

INTER TEL INC  
Form 10-K/A  
August 11, 2006

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-K/A**

**Amendment No. 2**

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT  
OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2005**

**Commission file number 1-10211**

**INTER-TEL (DELAWARE), INCORPORATED**

(formerly Inter-Tel, Incorporated)

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or  
organization)

86-0220994

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

1615 S. 52<sup>nd</sup> Street

Tempe, Arizona

(Address of principal executive offices)

85281

(Zip Code)

(480) 449-8900

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act: Common Stock, Par Value \$0.001 per Share

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES  NO

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. YES  NO

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, and (2) has been subject to such filing requirements for the past 90 days. YES  NO

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. YES  NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated Filer

Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES  NO

As of June 30, 2005, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was approximately \$485.3 million based on the closing sale price as reported on the Nasdaq National Market System. Shares of Common Stock held by each executive officer and director as of June 30, 2005 have been excluded in that such persons may be deemed to be affiliates.

As of March 6, 2006, there were 26,368,701 shares of the registrant's common stock outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

None

**INTER-TEL (DELAWARE), INCORPORATED  
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**EXPLANATORY NOTE**

Inter-Tel (Delaware), Incorporated (the Company) is filing this Amendment No. 2 to its annual report for the fiscal year ended December 31, 2005 on Form 10-K in order to correct a formatting error which occurred in connection with the original filing of the Company's annual report of March 16, 2006 (the Original Filing). *There are no changes to the Company's financial statements whatsoever.*

Subsequent to filing the annual report on Form 10-K for the year ended December 31, 2005, the Company reincorporated as a Delaware corporation and changed its name to Inter-Tel (Delaware), Incorporated from Inter-Tel, Incorporated. The cover page and signature pages for this Amendment No. 2 on Form 10-K/A use the current name of Inter-Tel (Delaware), Incorporated. The financial statements and the Report of Independent Registered Public Accounting Firm continue to use the name Inter-Tel, Incorporated as used in the original filing on Form 10-K. Due to an oversight in the preparation of the Original Filing on EDGAR, the Report of Independent Registered Public Accounting Firm provided by Ernst & Young became spatially separated from the financial statements. In the electronic version of the Original Filing, the Report of Independent Registered Public Accounting Firm was filed in Exhibit 13 to the Original Filing, while the financial statements appeared in the body of the Original Filing. This Amendment brings together the Report of Independent Registered Public Accounting Firm and financial statements for filing under Item 8. The formatting error occurred only in the EDGAR-filed version of the Original Filing and did not occur with respect to printed versions of the document.

**PART II**

**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

**Report of Independent Registered Public Accounting Firm**

Shareholders and Board of Directors

Inter-Tel, Incorporated

We have audited the accompanying consolidated balance sheets of Inter-Tel, Incorporated and subsidiaries as of December 31, 2005 and 2004, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2005. Our audits also included the financial statement schedule listed in the index at Item 15(a)2. These financial statements and the schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Inter-Tel, Incorporated and subsidiaries at December 31, 2005 and 2004, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

As described in Note A, Restatement of Previously Issued Financial Statements, the Company has restated previously issued financial statements as of December 31, 2004 and for the years ended December 31, 2004 and 2003 and beginning retained earnings as of January 1, 2003.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Inter-Tel, Incorporated's internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 10, 2006 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Phoenix, Arizona  
March 10, 2006

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CONSOLIDATED BALANCE SHEETS**

December 31, 2005 and 2004

(In thousands, except share amounts)

|  | <b>2005</b>       | <b>2004<br/>Restated</b> |
|--|-------------------|--------------------------|
| <b>ASSETS</b>  |                   |                          |
| <b>CURRENT ASSETS</b>  |                   |                          |
| Cash and equivalents   | \$ 103,774        | \$ 152,330               |
| Short-term investments   | 63,689            | 52,644                   |
| <b>TOTAL CASH AND SHORT-TERM INVESTMENTS</b>   | <b>167,463</b>    | <b>204,974</b>           |
| Accounts receivable, net of allowances of \$6,235 in 2005 and \$9,921 in 2004                    | 44,072            | 44,167                   |
| Inventories  | 19,644            | 16,055                   |
| Net investment in sales-leases, net of allowances of \$998 in 2005 and \$886 in 2004             | 19,699            | 17,151                   |
| Income taxes receivable  | 2,062             | 4,017                    |
| Deferred income taxes  | 12,590            | 10,563                   |
| Prepaid expenses and other assets  | 14,253            | 7,194                    |
| <b>TOTAL CURRENT ASSETS</b>  | <b>279,783</b>    | <b>304,121</b>           |
| <b>LONG-TERM INVESTMENTS</b>   |                   | 9,900                    |
| <b>PROPERTY, PLANT &amp; EQUIPMENT</b>   | 28,236            | 27,840                   |
| <b>GOODWILL</b>  | 29,840            | 21,057                   |
| <b>PURCHASED INTANGIBLE ASSETS</b>   | 23,651            | 10,987                   |
| <b>NET INVESTMENT IN SALES-LEASES</b> , net of allowances of \$1,926 in 2005 and \$1,810 in 2004 | 34,758            | 33,877                   |
| <b>TOTAL ASSETS</b>  | <b>\$ 396,268</b> | <b>\$ 407,782</b>        |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>   |                   |                          |
| <b>CURRENT LIABILITIES</b>   |                   |                          |
| Accounts payable   | \$ 29,879         | \$ 30,801                |
| Other current liabilities  | 54,386            | 52,923                   |
| <b>TOTAL CURRENT LIABILITIES</b>   | <b>84,265</b>     | <b>83,724</b>            |
| <b>DEFERRED TAX LIABILITY</b>  | 70,439            | 65,925                   |
| <b>LEASE RECOURSE LIABILITY</b>  | 14,199            | 12,241                   |
| <b>OTHER LIABILITIES</b>   | 7,034             | 7,063                    |
| <b>SHAREHOLDERS EQUITY</b>   |                   |                          |
| Common stock, no par value-authorized 100,000,000 shares; issued 27,161,823 shares;              |                   |                          |
| outstanding 26,264,458 shares at December 31, 2005 and 26,125,799 shares at December 31, 2004    | 120,489           | 116,598                  |
| Retained earnings  | 114,653           | 133,853                  |

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|   |            |            |
|---|------------|------------|
| Accumulated other comprehensive income (loss)                                     | (36)       | 924        |
|   | 235,106    | 251,375    |
| Less: Treasury stock at cost 897,365 shares in 2005 and 1,036,024 shares in 2004. | (14,775)   | (12,546)   |
| <b>TOTAL SHAREHOLDERS EQUITY</b>  | 220,331    | 238,829    |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>                                  | \$ 396,268 | \$ 407,782 |

See accompanying notes.

**Table of Contents****INTER-TEL, INCORPORATED AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME**

Years Ended December 31, 2005, 2004 and 2003

(In thousands, except per share data)

|   | <b>2005</b> | <b>2004<br/>Restated</b> | <b>2003<br/>Restated</b> |
|---|-------------|--------------------------|--------------------------|
| <b>NET SALES</b>                                    |             |                          |                          |
| Telecommunications systems, software and related    | \$ 387,606  | \$ 367,969               | \$ 330,014               |
| Resale of local, long distance and network services | 55,288      | 48,799                   | 43,624                   |
| <b>TOTAL NET SALES</b>                              | 442,894     | 416,768                  | 373,638                  |
| Cost of sales                                       |             |                          |                          |
| Telecommunications systems, software and related    | 182,789     | 165,345                  | 150,237                  |
| Resale of local, long distance and network services | 33,795      | 29,973                   | 26,526                   |
| <b>TOTAL COST OF SALES</b>                          | 216,584     | 195,318                  | 176,763                  |
| <b>GROSS PROFIT</b>                                 | 226,310     | 221,450                  | 196,875                  |
| Research and development                            | 33,258      | 28,815                   | 21,978                   |
| Selling, general and administrative                 | 151,586     | 139,917                  | 128,964                  |
| Amortization of purchased intangible assets         | 4,194       | 1,867                    | 1,803                    |
| In-process research and development                 | 2,600       |                          |                          |
| Other charges                                       | 11,986      | 9,261                    |                          |
|   | 203,624     | 179,860                  | 152,745                  |
| <b>OPERATING INCOME</b>                             | 22,686      | 41,590                   | 44,130                   |
| Recovery of investment in Inter-Tel.NET / Vianet    |             |                          | 124                      |
| Interest and other income                           | 4,073       | 2,654                    | 1,683                    |
| Foreign currency transaction gains (losses)         | 215         | (399)                    | 18                       |
| Interest expense                                    | (85)        | (118)                    | (155)                    |
| <b>INCOME BEFORE INCOME TAXES</b>                   | 26,889      | 43,727                   | 45,800                   |
| <b>INCOME TAXES (BENEFIT)</b>                       |             |                          |                          |
| Current   | 7,136       | 5,675                    | (12,784)                 |
| Deferred  | 1,899       | 10,839                   | 29,949                   |
|   | 9,035       | 16,514                   | 17,165                   |



|  |           |           |           |
|--|-----------|-----------|-----------|
| <b>NET INCOME</b>                      | \$ 17,854 | \$ 27,213 | \$ 28,635 |
| <b>NET INCOME PER SHARE</b>            |           |           |           |
| Basic                                  | \$ 0.68   | \$ 1.06   | \$ 1.14   |
| Diluted                                | \$ 0.66   | \$ 1.00   | \$ 1.08   |
| Weighted average basic common shares   | 26,261    | 25,767    | 25,078    |
| Weighted average diluted common shares | 27,207    | 27,266    | 26,473    |

See accompanying notes.

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CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY**

Years Ended December 31, 2005, 2004 and 2003

|  | Outstanding | Common     | Share-<br>holder | Retained  | Accumulated<br>Other<br>Comprehensive<br>Income | Treasury    | Total      |
|--|-------------|------------|------------------|-----------|---|-------------|------------|
| (in thousands)   | Shares      | Stock      | Loans            | Earnings  | (Loss)  | Stock       |            |
| <b>Balance at<br/>December 31, 2002<br/>(Restated)</b> | 24,910      | \$ 111,639 | \$ (338)         | \$ 88,765 | \$ 195  | \$ (27,236) | \$ 173,025 |
| Net income Restated                                    |             |            |                  | 28,635    |   |             | 28,635     |
| Gain on currency<br>translation                        |             |            |                  |           | 830   |             | 830        |
| Comprehensive income                                   |             |            |                  |           |   |             | 29,465     |
| Stock repurchase                                       | (8)         |            |                  | (58)      |   | (149)       | (207)      |
| Exercise of stock options                              | 470         |            |                  | (465)     |   | 5,701       | 5,236      |
| Tax benefit from stock<br>options                      |             | 2,321      |                  |           |   |             | 2,321      |
| Shareholder loan<br>repayments                         |             |            | 338              |           |   |             | 338        |
| Stock issued under ESPP                                | 58          |            |                  | 210       |   | 705         | 915        |
| Dividends  |             |            |                  | (4,549)   |   |             | (4,549)    |
| <b>Balance at<br/>December 31, 2003<br/>(Restated)</b> | 25,430      | 113,960    |                  | 112,538   | 1,025   | (20,979)    | 206,544    |
| Net income Restated                                    |             |            |                  | 27,213    |   |             | 27,213     |
| Loss on currency<br>translation                        |             |            |                  |           | (101)   |             | (101)      |
| Comprehensive income                                   |             |            |                  |           |   |             | 27,112     |
| Exercise of stock options                              | 646         |            |                  | 380       |   | 7,830       | 8,210      |
| Tax benefit from stock<br>options                      |             | 2,638      |                  |           |   |             | 2,638      |
| Stock issued under ESPP                                | 50          |            |                  | 448       |   | 603         | 1,051      |
| Dividends  |             |            |                  | (6,726)   |   |             | (6,726)    |

|  |        |            |    |            |         |             |            |
|--|--------|------------|----|------------|---------|-------------|------------|
| <b>Balance at<br/>December 31, 2004<br/>(Restated)</b> | 26,126 | 116,598    |    | 133,853    | 924     | (12,546)    | 238,829    |
| Net income   |        |            |    | 17,854     |         |             | 17,854     |
| Loss on currency<br>translation                        |        |            |    |            | (960)   |             | (960)      |
| Comprehensive income                                   |        |            |    |            |         |             | 16,894     |
| Stock repurchase                                       | (717)  |            |    |            |         | (13,777)    | (13,777)   |
| Exercise of stock options                              | 786    |            |    | (1,980)    |         | 10,406      | 8,426      |
| Tax benefit from stock<br>options                      |        | 3,891      |    |            |         |             | 3,891      |
| Stock issued under ESPP                                | 69     |            |    | 54         |         | 1,142       | 1,196      |
| Dividends  |        |            |    | (35,128)   |         |             | (35,128)   |
| <b>Balance at<br/>December 31, 2005</b>                | 26,264 | \$ 120,489 | \$ | \$ 114,653 | \$ (36) | \$ (14,775) | \$ 220,331 |

See accompanying notes.

**Table of Contents****INTER-TEL, INCORPORATED AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS**

Years Ended December 31, 2005, 2004 and 2003

(In thousands)

|   | <b>2005</b>     | <b>2004</b><br><b>Restated</b> | <b>2003</b><br><b>Restated</b> |
|---|-----------------|--------------------------------|--------------------------------|
| <b>OPERATING ACTIVITIES:</b>  |                 |                                |                                |
| Net income  | \$ 17,854       | \$ 27,213                      | \$ 28,635                      |
| Adjustments to reconcile net income to net cash provided by operating activities: |                 |                                |                                |
| Depreciation of fixed assets  | 9,260           | 7,915                          | 7,109                          |
| Amortization of purchased intangibles   | 4,194           | 1,867                          | 1,803                          |
| Amortization of patents included in research and development expenses             | 199             | 222                            | 222                            |
| In-process research and development   | 2,600           |                                |                                |
| Non-cash portion of other charges (recoveries)                                    |                 |                                | (124)                          |
| Provision for losses on receivables   | 1,151           | 1,525                          | 3,164                          |
| Provision for losses on leases  | 3,772           | 3,839                          | 4,528                          |
| Provision for inventory valuation   | 579             | 1,377                          | 991                            |
| Decrease in other liabilities   | (1,110)         | (2,380)                        | (3,564)                        |
| Loss on sale of property and equipment  | 83              | 10                             | 118                            |
| Deferred income tax expense   | 1,899           | 10,839                         | 29,949                         |
| Changes in operating assets and liabilities                                       | (10,994)        | 2,123                          | (18,771)                       |
| <b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>                                  | <b>29,487</b>   | <b>54,550</b>                  | <b>54,060</b>                  |
| <b>INVESTING ACTIVITIES:</b>  |                 |                                |                                |
| Purchases of available for sale short-term investments                            | (60,832)        | (78,411)                       | (170,464)                      |
| Maturities and sales of available for sale short-term investments                 | 57,687          | 87,100                         | 152,046                        |
| Purchases of held-to-maturity investments   |                 | (11,900)                       |                                |
| Maturities of held-to-maturity investments  | 2,000           |                                |                                |
| Additions to property and equipment and equipment held under lease                | (8,706)         | (10,705)                       | (7,048)                        |
| Proceeds from sale of property and equipment and equipment held under lease       | 32              | 25                             | 76                             |
| Proceeds from investment in Inter-Tel.NET/Vianet                                  |                 |                                | 1,450                          |
| Cash used in acquisitions and other investments                                   | (28,208)        | (6,205)                        | (3,100)                        |
| <b>NET CASH USED IN INVESTING ACTIVITIES</b>                                      | <b>(38,027)</b> | <b>(20,096)</b>                | <b>(27,040)</b>                |
| <b>FINANCING ACTIVITIES:</b>  |                 |                                |                                |
| Cash dividends paid   | (34,854)        | (6,422)                        | (3,756)                        |
| Payments on term debt   | (47)            | (59)                           | (102)                          |
| Treasury stock purchases  | (13,777)        |                                | (207)                          |
| Proceeds from stock issued under the Employee Stock Purchase Plan                 | 1,196           | 1,051                          | 915                            |
| Proceeds from exercise of stock options, including shareholder loan repayments    | 8,426           | 8,210                          | 5,574                          |
|   | (39,056)        | 2,780                          | 2,424                          |

**NET CASH (USED IN)/PROVIDED BY FINANCING  
ACTIVITIES**

|  |                   |                   |                   |
|--|-------------------|-------------------|-------------------|
| Effect of exchange rate changes                    | (960)             | (101)             | 830               |
| <b>(DECREASE) INCREASE IN CASH AND EQUIVALENTS</b> | <b>(48,556)</b>   | <b>37,133</b>     | <b>30,274</b>     |
| <b>CASH AND EQUIVALENTS AT BEGINNING OF YEAR</b>   | <b>152,330</b>    | <b>115,197</b>    | <b>84,923</b>     |
| <b>CASH AND EQUIVALENTS AT END OF YEAR</b>         | <b>\$ 103,774</b> | <b>\$ 152,330</b> | <b>\$ 115,197</b> |

See accompanying notes.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

December 31, 2005, 2004 and 2003

**NOTE A RESTATEMENT OF PREVIOUSLY ISSUED FINANCIAL STATEMENTS**

During the Company's year-end close procedures, the Company determined that revenues recorded in 2005 and in prior years that related to a portion of the resale of local and long distance and network services billings were inadvertently recorded in advance of the related service period due to an error in determining the proper time periods covered for certain advance billed products. As a result, the Company herein restated its revenues and related income tax provision for the years ended December 31, 2004 and 2003 and the first three quarters of 2005. This adjustment grew in small increments over a number of years and the effect on each of the prior quarterly and annual results was not material. However, the cumulative amount of the quarterly differences was deemed too large to record in only the fourth quarter of 2005, so management elected to restate prior periods to correct this difference. The cumulative effect of the adjustments resulted in a current liability for deferred revenues of approximately \$0.9 million, a decrease in accounts receivable of \$1.3 million and a decrease in revenues of \$2.2 million on a cumulative basis for all periods prior to the beginning of the quarter ended December 31, 2005.

In addition, the Company determined that the tax treatment of certain intangible assets recorded as part of the acquisition of two foreign subsidiaries (one in 2002 and one in 2005) had not been accounted for correctly. The effect was to overstate our income taxes in 2003 by \$240,000, in 2004 by \$236,000 and by \$329,000 for the nine months ended September 30, 2005. The amounts of the adjustments would not have been material to any of the quarterly or annual results of operations previously reported; however, the cumulative amount of \$805,000 was considered too large to record as an adjustment in only the fourth quarter of 2005, so management elected to restate prior periods to correct this difference.

Management has restated previously issued financial statements to reflect these adjustments. The impact on net income from the adjustments is immaterial to the respective restated quarterly and annual results of operations. Based on recalculations of incentive compensation, management and the board of directors do not believe there are any changes in incentive compensation paid to corporate executives for any of the past 3 years.

The following table reflects the effect of the restatement on the Consolidated Statements of Income (in thousands, except per share amounts):

|  | Year Ended December 31,<br>2004    |                | Year Ended December 31,<br>2003 |                |
|--|------------------------------------|----------------|---------------------------------|----------------|
|  | As<br>Previously<br>Reported       | As<br>Restated | As<br>Previously<br>Reported    | As<br>Restated |
|  | Selected Statement of Income Data: |                |                                 |                |
| Net sales from resale of local, long distance and network services | \$ 48,924                          | \$ 48,799      | \$ 43,822                       | \$ 43,624      |
| Total net sales  | 416,893                            | 416,768        | 373,836                         | 373,638        |
| Gross profit   | 221,575                            | 221,450        | 197,073                         | 196,875        |
| Operating income   | 41,715                             | 41,590         | 44,328                          | 44,130         |
| Income before income taxes   | 43,852                             | 43,727         | 45,998                          | 45,800         |
| Income taxes   | 16,798                             | 16,514         | 17,480                          | 17,165         |
| Net income   | \$ 27,054                          | \$ 27,213      | \$ 28,518                       | \$ 28,635      |
| Net income per share basic   | \$ 1.05                            | \$ 1.06        | \$ 1.14                         | \$ 1.14        |
| Net income per share diluted                                       | \$ 0.99                            | \$ 1.00        | \$ 1.08                         | \$ 1.08        |

The following table reflects the effect of the restatement on the 2004 Consolidated Balance Sheet (in thousands):

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|  | December 31, 2004   |             |
|--|---------------------|-------------|
|  | As                  |             |
|  | Previously Reported | As Restated |
| Selected Balance Sheet Data:             |                     |             |
| Accounts receivable net of allowance     | \$ 45,176           | \$ 44,167   |
| Deferred income taxes                    | 9,905               | 10,563      |
| Total current assets                     | 304,472             | 304,121     |
| Goodwill                                 | 19,890              | 21,057      |
| Total assets                             | 406,966             | 407,782     |
| Other current liabilities                | 52,196              | 52,923      |
| Total current liabilities                | 82,997              | 83,724      |
| Deferred tax liability                   | 65,234              | 65,925      |
| Retained earnings                        | 134,455             | 133,853     |
| Total liability and shareholders' equity | \$406,966           | \$407,782   |

The following table reflects the effect of the restatement on the Consolidated Statements of Cash Flows (in thousands):

|   | Year Ended December 31, 2004 |             | Year Ended December 31, 2003 |             |
|---|------------------------------|-------------|------------------------------|-------------|
|   | As                           |             | As                           |             |
|   | Previously Reported          | As Restated | Previously Reported          | As Restated |
| Selected Cash Flow Data:                    |                              |             |                              |             |
| Net income                                  | \$ 27,054                    | \$ 27,213   | \$ 28,518                    | \$ 28,635   |
| Deferred income tax expense                 | 11,122                       | 10,839      | 30,264                       | 29,949      |
| Changes in operating assets and liabilities | \$ 1,998                     | \$ 2,123    | \$ (18,969)                  | \$ (18,771) |

**NOTE B SIGNIFICANT ACCOUNTING POLICIES**

*Description of Business.* Inter-Tel, incorporated in 1969, is a single point of contact, full-service provider of converged voice and data business communications systems; related networking applications; and presence management, collaboration, and messaging applications. Our diverse suite of applications includes unified communications; voice processing and unified messaging software; audio, video and Web conferencing applications; workgroup and call center management solutions; Internet Protocol (IP) telephony software; Computer Telephony Integration (CTI) applications; and other communications services. Our communications platforms include Inter-Tel 5000 Network Communications Solutions, Inter-Tel Axxess® and Lake converged business communication systems. We also provide managed services such as, local and long distance calling services; networking; maintenance; leasing; and support services for our products. Our customers include business enterprises, government agencies and non-profit organizations. Our common stock is quoted on the Nasdaq National Market under the symbol INTL.

*Principles of Consolidation.* The consolidated financial statements include the accounts of Inter-Tel, Incorporated and all significant subsidiaries. Intercompany accounts and transactions have been eliminated in consolidation.

*Cash and Equivalents, Short-Term Investments and Long-term Investments.* Cash and equivalents include all highly liquid investments with a remaining maturity of three months or less at date of acquisition. Cash and equivalents are primarily invested in mutual funds comprised of foreign and domestic high quality dollar denominated money market instruments rated A-1 by Standard & Poor's Ratings Group, or equivalent.

The Company accounts for short-term and long-term investments in accordance with Financial Accounting Standard No. 115, Accounting for Certain Investments in Debt and Equity Securities. The Company's short-term investments are classified as available-for-sale, and have been recorded at fair value,





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which approximates cost. The Company's long-term investments in debt securities have been classified as held-to-maturity and are carried at cost.

*Allowance for Doubtful Accounts.* We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. Additional reserves or allowances for doubtful accounts are recorded for our sales-type leases, discussed below in Sales-Leases. We establish and maintain reserves against estimated losses based upon historical loss experience, past due accounts and specific account analysis. Management reviews the level of the allowances for doubtful accounts on a regular basis and adjusts the level of the allowances as needed. In evaluating our allowance we consider accounts in excess of 60 days old as well as other risks in the more current portions of the accounts included. At December 31, 2005, our allowance for doubtful accounts for accounts receivable was \$6.2 million of our \$50.3 million in gross accounts receivable.

*Inventories.* We value our inventories at the lower of cost (principally on a standard cost basis, which approximates the first-in, first-out (FIFO) method) or market. Significant management judgment is required to determine possible obsolete or excess inventory and we make our assessment primarily on a significant product-by-product basis and consider whether such products turned in the immediately preceding twelve-month period, adjusted for expected changes in projected sales or marketing demand. Inventory on hand may exceed future demand either because the product is outdated or obsolete, or because the amount on hand is more than can be used to meet estimated future needs. We consider criteria such as customer demand, product life-cycles, changing technologies, slow moving inventory and market conditions. We write down our excess and obsolete inventory equal to the difference between the cost of inventory and the estimated market value. In estimating obsolescence, we primarily evaluate estimates of demand over a 12-month period and provide for inventory on hand in excess of the estimated 12-month demand.

*Property, Plant and Equipment.* Property, plant and equipment is stated at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the related real and personal property, which range from 3 years to 30 years. Leasehold improvements are depreciated over the shorter of the related lease terms or the estimated useful lives of the improvements. Within the category computer systems and equipment, including database and enterprise software, WAN and LAN equipment and software, personal computers, servers and related software, the range for estimated useful lives is 3 to 7 years.

*Goodwill and Other Intangible Assets.* On January 1, 2002, Inter-Tel adopted SFAS No. 141, *Business Combinations*, and SFAS No. 142, *Goodwill and Other Intangible Assets*. Purchase prices of acquired businesses have been allocated to the assets and liabilities acquired based on the estimated fair values on the respective acquisition dates. Based on these values, the excess purchase prices over the fair value of the net assets acquired were allocated to goodwill.

Prior to January 1, 2002, Inter-Tel amortized goodwill over the useful life of the underlying asset, not to exceed 40 years. On January 1, 2002, Inter-Tel began accounting for goodwill under the provisions of SFAS Nos. 141 and 142 and discontinued the amortization of goodwill after January 1, 2002.

The Company performs an annual impairment test on goodwill using the two-step process prescribed in SFAS No. 142. The first step is a screen for potential impairment, while the second step measures the amount of the impairment, if any. In addition, the Company will perform impairment tests during any reporting period in which events or changes in circumstances indicate that an impairment may have incurred. Inter-Tel performed the first step of the required impairment tests for goodwill as of December 31, 2005 and determined that goodwill is not impaired and it is not necessary to record any impairment losses related to goodwill. At December 31, 2005, \$27.7 million of the Company's goodwill, net of amortization, relates to the Company's principal segment and \$2.1 million relates to the Network Services segment. There is only one reporting unit (i.e., one component) as defined in paragraph 30 of SFAS 142 within each of the Company's two operating segments as defined in paragraph 10 of SFAS 131. Therefore the reporting units are identical to the segments. Fair value has been determined for each segment in order to determine the recoverability of the recorded goodwill. At December 31, 2005, the Company primarily considered an allocated portion of the market capitalization for the entire Company using average common stock prices in determining that no impairment has occurred. This allocated market capitalization value far exceeded the net carrying value of the reporting units. Therefore, the second step for potential impairment was unnecessary.



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The Company evaluates the remaining useful lives of its purchased intangible assets, all of which are subject to amortization, each reporting period. Any changes to estimated remaining lives prospectively effect the remaining period of amortization. In addition, the purchased intangible assets are reviewed for possible impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. A loss would be recognized for any excess of the carrying amount over the estimated fair value.

At December 31, 2005 and December 31, 2004, goodwill, net of accumulated amortization, totaled \$29.8 million and \$21.1 million, respectively. Other acquisition-related intangibles, net of accumulated amortization, totaled \$23.7 million at December 31, 2005 and \$11.0 million at December 31, 2004. Accumulated amortization through December 2005 was \$17.5 million, including \$5.0 million of accumulated amortization attributable to goodwill and \$12.5 million of accumulated amortization of other acquisition-related intangibles. Accumulated amortization through December 31, 2004 was \$13.1 million, including \$5.0 million of accumulated amortization attributable to goodwill and \$8.1 million of accumulated amortization of other acquisition-related intangibles. Purchased intangible assets, comprised primarily of developed technology (5-10 year lives), customer lists (5-8 year lives) and non-competition agreements (2-8 year lives), are amortized on a straight-line basis. The useful lives for developed technology are based on the remaining lives of patents acquired or the estimated useful life of the technology, whichever is shorter. The useful lives of the customer lists are based on the expected period of value for such lists. The useful lives for non-competition agreements are based on the contractual terms of the agreements.

*Sales-Leases.* For our sales-type lease accounting, we follow the guidance provided by FASB Statement No. 13, Accounting for Leases and FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities – A Replacement of FASB Statement No. 125. We record the discounted present values of minimum rental payments under sales-type leases as sales, net of provisions for continuing administration and other expenses over the lease period. We record the lease sales at the time of system sale and installation pursuant to Staff Accounting Bulletin No. 104, as discussed below for sales to end user customers, and upon receipt of the executed lease documents. The costs of systems installed under these sales-leases are recorded as costs of sales. The net rental streams are sold to funding sources on a regular basis with the income streams discounted by prevailing like-term rates at the time of sale. Gains or losses resulting from the sale of net rental payments from such leases are recorded as net sales. We establish and maintain reserves against potential recourse following the resales based upon historical loss experience, past due accounts and specific account analysis. The allowance for uncollectible minimum lease payments and recourse liability at the end of the year represents reserves against the entire lease portfolio. Management reviews the adequacy of the allowance on a regular basis and adjusts the allowance as required. These reserves are either netted in the accounts receivable, current and long-term components of Net investments in Sales-Leases on the balance sheet, or included in lease recourse liability on our balance sheet for the estimated recourse liability for lease streams sold.

*Income Taxes.* Deferred income taxes result from temporary differences in the recognition of revenues and expenses for financial reporting and income tax purposes.

*Advertising.* The cost of advertising is expensed as incurred. We incurred \$419,000; \$373,000; and \$331,000 in advertising costs during 2005, 2004, and 2003, respectively.

*Revenue Recognition.* Revenue is recognized pursuant to Staff Accounting Bulletin No. 104 (SAB 104), Revenue Recognition in Financial Statement.

*End-user sales through our direct sales offices and national, government and education accounts division.* Revenue is recognized when all four of the following criteria are met: (i) persuasive evidence that arrangement exists; (ii) delivery of the products and/or services has occurred; (iii) the selling price is both fixed and determinable and; (iv) collectibility is reasonably probable. Revenue derived from sales of systems and services to end-user customers is recognized upon primary installation of the systems and performance of the services, respectively, allowing for use by our customers of these systems. Pre-payments for communications services are deferred and recognized as revenue as the communications services are provided.

*Dealer and VAR sales.* For shipments to dealers and other distributors, our revenues are recorded as products are shipped and services are rendered, when the sales process is complete. These shipments are primarily to third-party dealers and distributors, and title passes when goods are shipped (free-on-board



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shipping point). However, in connection with our recent Lake acquisition, shipments to one international dealer are initially held by that dealer on a consignment basis. Such inventory is owned by Inter-Tel and reported on Inter-Tel's books and records until the inventory is sold to third parties, at which time the revenue is recorded. We provide a number of incentives, promotions and awards to certain dealers and other distributors. These incentives primarily represent discounts (which are recognized as a reduction of sales), advertising allowances and awards (which are recognized as marketing expense) and management assistance (which is expensed as incurred).

*Resale of long distance.* We recognize revenue from long distance resale services as services are provided.

*Extended Maintenance.* End-user customers can purchase extended maintenance agreements from us beyond the 1-year warranty provided by the manufacturers. In these cases, we defer and amortize the revenue related to the extended maintenance agreement over the term of the extended agreement.

*Software, software support and maintenance agreements.* Revenues for sales of software to dealers or end-users are generally recognized upon shipment. Revenues related to software support and maintenance agreements are recognized ratably over the life of the support or maintenance agreements.

*Sales Returns.* We do not generally allow sales returns either by the terms of our contracts or in practice, except for returns related to warranty provisions. Once a product has been installed or delivered, such that revenue recognition requirements have been met, it would be very unusual to take back a system. This would likely happen in the case of a collection problem, where we attempt to recover assets to reduce a bad debt, or in a dispute where we ultimately decide to take back the system rather than proceed to possible litigation. However, we allow returns for our errors (shipping the wrong product or wrong volume). Such returns have not been significant during the last 3 years. We may accept, but are under no obligation to accept a return where a customer ordered a part in error. In these unusual cases, we would charge a restocking fee, typically 25 percent of the original invoiced price.

*Warranties.* We do not have a provision or accrual for warranties for either end-users or dealers since we do not manufacture our own products. Any warranties are generally passed through from our third-party manufacturers and vendors, and are generally for periods of up to 2 years.

*Shipping and Handling Costs.* EITF 00-10 Accounting for Shipping and Handling Fees and Costs, addresses the accounting for shipping and handling fees and costs. Our policy is primarily not to bill customers for shipping costs, unless the customer requests priority shipping. Such amounts are not significant to our operations. Shipping and handling costs recorded in 2005, 2004 and 2003 were approximately \$1.1 million, \$1.3 million, and \$1.4 million, respectively, and are included in cost of sales.

*Stock Based Compensation.* The Company accounts for employee stock options relating to its common stock in accordance with Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees and related interpretations (APB) and provides the pro forma disclosures required by SFAS No. 123 Accounting for Stock Based Compensation (SFAS No. 123). Had the Company determined employee stock compensation expense in accordance with SFAS No. 123, the Company's net income for 2005, 2004, and 2003 would have been adjusted to the pro forma amounts indicated below and in Note L:

| (in thousands, except per share data)   | Years Ended December 31, |                  |                  |
|---|--------------------------|------------------|------------------|
|   | 2005                     | 2004<br>Restated | 2003<br>Restated |
| Net income, as reported   | \$ 17,854                | \$ 27,213        | \$ 28,635        |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects (1) | (8,663)                  | (3,340)          | (3,007)          |
| Pro forma net income  | \$ 9,191                 | \$ 23,873        | \$ 25,628        |



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| (in thousands, except per share data) | Years Ended December 31, |                  |                  |
|---------------------------------------|--------------------------|------------------|------------------|
|                                       | 2005                     | 2004<br>Restated | 2003<br>Restated |
| Earnings per share:                   |                          |                  |                  |
| Basic as reported                     | \$ 0.68                  | \$ 1.06          | \$ 1.14          |
| Basic pro forma                       | \$ 0.35                  | \$ 0.93          | \$ 1.02          |
| Diluted as reported                   | \$ 0.66                  | \$ 1.00          | \$ 1.08          |
| Diluted pro forma                     | \$ 0.34                  | \$ 0.88          | \$ 0.97          |

(1) Total stock-based employee compensation expense for the year ended December 31, 2005 includes the impact from the May 3, 2005 acceleration of vesting of certain stock options. This acceleration of the vesting provision increased the stock based compensation expense and decreased the pro forma net income \$5.4 million for the year ended December 31, 2005. See Note L for further discussion.

Pro forma results disclosed are based on the provisions of SFAS 123 using the Black-Scholes option valuation model and are not likely to be representative of the effects on pro forma net income for future years. In addition, the Black-Scholes option valuation model was developed for use in estimating the fair value of traded options, which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because our stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in our opinion, the estimating models do not necessarily provide a reliable single measure of the fair value of our stock options. See Note L for further discussion of the Company's stock-based employee compensation.

*Foreign Currency Translation and Transactions.* For our foreign operations, the local currency is the functional currency. All assets and liabilities are translated at period-end exchange rates and all income statement and cash flow amounts are translated at an average of month-end rates. Adjustments resulting from this translation are recorded in accumulated other comprehensive income (loss). Foreign currency transaction gains and losses also result from transactions denominated in a currency other than U.S. dollars; gains and losses resulting from remeasuring monetary assets and liability accounts that are denominated in currencies other than a subsidiary's functional currency are included in other income under the caption Foreign currency transaction gains (losses).

*Contingencies.* We are a party to various claims and litigation in the normal course of business. Management's current estimated range of liability related to various claims and pending litigation is based on claims for which our management can estimate the amount and range of loss, or can estimate a minimum amount of a loss. Because of the uncertainties related to both the amount and range of loss on the remaining pending claims and litigation, management is unable to make a reasonable estimate of the liability that could result from an unfavorable outcome. As additional information becomes available, we will assess the potential liability related to our claims and pending litigation, revise our estimates and accrue for any losses to the extent that they are probable and the amount is estimable. Such revisions in our estimates of the potential liability could materially impact our results of operations and financial position. However, at December 31, 2005, management did not believe that the ultimate impact of various claims and pending litigation would have a materially adverse impact on the Company.

Other charges recorded in 2005 primarily consist of pre-tax costs associated with a legal judgment, legal settlement and related costs totaling \$12.0 million, net of amounts previously accrued. A Florida state court jury rendered a verdict against Inter-Tel (the Florida trial) in the net amount of approximately \$7.4 million. The Company also incurred additional legal costs in connection with the Florida trial. Although the Company is appealing the verdict, the Company has accrued the net verdict amount, plus related legal costs incurred. Should the Company be successful or unsuccessful in the appeals process, these costs may be adjusted in the future. In connection with the appeal of the Florida trial, the Company posted collateral of \$6.3 million in order to secure an appellate bond. The Company also reached a separate settlement in another legal matter during the third quarter in connection with a longstanding dispute

with a third-party vendor and customer. The net settlement plus related legal fees incurred during the third quarter for both events totaled approximately \$3.0 million, net of amounts previously accrued, and are included in the pre-tax total costs of \$12.0 million identified above. Further, in March 2006, other prior Executone dealers filed a complaint in Columbus, Ohio similar to the complaint in the Florida trial. The Company is in the process of evaluating the complaint.



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Subsequent to December 31, 2005, the Company settled another legal matter in connection with a longstanding dispute with a former international dealer that existed as of December 31, 2005. The Company recorded an accrual for the settlement amount and related fourth quarter legal fees as of December 31, 2005. The settlement plus related fourth quarter legal fees totaled \$1.6 million. Additional legal fees totaling approximately \$1.2 million are expected to be recorded as period costs during the first quarter of 2006 relating to this matter.

On January 5, 2005, the Company received court approval of a civil settlement agreement (the Civil Settlement ) and a criminal plea agreement (the Plea Agreement ) with the United States of America, each dated as of December 8, 2004 and disclosed on that same date. The court approval of the Civil Settlement and Plea Agreement resolves the investigation of the Department of Justice into the participation of Inter-Tel Technologies, Inc., the Company's wholly-owned subsidiary ( Technologies ) in a federally administered e-Rate program to connect schools and libraries to the Internet. In connection with the Civil Settlement, Technologies paid a penalty of \$6.7 million and forgave the collection of certain accounts receivable of \$0.3 million related to Technologies' participation in the e-Rate program. In connection with the Plea Agreement, Technologies entered guilty pleas to charges of mail fraud and an antitrust violation. Under the Plea Agreement, Technologies paid a fine of \$1.7 million and is observing a three-year probationary period, which has, among other things, required Technologies to implement a comprehensive corporate compliance program. On December 20, 2005, in connection with the Civil Settlement, Technologies paid outside counsel for the plaintiffs in that action \$0.1 million in settlement of their demand for attorneys' fees and costs. On March 10, 2006, Technologies agreed to pay an additional \$0.4 million to plaintiffs' inside counsel in settlement of their separate demand for fees and costs.

The resolution has cost Inter-Tel approximately \$9.5 million in total, including criminal fines, civil settlement and restitution, uncompensated e-Rate work, accounts receivable forgiveness, and related remaining attorneys' fees and other expenses. The payments constituting the primary components of the settlement are not tax deductible. The effect of the resolution on 2004 results of operations was a reduction to net income by approximately \$9.0 million, after considering (1) accounts receivable reserves previously accrued and (2) an income tax benefit of approximately \$0.3 million related to attorneys' fees and other expenses.

In addition, on January 21, 2005, Inter-Tel Technologies received notification from the Federal Communications Commission that the Technologies subsidiary was temporarily suspended from participation in the e-Rate program pending a final hearing to determine debarment. Technologies has contested the scope and length of the proposed debarment from the e-Rate program, but there can be no assurance that Technologies will be successful in this regard. Revenues in 2005 and 2004 relating to Inter-Tel Technologies' participation in the e-Rate program were not significant.

During the second quarter of 2005, we identified variances in our sales processes as they relate to certain terms included in the U.S. General Services Administration (GSA) pricing and trade agreement requirements applicable to our business. As a result of this identification, Inter-Tel made voluntary self-disclosure of the matter to the Inspector General of the GSA. The potential variances relate primarily to compliance with certain pricing thresholds and compliance with trade agreements that are applicable to transactions with certain government agencies. We continue to review our compliance and have taken appropriate corrective measures with respect to these potential variances. In the second quarter, we accrued \$1.8 million in estimated pre-tax adjustments, including reductions in net sales and increases to costs, fines and penalties that may be incurred to correct this issue, of which we have paid \$1.2 million through December 31, 2005. Our estimate at December 31, 2005 remains the same as the total identified as of the end of the second quarter of 2005. The total sales potentially subject to the GSA agreements were approximately \$5.5 million during the period from March 28, 2001 through June 10, 2005. Our current contract with the GSA expires in March 2006, but we have requested and expect to receive a five-year contract extension.

*Use of Estimates.* The preparation of the 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 consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

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*Reclassifications.* Certain reclassifications have been made to the 2004 and 2003 financial statements to conform to the 2005 presentation.

**Recent Accounting Pronouncements**

In December 2004, the FASB issued Statement No. 123 (revised 2004), Share-Based Payment ( SFAS 123R ), which replaces SFAS No. 123, Accounting for Stock-Based Compensation, (SFAS 123) and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees. SFAS 123R requires all share-based payments to employees, including grants of employee stock options and employee stock purchase plan shares, to be recognized in the financial statements over the period during which employees are required to provide services based on their grant-date fair values. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. We are required to adopt SFAS 123R in the first quarter of fiscal 2006, beginning January 1, 2006.

We plan to adopt SFAS No. 123R using the modified prospective application method as defined by SFAS No. 123R and accordingly will begin recognizing compensation expense for all unvested and partially vested stock options, employee stock purchase plan shares, and restricted stock, if applicable, in the first quarter of 2006. We are evaluating the requirements of SFAS 123R and expect that the adoption of SFAS 123R will have a material impact on our consolidated results of operations and earnings per share. In addition, this new statement could impact our ability to utilize broad-based employee stock plans to reward employees and could result in a competitive disadvantage to us in the employee marketplace.

In December 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets ( SFAS No. 153 ), an amendment of APB Opinion No. 29 Accounting for Nonmonetary Transactions ( APB No. 29 ). SFAS No. 153 eliminates the exception from fair value measurement for nonmonetary exchanges of similar productive assets in paragraph 21 (b) of APB No. 29, and replaces it with an exception for exchanges that do not have commercial substance. SFAS No. 153 specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS No. 153 is effective for the fiscal periods beginning after June 15, 2005 and we will adopt this Statement in the first quarter of fiscal 2006. We currently do not anticipate that the effects of the statement will materially affect its consolidated financial position or consolidated results of operations upon adoption.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections A Replacement of APB Opinion No. 20 and FASB Statement No. 3 ( SFAS No. 154 ). SFAS No. 154 requires the retrospective application to prior periods financial statements of changes in accounting principle, unless it is impractical to determine either the period-specific effects or cumulative effect of the accounting change. SFAS No. 154 also requires that a change in depreciation, amortization, or depletion method for long-lived non-financial assets be accounted for as a change in accounting estimate affected by a change in accounting principle. SFAS No. 154 is affective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005 and we will adopt this provision, as applicable, during fiscal year 2006.

**NOTE C ACQUISITIONS, TECHNOLOGY INVESTMENTS, DISPOSITIONS AND RESTRUCTURING CHARGES**

**Lake.** On February 28, 2005, Inter-Tel Lake Ltd., a wholly owned Irish subsidiary of Inter-Tel, Incorporated ( Inter-Tel ) executed an agreement for the purchase of 100% of the issued share capital of Lake Communications Limited and certain affiliated entities (collectively, Lake ) for \$28.7 million (including capitalized transaction costs of \$0.7 million), plus an earn-out of up to \$17.6 million based upon certain targets relating to operating results for Lake through the first eighteen months following the closing date of the transaction. The transaction closed out of escrow on March 4, 2005 upon the release from escrow of closing documentation. In total, the Company recorded \$19.3 million of intangible assets of which a total of \$2.6 million was charged to expense in the first quarter of 2005 as in-process research and development costs with the balance being amortized over eight years. Additionally we recorded \$8.7 million of goodwill, which is non-amortizable. As of December 31, 2005, none of the potential earn-out has been accrued, as there is no amount that has been earned or has been estimated as being probable of being paid. The final measurement for the possible earn-out will occur during the Company s third fiscal quarter of 2006.

Lake, based in Dublin, Ireland, is a provider of converged communications products in the under 40 user market, including EncoreCX<sup>®</sup> and Sigma products currently being distributed by Inter-Tel in the United States. Lake designs and develops its products for sale through a distribution network of telecom operators

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and distributors, including Inter-Tel in the United States. Lake outsources its manufacturing to third-party suppliers. For more than a year, Lake has sold certain communication products to the Company in the ordinary course of business.

**New Sales Offices in 2004.** In January, July and October 2004, we acquired certain assets and assumed certain liabilities relating to the customer bases of former dealers in Nashville and Memphis, Tennessee; Greenville, South Carolina; Pittsburgh, Pennsylvania and Las Vegas, Nevada. The total assets acquired and liabilities assumed from these acquisitions were approximately \$1.7 million and \$0.4 million, respectively. Purchased intangibles and goodwill recorded as a result of the transactions totaled \$0.9 million and \$2.7 million, respectively. The goodwill is non-amortizable. The balances included in other purchased intangible assets will be amortized over a period of five years from the date of each acquisition.

**New Technology Investments in 2004.** In October 2004, the Company acquired certain assets and assumed certain liabilities of Converging Technologies, Inc. The acquired assets primarily include Web-based conferencing solutions, notably Linktivity® software. Tangible assets acquired, liabilities assumed and purchased intangibles (all technology related) acquired were \$0.5 million, \$0.3 million and \$3.0 million, respectively. The purchased intangible is being amortized over five years. Also in October 2004, the Company obtained a license of intellectual property from eDial, a division of Alcatel USA Marketing, Inc. for a total price of \$1.0 million. The eDial intangible is being amortized over five years.

**Technology Investment in 2003.** In connection with the acquisition of the rights to certain developed technology for a capitalized purchase price of \$2.25 million (included in purchased intangible assets) during the year ended December 31, 2003, the Company entered into an arrangement with the selling entity under which the selling entity would perform additional development activities on a cost reimbursement basis through August 15, 2004. Under the terms of the arrangement, the selling entity could also earn bonus payments totaling up to \$1,000,000 for meeting certain development milestones. Milestone bonuses totaling \$250,000 for the year ended December 31, 2005 and \$750,000 for the year ended December 31, 2004 were achieved and expensed as research and development costs. The following table summarizes details of the expenses in connection with this technology investment recorded during the respective periods:

| (In thousands)                                       | 2005   | 2004     | 2003   |
|--|--------|----------|--------|
| Milestone bonus payments accrued                     | \$ 250 | \$ 750   | \$     |
| Development activities on a cost reimbursement basis |        | 665      | 525    |
| Totals   | \$ 250 | \$ 1,415 | \$ 525 |

**Swan.** On December 3, 2002, Inter-Tel Integrated Systems, Inc., our wholly owned subsidiary, acquired 100% of the capital stock of Swan Solutions Limited (Swan) in England and Wales, for \$4.0 million in cash. \$3.0 million was paid at closing, \$250,000 was paid in June 2003 and \$250,000 was paid in December 2003. The remaining \$500,000 was subject to the achievement of five performance milestones at \$100,000 each. As of June 30, 2004, portions of all five \$100,000 milestones had been achieved for which \$450,436 was paid to the Swan shareholders. Of this amount, the final \$100,000 milestone achievement was paid during the second quarter of 2004. Payments relating to the achievement of performance milestones were capitalized and are being amortized as purchased intangible assets. In total, the Company recorded amortizable intangible technology assets totaling \$3.9 million and goodwill of \$1.2 in connection with this acquisition. These technology assets are being amortized over five years. During the years ended December 31, 2005, 2004 and 2003, the amortization of purchased intangible assets from Swan was approximately \$0.8 million per year.

The values for acquired developed technology were determined based on the negotiated prices paid to acquire the technology. Each of our technology acquisitions was made primarily to acquire a specific technology, rather than for the purpose of acquiring an operating company. The technologies acquired have been used to add additional features/applications to our current products, sold separately as new products or obtained primarily for use with our

next generation of products.

The weighted-average amortization period for total purchased intangibles as of December 31, 2005 and December 31, 2004 was approximately 7.5 years and 6.8 years for each period, respectively. The weighted-average amortization period as of December 31, 2005 and December 31, 2004 for developed technology was

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approximately 7.3 and 7.0 years for each period, respectively, and 7.8 and 5.0 years as of December 31, 2005 and 2004, respectively, for customer lists and non-compete agreements.

Each of the acquisitions discussed above was not a material business acquisition either individually or collectively and has been accounted for using the purchase method of accounting. The results of operations of each of these acquisitions have been included in our accompanying consolidated statements of operations from the date of acquisitions.

**Executone.** On January 1, 2000 Inter-Tel purchased certain computer telephony assets and assumed certain liabilities of Executone Information Systems, Inc. (Executone). The Executone transaction was accounted for using the purchase method of accounting. The aggregate purchase price was allocated to the fair value of the assets and liabilities acquired, of which \$5.4 million (\$3.4 million after taxes) was written-off as purchased in-process research and development. In connection with the Executone acquisition, we sold Executone's manufacturing assets and liabilities to Jabil Circuit, Inc. (formerly Varian, Inc.) of Tempe, Arizona at a net book value of \$6.6 million.

During the second quarter of 2000, we decided to close the primary Executone facility in Milford, Connecticut and to recognize a restructuring charge related to our exit plan and closure of the Executone operations. We have accounted for the restructuring of the Executone operations, including severance and related costs, the shut down and consolidation of the Milford facility and the impairment of assets associated with the restructuring. We finalized our plan for the exiting of activities and the involuntary termination or relocation of the employees. Accrued costs associated with this plan were estimates, although the original estimates made for the second quarter of 2000 did not change significantly and the final costs incurred resulted in a nominal adjustment to current operating results during 2005.

Exit costs associated with the closure of the Milford facility also included liabilities for building, furniture and equipment lease, and other contractual obligations. We were liable for the lease on the Milford buildings through January 14, 2005. Various other furniture, computer and equipment leases terminated on varying dates through September 2002. The reserves for lease and other contractual obligations are identified in the table below.

The total restructuring charge from this event totaled \$50.9 million. The following table summarizes the final details of the restructuring charge in connection with the Executone acquisition, including the description of the type and amount of liabilities assumed, and activity in the reserve balances from the date of the charge through December 31, 2005. Activity represents payments made or amounts written off.

| Description   | Cash/<br>Non-Cash | (In thousands)                  |                             |                  |                  |                  | Reserve<br>Balance<br>At<br>12/31/05 |
|---|-------------------|---------------------------------|-----------------------------|------------------|------------------|------------------|--------------------------------------|
|   |                   | 2000<br>Restructuring<br>Charge | Activity<br>through<br>2002 | 2003<br>Activity | 2004<br>Activity | 2005<br>Activity |                                      |
| <b>Personnel Costs:</b>   |                   |                                 |                             |                  |                  |                  |                                      |
| Severance and termination costs   | Cash              | \$ (1,583)                      | \$ 1,580                    | \$ 3             | \$               | \$               | \$                                   |
| Other Plant closure costs   | Cash              | (230)                           | 230                         |                  |                  |                  |                                      |
| <b>Lease termination and other contractual obligations (net of anticipated recovery):</b> |                   |                                 |                             |                  |                  |                  |                                      |
| Building and equipment leases   | Cash              | (7,444)                         | 5,431                       | 767              | 1,238            | 8                |                                      |

|                                      |          |                    |                  |                 |                 |               |           |
|--------------------------------------|----------|--------------------|------------------|-----------------|-----------------|---------------|-----------|
| Other contractual obligations        | Cash     | (1,700)            | 1,700            |                 |                 |               |           |
| <b>Impairment of Assets:</b>         |          |                    |                  |                 |                 |               |           |
| Inventories                          | Non-Cash | (3,454)            | 3,454            |                 |                 |               |           |
| Prepaid inventory and other expenses | Non-Cash | (2,485)            | 2,485            |                 |                 |               |           |
| Accounts receivable                  | Non-Cash | (1,685)            | 854              | 831             |                 |               |           |
| Fixed assets                         | Non-Cash | (3,151)            | 2,995            | 14              | 26              | 116           |           |
| Net intangible assets                | Non-Cash | (29,184)           | 29,184           |                 |                 |               |           |
| <b>Total</b>                         |          | <b>\$ (50,916)</b> | <b>\$ 47,913</b> | <b>\$ 1,615</b> | <b>\$ 1,264</b> | <b>\$ 124</b> | <b>\$</b> |

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Included in the total Executone restructuring costs of \$50.9 million is a \$43.3 million restructuring charge for exit costs and asset impairment included in other charges, and \$7.6 million associated with the impairment of inventories, which has accordingly been recorded as additional costs of sales.

**NOTE D SHORT-TERM AND LONG-TERM INVESTMENTS**

The Company accounts for its investments in accordance with Financial Accounting Standard No. 115, Accounting for Certain Investments in Debt and Equity Securities. Most of the Company's short-term investments are classified as available-for-sale, and have been recorded at fair value, which approximates cost. Fair value has been determined to approximate cost. We have also historically purchased and sold similar investments at face value. The short-term investments that are classified as held-to-maturity have been recorded at cost and amortized to face value. The long-term investments, which are all classified as held-to-maturity, have been recorded at cost and amortized to face value. At December 31, 2005 and December 31, 2004, \$53.8 million and \$49.8 million, respectively, were recorded as short-term investments, available-for-sale. At December 31, 2005 and December 31, 2004 \$9.9 million and \$2.8 million were recorded as short-term investments, held-to-maturity. Short-term investments include certificates of deposit, municipal preferred securities, equity securities, federal agency issues, and mutual funds. The municipal preferred securities and equity securities are auction rate securities which are adjustable-rate securities with dividend rates that are reset periodically by bidders through periodic Dutch auctions generally conducted every 7 to 49 days by a trust company or broker/dealer on behalf of the issuer. The Company believes these securities are highly liquid investments through the related auctions; however, the collateralizing securities have stated terms of up to thirty-five (35) years. At December 31, 2005, the Company had no investments that were classified as long-term investments. At December 31, 2004, \$9.9 million were recorded as long-term investments, held-to-maturity. All investment instruments are rated A or higher by Standard & Poor's Ratings Group, or equivalent.

The Company's investments are intended to establish a high-quality portfolio that preserves principal, meets liquidity needs, avoids inappropriate concentrations and delivers an appropriate yield in relationship to the Company's investment guidelines and market conditions.

The following is a summary of available-for-sale and held-to-maturity securities:

**December 31, 2005**

| (in thousands)                         | Cost      | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Gross Fair<br>Value |
|--|-----------|------------------------------|-------------------------------|---------------------|
| <b>Short-term, available-for-sale:</b> |           |                              |                               |                     |
| Equity securities                      | \$ 2,988  | \$                           | \$                            | \$ 2,988            |
| Mutual funds                           | 370       |                              |                               | 370                 |
| Certificate of deposit                 | 1,034     |                              |                               | 1,034               |
| Municipal bonds                        | 49,397    |                              |                               | 49,397              |
| Totals                                 | \$ 53,789 | \$                           | \$                            | \$ 53,789           |
| <b>Short-term, held-to-maturity:</b>   |           |                              |                               |                     |
| Federal agency issues (mature in 2006) | \$ 9,900  | \$                           | \$ 72                         | \$ 9,828            |
| Totals                                 | \$ 9,900  | \$                           | \$ 72                         | \$ 9,828            |

**December 31, 2004**

| (in thousands) | Cost | Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Gross<br>Gross Fair<br>Value |
|----------------|------|---------------------|-------------------------------|------------------------------|
|----------------|------|---------------------|-------------------------------|------------------------------|



**Short-term, available-for-sale:**

|                        |           |    |    |           |
|------------------------|-----------|----|----|-----------|
| Equity securities      | \$ 12,998 | \$ | \$ | \$ 12,998 |
| Mutual funds           | 6,662     |    |    | 6,662     |
| Certificate of deposit | 1,008     |    |    | 1,008     |
| Municipal bonds        | 29,150    |    |    | 29,150    |
| Totals                 | \$ 49,818 | \$ | \$ | \$ 49,818 |

**Table of Contents****December 31, 2004**

| (in thousands)                         | Cost     | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Gross<br>Fair<br>Value |
|--|----------|------------------------------|-------------------------------|------------------------|
| <b>Short-term, held-to-maturity:</b>   |          |                              |                               |                        |
| Federal agency issues (mature in 2005) | \$ 2,000 | \$                           | \$ 18                         | \$ 1,982               |
| Municipal bonds                        | 826      |                              |                               | 826                    |
| Totals                                 | \$ 2,826 | \$                           | \$ 18                         | \$ 2,808               |
| <b>Long-term, held-to-maturity:</b>    |          |                              |                               |                        |
| Federal agency issues (mature in 2006) | \$ 9,900 | \$                           | \$ 140                        | \$ 9,760               |
| Totals                                 | \$ 9,900 | \$                           | \$ 140                        | \$ 9,760               |

**NOTE E NET INVESTMENT IN SALES-LEASES**

Net investment in sales-leases represents the value of sales-leases presently held under our TotalSolution<sup>SM</sup> program. We currently sell the rental payments due to us from some of the sales-leases. We maintain reserves against our estimate of potential recourse for the balance of sales-leases and for the balance of sold rental payments remaining unbilled. The following table provides detail on the total net balances in sales-leases (In thousands):

|  | 2005       | December 31<br>2004 | 2003       |
|--|------------|---------------------|------------|
| Lease balances included in consolidated accounts receivable, net of allocated allowances of \$980 in 2005; \$1,177 in 2004; and \$1,774 in 2003  | \$ 8,860   | \$ 6,390            | \$ 7,240   |
| Net investment in Sales-Leases:  |            |                     |            |
| Current portion, net of allowances of \$998 in 2005; \$886 in 2004; and \$749 in 2003  | 19,699     | 17,151              | 15,502     |
| Long-term portion, includes residual amounts of \$625 in 2005; \$510 in 2004; and \$652 in 2003, net of allowances of \$1,926 in 2005; \$1,810 in 2004; and \$1,985 in 2003            | 34,758     | 33,877              | 32,529     |
| Total investment in Sales-Leases, net of allowances of \$3,904 in 2005; \$3,873 in 2004; and \$4,508 in 2003   | 63,318     | 57,418              | 55,271     |
| Sold rental payments remaining unbilled (subject to limited recourse provisions), net of lease recourse liability reserves of \$14,199 in 2005; \$12,241 in 2004; and \$12,020 in 2003 | 256,143    | 229,163             | 198,091    |
| Total balance of sales-leases and sold rental payments remaining unbilled, net of allowances and reserves  | \$ 319,460 | \$ 286,581          | \$ 253,362 |

|   |           |           |           |
|---|-----------|-----------|-----------|
| Total allowances and reserves for entire lease portfolio (including lease recourse liabilities) | \$ 18,103 | \$ 16,114 | \$ 16,528 |
|---|-----------|-----------|-----------|

Reserve levels are established based on portfolio size, loss experience, levels of past due accounts and periodic, detailed reviews of the portfolio. Recourse on the sold rental payments is contractually limited to a percentage of the net credit losses in a given annual period as compared to the beginning portfolio balance for a specific portfolio of sold leases. While our recourse is limited, we maintain reserves at a level sufficient to cover all anticipated credit losses. The aggregate reserve for uncollectible lease payments and recourse liability represents the reserve for the entire lease portfolio. These reserves are either netted from consolidated accounts receivable, netted against current or long-term investment in sales-leases or included in long-term liabilities for sold rental payments remaining unbilled. Sales of rental payments per period:

| (In thousands)                                  | Years Ended December 31 |            |            |
|---|-------------------------|------------|------------|
|   | 2005                    | 2004       | 2003       |
| Sales of rental payments                        | \$ 119,060              | \$ 113,172 | \$ 88,352  |
| Sold payments remaining unbilled at end of year | \$ 270,342              | \$ 241,404 | \$ 210,111 |

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Sales of rental payments represents the gross selling price or total present value of the payment stream on the sale of the rental payments to third parties. Sold payments remaining unbilled at the end of the year represents the total balance of leases that are not included in our balance sheet. We do not expect to incur any significant losses in excess of reserves from the recourse provisions related to the sale of rental payments. Inter-Tel is compensated for administration and servicing of rental payments sold.

At December 31, 2005, future minimum lease payments related to the sold rental streams remaining unbilled are: 2006 \$82.5 million, 2007 \$71.9 million, 2008 \$58.7 million, 2009 \$40.4, 2010 \$16.6 million, thereafter \$0.1 million.

At December 31, 2005, future minimum lease receipts due from customers related to the lease portfolio included in our December 31, 2005 balance sheet are: 2006 \$21.4 million, 2007 \$13.1 million, 2008 \$9.8 million, 2009 \$7.1 million, 2010 \$5.3, thereafter \$139,000.

During 2005, the Company has entered into rate-lock agreements with a financial institution in the form of commitments to sell the cash flow streams for leases at a fixed interest rate to the financial institution. As of December 31, 2005, the Company has one outstanding agreement in place to sell cash flow streams with a present value of \$15.0 million in March 2006 at a fixed interest rate to the financial institution. Should interest rates decrease substantially, the Company has the option to pay a fee to the financial institution to cancel the commitment.

**NOTE F PROPERTY, PLANT & EQUIPMENT**

| (In thousands)   | December 31 |           |
|--|-------------|-----------|
|  | 2005        | 2004      |
| Computer systems, data processing and other office equipment | \$ 63,572   | \$ 46,397 |
| Transportation equipment                                     | 4,026       | 3,820     |
| Furniture and fixtures                                       | 5,212       | 4,221     |
| Leasehold improvements                                       | 4,341       | 4,673     |
| Building   | 7,318       | 7,318     |
| Land   | 2,499       | 2,499     |
|  | 86,968      | 68,928    |
| Less: Accumulated depreciation and amortization              | (58,732)    | (41,088)  |
| Net property, plant & equipment                              | \$ 28,236   | \$ 27,840 |

**NOTE G GOODWILL AND PURCHASED INTANGIBLE ASSETS**

| (In thousands)                                | December 31 |                  |
|---|-------------|------------------|
|   | 2005        | 2004<br>Restated |
| Goodwill                                      | \$ 34,865   | \$ 26,082        |
| Less: Accumulated amortization                | (5,025)     | (5,025)          |
| Net Goodwill                                  | \$ 29,840   | \$ 21,057        |
| Purchased intangible assets:                  |             |                  |
| Acquired developed technology                 | \$ 26,332   | \$ 15,517        |
| Customer lists and non-competition agreements | 9,793       | 3,550            |

|                                 |           |           |
|---------------------------------|-----------|-----------|
|                                 | 36,125    | 19,067    |
| Less: Accumulated amortization  | 12,474    | 8,080     |
| Net Purchased intangible assets | \$ 23,651 | \$ 10,987 |

For the years ending December 31, 2006, 2007, 2008, 2009 and 2010, the estimated amortization expense on purchased intangible assets is \$4.5 million, \$4.3 million, \$3.5 million, \$3.1 million and \$2.3 million, respectively.

**Table of Contents****NOTE H OTHER CURRENT LIABILITIES**

| (In thousands)                     | December 31 |                  |
|------------------------------------|-------------|------------------|
|                                    | 2005        | 2004<br>Restated |
| Compensation and employee benefits | \$ 15,703   | \$ 17,378        |
| Customer deposits                  | 4,252       | 4,641            |
| Deferred revenues                  | 8,344       | 7,664            |
| Miscellaneous taxes payable        | 3,295       | 2,842            |
| Legal settlements                  | 10,081      | 9,261            |
| Other accrued expenses             | 12,711      | 11,137           |
|                                    | \$ 54,386   | \$ 52,923        |

**NOTE I CREDIT LINE**

We maintain a \$10 million unsecured bank credit line at prime rate to cover international letters of credit and for other purposes. The credit agreement matures June 30, 2007 and contains certain restrictions and financial covenants. At December 31, 2005, none of the credit line was committed under letter of credit arrangements.

**NOTE J LEASES**

Noncancellable operating leases are primarily for buildings. Certain of the leases contain provisions for renewal options and scheduled rent increases. Rental expense amounted to \$9.9 million, \$9.4 million, and \$9.6 million in 2005, 2004, and 2003, respectively, as follows:

| (In thousands)                 | 2005      | 2004     | 2003     |
|--------------------------------|-----------|----------|----------|
| Rental expense, gross (1)      | \$ 10,329 | \$ 9,926 | \$ 9,811 |
| Less: Sublease receipts, gross | (429)     | (545)    | (221)    |
| Net rental expense             | \$ 9,900  | \$ 9,381 | \$ 9,590 |

(1) The amounts in the table above do not include rental expense in connection with the Milford, Connecticut building, which we leased in connection with our acquisition in 2000 of selected assets and assumption of certain liabilities of Executone. The Milford lease expired on January 14, 2005 and we did not renew the lease. In connection with the Executone charge taken in 2000, we accrued the anticipated lease costs through the lease termination date, offset by expected sublease receipts. The net rental payments in Milford (offset by sublease receipts) were \$21,000, \$1.3 million, and \$2.2 million in 2005, 2004, and 2003 respectively. The total costs excluded from the gross rental expense above associated with the Milford lease totaled \$55,000 in 2005, \$2.3 million in 2004, and \$2.9 million in 2003, offset in part by sublease receipts totaling \$34,000, \$1.0 million, and \$0.8 million in 2005, 2004, and 2003 respectively. Refer to Note C Acquisitions, Technology Investments, Dispositions and Restructuring Charges for additional information regarding the Executone charge and building lease.

At December 31, 2005, future minimum commitments under noncancellable leases are as follows: 2006 \$8.0 million, 2007 \$6.6 million, 2008 \$3.9 million, 2009 \$2.7 million, 2010 \$1.7 million.

**NOTE K INCOME TAXES**

We account for income taxes under Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes (SFAS 109). Under SFAS 109, the liability method is used in accounting for income taxes. Under this method, deferred tax assets and liabilities are determined (and classified as current or long-term) based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse.



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Significant components of our deferred tax liabilities and assets as of December 31 are as follows:

| (in thousands)   | December 31, |                  |
|--|--------------|------------------|
|  | 2005         | 2004<br>Restated |
| Deferred tax liabilities:  |              |                  |
| Lease sales and capitalized costs  | \$82,777     | \$ 80,921        |
| Write-off of Japan intercompany receivables  |              | 1,051            |
| Foreign Intangibles  | 2,325        | 691              |
| Tax over book depreciation   | 2,417        | 2,986            |
| Other  | 3,057        | 3,579            |
| Total deferred tax liabilities   | 90,576       | 89,228           |
| Deferred tax assets:   |              |                  |
| Net operating loss carryforward  |              | 2,905            |
| Tax credit carryforward  | 5,052        | 4,026            |
| Insurance reserves   | 672          | 1,559            |
| Accounts receivable reserves   | 2,196        | 3,457            |
| Accrued vacation pay   | 2,188        | 1,906            |
| Inventory reserve  | 982          | 294              |
| Accrued legal  | 1,425        | 875              |
| Foreign loss carryforwards   | 2,553        | 1,051            |
| In-process R&D write-off   | 4,354        | 4,852            |
| Restructuring/Special Charge   | 1,156        | 1,167            |
| Lease receivable reserves  | 9,655        | 8,047            |
| Other net  | 3,994        | 3,727            |
| Deferred tax assets  | 34,227       | 33,866           |
| Less valuation reserve   | 1,500        |                  |
| Net deferred tax assets  | 32,727       | 33,866           |
| Net deferred tax liabilities (total deferred tax liabilities less net deferred tax assets) | \$ 57,849    | \$ 55,362        |

The net deferred tax liabilities increased in 2005 due primarily to: temporary differences relating to amortization of intangibles from the acquisition of foreign subsidiaries, leases in our TotalSolution<sup>SM</sup> program and reduction of the net operating loss carryforward deferred tax asset. Federal tax depreciation deductions (bonus depreciation) ended as of December 31, 2004 although differing treatment for state depreciation will impact state taxes favorably for subsequent years. Effective May 6, 2003, the bonus depreciation increased from a 30% to a 50% bonus which favorably impacted the depreciation deduction for 2004 and 2003.

The Company has utilized all domestic net operating loss carryforwards in 2005. It continues to have research and minimum tax credits which management believes will be utilized in 2006. The Company filed a change in accounting method with the Internal Revenue Service for the 2002 tax year to utilize accelerated depreciation for dealer leases. This depreciation deduction generated a net operating loss in 2002 that was carried back to 2001 and carried forward to 2003, 2004 and 2005. The net operating loss carryforward is fully utilized in 2005. The 2002 net operating loss created deferred tax assets, not only for the loss, but also for research credits and minimum tax credits.



During 2005, 2004 and 2003, the Company recorded income of \$2.9 million, \$1.7 million, and \$1.0 million respectively, from foreign operations. At December 31, 2005, the Company had a deferred tax asset relating to foreign loss carryforwards of approximately \$2.6 million and a valuation allowance of \$1.5 million for the acquisition of Lake based upon management's estimate of the portion of the acquired loss carryforward that does not meet the more likely than not threshold for recoverability. Any reduction of the valuation allowance would result in a reduction of goodwill based on purchase accounting rules. The foreign loss carryforwards do not have an expiration date. The Company also recognized a tax benefit for the write-off of the Japanese investment in the amount of \$550,000 in 2004.

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Federal and state income taxes consisted of the following:

| (In thousands) | 2005     | 2004      | 2003      |
|----------------|----------|-----------|-----------|
|                |          | Restated  | Restated  |
| Federal        | \$ 3,202 | \$ 14,203 | \$ 15,057 |
| State          | 3,401    | 2,468     | 1,614     |
| Foreign        | 2,432    | (157)     | 494       |
|                | \$ 9,035 | \$ 16,514 | \$ 17,165 |

The principal reasons for the difference between total income taxes (benefit) and the amount computed by applying the statutory federal income tax rate to income before taxes are as follows:

|  | 2005  | 2004     | 2003     |
|--|-------|----------|----------|
|  |       | Restated | Restated |
| Federal tax at statutory rates applied to pre-tax income | 35.0% | 35.0%    | 35.0%    |
| State tax net of federal benefit                         | 9.9   | 3.7      | 2.3      |
| Credit for research activities                           | (3.7) | (1.6)    | (1.1)    |
| Write-off of Japan                                       |       | (3.4)    |          |
| E-Rate settlement  |       | 6.8      |          |
| Release of reserve                                       | (5.3) |          |          |
| Tax exempt interest                                      | (3.4) | (1.5)    | (.5)     |
| Other net  | 1.1   | (1.2)    | 1.8      |
|  | 33.6% | 37.8%    | 37.5%    |

The state tax expense increase, as a percentage of pre-tax net income, was primarily due to the change in the tax rate at which the deferred taxes are expected to be incurred, which resulted in a state tax expense of \$1.1 million for the year ended December 31, 2005, and to a lesser extent to the limited utilization of net operating losses in certain subsidiaries relative to prior years. Increased expenditures for research and development resulted in increased research credits both for 2005 and in the 2004 provision to return reconciliation. In 2005, the Company finalized federal tax audits with favorable outcomes resulting in the release of contingencies.

The 2004 e-Rate settlement of \$9.5 million, further described in Note B to the Consolidated Financial Statements, consisted primarily of nondeductible fines and penalties. The non-deductibility of these fines and penalties also unfavorably impacted the state effective tax rate.

The 2004 write-off of Japan consists of the recognition of the valuation allowance and 2004 Japanese loss, as well as a tax benefit for the write-off of the investment. In prior years the tax benefit of the Japanese operations were offset by a valuation allowance due to historical losses and an inability to project future income by management.

Undistributed earnings of the Company's foreign subsidiaries totaling approximately \$8.9 million and \$4.3 million as of December 31, 2005 and 2004, respectively, are considered by the Company to be permanently reinvested; accordingly, deferred income taxes have not been provided on these earnings. Determining the tax liability that would arise if these earnings were remitted is not practicable. The amount would depend on a number of factors, including the amount of the earnings distributed and whether the U.S. operations were generating profits or losses.

The Company believes that it maintains adequate tax reserves to offset the potential liabilities that may arise upon audit. If such reserves ultimately prove to be unnecessary, the resulting reversal of such reserves would result in tax

benefits being recorded in the period the reserves are no longer deemed necessary. If such reserves ultimately prove to be less than the ultimate assessment, a future charge to expense would result. The Company has included reserves for potential losses in deferred income tax liabilities.

**NOTE L EQUITY TRANSACTIONS**

*Treasury Stock.* In February 2005, we initiated a stock repurchase program, with no stated expiration date, under which the Board of Directors authorized Inter-Tel to purchase up to \$75 million of Inter-Tel Common Stock in the open market from time to time, depending upon general market conditions, the

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Company's share price, the level of employee stock option exercises, the level of employee stock purchase plan purchases, the availability of funds and other factors. Under this authorization, we repurchased 716,500 shares during 2005, expending \$13.8 million to repurchase these shares. During the first quarter of 2001, we initiated a prior stock repurchase program under which the Board of Directors authorized the repurchase of up to 4,000,000 shares of Inter-Tel Common Stock. We did not repurchase shares during 2004. Under the 2001 and prior authorizations, we repurchased 8,271 shares during 2003, expending \$207,000 to repurchase shares for cash pay-outs to former employees in place of ESOP share distributions during 2003. We reissued approximately 855,000, 696,000 and 529,000 shares in 2005, 2004 and 2003, respectively, through stock option and employee stock purchase plan exercises and issuances. The proceeds received for the stock reissued were less than our total cost basis in 2005 and 2003. Accordingly, the difference was recorded as a reduction to retained earnings. During 2004 we reissued treasury shares through stock option and ESPP exercises and issuances, with the proceeds received totaling more than the cost basis of the treasury stock reissued. Accordingly, the difference was recorded as an increase to retained earnings. Attached below is a summary of treasury share activity for the past three years:

| Treasury shares                   | 2005      | 2004      | 2003      |
|-----------------------------------|-----------|-----------|-----------|
| Balance on January 1              | 1,036,024 | 1,732,181 | 2,252,840 |
| Stock repurchases, including ESOP | 716,500   |           | 8,271     |
| Shares reissued                   | (855,159) | (696,157) | (528,930) |
| Balance on December 31            | 897,365   | 1,036,024 | 1,732,181 |

*Dividend Policy.* Since December 31, 1997, we have paid quarterly cash dividends (the cash dividend) for every share of Common Stock to shareholders of record. Dividend payments commence on or about 15 days after the end of each fiscal quarter. Our Board of Directors has periodically increased the cash dividend and attached below is a summary of our dividends accrued and paid since December 31, 1997, the date we first declared cash dividends on our Common Stock. Included in the schedule below is a one-time special dividend of \$1.00 per share, approved by the Board of Directors in February 2005 and effective for shareholders of record at March 31, 2005 and paid on or about April 15, 2005.

| Period | Q1     | Q2     | Q3     | Q4     | Totals |
|--------|--------|--------|--------|--------|--------|
| 1997   |        |        |        | \$0.01 | \$0.01 |
| 1998   | \$0.01 | \$0.01 | \$0.01 | \$0.01 | \$0.04 |
| 1999   | \$0.01 | \$0.01 | \$0.01 | \$0.01 | \$0.04 |
| 2000   | \$0.01 | \$0.01 | \$0.01 | \$0.01 | \$0.04 |
| 2001   | \$0.01 | \$0.01 | \$0.01 | \$0.02 | \$0.05 |
| 2002   | \$0.02 | \$0.02 | \$0.03 | \$0.03 | \$0.10 |
| 2003   | \$0.03 | \$0.03 | \$0.06 | \$0.06 | \$0.18 |
| 2004   | \$0.06 | \$0.06 | \$0.07 | \$0.07 | \$0.26 |
| 2005   | \$0.08 | \$1.08 | \$0.08 | \$0.08 | \$1.32 |

*Stock Option Plans.* In July 1990, we adopted the Director Stock Option Plan (the Director Plan) and reserved a total of 500,000 shares of Common Stock for issuance thereunder. Commencing with the adoption of the Plan through 2001, each Eligible Director received a one-time automatic grant of an option to purchase 5,000 shares of our Common Stock. In addition, through 2001 each Eligible Director was granted an option to purchase 5,000 shares upon the date five (5) days after such person became Director, and an additional option to purchase 5,000 shares five (5) days after the date of the regularly scheduled board meeting following the close of our third quarter. All options granted through 2001 had a five-year term and fully vested at the end of six months from the grant date.

In July 2001, as approved by shareholders at the annual shareholders meeting in April 2002, the board of directors extended the term of the Director Plan to 2010. Our shareholders also approved amendments to change the date of the annual grant to directors under the Director Plan to five (5) business days after the re-election of directors at the annual meeting of shareholders, and increased the initial automatic option grant and each annual option grant from 5,000 to 7,500 shares. The term of options granted under the Director Plan was also increased from five (5) years to ten (10) years. These amendments did not increase the number of shares authorized for the Director Plan. In each instance, Director Plan options must be granted at not less than 100% of the fair market value of our stock at the dates of grant.

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In November 1993, the Board of Directors authorized the Inter-Tel, Incorporated Long-Term Incentive Plan ( the 1994 Long Term Plan ). 2,000,000 shares of Common Stock have been reserved for issuance under the 1994 Long Term Plan to selected officers and key employees. Options must be granted at not less than 100% of the fair market value of our stock at the dates of grant. Options generally vest over four or five years and expire five to ten years from the date of grant. The 1994 Long Term Plan does not allow incentive stock options to be granted after November 19, 2003, but other forms of awards, as defined in the plan, may be continue to be granted to participants.

In February 1997, the Board of Directors authorized the Inter-Tel, Incorporated 1997 Long-Term Incentive Plan ( the 1997 Long Term Plan ). The 1997 Long-Term Plan allows various types of awards, including incentive stock options nonqualified stock options, stock appreciation rights, restricted stock awards, performance share awards, dividend equivalent awards, other stock-based awards, or any other right or interest relating to stock or cash, granted to a participant under the 1997 Long Term Plan. In the past, the Company typically awarded stock options from this Plan. However, future awards may be in any of the forms allowed under the Plan. Options must be granted at not less than 100% of the fair market value of our stock at the dates of grant. Options generally vest over three to five years and expire ten years from the date of grant. In March 2000, the Board of Directors authorized an amendment to the 1997 Long Term Plan to limit our ability to reprice options under the 1997 Long Term Plan. Prior to January 1, 2002, a total of 3,650,000 shares of Common Stock had been reserved for issuance under the 1997 Long Term Plan to selected officers and key employees.

On February 27, 2001 our Board of Directors authorized an amendment to the 1997 Long Term Plan, approved by the stockholders, that provides for an automatic increase in the number of shares of Common Stock reserved thereunder on the first day of each fiscal year equal to the lesser of (a) 2.5% of the outstanding shares on that date, (b) 750,000 shares (subject to appropriate adjustment for all stock splits, dividends, subdivisions, combinations, recapitalizations and like transactions) or (c) a lesser amount as determined by the Board of Directors (the Renewal Feature ). Based on shares outstanding at January 1 and as approved each year by our Board of Directors for each of the respective periods noted below, the Renewal Feature provided for increases in the number of shares available for issuance under the 1997 Long Term Plan, as follows:

Under the 1994 and 1997 Long Term Plans, in some instances, predetermined share market value increases must be met to allow acceleration of option vesting provisions before the end of the option term.

In April 1998, the Board of Directors authorized the Inter-Tel, Incorporated Acquisition Stock Option Plan (the Acquisition Plan). A total of 82,428 shares of Common Stock was reserved for issuance under the Acquisition Plan to selected key employees hired as a result of the acquisition of TMSI. New options must be granted at not less than 100% of the fair market value of our stock at the dates of grant. Options generally vest over four or five years and expire ten years from the date of grant. A portion of the options granted were replacements for options held to purchase shares of stock of the selling company; such replacement grants retained the original terms, including grant dates for vesting purposes and the original grant prices, adjusted using the applicable conversion ratio of the fair value of Inter-Tel s stock compared to that of the selling company.

In March 2000, the Board of Directors authorized an additional 216,000 shares of Common Stock for issuance under the Acquisition Plan to selected employees hired as a result of the acquisition of selected assets of Executone. In February 2001, the Board of Directors authorized an additional 300,000 shares of Common Stock for issuance under the Acquisition Plan to selected employees hired as a result of the acquisition of selected assets of Convergent. In addition, in October 2001, the Board of Directors authorized an additional 150,000 shares of Common Stock for issuance under the Acquisition Plan to selected employees hired as a result of the acquisition of Mastermind Technologies. Options in each instance must be granted at not less than 100% of the fair market value of our stock at the dates of grant. Options vest over five years and expire ten years from the date of grant.

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On April 26, 2005, the Compensation Committee of the Board of Directors of Inter-Tel, with the approval of the board of directors, approved the acceleration of the vesting of certain unvested stock options previously granted to employees under the 1994 Long Term Plan, the 1997 Long Term Plan and the Acquisition Stock Option Plan. With the exception of any options granted to all Directors and Named Executive Officers, all unvested options with exercise prices greater than the closing price as of the close of the Nasdaq stock market on May 3, 2005 (\$19.13) became exercisable in full. Such options would otherwise have vested from time to time over the subsequent five years. Approximately 617,000 options were accelerated at grant prices ranging from \$19.16 to \$31.58. All other terms and conditions applicable to outstanding stock option grants, including the exercise prices and number of shares subject to the accelerated options, were unchanged. The stock option agreements with respect to the options were deemed amended accordingly. This acceleration of the vesting provision increased the stock based compensation expense and decreased the pro forma net income shown in the table in Note B above by \$5.4 million for the year ended December 31, 2005.

The Board of Directors considered several factors in determining to accelerate the vesting of these options, including the effect on the Company's reported stock option expense in future periods, administrative burden required to track and account for the vesting periods under new accounting rules and the potential benefit to the Company and its shareholders in retaining the services of the affected employees.

Option activity for the past three years under all plans is as follows:

| (Number of shares)                              | Years Ended December 31, |           |           |
|---|--------------------------|-----------|-----------|
|   | 2005                     | 2004      | 2003      |
| Outstanding at beginning of year                | 4,124,118                | 4,416,131 | 4,188,641 |
| Granted   | 707,300                  | 484,000   | 879,950   |
| Exercised (1)                                   | (788,338)                | (649,543) | (476,410) |
| Expired or canceled                             | (187,092)                | (126,470) | (176,050) |
| Outstanding at end of year                      | 3,855,988                | 4,124,118 | 4,416,131 |
| Exercisable at end of year                      | 2,462,798                | 2,002,768 | 1,877,151 |
| Weighted-average grant price of options granted | \$ 16.36                 | \$ 14.88  | \$ 13.66  |

(1) The difference between shares exercised in the table above and shares exercised as reflected in the Consolidated Statements of Shareholders Equity relates to mature shares tendered in connection with the shares exercised. The

Company permits the tendering of mature shares to exercise stock options provided that the shares have been held for six months or more. Mature shares tendered for the years ended December 31, 2005, 2004 and 2003 were 2,504, 3,144 and 5,722 shares, respectively.

At December 31, 2005, we have reserved 4,822,612 shares of Common Stock for issuance in connection with the stock option plans.

The following table summarizes information about stock options outstanding at December 31, 2005:

| Range of Exercise Price | Number Outstanding at 12-31-05 | Weighted-Average Remaining Contractual Life | Weighted Average Exercise Price |
|-------------------------|--------------------------------|---|---------------------------------|
| \$5.25 - \$10.00        | 956,690                        | 4.8 years                                   | \$9.30                          |
| \$10.01 - \$15.12       | 879,621                        | 6.4 years                                   | \$13.58                         |
| \$15.13 - \$19.13       | 967,100                        | 7.7 years                                   | \$18.47                         |
| \$19.14 - \$43.44       | 1,052,577                      | 6.6 years                                   | \$23.16                         |

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The following table summarizes information about stock options exercisable at December 31, 2005:

| Range of Exercise Price | Number Exercisable at 12-31-05 | Weighted-Average Remaining Contractual Life | Weighted Average Exercise Price |
|-------------------------|--------------------------------|---|---------------------------------|
| \$5.25 - \$10.00        | 678,920                        | 4.8 years                                   | \$9.20                          |
| \$10.01 - \$15.12       | 442,801                        | 6.4 years                                   | \$13.52                         |
| \$15.13 - \$19.13       | 296,300                        | 7.7 years                                   | \$17.30                         |
| \$19.14 - \$43.44       | 1,044,777                      | 6.6 years                                   | \$23.18                         |

During 2005, the weighted average exercise price of options granted, exercised, and expired or canceled in 2005 was \$19.15, \$10.78 and \$17.88, respectively.

Pro forma information regarding net income and net income per common share, as disclosed in Note B has been determined as if the Company had accounted for its employee stock-based compensation plans and other stock options under the fair method of SFAS No. 123. Employee stock options vest over three to five year periods and director options vest at the end of six months from the grant date. The fair value of these options was estimated at the date of grant using a Black-Scholes option pricing model with the following assumptions:

|                                 | 2005      | 2004    | 2003    |
|---------------------------------|-----------|---------|---------|
| Expected dividend yield         | 1.55%     | 0.93%   | 1.2%    |
| Expected stock price volatility | 0.488     | 0.478   | 0.560   |
| Risk-free interest rate         | 3.98%     | 3.29%   | 3.05%   |
| Expected life of options        | 3-5 years | 5 years | 5 years |

The Black-Scholes option pricing model was developed for use in estimating the fair value of traded options, which, unlike options granted by the Company, have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, including the expected stock price volatility. Because the Company's stock options have characteristics significantly different from options traded on an exchange, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its stock options. The weighted average fair value of options granted during fiscal 2005, 2004 and 2003 was \$6.34, \$10.38 and \$7.04 per share, respectively.

*1997 Employee Stock Purchase Plan.* In April 1997, the Board of Directors and stockholders adopted the Employee Stock Purchase Plan (the Purchase Plan) and reserved 500,000 shares for issuance to eligible employees. In April 2002, the Board of Directors and stockholders approved an amendment to the Plan to increase the number of authorized shares by 500,000 shares for a total of 1,000,000 authorized thereunder. Under the Purchase Plan, employees are granted the right to purchase shares of Common Stock at a price per share that is 85% of the lesser of the fair market value of the shares at: (i) the participant's entry date into each six-month offering period, or (ii) the end of each six-month offering period. Employees may designate up to 10% of their compensation for the purchase of stock. Under the Plan, we sold 69,325 shares for approximately \$1,196,000 (\$17.25 per share) to employees in 2005, 49,758 shares for approximately \$1,051,000 (\$21.13 per share) to employees in 2004, and 58,242 shares for approximately \$915,000 (\$15.71 per share) to employees in 2003. At December 31, 2005, 397,259 shares remained authorized under the Plan.

**Table of Contents****NOTE M EARNINGS PER SHARE**

The following table sets forth the computation of basic and diluted earnings per share:

| (In thousands, except per share amounts)  | Years Ended December 31, |                  |                  |
|---|--------------------------|------------------|------------------|
|   | 2005                     | 2004<br>Restated | 2003<br>Restated |
| Numerator:  |                          |                  |                  |
| Net income  | \$ 17,854                | \$ 27,213        | \$ 28,635        |
| Denominator:  |                          |                  |                  |
| Denominator for basic earnings per share weighted average shares                                    | 26,261                   | 25,767           | 25,078           |
| Effect of dilutive securities:  |                          |                  |                  |
| Employee and director stock options   | 946                      | 1,499            | 1,395            |
| Denominator for diluted earnings per share adjusted weighted average shares and assumed conversions | 27,207                   | 27,266           | 26,473           |
| Basic income per share  | \$ 0.68                  | \$ 1.06          | \$ 1.14          |
| Diluted income per share  | \$ 0.66                  | \$ 1.00          | \$ 1.08          |

In 2005, 2004 and 2003, options to purchase 669,200; 201,000; and 227,150 shares, respectively, of Inter-Tel stock were excluded from the calculation of diluted net earnings per share because the exercise price of these options was greater than the average market price of the common shares for the respective fiscal years, and therefore the effect would have been antidilutive.

**NOTE N RETIREMENT PLANS**

Inter-Tel maintains retirement plans for the benefit of our employees. Under our 401(k) Retirement Plan, participants may contribute on an annual basis up to the maximum amount allowed by the Internal Revenue Service. We make voluntary annual contributions to the Plan of 50% of contributions made by Plan participants of up to 6 percent of each participant's compensation. Our matching contributions to the Plan totaled \$2.0 million, \$1.9 million, and \$1.6 million, in 2005, 2004 and 2003, respectively.

**NOTE O SEGMENT INFORMATION**

Inter-Tel follows Statement of Financial Accounting Standards No. 131, Disclosures about Segments of an Enterprise and Related Information (SFAS 131). SFAS 131 established standards for reporting information regarding operating segments in annual financial statements and requires selected information for those segments to be presented in interim financial reports issued to stockholders. SFAS 131 also established standards for related disclosures about products and services and geographic areas. Operating segments are identified as components of an enterprise about which separate discrete financial information is available for evaluation by the chief operating decision maker, or decision-making group, in making decisions as to how to allocate resources and assess performance. The Company's chief decision maker, as defined under SFAS 131, is the Chief Executive Officer.

We view our operations as primarily composed of two segments: (1) our principal segment, which includes sales of telephone systems, telecommunications software, hardware and related services, and (2) network services, including resale of local and long distance calling services, voice circuits and data circuits through Inter-Tel NetSolutions® (NetSolutions), as well as commissions earned by Network Services Agency, our division serving as an agent selling local and network services such as T-1 access, frame relay and other voice and data circuit services on behalf of Regional Bell Operating Companies (RBOCs) and local exchange carriers (collectively, Network Services). Sales of these systems, software, related services and Network Services are provided through the Company's direct sales offices and dealer network to business customers in North America, and in parts of Europe, South Africa and

Asia. As a result, financial information disclosed represents substantially all of the financial information related to the Company's two principal operating segments. Results of operations for the Network Services segment, if the operations were not included as part of the consolidated group, could differ materially, as the operations are integral to the total telephony solution offered by us to our customers.

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For the years ended December 31, we generated income from business segments, including charges, as follows:

| (In thousands, except per share amounts) | Principal Segment | Legal Judgment & Settlement | Subtotal Principal Segment | Resale of Local, Long Distance and Network Services | Total     |
|--|-------------------|-----------------------------|----------------------------|---|-----------|
| <b>2005</b>                              |                   |                             |                            |   |           |
| Net sales                                | \$387,606         | \$                          | \$387,606                  | \$55,288  | \$442,894 |
| Gross profit                             | 204,817           |                             | 204,817                    | 21,493  | 226,310   |
| Operating income                         | 24,689            | (11,986)                    | 12,703                     | 9,983   | 22,686    |
| Interest and other income                | 3,901             |                             | 3,901                      | 172   | 4,073     |
| Gain on foreign currency transactions    | 215               |                             | 215                        | 0   | 215       |
| Interest expense                         | (80)              |                             | (80)                       | (5)   | (85)      |
| Net income (loss)                        | \$ 18,436         | \$ (7,862)                  | \$ 10,574                  | \$ 7,280  | \$ 17,854 |
| Net income (loss) per diluted share (1)  | \$ 0.68           | \$ (0.29)                   | \$ 0.39                    | \$ 0.27   | \$ 0.66   |
| Weighted average diluted shares (1)      | 27,207            | 27,207                      | 27,207                     | 27,207  | 27,207    |
| Goodwill                                 | \$ 27,705         | \$                          | \$ 27,705                  | \$ 2,135  | \$ 29,840 |
| Total assets                             | 381,729           |                             | 381,729                    | 14,539  | 396,268   |
| Depreciation and amortization            | \$ 13,596         | \$                          | \$ 13,596                  | \$ 57   | \$ 13,653 |

| (In thousands, except per share amounts) | Principal Segment | E-Rate     | Subtotal Principal Segment | Resale of Local, Long Distance and Network Services | Total     |
|--|-------------------|------------|----------------------------|---|-----------|
| <b>2004 (as restated)</b>                |                   |            |                            |   |           |
| Net sales                                | \$367,969         | \$         | \$367,969                  | \$48,799  | \$416,768 |
| Gross profit                             | 202,624           |            | 202,624                    | 18,826  | 221,450   |
| Operating income                         | 43,177            | (9,261)    | 33,916                     | 7,674   | 41,590    |
| Interest and other income                | 2,463             |            | 2,463                      | 191   | 2,654     |
| Gain on foreign currency transactions    | (399)             |            | (399)                      |   | (399)     |
| Interest expense                         | (109)             |            | (109)                      | (9)   | (118)     |
| Net income (loss)                        | \$ 30,761         | \$ (8,957) | \$ 21,804                  | \$ 5,409  | \$ 27,213 |
| Net income (loss) per diluted share (1)  | \$ 1.13           | \$ (0.33)  | \$ 0.80                    | \$ 0.20   | \$ 1.00   |
| Weighted average diluted shares (1)      | 27,266            | 27,266     | 27,266                     | 27,266  | 27,266    |
| Goodwill                                 | \$ 18,923         | \$         | \$ 18,923                  | \$ 2,135  | \$ 21,058 |
| Total assets                             | 399,069           |            | 399,069                    | 8,714   | 407,783   |
| Depreciation and amortization            | \$ 9,897          | \$         | \$ 9,897                   | \$ 107  | \$ 10,004 |

Resale of

| (In thousands, except per share amounts) | <b>Principal<br/>Segment</b> | <b>Legal<br/>Judgment<br/>&amp;<br/>Settlement</b> | <b>Subtotal<br/>Principal<br/>Segment</b> | <b>Local,<br/>Long<br/>Distance<br/>and<br/>Network<br/>Services</b> | <b>Total</b> |
|--|------------------------------|--|---|--|--------------|
| <b>2003</b> (as restated)                |                              |  |   |  |              |
| Net sales                                | \$330,014                    | \$   | \$330,014                                 | \$43,624   | \$373,638    |
| Gross profit                             | 179,777                      |  | 179,777                                   | 17,098   | 196,875      |
| Operating income                         | 37,379                       |  | 37,379                                    | 6,751  | 44,130       |
| Interest and other income                | 1,650                        |  | 1,650                                     | 157  | 1,807        |
| Gain on foreign currency transactions    | 18                           |  | 18  |  | 18           |
| Interest expense                         | (153)                        |  | (153)                                     | (2)  | (155)        |
| Net income (loss)                        | \$ 24,326                    | \$   | \$ 24,326                                 | \$ 4,309   | \$ 28,635    |
| Net income (loss) per diluted share (1)  | \$ 0.92                      | \$   | \$ 0.92                                   | \$ 0.16  | \$ 1.08      |
| Weighted average diluted shares (1)      | 26,473                       | 26,473   | 26,473                                    | 26,473   | 26,473       |
| Goodwill                                 | \$ 17,000                    | \$   | \$ 17,000                                 | \$ 2,135   | \$ 19,135    |
| Total assets                             | 339,804                      |  | 339,804                                   | 20,790   | 360,594      |
| Depreciation and amortization            | \$ 8,973                     | \$   | \$ 8,973                                  | \$ 161   | \$ 9,134     |

(1) Options that are antidilutive because the exercise price was greater than the average market price of the common shares are not included in the computation of diluted earnings per share. See Note L for additional information.

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Our revenues are generated predominantly in the United States. Total revenues generated from U.S. customers totaled \$405.6 million, or 91.6% of total revenues, \$403.7 million, or 96.8% of total revenues, and \$362.6 million, or 97.0% of total revenues for the year ended December 31, 2005, 2004, and 2003, respectively. Revenues from customers located internationally accounted for 8.4%, 3.2%, and 3.0% of total revenues for the year ended December 31, 2005, 2004, and 2003, respectively. Substantially all of the foreign revenues were generated by our principal segment for each of the last three years. Refer to the tables below for additional geographical revenue data.

(in thousands,  
except percentages)

| Source of net sales | Year Ended December 31, |       |                  |       |                  |       |
|---------------------|-------------------------|-------|------------------|-------|------------------|-------|
|                     | 2005                    |       | 2004<br>Restated |       | 2003<br>Restated |       |
|                     | \$                      | %     | \$               | %     | \$               | %     |
| Domestic            | 405,607                 | 91.6  | 403,620          | 96.8  | 362,592          | 97.0  |
| Lake Communications | 22,996                  | 5.2   |                  |       |                  |       |
| Other International | 14,291                  | 3.2   | 13,148           | 3.2   | 11,046           | 3.0   |
| Total net sales     | 442,894                 | 100.0 | 416,768          | 100.0 | 373,638          | 100.0 |

2005 revenue percentages from foreign sources primarily increased as a result of our acquisition of Lake in March 2005. Lake is based in Dublin, Ireland with majority of its sales made to the United Kingdom, Australia, other European countries, and South Africa. Other International revenues identified in the table above primarily consist of revenues from Inter-Tel UK and Swan Solutions. These other international offices sell predominantly into the United Kingdom and other European countries. All sales made between Inter-Tel divisions are eliminated and are not represented in the above amounts or in the Consolidated Statements of Income. For the year ended December 31, 2005, \$1.3 million of income before income taxes resulted from our foreign operations.

Our applicable long-lived assets at December 31, 2005, included Property, Plant & Equipment; Goodwill; and Purchased Intangible Assets. The net amount located in the United States was \$60.2 million and the amount in foreign countries was \$21.5 million at December 31, 2005. At December 31, 2004, the net amount located in the United States was \$56.1 million and the amount in foreign countries was \$3.8 million (as restated). The increase in foreign assets relates to the acquisition of Lake.

**NOTE P FINANCIAL INSTRUMENTS**

*Concentration of Credit Risk.* Financial instruments that potentially subject Inter-Tel to significant concentrations of credit risk consist principally of cash investments, trade accounts receivable, and net investment in sales-leases. We maintain cash and equivalents not invested in money market funds with a major bank in our marketplace. We perform periodic evaluations of the relative credit standing of the financial institution. Concentrations of credit risk with respect to trade accounts receivable and net investment in sales-leases are limited due to the large number of entities comprising our customer base.

*Fair Value of Financial Instruments.* The carrying amount of cash and equivalents, accounts receivable, net investment in sales-leases, and accounts payable reported in the consolidated balance sheets approximate their fair value.

**NOTE Q SUPPLEMENTAL CASH FLOW**

| (In thousands)        | Years Ended December 31, |                  |                  |
|-----------------------|--------------------------|------------------|------------------|
|                       | 2005                     | 2004<br>Restated | 2003<br>Restated |
| <b>Cash paid for:</b> |                          |                  |                  |
| Interest              | \$ 85                    | \$ 118           | \$ 155           |

|                              |       |            |            |
|------------------------------|-------|------------|------------|
| Income taxes paid (received) | 1,222 | \$ (1,156) | \$ (9,384) |
|------------------------------|-------|------------|------------|

**Additional disclosure of cash flow information:**

|                                |          |          |          |
|--------------------------------|----------|----------|----------|
| Tax benefit from stock options | \$ 3,891 | \$ 2,638 | \$ 2,321 |
|--------------------------------|----------|----------|----------|

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| (In thousands)  | Years Ended December 31, |                  |                  |
|---|--------------------------|------------------|------------------|
|   | 2005                     | 2004<br>Restated | 2003<br>Restated |
| <b>Changes in operating assets and liabilities:</b>                   |                          |                  |                  |
| Increase in receivables and current net investment in sales-leases    | \$ (1,295)               | \$ (4,494)       | \$ (6,082)       |
| Increase in inventories   | (2,988)                  | (2,192)          | (4,069)          |
| (Increase) decrease in prepaid expenses and other assets              | (998)                    | 5,933            | (2,935)          |
| Increase in long-term net investment in sales-leases and other assets | (1,348)                  | (1,809)          | (6,962)          |
| (Decrease) increase in accounts payable and other current liabilities | (4,365)                  | 4,685            | 1,277            |
|   | \$ (10,994)              | \$ 2,123         | \$ (18,771)      |

**NOTE R QUARTERLY RESULTS OF OPERATIONS (UNAUDITED)**

A summary of the quarterly results of operations for the years ended December 31, 2005 and 2004 follows (quarterly amounts may not add to the year-end totals due to rounding):  
(In thousands, except per share amounts and note 1)

| <b>2005</b>                            | <b>1st Qtr<br/>Restated<br/>(1)</b> | <b>2nd Qtr<br/>Restated<br/>(1)</b> | <b>3rd Qtr<br/>Restated<br/>(1)</b> | <b>4th Qtr</b> |
|--|-------------------------------------|-------------------------------------|-------------------------------------|----------------|
| Net sales                              | \$ 105,618                          | \$ 115,265                          | \$ 111,335                          | \$ 110,676     |
| Gross profit                           | \$ 53,965                           | \$ 60,045                           | \$ 56,260                           | \$ 56,040      |
| Other charges                          | \$                                  | \$                                  | \$ 10,378                           | \$ 1,608       |
| Net income                             | \$ 1,958                            | \$ 6,941                            | \$ 735                              | \$ 8,220       |
| Net income per share Basic             | \$ 0.07                             | \$ 0.26                             | \$ 0.03                             | \$ 0.31        |
| Net income per share Diluted           | \$ 0.07                             | \$ 0.26                             | \$ 0.03                             | \$ 0.31        |
| Weighted average basic common shares   | 26,373                              | 26,301                              | 26,147                              | 26,222         |
| Weighted average diluted common shares | 27,788                              | 27,069                              | 27,056                              | 26,914         |

| <b>2004</b>                            | <b>1st Qtr<br/>Restated<br/>(1)</b> | <b>2nd Qtr<br/>Restated<br/>(1)</b> | <b>3rd Qtr<br/>Restated<br/>(1)</b> | <b>4th Qtr<br/>Restated<br/>(1)</b> |
|--|-------------------------------------|-------------------------------------|-------------------------------------|-------------------------------------|
| Net sales                              | \$ 97,927                           | \$ 102,657                          | \$ 105,344                          | \$ 110,840                          |
| Gross profit                           | \$ 51,994                           | \$ 54,048                           | \$ 55,772                           | \$ 59,636                           |
| Other charges e-Rate                   | \$                                  | \$                                  | \$                                  | \$ 9,261                            |
| Net income                             | \$ 6,815                            | \$ 8,019                            | \$ 9,165                            | \$ 3,214                            |
| Net income per share Basic             | \$ 0.27                             | \$ 0.31                             | \$ 0.36                             | \$ 0.12                             |
| Net income per share Diluted           | \$ 0.25                             | \$ 0.29                             | \$ 0.34                             | \$ 0.12                             |
| Weighted average basic common shares   | 25,543                              | 25,715                              | 25,816                              | 25,994                              |
| Weighted average diluted common shares | 27,350                              | 27,262                              | 26,944                              | 27,509                              |

(1) The Company has restated its previously reported



consolidated financial statements for changes in net sales and income tax provision as described in Note A. The effect of the restatement on net income is a decrease of approximately \$5,000, \$98,000, and \$41,000 for the first, second and third quarter of fiscal 2004, respectively, and an increase of approximately \$103,000 for the fourth quarter in fiscal 2004. The effect of the restatement on net income is an increase of approximately \$23,000 and \$88,000 in the first and third quarter of fiscal 2005, respectively, and a decrease in net income of approximately \$52,000 for the second quarter of fiscal 2005. The effect on reported quarterly basic net income per share was a decrease of \$0.01 for both

the second quarter of fiscal 2004 and the second quarter of fiscal 2005, and an increase of \$0.01 for both the fourth quarter of fiscal 2004 and the third quarter of fiscal 2005.

There was no effect on reported quarterly basic net income per share for the first and third quarters of fiscal 2004 or for the first quarter of fiscal 2005. The effect on reported quarterly diluted net income per share was a decrease of \$0.01 for the second quarter of fiscal 2004 and an increase of \$0.01 for the fourth quarter of fiscal 2004 and the third quarter of fiscal 2005.

There was no effect on quarterly diluted net income per share for the first and third quarters of fiscal 2004 or for the first and second quarters of fiscal 2005.

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**NOTE S SUBSEQUENT EVENT**

Subsequent to December 31, 2005, the Company settled a legal matter that existed as of December 31, 2005. The Company recorded an accrual for the settlement amount and related fourth quarter legal fees as of December 31, 2005. The settlement plus costs and related fourth quarter legal fees totaled \$1.6 million. Additional legal fees and costs totaling approximately \$1.2 million are expected to be recorded as period costs during the first quarter of 2006 relating to this matter.

**Table of Contents****SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS**

| DESCRIPTION                         | (In Thousands)                                    |  |   |                                       |  |
|-------------------------------------|---|--|---|---------------------------------------|--|
|                                     | Col. A<br>Balance<br>at<br>Beginning<br>of Period | Col. B<br>Charged<br>to Costs<br>&<br>Expenses | Col. C<br>Charged<br>to Other<br>Accounts | Col. D<br>Charged<br>to<br>Deductions | Col. E.<br>Balance<br>at End<br>of<br>Period |
| <b>Year ended December 31, 2005</b> |   |  |   |                                       |  |
| Deducted from asset accounts:       |   |  |   |                                       |  |
| Allowance for Doubtful Accounts     | \$ 9,921  | \$ 1,151                                       | \$ (405)(2)                               | \$ 4,432(1)                           | \$ 6,235                                     |
| Allowance for Sales-Leases          | 2,696   | 683  |   | 455                                   | 2,924  |
| Lease Recourse Liability            | 12,241  | 3,089  |   | 1,131(1)                              | 14,199                                       |
| <b>Year ended December 31, 2004</b> |   |  |   |                                       |  |
| Deducted from asset accounts:       |   |  |   |                                       |  |
| Allowance for Doubtful Accounts     | \$ 11,010   | \$ 1,525                                       | \$ (349)(2)                               | \$ 2,265(1)                           | \$ 9,921                                     |
| Allowance for Sales-Leases          | 2,734   | 711  |   | 749                                   | 2,696  |
| Lease Recourse Liability            | 12,020  | 3,128  |   | 2,907(1)                              | 12,241                                       |
| <b>Year ended December 31, 2003</b> |   |  |   |                                       |  |
| Deducted from asset accounts:       |   |  |   |                                       |  |
| Allowance for Doubtful Accounts     | \$ 12,159   | \$ 3,164                                       | \$ (770)(2)                               | \$ 3,543(1)                           | \$ 11,010                                    |
| Allowance for Sales-Leases          | 1,927   | 765  |   | (42)                                  | 2,734  |
| Lease Recourse Liability            | 11,125  | 3,763  |   | 2,868(1)                              | 12,020                                       |

(1) Uncollectible accounts written off, net of recoveries.

(2) Acquisition related adjustments.

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**PART IV**

**ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULE**

**(a) The following documents are filed as part of this Report:**

**1. Financial Statements**

See Item 8 of this Annual Report on Form 10-K where the following financial statements are presented:

- Report of Independent Registered Public Accounting Firm
- Consolidated balance sheets December 31, 2005 and 2004 (Restated)

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- Consolidated statements of income years ended December 31, 2005, 2004 (Restated) and 2003 (Restated)
- Consolidated statements of shareholders equity years ended December 31, 2005, 2004 (Restated) and 2003 (Restated)
- Consolidated statements of cash flows years ended December 31, 2005, 2004 (Restated) and 2003 (Restated)
- Notes to consolidated financial statements (portions restated)

**2. Financial Statement Schedules**

The following consolidated financial statement schedule of Inter-Tel, Incorporated, and subsidiaries is filed as part of this Report and should be read in conjunction with the Consolidated Financial Statements of Inter-Tel, Incorporated and subsidiaries, and the notes thereto.

Schedule for the three years ended December 31, 2005:

Schedule II Valuation and Qualifying Accounts Page No. 33

Schedules not listed above have been omitted because they are not applicable or are not required or the information required to be set forth therein is included in the Consolidated Financial Statements or notes thereto.

**3. Exhibits**

Exhibits incorporated herein by reference.

- 3.1(10) Articles of Incorporation, as amended.
- 3.2(22) By-Laws, as amended.
- 10.15(1) Registrant's form of standard Distributor Agreement.
- 10.16(1) Registrant's form of standard Service Agreement.
- 10.35(3) Agreement between Registrant and Samsung Semiconductor and Telecommunications Company, Ltd. dated October 17, 1984.
- 10.37(3) \* Tax Deferred Savings Plan.
- 10.51(11) \* 1990 Directors' Stock Option Plan and form of Stock Option Agreement.
- 10.52(15) \* Inter-Tel, Incorporated 1994 Long-Term Incentive Plan and forms of Stock Option Agreements.
- 10.53(12) Agreement between Registrant and Maxon Systems, Inc. dated February 27, 1990.
- 10.54(12) Agreement between Registrant and Varian Tempe Electronics Center dated February 26, 1991.
- 10.55(12) Agreement between Registrant and Jetcrown Industrial Ltd. dated February 18, 1993.
- 10.56(13) \* Employee Stock Ownership Plan.
- 10.57(14) Loan and Security Agreement dated March 4, 1997 between Bank One, Arizona, N.A. and Registrant and Modification Agreement dated July 25, 1997.
- 10.58 (16) Development, Supply and License Agreement between Registrant and QUALCOMM dated January 17, 1996.
- 10.59(17) \* Inter-Tel, Incorporated 1997 Long-Term Incentive Plan.

10.60(18) \* Inter-Tel, Incorporated 1997 Employee Stock Purchase Plan.

10.61(19) \* Inter-Tel, Incorporated Acquisition Stock Option Plan and form of Stock Option Agreement.

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- 10.62(20) Computer Telephony Asset Purchase Agreement dated as of October 17, 1999 by and between Executone Information Systems, Inc., Inter-Tel, Incorporated and Executone Inter-Tel Business Information Systems, Inc.
- 10.63(21) \* Form of Key Employee Tier 1 Change of Control Severance Agreement.
- 10.64(21) \* Form of Key Employee Tier 2 Change of Control Severance Agreement.
- 23.0(23) Consent of Ernst & Young LLP, Independent Registered Public Accounting Firm.
- (1) Incorporated by reference to Registrant's Registration Statement on Form S-1 (File No. 2-70437).
- (3) Incorporated by reference to Registrant's Annual Report on Form 10-K for the year ended November 30, 1984 (File No. 0-10211), Registration Statement on Form S-8 (File No. 333-106868) and Registrant's Annual Report on Form 11-K for the year ended December 31, 2002 (File No. 0-10211)
- (10) Incorporated by reference to Registrant's Annual Report on Form 10-K for the year



ended  
December 31,  
1988 (File  
No. 0-10211).

(11) Incorporated by  
reference to  
Registrant's  
Registration  
Statement on  
Form S-8 (File  
No. 33-40353).

(12) Incorporated by  
reference to  
Registrant's  
Registration  
Statement on  
Form S-1 (File  
No. 33-70054).

(13) Incorporated by  
reference to  
Registrant's  
Registration  
Statement on  
Form S-8 (File  
No. 33-73620).

(14) Incorporated by  
reference to  
Registrant's  
Annual Report  
on Form 10-K  
for the year  
ended  
December 31,  
1998 (File  
No. 0-10211).

(15) Incorporated by  
reference to  
Registrant's  
Proxy Statement  
dated March 23,  
1994 and to  
Registrant's  
Registration  
Statement on  
Form S-8 (File  
No. 33-83826).

- (16) Incorporated by reference to Registrant's Annual Report on Form 10-K for the year ended December 31, 1995 (File No. 0-10211).
- (17) Incorporated by reference to Registrant's Registration Statements on Forms S-8 (File Nos. 333-41197, 333-85098, 333-104642, 333-113600, and 333-123506).
- (18) Incorporated by reference to Registrant's Registration Statements on Forms S-8 (File Nos. 333-41197 and 333-87474).
- (19) Incorporated by reference to Registrant's Registration Statements on Forms S-8 (File Nos. 333-56872, 333-67261 and 333-85098).
- (20) Incorporated by reference to Registrant's Report on Form 8-K (File No. 0-10211, filed on January

14, 2000).

(21) Incorporated by reference to Registrant's Annual Report on Form 10-K for the year ended December 31, 2003 (File No. 0-10211).

(22) Incorporated by reference to Registrant's Report on Form 8-K (File No. 0-10211, filed on February 27, 2006).

(23) Incorporated by reference to Registrant's Annual Report on Form 10-K for the year ended December 31, 2005 (File No. 0-10211).

\* Management contracts or compensatory plan or arrangement required to be filed as an exhibit to this report on Form 10-K.

**(b) Exhibits filed herewith.**

31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1

Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code).

See Item 15(a) 3 also.

(c) **Financial Statement Schedule.** The response to this portion of Item 15 is submitted as a separate section of this report. See Item 8.

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant, Inter-Tel, Incorporated, has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

INTER-TEL (DELAWARE)  
INCORPORATED

BY: /s/ Norman Stout  
Norman Stout  
Director and Chief Executive Officer

Dated: August 10, 2006

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