSITIONS

In March 2004, the Company signed an agreement to acquire California-Oregon Telecommunications Company ("Cal-Ore") located in Dorris, California. Cal-Ore's subsidiary Cal-Ore Telephone Company is the incumbent service provider for a rural area of about 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 interests in certain cellular partnerships. The acquisition price is \$21.2 million, subject to certain closing adjustments. On May 5, 2005, the California Public Utilities Commission approved the transaction subject to various conditions. The Company expects the acquisition to close in the third quarter of 2005.

In February 2005, Lynch 3G participated in Auction 58 for PCS Spectrum and was high bidder for two licenses, Marquette, MI and Klamath Falls, OR, for a total cost of \$0.5 million.

On March 18, 2005, a subsidiary of the Company, Central Telcom Services, LLC, closed on an agreement with Precis Communications, LLC, to acquire its cable television assets for a purchase price of \$3.5 million. The system has 2,411 cable subscribers located in Sanpete and Sevier Counties, Utah. The preliminary allocation of the purchase price included \$0.4 million of goodwill and \$0.4 million for subscriber lists and other intangible assets.

On July 29, 2005, a subsidiary of the Company closed on the sale of approximately 62% of the Company's security business accounts to an investment group for approximately \$2.75 million, net of holdbacks and fees. The proceeds will be used to retire debt.

### D. INVESTMENTS IN AFFILIATED COMPANIES

Interactive has equity investments in both broadcasting and telecommunications companies.

Summarized financial information for broadcasting companies accounted for by the equity method as of and for the three and six months ended June 30, 2005 and 2004 and as of December 31, 2004, is as follows:

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BROADCASTING COMBINED

|  | JUNE 30,<br>2005 | DECEMBER 31,<br>2004 | JUNE 30,<br>2004 |
|--|------------------|----------------------|------------------|
|  | (in thousands)   |                      |                  |
| Current assets                                   | \$ 4,183         | \$ 6,896             | \$ 5,163         |
| Property, plant & equipment, intangibles & other | 10,463           | 9,558                | 8,749            |
| Total Assets                                     | \$ 14,646        | \$ 16,454            | \$ 13,912        |

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|                            |           |           |           |
|----------------------------|-----------|-----------|-----------|
| Current liabilities        | \$ 2,256  | \$ 3,383  | \$ 2,400  |
| Long term liabilities      | 16,231    | 16,751    | 15,756    |
| Equity                     | (3,841)   | (3,680)   | (4,244)   |
| Total liabilities & equity | \$ 14,646 | \$ 16,454 | \$ 13,912 |
| THREE MONTHS ENDED         |           |           |           |
| Revenues                   | \$ 2,972  |           | \$ 3,204  |
| Gross profit               | 807       |           | 1,062     |
| Net income (loss)          | (72)      |           | 328       |
| SIX MONTHS ENDED           |           |           |           |
| Revenues                   | \$ 6,028  |           | \$ 6,694  |
| Gross profit               | 1,557     |           | 2,318     |
| Net income (loss)          | (171)     |           | 682       |

A wholly owned subsidiary of the Company has a 20% investment in Coronet Communications Company ("Coronet"), which operates television station WHBF-TV, a CBS affiliate in Rock Island, Illinois. A second wholly owned subsidiary of the Company has a 49% investment in Capital Communications Company, Inc. ("Capital"), which operates television station WOI-TV, an ABC affiliate in Des Moines, Iowa. At June 30, 2005, December 31, 2004 and June 30, 2004, the investment in Coronet was carried at a negative \$0.6 million, \$0.6 million and \$0.7 million, respectively, due to the subsidiary's guarantee of \$3.8 million of Coronet's third party debt. The guarantee is in effect for the duration of the loan which expires on December 31, 2005 and would be payable if the equity investee fails to make such payment in accordance with the terms of the loan. Long-term debt of Coronet, at June 30, 2005, totaled \$9.2 million payable quarterly through December 31, 2005 to a third party lender.

At June 30, 2005, December 31, 2004 and June 30, 2004, 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.

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Summarized financial information for telecommunications companies which includes the cellular telephone providers, spectrum license holders, and other telecommunication operations accounted for by the equity method as of and for the three and six months ended June 30, 2005 and 2004 and as of December 31, 2004 is as follows (in thousands):

|  | TELECOMMUNICATIONS COMBINED |                      |                  |
|--|-----------------------------|----------------------|------------------|
|  | JUNE 30,<br>2005            | DECEMBER 31,<br>2004 | JUNE 30,<br>2004 |
|  | (in thousands)              |                      |                  |
| Current assets                                   | \$33,256                    | \$36,080             | \$31,064         |
| Property, plant & equipment, intangibles & other | 34,900                      | 33,087               | 26,350           |
| <b>Total Assets</b>                              | <b>\$68,156</b>             | <b>\$69,167</b>      | <b>\$57,414</b>  |
| Current liabilities                              | \$22,941                    | \$22,745             | \$22,107         |
| Long term liabilities                            | 6,002                       | 5,900                | 8,223            |
| Equity   | 39,213                      | 40,522               | 27,084           |
| <b>Total liabilities &amp; equity</b>            | <b>\$68,156</b>             | <b>\$69,167</b>      | <b>\$57,414</b>  |
| <b>THREE MONTHS ENDED</b>                        |                             |                      |                  |
| Revenues   | \$15,229                    |                      | \$14,443         |
| Gross profit                                     | 6,920                       |                      | 6,567            |
| Net income                                       | 4,005                       |                      | 4,357            |
| <b>SIX MONTHS ENDED</b>                          |                             |                      |                  |
| Revenues   | \$29,998                    |                      | \$26,749         |
| Gross profit                                     | 13,406                      |                      | 12,042           |
| Net income                                       | 7,645                       |                      | 7,652            |

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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 \$4.9 million, \$6.5 million and \$5.5 million at June 30, 2005, December 31, 2004 and June 30, 2004, respectively and included in Investment in and advances to affiliated entities.

E. INDEBTEDNESS

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In June 2005, Interactive closed on a new \$10 million unsecured revolving credit facility, at 1.5% over prime, expiring in 2008, replacing the previous short-term line of credit facility. Borrowings under this and the previous facility, included in Notes payable to banks, were \$4.3 million, \$1.1 million and \$2.6 million at June 30, 2005, December 31, 2004 and June 30, 2004, respectively.

Long-term debt consists of (all interest rates are at June 30, 2005) (in thousands):

|  | JUNE 30,<br>2005 | DECEMBER 31,<br>2004 |     |
|--|------------------|----------------------|-----|
|  |                  |                      |     |
| Rural Electrification Administration ("REA") and Rural Telephone Bank ("RTB") notes payable due quarterly through 2027 at fixed interest rates ranging from 2% to 7.5%. (5.1% weighted average, secured by assets of the telephone companies with a net book value of \$150 million) | \$55,211         | \$ 57,129            | \$  |
| Bank Credit facilities utilized by certain telephone and telephone holding companies due from 2005 to 2016, \$8.3 million at fixed interest rates averaging 8.3% and \$60.0 million at variable interest rates averaging 5.3%.   | 68,347           | 70,402               |     |
| Unsecured notes issued in connection with acquisitions through 2008, at fixed interest rates averaging 9.5%  | 38,419           | 38,983               |     |
| Other  | 1,751            | 2,452                |     |
|  | 163,728          | 168,966              | 1   |
| Current maturities   | (25,068)         | (14,364)             | (   |
|  | \$ 138,660       | \$154,602            | \$1 |
|  |                  |                      |     |

In March 2005, in conjunction with the acquisition of cable assets in Utah, a subsidiary of the Company borrowed \$2.2 million from a bank at variable interest rates included in Bank Credit facilities above.

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 June 30, 2005, the Company is in compliance with all covenants. At June 30, 2005, December 31, 2004 and June 30, 2004, substantially all the subsidiaries' net assets are restricted from distribution to Lynch Interactive.

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F. COMPREHENSIVE INCOME

Other comprehensive income, net of tax, which consists of unrealized gains (losses) on available for sale securities, as of June 30, 2005 and 2004 are as follows (in thousands):

|                                | THREE MONTHS ENDED<br>JUNE 30, |        | SIX MONTHS ENDED<br>JUNE 30, |          |
|--------------------------------|--------------------------------|--------|------------------------------|----------|
|                                | 2005                           | 2004   | 2005                         | 2004     |
| Net income                     | \$ 213                         | \$ 384 | \$ 908                       | \$ 1,987 |
| Unrealized gains               | 209                            | 305    | 69                           | 1,166    |
| Tax effect                     | (71)                           | (104)  | (24)                         | (399)    |
| Net other comprehensive income | 138                            | 201    | 45                           | 767      |
| Comprehensive income           | \$ 351                         | \$ 585 | \$ 953                       | \$ 2,754 |

G. TREASURY STOCK PURCHASES

In January 2005, the Company purchased 5,700 shares of its common stock for treasury at an average investment of \$31.53 per share. The Company has made no additional share repurchases since January.

H. LITIGATION

TAYLOR LITIGATION.

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

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

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Interactive strongly believes that this lawsuit is completely without merit and that relator's damage computations are without basis, and intends to defend the suit vigorously. The U.S. Department of Justice has notified the court that it has declined to intervene in the case. Nevertheless, we cannot predict the ultimate outcome of the litigation, nor can we predict the effect that the lawsuit or its outcome will have on our business or plan of operation. Interactive does not have any insurance to cover its cost of defending this lawsuit, which costs will be material. Interactive does have a directors and officers liability policy but the insurer has reserved its rights under the policy and, as a result, any coverage to be provided to any director or officer of Interactive in connection with a judgment rendered in this action is unclear at this time.

Interactive was formally served with the complaint in July 2002. In September 2002, the defendants filed two motions with the United States District Court for the District of Columbia: a motion to dismiss the lawsuit and a motion to

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transfer the action to the Southern District of New York. In September 2003, the Court granted our motion to transfer the action. A scheduling conference was held in February 2004, at which time the judge approved a scheduling order and discovery commenced. In July 2004, the judge denied in part and granted in part our motion to dismiss. Interactive and its subsidiaries remain parties to the litigation.

In December 2004, the defendants filed a motion in the United States District Court for the District of Columbia to compel the FCC to provide certain information subpoenaed by defendants in order to enable them to conduct their defense. This motion was denied in May 2005 and defendants have filed a notice of appeal with the U. S. Court of Appeals for the D.C. Circuit. Discovery is substantially complete and the preparation and filing of dispositive motions has begun. See "History of Lynch's "C" Block Activities" below.

### HISTORY OF LYNCH'S "C" BLOCK ACTIVITIES.

As part of the Omnibus Budget Resolution of 1993, Congress authorized the FCC to employ competitive bidding procedures to select among mutually exclusive applicants for certain spectrum licenses. Initially the FCC had an initiative to include, among others, African Americans, Native Americans, Asian Americans and women. As a result of this, the FCC conducted auctions beginning in 1995 to allocate spectrum in a competitive manner. Interactive was a participating investor and/or service provider to various entities in this "C-Block" auction.

By December 18, 1995, Interactive (through its predecessor Lynch Corporation) had investments in five entities that participated in the FCC auction for broadband PCS "C" block spectrum (Auction 5). When the auction closed, on May 6, 1996, these five entities, on a combined basis, were the higher bidders for thirty-one 30 MHz licenses at a gross cost of \$288.2 million. These entities were initially put together under the FCC's initiative to include, among others, women, African Americans, Native Americans and Asian Americans. As a result of changes in these initiatives, these same individuals were qualified as small businesses and remained eligible as bidders. These entities received \$72 million of bidding credits, and accordingly the net cost was \$216.2 million. The federal government provided financing for 90% of the cost of these licenses, or \$194.6 million. Interactive's investments in these entities totaled \$21 million.

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Events during and subsequent to Auction 5, made financing these licenses through the capital markets much more difficult than originally anticipated. On April 18, 1997, among other reasons, in order to obtain some economies of scale, such as financing, the five entities merged into Fortunet Communications, Inc. The FCC, in partial response to actions by Nextwave and others, promoted a plan for refinancing the "C" block licenses. In 1997, many of the license holders from Auction 5, including Fortunet, petitioned the FCC for relief in order to afford these small businesses the opportunity to more realistically restructure and build out their systems. The President of Fortunet, Karen Johnson, participated in an FCC sponsored forum on this issue on June 30, 1997. The response from the FCC, which was announced on September 26, 1997 and modified on March 24, 1998, afforded license holders four options. One of these options was the resumption of current debt payments, which had been suspended earlier in 1997 for all such license holders. Another option, amnesty, was to return all licenses and forgo any amounts deposited in exchange for forgiveness of the FCC debt. Other options included: disaggregation, splitting a 30 MHz license into two 15 MHz licenses and forgoing 50% of the amount deposited; and prepayment, return of certain licenses and utilizing 70% of the amount deposited to acquire other licenses, with the other 30% of the deposits to be forfeited.

On June 8, 1998, Fortunet elected to apply its eligible credits relating to its original down payment to the purchase of three licenses for 15 MHz of PCS spectrum in Tallahassee, Panama City and Ocala, Florida. Consistent with an FCC promulgated disaggregation alternative, Fortunet surrendered all the remaining licenses and forfeited 30% of its original down payment in full satisfaction of its government obligations, including forgiveness of all accrued interest. Accordingly, Fortunet retained 15 MHz of spectrum in the three Florida markets covering a population of approximately 962,000 at a net auction cost of \$15.8 million. As a result of this FCC process, disaggregation resulted in a reduction of the bidding credits to \$5.3 million. Fortunet also lost \$6.0 million of its down payment. As a result of this decision, during 1997, Interactive recorded a

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\$7.0 million write down of its investment in Fortunet. As a lawyer who worked on many applications for FCC licenses, Taylor (the relator in this case) is doubtless aware of the details of these FCC initiated alternatives for the "C" Block, as presumably are his law firms.

On April 15, 1999, the FCC completed a reaction of all the C-Block licenses that were surrendered, including the 15 MHz of spectrum that Fortunet returned to the FCC on June 8, 1998 in respect of the Tallahassee, Panama City and Ocala, Florida markets. In that reaction, the successful bidders paid a total of \$2.7 million for those three 15 MHz licenses returned by Fortunet versus the \$15.8 million paid by Fortunet. As a result of this auction, Interactive recorded a further write down of its investment of \$15.4 million, including capitalized costs, to reflect the amount bid for the similar licenses in the reaction.

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

On December 31, 2003, Sunshine, after appropriate corporate and regulatory steps, sold its three 15 MHz licenses to Cingular Wireless for \$13.75 million. Interactive received \$7.6 million as part of the sale transaction versus its cash investment of \$21.9 million initially invested in the original five entities in 1992.

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### 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.

### I. MCI/WORLDCOM RECOVERY

During 2002, the Company wrote off substantially all receivables associated with MCI/WorldCom ("MCI"), which had filed for protection under bankruptcy laws. In the second quarter of 2005, certain of the Company's subsidiaries received cash and stock in MCI, Inc. valued at less than \$0.1 million which has been recorded in income as a reduction to General and Administrative Costs at Operations. In addition, the Company expects to receive \$0.2 million in cash and stock that will be recorded in income when such cash and stock is received.

### J. RELATED PARTY TRANSACTIONS

Expenditures for fees that the Company is incurring with regard to the False Claims Act litigation are based on allocations among defendants, and are subject to negotiation. It is expected that the final allocation may be adjusted subject to final conclusion of the litigation.

At June 30, 2005, December 31, 2004, and June 30, 2004, assets of \$20.8 million, \$15.2 million and \$14.1 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.

### ITEM 2. 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 included elsewhere in this Quarterly Report.

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### 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 fourteen telephone companies, four of which have indirect minority ownership of 2% to 19%, whose operations range in size from approximately 800 to over 10,000 access lines. The Company's telephone operations are located in 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.



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- o 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.
- o 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.
- o THE ECONOMY- Unemployment, building starts, business bankruptcies and the overall health of the economy have a significant effect on demand for our services.
- o 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 has recovered settlements from MCI of less than \$0.1 million through June 30, 2005 and expects to recover an additional \$0.2 million in the third quarter of 2005.
- o 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 Acto ("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.

- o 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.
- o 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.
- o All of our RLECs participate in the National Exchange Carrier Association ("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 nine

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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.

- o USF subsidies are primarily driven by 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.
- o 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 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.
- o 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 Interexchange Carriers ("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:

- o Universal Service Reform: Efforts to modify universal service mechanisms are currently underway at the FCC. In June 2004, the FCC asked the Federal-State Joint Board on Universal Service ("Joint Board") to review the rules relating to the high-cost universal service support mechanisms for rural carriers and to determine the appropriate rural mechanism to succeed the five-year plan adopted in the Rural Task Force Order. In particular, the FCC asked the Joint Board to make recommendations on a long-term universal service plan that ensures that support is specific, predictable, and sufficient to preserve and advance universal service. The FCC asked the Joint Board to ensure that its recommendations are consistent with the goal of ensuring that consumers in rural, insular, and high-cost areas have access to telecommunications and information services at rates that are affordable and reasonably comparable to rates charged for similar services in urban areas. The FCC also asked the Joint Board to consider how support can be effectively targeted to rural telephone companies serving the highest cost areas, while protecting against excessive fund growth. In conducting its review, the Joint Board is supposed to take into account the significant distinctions among rural carriers, and between rural and non-rural carriers and consider all options for determining appropriate universal service support. The Company participated with the RLEC industry in comments to the FCC regarding the potential impact to customers and RLECs in rural America. Total USF support payments are material to the

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Company's financial results.

- o 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 sustaining revenue losses for RLECs.
- o 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

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revenue losses from traditional voice services, Interactive is installing more broadband services and is exploring how to best incorporate VoIP into its business model.

- o Intrastate revenue and operating income at our Michigan telephone company will be substantially reduced in the future due to a state requirement to expand the local calling area. The Company has filed with the state commission to recover a portion of the revenue deficiency by increasing local access rates, however, there is no assurance that it will be successful.

### SECOND QUARTER ENDED JUNE 30, 2005 COMPARED TO 2004

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

|  | Three months ended June 30, |          | Increase   |
|--|-----------------------------|----------|------------|
|  | 2005                        | 2004     | (Decrease) |
| -----  |                             |          |            |
| (Unaudited)                                    |                             |          |            |
| Revenues:                                      |                             |          |            |
| Local access                                   | \$ 2,986                    | \$ 3,058 | \$ (72)    |
| Interstate access                              | 10,237                      | 9,272    | 965        |
| Intrastate access                              | 3,478                       | 3,693    | (215)      |
| Other business                                 | 5,770                       | 5,064    | 706        |
| -----  |                             |          |            |
| Total  | 22,471                      | 21,087   | 1,384      |
| -----  |                             |          |            |
| Operating Cost and Expense:                    |                             |          |            |
| Cost of revenue, excluding depreciation        | 8,095                       | 7,407    | 688        |
| General and administrative costs at operations | 3,343                       | 3,253    | 90         |

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|                               |          |          |          |
|-------------------------------|----------|----------|----------|
| Corporate office expenses     | 2,742    | 2,273    | 469      |
| Depreciation and amortization | 5,346    | 4,927    | 419      |
|                               |          |          |          |
| Total                         | 19,526   | 17,860   | 1,666    |
|                               |          |          |          |
| Operating profit              | \$ 2,945 | \$ 3,227 | \$ (282) |
|                               |          |          |          |

Total revenues in the 2005 second quarter increased \$1.4 million, 6.6%, to \$22.5 million compared to \$21.1 million in 2004. Local access revenue decreased by \$72 resulting from a 3.6% decrease in access lines partially offset by the sale of additional features. The decrease in access lines is due to the increase in cell phone usage and reduction in second lines as customers switch from dial-up internet service to DSL. Interstate access revenue increased \$1.0 million in 2005 primarily due to infrastructure development undertaken in 2002 and 2003, which entitled the Company to increased network access and USF support primarily at the Haviland Telephone Company in Kansas, and to a lesser extent, the effects of 2005 investments resulted in increased network access revenue at our Michigan telephone company. Intrastate network access revenue decreased \$0.2 million due to a loss of toll revenue for dial-up access to the internet at our Michigan telephone company, the gradual phase-out of a New York pool for small carriers, and a reduction of minutes of use at several of our companies. Other business revenues increased \$0.7 million due to increased DSL penetration, and revenues from a small cable company in Utah that the Company acquired in February 2004 as well as a larger acquisition of cable television assets that was completed in March 2005.

Total costs and expenses increased by \$1.7 million to \$19.5 million in the second quarter of 2005. Costs of revenue increased \$0.7 million, or 9.3%, due to additional operating costs related to the infrastructure development in Haviland and costs generated by the cable television operations acquired in February 2004 and March 2005. General and administrative costs incurred at the operations increased \$0.1 million primarily due to increased property taxes due to the Haviland infrastructure development. Corporate office expenses increased \$0.5 million resulting from \$1.6 million of legal costs incurred defending the False Claims Act litigation in 2005 compared to \$0.8 million in 2004. In addition, in

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2005 the Company incurred legal and consulting costs in conjunction with a shareholder proposal to deregister as a public company. Depreciation and amortization increased \$0.4 million primarily due to a 2004 regulatory adjustment.

As a result of the above, operating profit in the second quarter of 2005 decreased by \$0.3 million to \$2.9 million compared to 2004.

### 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

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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" as used in this Form 10-Q 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:

- o 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.
- o 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.
- o 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.
- o 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.

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- o 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.
- o 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.
- o 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.
- o 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 (in thousands):

|                                 | Three months ended June 30,<br>2005 | 2004      | Increase<br>(Decrease) |
|---------------------------------|-------------------------------------|-----------|------------------------|
| -----<br>(Unaudited)            |                                     |           |                        |
| Adjusted operating profit from: |                                     |           |                        |
| Operating units                 | \$ 11,033                           | \$ 10,427 | \$ 606                 |
| Corporate expense:              |                                     |           |                        |
| Taylor litigation               | 1,607                               | 778       | 829                    |
| Other                           | 1,135                               | 1,495     | (360)                  |
|                                 | -----                               |           |                        |
| Total corporate expenses        | 2,742                               | 2,273     | 469                    |
|                                 | -----                               |           |                        |
| Adjusted operating profit       | \$ 8,291                            | \$ 8,154  | \$ 137                 |
|                                 | =====                               |           |                        |
| Reconciliation to net income:   |                                     |           |                        |
| Adjusted operating profit       | \$ 8,291                            | \$ 8,154  | \$ 137                 |
| Depreciation and amortization   | (5,346)                             | (4,927)   | (419)                  |
| Investment income               | 191                                 | 82        | 109                    |
| Interest expense                | (2,950)                             | (2,851)   | (99)                   |
| Equity in income of affiliates  | 841                                 | 886       | (45)                   |

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|                    |        |        |          |
|--------------------|--------|--------|----------|
| Income tax         | (330)  | (473)  | 143      |
| Minority Interests | (484)  | (487)  | 3        |
| -----              |        |        |          |
| Net income         | \$ 213 | \$ 384 | \$ (171) |
| =====              |        |        |          |

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OTHER INCOME (EXPENSE)

In 2005, investment income increased by \$0.1 million primarily due to an increase in interest rates.

Interest expense decreased \$0.1 million due primarily to lower average outstanding borrowings partially offset by higher interest rates.

Equity in earnings of affiliates was \$0.8 million in 2005 and \$0.9 million in 2004 reflecting consistent earnings of the Company's New Mexico cellular investments (RSA 3 and 5) in both periods.

INCOME TAX PROVISION

The income tax provision includes federal, as well as state and local taxes. The tax provision for the second quarter of 2005 and 2004, represent effective tax rates of 45.1% and 44.4% 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 \$0.5 million in both 2005 and 2004 reflecting the consistent earnings of the Company's New Mexico cellular investments.

NET INCOME

Net income in 2005 was \$0.2 million, or \$0.08 per share (basic and diluted), compared to a net income last year of \$0.4 million, or \$0.14 per share (basic and diluted). The Company has no dilutive instruments outstanding.

SIX MONTHS ENDED JUNE 30, 2005 COMPARED TO 2004

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

|                   | Six months ended June 30,<br>2005 | 2004     | Increase<br>(Decrease) |
|-------------------|-----------------------------------|----------|------------------------|
| -----             |                                   |          |                        |
| (Unaudited)       |                                   |          |                        |
| Revenues:         |                                   |          |                        |
| Local access      | \$ 5,844                          | \$ 5,947 | \$ (103)               |
| Interstate access | 19,932                            | 18,610   | 1,322                  |
| Intrastate access | 7,175                             | 7,814    | (639)                  |
| Other business    | 11,138                            | 10,140   | 998                    |
| -----             |                                   |          |                        |
| Total             | 44,089                            | 42,511   | 1,578                  |
| -----             |                                   |          |                        |

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|  |          |          |            |
|--|----------|----------|------------|
| Operating Cost and Expense:                    |          |          |            |
| Cost of revenue, excluding depreciation        | 15,746   | 14,610   | 1,136      |
| General and administrative costs at operations | 6,766    | 6,392    | 374        |
| Corporate office expenses                      | 4,834    | 3,246    | 1,588      |
| Depreciation and amortization                  | 10,541   | 10,148   | 393        |
|  |          |          |            |
| Total  | 37,887   | 34,396   | 3,491      |
|  |          |          |            |
| Operating profit                               | \$ 6,202 | \$ 8,115 | \$ (1,913) |
|  |          |          |            |

Total revenues in the first six months of 2005 increased \$1.6 million, or 3.7%, to \$44.1 million compared to \$42.5 million in 2004. Local access revenue decreased by \$0.1 million resulting from a 3.6% decrease in access lines

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partially offset by the sale of additional features. The decrease in access lines is due to the increase in cell phone usage and reduction in second lines as customers switch from dial-up internet service to DSL. Interstate access revenue increased \$1.3 million in 2005 primarily due to infrastructure development undertaken in 2002 and 2003, which entitled the Company to increased network access and USF support primarily at the Haviland Telephone Company in Kansas, and to a lesser extent, the effects of 2005 investments resulted in increased network access revenue at our Michigan telephone company. Intrastate network access revenue decreased \$0.6 million due to a loss of toll revenue for dial-up access to the internet at our Michigan telephone company, the gradual phase-out of a New York pool for small carriers, and a reduction of minutes of use at several of our companies. Other business revenues increased \$1.0 million due to increased DSL penetration, and revenues from a small cable company in Utah that the Company acquired in February 2004 as well as a larger acquisition of cable television assets that was completed in March 2005.

Total costs and expenses increased by \$3.5 million to \$37.9 million in the first six months of 2005. Costs of revenue increased \$1.1 million, or 7.8%, due to additional operating costs related to the infrastructure development in Haviland and costs generated by the cable television operations acquired in February 2004 and March 2005. General and administrative costs incurred at the operations increased \$0.4 million primarily due to professional fees with regard to local area calling in Michigan and increased audit and Sarbanes - Oxley implementation fees. Corporate office expenses increased \$1.6 million resulting from \$2.8 million of legal costs incurred defending the False Claims Act litigation in 2005 compared to \$1.2 million in 2004. In addition, the Company incurred legal and consulting costs in conjunction with a shareholder proposal to deregister as a public company. Depreciation and amortization increased \$0.4 million primarily due to a 2004 regulatory adjustment.

As a result of the above, operating profit in 2005 decreased by \$1.9 million to \$6.2 million compared to 2004.

### ADJUSTED OPERATING PROFIT

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



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|                                 | Six months ended June 30, |           | Increase   |
|---------------------------------|---------------------------|-----------|------------|
|                                 | 2005                      | 2004      | (Decrease) |
|                                 | -----                     |           |            |
|                                 | (Unaudited)               |           |            |
| Adjusted operating profit from: |                           |           |            |
| Operating units                 | \$ 21,577                 | \$ 21,509 | \$ 68      |
| Corporate expense:              |                           |           |            |
| Taylor litigation               | 2,808                     | 1,150     | 1,658      |
| Other                           | 2,026                     | 2,096     | (70)       |
|                                 | -----                     |           |            |
| Total corporate expenses        | 4,834                     | 3,246     | 1,588      |
|                                 | -----                     |           |            |
| Adjusted operating profit       | \$ 16,743                 | \$ 18,263 | \$ (1,520) |
|                                 | =====                     |           |            |
| Reconciliation to net income:   |                           |           |            |
| Adjusted operating profit       | \$ 16,743                 | \$ 18,263 | \$ (1,520) |
| Depreciation and amortization   | (10,541)                  | (10,148)  | (393)      |
| Investment income               | 984                       | 810       | 174        |
| Interest expense                | (5,772)                   | (5,670)   | (102)      |
| Equity in income of affiliates  | 1,552                     | 1,598     | (46)       |
| Income tax                      | (1,097)                   | (1,922)   | 825        |
| Minority Interests              | (961)                     | (944)     | (17)       |
|                                 | -----                     |           |            |
| Net income                      | \$ 908                    | \$ 1,987  | \$ (1,079) |
|                                 | =====                     |           |            |

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OTHER INCOME (EXPENSE)

In 2005, investment income increased by \$0.2 million primarily due to an increase in CoBank patronage refunds and a \$0.1 million retroactive dividend from Iowa Network Services. Such increases were offset by a \$0.2 million gain on the sale of an investment in the 2004 period.

Interest expense decreased \$0.1 million due primarily to lower average outstanding borrowings partially offset by higher interest rates.

Equity in earnings of affiliates decreased slightly in 2005 reflecting consistent earnings of the Company's New Mexico cellular investments (RSA 3 and 5) in both periods.

INCOME TAX PROVISION

The income tax provision includes federal, as well as state and local taxes. The tax provision for the first six months of 2005 and 2004, represent effective tax rates of 45.5% and 44.5%, respectively. The difference between these effective rates and the federal statutory rate is principally due to state income taxes, including the effect of earnings attributable to different state jurisdictions.

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### MINORITY INTERESTS

Minority interests decreased earnings by similar amounts in both 2005 and 2004 reflecting the consistent earnings of the Company's New Mexico cellular investments.

### NET INCOME

Net income in 2005 was \$0.9 million, or \$0.33 per share (basic and diluted), compared to a net income last year of \$2.0 million, or \$0.72 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. The Interactive parent company ("Parent Company") needs cash primarily to pay corporate expenses, 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.

In June 2005, Interactive closed on a new \$10 million unsecured revolving credit facility of which \$5.7 million was available at June 30, 2005, at 1.5% over prime, expiring in 2008, replacing the previous short-term line of credit facility. The Company continues to have a need for additional credit facilities, but management believes that it has various alternative means to obtain adequate resources to fund operations over the next twelve months.

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

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and lease agreements to make certain cash payments over the term of the agreements. The following table summarizes, as of June 30, 2005 for the periods shown, these contractual obligations and certain other financing commitments from banks and other financial institutions that provide liquidity:

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Payments Due by Period  
(In thousands)

|   | Total     | Less than<br>1 year | 1 - 3 years | 4 - 5 years | After 5<br>years |
|---|-----------|---------------------|-------------|-------------|------------------|
| Long-term debt (a)                                    | \$163,728 | \$ 25,068           | \$ 54,087   | \$ 35,582   | \$ 48,991        |
| Operating leases                                      | 1,271     | 286                 | 455         | 230         | 300              |
| Notes payable to banks                                | 8,419     | 8,419               | --          | --          | --               |
| Guarantees  | 3,750     | 3,750               | --          | --          | --               |
| Total contractual cash obligations<br>and commitments | \$177,168 | \$ 37,523           | \$ 54,542   | \$ 35,812   | \$ 49,293        |

(a) Does not include interest payments on debt

A subsidiary of the Company has guaranteed \$3.8 million of an equity investee's total debt of \$9.2 million. The guarantee is in effect for the duration of the loan which expires on December 31, 2005 and would be payable if the equity investee fails to make such payment in accordance with the terms of the loan.

At June 30, 2005, total debt (including notes payable to banks) was \$172.1 million, a decrease of \$1.7 million from December 31, 2004. At June 30, 2005, there was \$102.6 million of fixed interest rate debt outstanding averaging 7.0% and \$69.6 million of variable interest rate debt averaging 6.3%. The debt at fixed interest rates includes \$38.1 million of subordinated notes at interest rates averaging 9.5% issued to sellers as part of acquisitions. The long-term debt facilities at certain subsidiaries are secured by substantially all of such subsidiaries' assets, while at other subsidiaries it is secured by the common stock of such subsidiaries. In addition, the debt facilities contain certain covenants restricting distribution to Lynch Interactive. At June 30, 2005, December 31, 2004 and June 30, 2004, substantially all of the subsidiaries' net assets are restricted.

Interactive has a high degree of financial leverage. As of June 30, 2005, the ratio of total debt to equity was 4.9 to 1. Certain subsidiaries also have high debt to equity ratios. Management believes that it is currently more beneficial to hold excess cash at certain of our subsidiaries rather than utilizing the cash to pay-down existing credit facilities.

As of June 30, 2005, Interactive had current assets of \$39.7 million and current liabilities of \$50.2 million resulting in a working capital deficiency of \$10.5 million, compared to a surplus of \$3.9 million at December 31, 2004. The reduction in working capital was primarily due to the reclassification of \$11.9 million of long-term debt to current maturities, which will become due prior to June 30, 2006. The Company expects to re-finance such debt prior to their maturity dates.

SOURCES AND USES OF CASH

Cash at June 30, 2005, was \$27.7 million, an increase of \$0.5 million compared to December 31, 2004. The majority of the cash is restricted by debt covenant to the subsidiary that generated it and is generally not available for transfer to the Parent Company. In 2005, net cash provided by operations of \$11.7 million was used to invest in plant and equipment and to repay debt. The acquisition of cable assets in March 2005 was funded in part by \$2.2 million of new borrowings.

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Capital expenditures were \$4.2 million in the 2005 six month period, compared to \$6.3 million in 2004 which is predominantly spent at the RLECs and will be

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included in their rate bases for rate setting purposes. Capital expenditures in 2005 are expected to be approximately \$11 million, most of which will be added to the RLEC rate bases.

On March 18, 2005, a subsidiary of the Company, Central Telcom Services, LLC, closed on an agreement with Precis Communications, LLC, to acquire a cable television assets for a purchase price of \$3.5 million of which \$2.2 million was financed with secured bank debt.

On July 29, 2005, a subsidiary of the Company closed on the sale of approximately 62% of the company's security accounts to an investment group for approximately \$2.75 million, net of holdbacks and fees. The proceeds will be used to retire debt. The Company will continue to monitor such accounts and provide billing and collection services for the new owner.

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.

Subsequent to the spin-off by Lynch Corporation, the Board of Directors of Lynch Interactive Corporation authorized the purchase of up to 100,000 shares of common stock. Through June 30, 2005, 72,700 shares had been purchased at an average cost of \$32.26 per share.

President Bush's proposed Budget for Fiscal Year 2006 establishes the process and terms to implement the dissolution of the Rural Telephone Bank ("RTB"). Under RTB's By-Laws, on dissolution, the holders of its Class B and Class C stock would be paid the par value of their stock. As of December 31, 2004, the total par value of RTB Class B and Class C stock at the Company's subsidiaries was \$11.3 million. The net book value and tax basis of this stock, at that date, was \$1.1 million. The dissolution of the RTB and payments to the stockholders is subject to numerous approvals and actions, including Congressional approval of President Bush's proposed Budget for Fiscal Year 2006 and actions by RTB's Board of Directors. Therefore, the Company cannot predict whether, or when, such payments will actually be made to the Company's subsidiaries.

Lynch Corporation, the Company's predecessor, has not paid any cash dividends on its common stock since 1989. 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.

### CONTINGENCIES

#### TAYLOR LITIGATION.

Interactive and several other parties, including Interactive's CEO, and Fortunet Communications, L.P., which was Sunshine PCS Corporation's predecessor-in-interest, have been named as defendants in a lawsuit brought by

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Taylor under the so-called qui tam provisions of the federal False Claims Act in the United States District Court for the District of Columbia. The complaint was filed under seal with the court in February 2001. At the initiative of one of the defendants, the seal was lifted in January 2002. Under the False Claims Act, a private plaintiff called a relator may file a civil action on the U.S. government's behalf against another party for violation of the statute. In return, the relator receives a statutory bounty from the government's litigation proceeds if he is successful.

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

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Interactive strongly believes that this lawsuit is completely without merit and that relator's initial damage computations are without basis, and intends to defend the suit vigorously. The U.S. Department of Justice has notified the court that it has declined to intervene in the case. Nevertheless, we cannot predict the ultimate outcome of the litigation, nor can we predict the effect that the lawsuit or its outcome will have on our business or plan of operation. Interactive does not have any insurance to cover its cost of defending this lawsuit, which costs will be material. Interactive does have a directors and officers liability policy but the insurer has reserved its rights under the policy and, as a result, any coverage to be provided to any director or officer of Interactive in connection with a judgment rendered in this action is unclear at this time.

Interactive was formally served with the complaint in July 2002. In September 2002, the defendants filed two motions with the United States District Court for the District of Columbia: a motion to dismiss the lawsuit and a motion to transfer the action to the Southern District of New York. In September 2003, the Court granted our motion to transfer the action. A scheduling conference was held in February 2004, at which time the judge approved a scheduling order and discovery commenced. In July 2004, the judge denied in part and granted in part our motion to dismiss. Interactive and its subsidiaries remain parties to the litigation.

In December 2004, the defendants filed a motion in the United States District Court for the District of Columbia to compel the FCC to provide certain information subpoenaed by defendants in order to enable them to conduct their defense. This motion was denied in May 2005 and defendants have filed a notice of appeal with the U.S. Court of Appeals for the D.C. Circuit. Discovery is substantially complete and the preparation and filing of dispositive motions has begun.

See also "H. Litigation - History of Lynch's C-Block Activities" above for a history of our involvement in Auction 5.

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### 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.

### CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of consolidated financial statements requires Interactive's management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, Interactive evaluates its estimates, including those related to revenue recognition, carrying value of its investments in spectrum entities and long-lived assets, purchase price allocations, and contingencies and litigation. Interactive bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Interactive believes the following critical accounting policies affect its more significant judgments and estimates used in the preparation of its consolidated financial statements.

We believe that revenue from interstate access for our "cost-based" companies is based on critical accounting estimates and judgment. Such revenue 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 for cost-based companies are determined based on the various subsidiaries' cost of providing interstate telecommunications service. Interactive recognizes interstate access revenue as services are provided based on an estimate of the current year cost of providing service. Estimated revenue is adjusted to actual upon the completion of cost

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studies in the subsequent period. In addition, an accounting estimate is required of the potential liability that may be required for NECA pool over-earnings.

Interactive's business development strategy is to expand its existing operations through internal growth and acquisition. From 1989 through 2001, the Company has acquired fourteen telephone companies. Significant judgments and estimates are required to allocate the purchase price of acquisitions to the fair value of tangible assets acquired and identifiable intangible assets and liabilities assumed. Any excess purchase price over the above fair values is allocated to goodwill. Additional judgments and estimates are required to determine if identified intangible assets have finite or indefinite lives.

Annually, the Company tests goodwill and other intangible assets with indefinite lives for impairment. The Company screens for potential impairment by determining 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

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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.

We consider the estimate of fair value to be a critical accounting estimate because (a) a potential goodwill impairment could have a material impact on our financial position and results of operations and (b) the estimate is based on a number of highly subjective judgments and assumptions, the most critical of which is that the regulatory environment will continue in its current form.

Interactive tests its investments and other long-term non-regulated assets annually whenever events or changes in circumstances indicate that the carrying value of such assets may not be recoverable. Significant judgment is required to determine if an impairment has occurred and whether such impairment is "other than temporary."

The calculation of depreciation and amortization expense is based on the estimated economic useful lives of the underlying property, plant and equipment and intangible assets. Although Interactive believes it is unlikely that any significant changes to the useful lives of its tangible or intangible assets will occur in the near term, rapid changes in technology, the discontinuance of accounting under SFAS No. 71 by the Company's wireline subsidiaries, or changes in market conditions could result in revisions to such estimates that could materially affect the carrying value of these assets and the Company's future consolidated operating results.

### RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In June 2004, the Emerging Issues Task Force ("EITF") issued EITF No. 03-01, "The Meaning Of Other-Than-Temporary Impairment And Its Application To Certain Investments". EITF 03-01 includes new guidance for evaluating and recording impairment losses on debt and equity investments, as well as new disclosure requirements for investments that are deemed to be temporarily impaired. The provisions of EITF 03-01 were initially effective for reporting periods beginning after June 15, 2004, while the disclosure requirements for debt and equity securities accounted for under SFAS 115, "Accounting For Certain Investments In Debt And Equity Securities", are effective for annual periods ending after December 15, 2003. In September 2004, the FASB delayed the effective date for the measurement and recognition guidance of EITF 03-01. The Company will evaluate the effect of adopting the recognition and measurement guidance when the final consensus is reached.

In May 2005, the FASB issued SFAS 154, "Accounting Changes and Error Corrections". SFAS 154 eliminates the requirement in APB Opinion No. 20, "Accounting Changes", to include the cumulative effect of changes in accounting principle in the income statement in the period of change. Instead, to enhance the comparability of prior period financial statements, SFAS 154 requires that changes in accounting principle be retrospectively applied. Under the retrospective application, the new accounting principle is applied as of the beginning of the first period presented as if that principle had always been used. Adoption of SFAS 154 is required for accounting changes and corrections of errors made in the fiscal year beginning after December 15, 2005.

In December 2004, the FASB issued SFAS No.153, "Exchanges of Nonmonetary Assets", which eliminates the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. SFAS No.153 will be effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The Company does not believe the adoption of SFAS No.153 will have a material impact on its consolidated financial statements.

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In December 2004, the FASB issued SFAS No.123(R), "Share-Based Payment", which establishes standards for transactions in which an entity exchanges its equity instruments for goods or services. This standard requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. This eliminates the exception to account for such awards using the intrinsic method previously allowable under APB Opinion No.25. SFAS No.123(R) will be effective in the first quarter of 2006. The Company does not believe that the adoption of SFAS No.123(R) will have a material impact on its consolidated financial statements.

In March 2005, the FASB issued Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations" ("FIN 47"), which clarifies that conditional asset retirement obligations are within the scope of SFAS No. 143, "Accounting for Asset Retirement Obligations." FIN 47 requires the Company to recognize a liability for the fair value of conditional asset retirement obligations if the fair value of the liability can be reasonably estimated. The Company does not believe that the adoption of FIN 47 will have a material impact on its financial statements.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

The Company is exposed to market risks relating to changes in the general level of U.S. interest rates. Changes in interest rates affect the amount of interest earned on the Company's cash equivalents and short-term investments (approximately \$27.7 million at June 30, 2005 and \$27.2 million at December 31, 2004). The majority of the Company's debt is fixed rate and the Company generally finances the acquisition of long-term assets by borrowing on a fixed long-term basis. The Company does not use derivative financial instruments for trading or speculative purposes. Management does not foresee any significant changes in the strategies used to manage interest rate risk in the near future, although the strategies may be reevaluated as market conditions dictate. As of June 30, 2005, the fair value of debt was approximately equal to its carrying value.

At June 30, 2005 and December 31, 2004, approximately \$69.6 million and \$67.2 million, respectively, or 40% and 39% of Interactive's long-term debt and notes payable bears interest at variable rates. Accordingly, the Company's earnings and cash flows are affected by changes in interest rates. Assuming the current level of borrowings for variable rate debt and assuming a one percentage point change in the 2005 average interest rate under these borrowings, it is estimated that Interactive's interest expense in the six months of 2005 would have changed by approximately \$0.3 million. In the event of an adverse change in interest rates, management would likely take actions to further mitigate its exposure. However, due to the uncertainty of the actions that would be taken and their possible effects, no such actions are assumed. As of June 30, 2005, if the Company were to convert a significant portion of its variable interest rate debt into fixed interest rates, such conversion could have increased interest expense for the six month period by \$0.9 million assuming that variable rates remain constant. Further, such analysis does not consider the effects of the change in the level of overall economic activity that could exist in such an environment.

### ITEM 4. CONTROLS AND PROCEDURES

Our Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in



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Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934 (the "Act")) as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures as of the end of the period covered by this report were designed and were functioning effectively to provide reasonable assurance that the information required to be disclosed by the Company in reports filed under the Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. The Company believes that a controls system, no matter how well designed and operated, cannot provide absolute assurance that the objectives of the controls system are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected.

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During the period covered by this report, there have been no changes in our internal control over financial reporting that have materially affected, or is reasonably likely to materially affect, our financial statements.

### PART II. OTHER INFORMATION

#### ITEM 1. LEGAL PROCEEDINGS

##### TAYLOR LITIGATION.

Interactive and several other parties, including Interactive's CEO, and Fortunet Communications, L.P., which was Sunshine PCS Corporation's predecessor-in-interest, have been named as defendants in a lawsuit originally brought by Taylor under the so-called qui tam provisions of the federal False Claims Act in the United States District Court for the District of Columbia. The complaint was filed under seal with the court in February 2001. At the initiative of one of the defendants, the seal was lifted in January 2002. Under the False Claims Act, a private plaintiff called a relator may file a civil action on the U.S. government's behalf against another party for violation of the statute. In return, the relator receives a statutory bounty from the government's litigation proceeds if he is successful.

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

Interactive strongly believes that this lawsuit is completely without merit and that relator's damage computations are without basis, and intends to defend the suit vigorously. The U.S. Department of Justice has notified the court that it has declined to intervene in the case. Nevertheless, we cannot predict the ultimate outcome of the litigation, nor can we predict the effect that the lawsuit or its outcome will have on our business or plan of operation. Interactive does not have any insurance to cover its cost of defending this lawsuit, which costs will be material. Interactive does have a directors and

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officers liability policy but the insurer has reserved its rights under the policy and, as a result, any coverage to be provided to any director or officer of Interactive in connection with a judgment rendered in this action is unclear at this time.

Interactive was formally served with the complaint in July 2002. In September 2002, the defendants filed two motions with the United States District Court for the District of Columbia: a motion to dismiss the lawsuit and a motion to transfer the action to the Southern District of New York. In September 2003, the Court granted our motion to transfer the action. A scheduling conference was held in February 2004, at which time the judge approved a scheduling order and discovery commenced. In July 2004, the judge denied in part and granted in part our motion to dismiss. Interactive and its subsidiaries remain parties to the litigation.

In December 2004, the defendants filed a motion in the United States District Court for the District of Columbia to compel the FCC to provide certain information subpoenaed by defendants in order to enable them to conduct their defense. This motion was denied in May 2005 and defendants are considering appropriate responses. Discovery is substantially complete and the preparation and filing of dispositive motions has begun. See "History of Lynch's "C" Block Activities" below.

### HISTORY OF LYNCH'S "C" BLOCK ACTIVITIES.

As part of the Omnibus Budget Resolution of 1993, Congress authorized the FCC to employ competitive bidding procedures to select among mutually exclusive applicants for certain spectrum licenses. Initially the FCC had an initiative to include, among others, African Americans, Native Americans, Asian Americans and

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women. As a result of this, the FCC conducted auctions beginning in 1995 to allocate spectrum in a competitive manner. Interactive was a participating investor and/or service provider to various entities in this "C-Block" auction.

By December 18, 1995, Interactive (through its predecessor Lynch Corporation) had investments in five entities that participated in the FCC auction for broadband PCS "C" block spectrum (Auction 5). When the auction closed, on May 6, 1996, these five entities, on a combined basis, were the higher bidders for thirty-one 30 MHz licenses at a gross cost of \$288.2 million. These entities were initially put together under the FCC's initiative to include, among others, women, African Americans, Native Americans and Asian Americans. As a result of changes in these initiatives, these same individuals were qualified as small businesses and remained eligible as bidders. These entities received \$72 million of bidding credits, and accordingly the net cost was \$216.2 million. The federal government provided financing for 90% of the cost of these licenses, or \$194.6 million. Interactive's investments in these entities totaled \$21 million.

Events during and subsequent to Auction 5, made financing these licenses through the capital markets much more difficult than originally anticipated. On April 18, 1997, among other reasons, in order to obtain some economies of scale, such as financing, the five entities merged into Fortunet Communications, Inc. The FCC, in partial response to actions by Nextwave and others, promoted a plan for refinancing the "C" block licenses. In 1997, many of the license holders from Auction 5, including Fortunet, petitioned the FCC for relief in order to afford these small businesses the opportunity to more realistically restructure and

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build out their systems. The President of Fortunet, Karen Johnson, participated in an FCC sponsored forum on this issue on June 30, 1997. The response from the FCC, which was announced on September 26, 1997 and modified on March 24, 1998, afforded license holders four options. One of these options was the resumption of current debt payments, which had been suspended earlier in 1997 for all such license holders. Another option, amnesty, was to return all licenses and forgo any amounts deposited in exchange for forgiveness of the FCC debt. Other options included: disaggregation, splitting a 30 MHz license into two 15 MHz licenses and forgoing 50% of the amount deposited; and prepayment, return of certain licenses and utilizing 70% of the amount deposited to acquire other licenses, with the other 30% of the deposits to be forfeited.

On June 8, 1998, Fortunet elected to apply its eligible credits relating to its original down payment to the purchase of three licenses for 15 MHz of PCS spectrum in Tallahassee, Panama City and Ocala, Florida. Consistent with an FCC promulgated disaggregation alternative, Fortunet surrendered all the remaining licenses and forfeited 30% of its original down payment in full satisfaction of its government obligations, including forgiveness of all accrued interest. Accordingly, Fortunet retained 15 MHz of spectrum in the three Florida markets covering a population of approximately 962,000 at a net auction cost of \$15.8 million. As a result of this FCC process, disaggregation resulted in a reduction of the bidding credits to \$5.3 million. Fortunet also lost \$6.0 million of its down payment. As a result of this decision, during 1997, Interactive recorded a \$7.0 million write down of its investment in Fortunet. A lawyer who worked on many applications for FCC licenses, Taylor (the relator in this case) is doubtless aware of the details of these FCC initiated alternatives for the "C" Block, as presumably are his law firms.

On April 15, 1999, the FCC completed a reauction of all the C-Block licenses that were surrendered, including the 15 MHz of spectrum that Fortunet returned to the FCC on June 8, 1998 in respect of the Tallahassee, Panama City and Ocala, Florida markets. In that reauction, the successful bidders paid a total of \$2.7 million for those three 15 MHz licenses returned by Fortunet versus the \$15.8 million paid by Fortunet. As a result of this auction, Interactive recorded a further write down of its investment of \$15.4 million, including capitalized costs, to reflect the amount bid for the similar licenses in the reauction.

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

On December 31, 2003, Sunshine, after appropriate corporate and regulatory steps, sold its three 15 MHz licenses to Cingular Wireless for \$13.75 million. Interactive received \$7.6 million as part of the sale transaction versus its cash investment of \$21.9 million initially invested in the original five entities in 1992.

### 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.

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### ITEM 2. ISSUER PURCHASES OF EQUITY SECURITIES

| PERIOD            | TOTAL NUMBER<br>OF SHARES (OR<br>UNITS)<br>PURCHASED | AVERAGE PRICE<br>PAID PER SHARE<br>(OR UNIT) | TOTAL NUMBER OF<br>SHARES PURCHASED<br>AS PART OF PUBLICLY<br>ANNOUNCED PLANS<br>OR PROGRAMS (1) | MAXIMUM NUMBER<br>OF (OR APPROXIM<br>DOLLAR VALUE)<br>SHARES THAT MAY<br>BE PURCHASED U<br>THE PLANS O<br>PROGRAMS (1) |
|-------------------|--|--|--|--|
| -----             | -----  | -----  | -----  | -----  |
| 4/1/05 to 4/30/05 | --   | --   | --   | 27,300   |
| 5/1/05 to 5/31/05 | --   | --   | --   | 27,300   |
| 6/1/05 to 6/30/05 | --   | --   | --   | 27,300   |
| -----             |  |  |  |  |
| Total             | --   | --   | --   |  |
| =====             |  |  |  |  |

- (1) In September 1999, the Board of Interactive approved a stock repurchase program providing for the purchase of up to 100,000 shares of Common Stock in such manner, at such times and at such prices as the Chief Executive Officer or his designee determines.

### ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

#### (a) Exhibits

Exhibit 31.1 - Chief Executive Officer Section 302 Certification.  
 Exhibit 31.2 - Chief Financial Officer Section 302 Certification.  
 Exhibit 32.1 - Chief Executive Officer Section 906 Certification.  
 Exhibit 32.2 - Chief Financial Officer Section 906 Certification.

- (b) Reports on Form 8-K during the quarter reported on: - Current Report on Form 8-K filed April 4, 2005, under Items 7 and 12 reporting the issuance of a press release regarding the Company's operating results for the quarter and year ended December 31, 2004.  
 - Current Report on Form 8-K filed May 16, 2005, under Items 7 and 12 reporting the issuance of a press release regarding the company's first quarter 2005 operating results.  
 - Current Report on Form 8-K filed June 15, 2005 under Item 1 and Item 9 reporting on the closing of the Company's three year \$10 million revolving credit line with Webster Bank, N.A.

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SIGNATURE

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

LYNCH INTERACTIVE CORPORATION  
(Registrant)

/s/ Robert E. Dolan

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Robert E. Dolan  
Chief Financial Officer

August 15, 2005