

Edgar Filing: LYNCH INTERACTIVE CORP - Form 10-Q

LYNCH INTERACTIVE CORP  
Form 10-Q  
August 14, 2003

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SECURITIES & EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE
SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2003

or

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OF 15(D) OF THE
SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission File No. 1-15097

LYNCH INTERACTIVE CORPORATION

(Exact name of Registrant as specified in its charter)

Delaware 06-1458056
State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification No.)

401 Theodore Fremd Avenue, Rye, New York 10580
(Address of principal executive offices) (Zip Code)

(914) 921-8821

Registrant's telephone number, including area code

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

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

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

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| Class                           | Outstanding at July 30, 2003 |
|---------------------------------|------------------------------|
| -----                           | -----                        |
| Common Stock, \$.0001 par value | 2,782,751                    |

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INDEX

LYNCH INTERACTIVE CORPORATION AND SUBSIDIARIES

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

Condensed Consolidated Balance Sheets:

- June 30, 2003
- December 31, 2002
- June 30, 2002

Condensed Consolidated Statements of Operations:

- Three and six months ended June 30, 2003 and 2002

Condensed Consolidated Statements of Cash Flows:

- Six months ended June 30, 2003 and 2002

Notes to Condensed Consolidated Financial Statements

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Item 3. Quantitative and Qualitative Disclosure About Market Risk

Item 4. Controls and Procedures

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Item 4. Submission of Matters to a Vote of Security Holders

Item 6. Exhibits and Reports on Form 8-K

SIGNATURE

CERTIFICATIONS

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

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

|   | June 30,<br>2003  | December 31,<br>2002 | June 30,<br>2002  |
|---|-------------------|----------------------|-------------------|
|   | (Unaudited)       | (Note)               | (Unaudited)       |
| <b>ASSETS</b>   |                   |                      |                   |
| <b>CURRENT ASSETS:</b>  |                   |                      |                   |
| Cash and cash equivalents .....   | \$ 25,526         | \$ 23,356            | \$ 24,291         |
| Restricted Cash .....   | --                | --                   | 10,552            |
| Receivables, less allowances of \$258,<br>\$316 and \$928, respectively ..... | 8,553             | 8,916                | 8,982             |
| Material and supplies .....   | 3,300             | 3,351                | 3,687             |
| Prepaid expenses and other current assets .....                               | 1,290             | 1,451                | 2,443             |
| <b>TOTAL CURRENT ASSETS .....</b>   | <b>38,669</b>     | <b>37,074</b>        | <b>49,955</b>     |
| <b>PROPERTY, PLANT AND EQUIPMENT:</b>   |                   |                      |                   |
| Land .....  | 833               | 807                  | 840               |
| Buildings and improvements .....  | 13,332            | 12,741               | 10,918            |
| Machinery and equipment .....   | 203,807           | 195,015              | 183,979           |
|   | 217,972           | 208,563              | 195,737           |
| Accumulated Depreciation .....  | (97,312)          | (88,201)             | (81,834)          |
|   | 120,660           | 120,362              | 113,903           |
| GOODWILL, NET .....   | 60,884            | 60,884               | 60,889            |
| INVESTMENTS IN AND ADVANCES TO AFFILIATED ENTITIES .....                      | 10,100            | 9,343                | 15,375            |
| OTHER ASSETS .....  | 18,732            | 17,684               | 17,663            |
| <b>TOTAL ASSETS .....</b>   | <b>\$ 249,045</b> | <b>\$ 245,347</b>    | <b>\$ 257,785</b> |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>                                   |                   |                      |                   |
| <b>CURRENT LIABILITIES:</b>   |                   |                      |                   |
| Notes payable to banks .....  | \$ 11,623         | \$ 12,882            | \$ 12,776         |
| Trade accounts payable .....  | 3,118             | 1,638                | 479               |
| Accrued interest payable .....  | 372               | 384                  | 1,809             |
| Accrued liabilities .....   | 14,831            | 16,682               | 17,158            |
| Current maturities of long-term debt .....                                    | 18,619            | 18,272               | 21,151            |
| <b>TOTAL CURRENT LIABILITIES .....</b>  | <b>48,563</b>     | <b>49,858</b>        | <b>53,373</b>     |
| LONG-TERM DEBT .....  | 160,720           | 158,349              | 166,433           |
| DEFERRED INCOME TAXES .....   | 6,659             | 6,621                | 7,790             |
| OTHER LIABILITIES .....   | 645               | 736                  | 799               |
| MINORITY INTERESTS .....  | 7,414             | 7,151                | 6,814             |

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COMMITMENTS AND CONTINGENCIES

SHAREHOLDERS' EQUITY

|  |            |            |            |
|--|------------|------------|------------|
| COMMON STOCK, \$0.0001 PAR VALUE-10,000,000  |            |            |            |
| SHARES AUTHORIZED; 2,824,766 ISSUED; 2,782,751,<br>2,792,651 and 2,802,551 OUTSTANDING ..... | --         | --         | --         |
| ADDITIONAL PAID-IN CAPITAL .....   | 21,406     | 21,406     | 21,406     |
| RETAINED EARNINGS .....  | 4,448      | 1,879      | 1,625      |
| ACCUMULATED OTHER COMPREHENSIVE INCOME .....   | 599        | 534        | 467        |
| TREASURY STOCK, 42,015, 32,115 and 22,215 shares, at cost                                    | (1,409)    | (1,187)    | (922)      |
|  | -----      | -----      | -----      |
| TOTAL SHAREHOLDER'S EQUITY .....   | 25,044     | 22,632     | 22,576     |
|  | -----      | -----      | -----      |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY .....   | \$ 249,045 | \$ 245,347 | \$ 257,785 |
|  | =====      | =====      | =====      |

Note: The balance sheet at December 31, 2002 has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements.

See accompanying notes.

-1-

LYNCH INTERACTIVE CORPORATION AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
(UNAUDITED)

(In thousands, except per share and share amounts)

|  | Three Months Ended<br>June 30, |           | Six Mo<br>Ju |
|--|--------------------------------|-----------|--------------|
|  | 2003                           | 2002      | 2003         |
|  | -----                          | -----     | -----        |
| SALES AND REVENUES .....                               | \$ 21,343                      | \$ 21,098 | \$ 42,64     |
| COSTS AND EXPENSES:                                    |                                |           |              |
| Operations, exclusive of depreciation and amortization | 10,637                         | 11,104    | 21,48        |
| Depreciation and amortization .....                    | 4,913                          | 4,780     | 9,82         |
| Selling and administrative .....                       | 1,100                          | 757       | 1,86         |
|  | -----                          | -----     | -----        |
| OPERATING PROFIT .....                                 | 4,693                          | 4,457     | 9,46         |
|  | -----                          | -----     | -----        |
| Other income (expense):                                |                                |           |              |
| Investment income .....                                | 98                             | 235       | 65           |
| Interest expense .....                                 | (2,999)                        | (3,298)   | (6,02        |
| Equity in earnings of affiliated companies .....       | 425                            | 224       | 68           |
| Gain on sale of subsidiary stock .....                 | --                             | --        | --           |
|  | -----                          | -----     | -----        |
|  | (2,476)                        | (2,839)   | (4,68        |

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|   | -----     | -----     | -----     |
|---|-----------|-----------|-----------|
| INCOME BEFORE INCOME TAXES, MINORITY INTERESTS AND<br>OPERATIONS OF MORGAN GROUP HOLDING CO. DISTRIBUTED TO<br>SHAREHOLDERS                           |           |           |           |
|   | 2,217     | 1,618     | 4,788     |
| Provision for income taxes .....  | (875)     | (651)     | (1,951)   |
| Minority Interests .....  | (186)     | (62)      | (261)     |
|   | -----     | -----     | -----     |
| INCOME FROM CONTINUING OPERATIONS .....   | 1,156     | 905       | 2,566     |
| Loss from operations of Morgan Group Holding Co.<br>distributed to shareholders, net of income taxes of<br>\$-, and minority interests of \$868 ..... | --        | --        | --        |
|   | -----     | -----     | -----     |
| NET INCOME .....  | \$ 1,156  | \$ 905    | \$ 2,566  |
|   | =====     | =====     | =====     |
| Basic weighted average shares outstanding .....   | 2,787,000 | 2,809,000 | 2,789,000 |
| Diluted weighted average shares outstanding .....   | 2,787,000 | 2,809,000 | 2,789,000 |
| BASIC EARNINGS PER SHARE  |           |           |           |
| INCOME FROM CONTINUING OPERATIONS .....   | \$ 0.41   | \$ 0.32   | \$ 0.92   |
| Loss from operations of Morgan Group Holding Co.<br>distributed to shareholders .....   | --        | --        | --        |
|   | -----     | -----     | -----     |
| NET INCOME .....  | \$ 0.41   | \$ 0.32   | \$ 0.92   |
|   | =====     | =====     | =====     |
| DILUTED EARNINGS PER SHARE  |           |           |           |
| INCOME FROM CONTINUING OPERATIONS .....   | \$ 0.41   | \$ 0.32   | \$ 0.92   |
| Loss from operations of Morgan Group Holding Co.<br>distributed to shareholders.....  | --        | --        | --        |
|   | -----     | -----     | -----     |
| NET INCOME .....  | \$ 0.41   | \$ 0.32   | \$ 0.92   |
|   | =====     | =====     | =====     |

See accompanying notes.

-2-

LYNCH INTERACTIVE CORPORATION AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(UNAUDITED)  
(In thousands)

|  | Six Months Ended<br>June 30, |               |
|--|------------------------------|---------------|
|  | -----<br>2003                | -----<br>2002 |
|  | -----                        | -----         |
| OPERATING ACTIVITIES   |                              |               |
| Net Income .....   | \$ 2,569                     | \$ 3,290      |
| Adjustments to reconcile net income to net cash provided by operating<br>activities: |                              |               |
| Depreciation and amortization .....  | 9,828                        | 9,591         |
| Equity in earnings of affiliated companies .....                                     | (685)                        | (428)         |
| Minority interests .....   | 263                          | 694           |

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|  |           |           |
|--|-----------|-----------|
| Gain on sale of cellular partnership .....   | --        | (4,965)   |
| Gain on sale of available for sale securities .....  | --        | (24)      |
| Non-cash items and changes in operating assets and liabilities<br>from operations of Morgan Group Holding Co.<br>distributed to shareholders ..... | --        | 1,888     |
| Changes in operating assets and liabilities:   |           |           |
| Receivables .....  | 363       | 1,055     |
| Accounts payable and accrued liabilities .....   | (476)     | 1,174     |
| Other .....  | 212       | (1,000)   |
|  | -----     | -----     |
| NET CASH PROVIDED BY OPERATING ACTIVITIES .....  | 12,074    | 11,275    |
|  | -----     | -----     |
| INVESTING ACTIVITIES   |           |           |
| Capital expenditures .....   | (9,927)   | (7,794)   |
| Investment in and advances to affiliated entities .....  | (546)     | (1,912)   |
| Proceeds from sale of available for sale securities .....  | --        | 398       |
| Proceeds from sale of cellular partnership .....   | --        | 5,570     |
| Other .....  | (668)     | (75)      |
|  | -----     | -----     |
| NET CASH USED IN INVESTING ACTIVITIES .....  | (11,141)  | (3,813)   |
|  | -----     | -----     |
| FINANCING ACTIVITIES   |           |           |
| Issuance of long term debt .....   | 8,748     | 1,965     |
| Repayments of long term debt .....   | (6,030)   | (7,605)   |
| Net repayments on lines of credit .....  | (1,259)   | 2,440     |
| Treasury stock transactions .....  | (222)     | (691)     |
| Investment in restricted cash .....  | --        | (2,983)   |
| Other .....  | --        | 39        |
|  | -----     | -----     |
| NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES .....  | 1,237     | (6,835)   |
|  | -----     | -----     |
| Net increase in cash and cash equivalents .....  | 2,170     | 627       |
| Cash and cash equivalents at beginning of period .....   | 23,356    | 23,664    |
|  | -----     | -----     |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD .....   | \$ 25,526 | \$ 24,291 |
|  | =====     | =====     |

See accompanying notes.

-3-

LYNCH INTERACTIVE CORPORATION & SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

A. Subsidiaries of the Registrant

As of June 30, 2003, the Subsidiaries of the Registrant are as follows:

| Subsidiary                                | Owned by Lynch |
|---|----------------|
| Brighton Communications Corporation ..... | 100.0%         |
| Lynch Telephone Corporation IV .....      | 100.0%         |

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|   |        |
|---|--------|
| Bretton Woods Telephone Company .....         | 100.0% |
| World Surfer, Inc. ....                       | 100.0% |
| Lynch Broadband Corporation .....             | 100.0% |
| Lynch Telephone Corporation VI .....          | 98.0%  |
| JBN Telephone Company, Inc. ....              | 98.0%  |
| JBN Finance Corporation .....                 | 98.0%  |
| CLR Video, L.L.C .....                        | 98.0%  |
| Giant Communications, Inc. ....               | 100.0% |
| Lynch Telephone Corporation VII .....         | 100.0% |
| USTC Kansas, Inc. ....                        | 100.0% |
| Haviland Telephone Company, Inc. ....         | 100.0% |
| Haviland Finance Corporation .....            | 100.0% |
| DFT Communications Corporation .....          | 100.0% |
| DFT Telephone Holding Company, L.L.C .....    | 100.0% |
| Dunkirk & Fredonia Telephone Company .....    | 100.0% |
| Cassadaga Telephone Company .....             | 100.0% |
| Macom, Inc. ....                              | 100.0% |
| Comantel, Inc. ....                           | 100.0% |
| Erie Shore Communications, Inc. ....          | 100.0% |
| D&F Cellular Telephone, Inc. ....             | 100.0% |
| DFT Long Distance Corporation .....           | 100.0% |
| DFT Local Service Corporation .....           | 100.0% |
| DFT Security Services, Inc. ....              | 100.0% |
| LMT Holding Corporation .....                 | 100.0% |
| Lynch Michigan Telephone Holding Corporation  | 100.0% |
| Upper Peninsula Telephone Company .....       | 100.0% |
| Alpha Enterprises Limited .....               | 100.0% |
| Upper Peninsula Cellular North, Inc. .        | 100.0% |
| Upper Peninsula Cellular South, Inc. .        | 100.0% |
| Lynch Telephone Corporation IX .....          | 100.0% |
| Central Scott Telephone Company .....         | 100.0% |
| CST Communications Inc. ....                  | 100.0% |
| Global Television, Inc. ....                  | 100.0% |
| Inter-Community Acquisition Corporation ..... | 100.0% |
| Lynch Telephone Corporation X .....           | 100.0% |
| Central Utah Telephone, Inc. ....             | 100.0% |
| Central Telecom Services, LLC .....           | 100.0% |
| Cache Valley Wireless, LC .....               | 100.0% |

-4-

| Subsidiary                                 | Owned by Lynch |
|--|----------------|
| Lynch Entertainment, LLC .....             | 100.0%         |
| Lynch Entertainment Corporation II .....   | 100.0%         |
| Lynch Multimedia Corporation .....         | 100.0%         |
| Lynch Paging Corporation .....             | 100.0%         |
| Lynch PCS Communications Corporation ..... | 100.0%         |
| Lynch PCS Corporation A .....              | 100.0%         |
| Lynch PCS Corporation F .....              | 100.0%         |

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|  |        |
|--|--------|
| Lynch PCS Corporation G .....              | 100.0% |
| Lynch PCS Corporation H .....              | 100.0% |
| Lynch 3G Communications Corporation .....  | 100.0% |
| Lynch Telephone Corporation .....          | 83.1%  |
| Western New Mexico Telephone Company, Inc. | 83.1%  |
| Interactive Networks Corporation .....     | 83.1%  |
| WNM Communications Corporation .....       | 83.1%  |
| WNM Interactive, L.L.C .....               | 83.1%  |
| Wescel Cellular, Inc. ....                 | 83.1%  |
| Wescel Cellular of New Mexico, L.P. ....   | 42.4%  |
| Wescel Cellular, Inc. II .....             | 83.1%  |
| Enchantment Cable Corporation .....        | 83.1%  |
| Lynch Telephone II, LLC .....              | 100.0% |
| Inter-Community Telephone Company, LLC ... | 100.0% |
| Valley Communications, Inc. ....           | 100.0% |
| Lynch Telephone Corporation III .....      | 81.0%  |
| Cuba City Telephone Exchange Company ..... | 81.0%  |
| Belmont Telephone Company .....            | 81.0%  |

-5-

B. Basis of Presentation

The Company consolidates the operating results of its telephone and cable television subsidiaries (81-100% owned at June 30, 2003, December 31, 2002 and June 30, 2002). All material intercompany transactions and balances have been eliminated. Investments in affiliates in which the Company does not have a majority voting control are accounted for in accordance with the equity method. The Company accounts for the following affiliated companies on the equity basis of accounting: Coronet Communications Company (20% owned at June 30, 2003, December 31, 2002 and June 30, 2002), Capital Communications Company, Inc. (49% owned at June 30, 2003, December 31, 2002 and June 30, 2002. Note: Interactive owns a convertible preferred stock which, when converted, would increase its ownership in Capital to 50%) and the cellular partnership operations in New Mexico (17% to 21% owned at June 30, 2003, December 31, 2002 and June 30, 2002).

On January 24, 2002, Interactive spun off its interest in The Morgan Group, Inc. ("Morgan"), its only services subsidiary, via a tax-free dividend to its shareholders of the stock of Morgan Group Holding Co., a corporation that was formed to serve as a holding company for Interactive's controlling interest in Morgan. Morgan Group Holding Co. is now a public company. Accordingly, the amounts for Morgan are reflected on a one-line basis in the condensed consolidated financial statements for the six months ended June 30, 2002, as amounts "distributed to shareholders."

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Articles 10 and 11 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In



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the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three-month and six-month periods ended June 30, 2003 are not necessarily indicative of the results that may be expected for the year ending December 31, 2003. The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

As noted, in Note H, in the first quarter of 2003, the Company issued stock options to its President and Chief Operating Officer. The Company has elected to account for these options under the provisions of FASB Statement No. 123 "Accounting and Disclosure of Stock-Based Compensation" and FASB Statement No. 148 "Accounting for Stock-Based Compensation - Transition and Disclosure, an amendment of FASB Statement No. 123." Under the provisions of these two statements, stock options are valued at fair value on the date of the grant and such amount is amortized as an expense over the vesting period. During the second quarter of 2003, the President left the Company, and all options were forfeited. The \$50,000 of expense that was recognized in the first quarter, was reversed into net income.

In June 2001, the FASB issued SFAS No. 143, "Accounting for Asset Retirement obligations." This standard provides accounting guidance for legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction or development and (or) normal operation of that asset. According to the standard, the fair value of an asset retirement obligation (ARO liability) should be recognized in the period in which (1) a legal obligation to retire a long-lived asset exists and (2) the fair value of the obligation based on retirement cost and settlement date is reasonably estimable. Upon initial recognition of the ARO liability, the related asset retirement cost should be capitalized by increasing the carrying amount of the related long-lived asset. The Company adopted SFAS No. 143 on January 1, 2003. Although the Company generally has had no legal obligation to remove assets, depreciation rates of certain assets established by regulatory authorities for the Company's telephone operations subject to SFAS No. 71 have historically included a component for removal costs in excess of the related estimated salvage value. SFAS No. 71 requires the Company to not remove this accumulated liability for removal costs in excess of salvage value even though there is no legal obligation to remove the assets. For the Company's operations not subject to SFAS No. 71 the Company has not accrued a liability for anticipated removal costs in the past and will continue to expense the costs of removal as incurred since there is no legal obligation to remove such assets. Accordingly, the adoption of SFAS No. 143 had no impact on the Company's financial statements.

-6-

In January 2003, the FASB issued Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51." FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective immediately for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after June 15, 2003. Management of the Company is still evaluating the impact that FIN 46 will have on the Company's consolidated financial position, results of operations or cash flows.

Certain 2002 amounts have been reclassified to conform to the 2003 presentation.

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C. Intangibles

The application of the non-amortization provisions of Statement No. 142, Goodwill and Other Intangible Assets, has increased net income for both the three months ended June 30, 2003 and 2002 by \$0.7 million (\$0.24 per basic and diluted share) and approximately \$1.3 million (\$0.45 per basic and \$0.44 per diluted share) for the six months ended June 30, 2002 and approximately \$1.3 million (\$.045 per basic and diluted share) for the six months ended June 30, 2003.

The following tables display the details of goodwill and intangible assets as of the dates shown.

|  | June 30,<br>2003 | December 31,<br>2002 | June 30,<br>2002 |
|--|------------------|----------------------|------------------|
|  | (Unaudited)      |                      | (Unaudited)      |
|  | (000s)           |                      |                  |
| Intangible assets subject to amortization:     |                  |                      |                  |
| Subscriber lists .....                         | \$ 7,702         | \$ 7,284             | \$ 7,594         |
| Accumulated amortization .....                 | (2,665)          | (2,370)              | (1,774)          |
|  | -----            | -----                | -----            |
|  | \$ 5,037         | \$ 4,914             | \$ 5,820         |
|  | =====            | =====                | =====            |
| Amortization expense for three months ended .. | \$ 147           |                      | \$ 405           |
| Amortization expense for six months ended .... | \$ 295           |                      | \$ 808           |
| Intangible assets not subject for amortization |                  |                      |                  |
| Goodwill .....                                 | \$ 60,884        | \$ 60,884            | \$ 59,916        |
| Cellular Licenses .....                        | 1,650            | 1,650                | 1,650            |

Estimated aggregate amortization expense by year for Intangible assets subject to amortization:

|      | (000's) |
|------|---------|
|      | -----   |
| 2003 | \$552   |
| 2004 | \$552   |
| 2005 | \$547   |
| 2006 | \$547   |
| 2007 | \$547   |

-7-

D. Acquisitions and Dispositions

In March 2002, the Company sold its 20.8% interest in the New Mexico cellular partnership, RSA #1B, to Verizon Wireless for \$5.6 million (\$5 million pre-tax gain) and repaid \$2.6 million of outstanding indebtedness to Verizon.

E. Spin-off of Morgan

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On January 24, 2002, Interactive spun off its interest in The Morgan Group, Inc., its only services subsidiary, via a tax-free dividend to its shareholders of the stock of Morgan Group Holding Co., a corporation that was formed to serve as a holding company for Interactive's controlling interest in The Morgan Group, Inc. Morgan Group Holding Co. is now a public company.

### F. Investments in Affiliated Companies

Interactive has equity investments in both broadcasting and telecommunications companies.

Summarized financial information for companies accounted for by the equity method as of and for the three and six months ended June 30, 2003 and 2002 and as of December 31, 2002 is as follows (000's):

|  | Broadcasting Combined Information |                      |                                 |
|--|-----------------------------------|----------------------|---------------------------------|
|  | June 30,<br>2003<br>(Unaudited)   | December 31,<br>2002 | June 30,<br>2002<br>(Unaudited) |
| Current assets .....                             | \$ 5,404                          | \$ 6,181             | \$ 5,145                        |
| Property, plant & equipment, intangibles & other | 10,103                            | 11,260               | 12,494                          |
|  | -----                             | -----                | -----                           |
| Total assets .....                               | \$ 15,507                         | \$ 17,441            | \$ 17,639                       |
|  | =====                             | =====                | =====                           |
| Current liabilities .....                        | \$ 3,127                          | \$ 3,790             | \$ 4,140                        |
| Long term liabilities .....                      | 17,020                            | 18,069               | 18,856                          |
| Equity .....                                     | (4,640)                           | (4,418)              | (5,357)                         |
|  | -----                             | -----                | -----                           |
| Total liabilities & equity .....                 | \$ 15,507                         | \$ 17,441            | \$ 17,639                       |
|  | =====                             | =====                | =====                           |
| Three months ended                               |                                   |                      |                                 |
| Revenues .....                                   | \$ 2,900                          |                      | \$ 2,958                        |
| Gross profit .....                               | 782                               |                      | 954                             |
| Net (Loss) Profit .....                          | (7)                               |                      | 73                              |
| Six Months Ended                                 |                                   |                      |                                 |
| Revenues .....                                   | \$ 5,738                          |                      | \$ 5,581                        |
| Gross profit .....                               | 1,455                             |                      | 1,637                           |
| Net Loss .....                                   | (212)                             |                      | (151)                           |

At June 30, 2003, December 31, 2002, and June 30, 2002 the Company's investment in Coronet Communications Company ("Coronet") was carried at a negative \$793,000, a negative \$791,000, and a negative \$930,000 respectively, due to the Company's guarantee of \$3.8 million of Coronet's third party debt. Long-term debt of Coronet, at June 30, 2003, totaled \$10.4 million due to a third party lender which is due quarterly through December 31, 2005. The Company's investment in Capital Communications Company was carried at \$0 for all periods.

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Telecommunications Combined Information  
June 30, December 31, June 30,

|  | 2003<br>(Unaudited) | 2002<br>(Unaudited) | 2002<br>(Unaudited) |
|--|---------------------|---------------------|---------------------|
|  | (000`s)             |                     |                     |
| Current assets .....                             | \$11,597            | \$13,996            | \$11,544            |
| Property, plant & equipment, intangibles & other | 27,343              | 28,320              | 28,124              |
| Total assets .....                               | \$38,940            | \$42,316            | \$39,668            |
| Current liabilities .....                        | \$ 5,372            | \$ 9,243            | \$ 8,836            |
| Long term liabilities .....                      | 11,061              | 11,869              | 13,517              |
| Equity .....                                     | 22,507              | 21,204              | 17,315              |
| Total liabilities & equity .....                 | \$38,940            | \$42,316            | \$39,668            |
| Three months ended                               |                     |                     |                     |
| Revenues .....                                   | \$11,570            |                     | \$11,104            |
| Gross profit .....                               | 4,152               |                     | 3,277               |
| Net income .....                                 | 3,178               |                     | 2,481               |
| Six months ended                                 |                     |                     |                     |
| Revenues .....                                   | \$21,981            |                     | \$20,937            |
| Gross profit .....                               | 7,580               |                     | 5,836               |
| Net income .....                                 | 5,679               |                     | 4,395               |

G. Indebtedness

The parent company maintains a short-term line of credit facility totaling \$10.0 million. Borrowings under this facility were \$8.3 million, \$10.0 million and \$9.9 million at June 30, 2003, and December 31, 2002, and June 30, 2002 respectively. This facility will expire on August 31, 2003. Long-term debt consists of (all interest rates are at June 30, 2003):

-9-

| June 30,<br>2003<br>(Unaudited) | December 31,<br>2002 | June 30,<br>2002<br>(Unaudited) |
|---------------------------------|----------------------|---------------------------------|
| (In thousands)                  |                      |                                 |

Rural Electrification Administration (REA) and Rural

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|   |            |            |            |
|---|------------|------------|------------|
| Telephone Bank (RTB) notes payable through 2027 at fixed interest rates ranging from 2% to 7.5%. (5% weighted average, secured by assets of the telephone companies of \$152.8 million) .....                               | \$ 58,878  | \$ 58,119  | \$ 55,239  |
| Bank Credit facilities utilized by certain telephone and telephone holding companies through 2016, \$28.9 million at fixed interest rates averaging 7.9% and \$53.8 million at variable interest rates averaging 4.1% ..... | 82,681     | 80,166     | 84,060     |
| Unsecured notes issued in connection with acquisitions through 2006, at fixed interest rates of 10.0% .....   | 34,634     | 34,749     | 34,397     |
| Convertible note due in December 2007 at a fixed interest rate of 10% .....   | --         | --         | 10,000     |
| Other .....   | 3,146      | 3,587      | 3,888      |
|   | -----      | -----      | -----      |
|   | 179,339    | 176,621    | 187,584    |
| Current maturities .....  | (18,619)   | (18,272)   | (21,151)   |
|   | -----      | -----      | -----      |
|   | \$ 160,720 | \$ 158,349 | \$ 166,433 |
|   | =====      | =====      | =====      |

### H. Stock Options

The Company has a stock option plan which calls for 83,000 options to be issued, a maximum option term of ten years and vesting at the discretion of the Option Committee.

On February 10, 2003, the Company issued stock options to its newly hired President and Chief Operating Officer, covering 55,000 shares. The exercise prices were as follows: 20,000 at \$26.06 (market price at date of grant), 20,000 at \$36.06 and 15,000 at \$46.06. These options vested at one year, three years and four years from February 10, 2003 and expire on February 10, 2008. The estimated fair value of these options at the date of grant was \$650,000, using the Black-Scholes Option Pricing model with the following assumptions: risk free interest rate of 3%, dividend yield of 0% and volatility factor of the estimated market price of the Company's common stock of .582 and an expected life of the options of five years. \$50,000 of expense was recognized in the first quarter of 2003 for these options - \$30,000 net of tax. During the second quarter of 2003, the President left the Company, and all options were forfeited and the \$30,000 of expense, recognized in the first quarter, was reversed into income.

-10-

### I. Comprehensive Income

Balances of accumulated other comprehensive income, net of tax, which consists of unrealized gains (losses) on available for sale of securities, at June 30, 2003, December 31, 2002 and June 30, 2002 are as follows (in thousands):

Unrealized

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|                                  | Gain    | Tax Effect | Net    |
|----------------------------------|---------|------------|--------|
| Balance at December 31, 2002 ... | \$ 915  | \$ (381)   | \$ 534 |
| Current period unrealized losses | 104     | (39)       | 65     |
|                                  | -----   | -----      | -----  |
| Balance at June 30, 2003 .....   | \$1,019 | \$ (420)   | \$ 599 |
|                                  | =====   | =====      | =====  |
| Balance at June 30, 2002 .....   | \$ 799  | \$ (332)   | \$ 467 |

Comprehensive income, for the three month and six month periods ended June 30, 2003 and 2002 are as follows (in thousands):

|   | Three Months Ended<br>June 30, |        | Six Months Ended<br>June 30, |          |
|---|--------------------------------|--------|------------------------------|----------|
|   | 2003                           | 2002   | 2003                         | 2002     |
|   | -----                          | -----  | -----                        | -----    |
| Net income for the period   | \$ 1,156                       | \$ 905 | \$ 2,569                     | \$ 3,290 |
| Reclassification adjustment-net of income<br>tax benefit of \$--, \$20 and -- and \$146<br>respectively .....                                   | --                             | (32)   | --                           | (228)    |
| Unrealized losses on available for sale<br>securities - net of income tax benefit<br>as of (\$87), \$307, (\$39) and \$579<br>respectively..... | 131                            | (447)  | 65                           | (847)    |
|   | -----                          | -----  | -----                        | -----    |
| Comprehensive income .....  | \$ 1,287                       | \$ 426 | \$ 2,634                     | \$ 2,215 |
|   | =====                          | =====  | =====                        | =====    |

J. Earnings per share

The following table set forth the computation of basic and diluted earnings per share for the periods indicated: During the six months ended June 30, 2003, the Company purchased 9,900 shares of its common stock for treasury. During the period there were stock options outstanding that have been excluded from the earnings per share computation because their inclusion would have been anti-dilutive.

-11-

|                          | Three Months Ended<br>June 30, |            | Six Months Ended<br>June 30, |             |
|--------------------------|--------------------------------|------------|------------------------------|-------------|
|                          | 2003                           | 2002       | 2003                         | 2002        |
|                          | -----                          | -----      | -----                        | -----       |
| Basic earnings per share |                                |            |                              |             |
| Numerator:               |                                |            |                              |             |
| Net Income .....         | \$1,156,000                    | \$ 905,000 | \$2,569,000                  | \$3,290,000 |
| Denominator:             |                                |            |                              |             |

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|  |             |            |             |             |
|--|-------------|------------|-------------|-------------|
| Weighted average shares outstanding ..   | 2,787,000   | 2,809,000  | 2,789,000   | 2,813,000   |
|  | -----       | -----      | -----       | -----       |
| Earnings per share:  |             |            |             |             |
| Net income .....   | \$ 0.41     | \$ 0.32    | \$ 0.92     | \$ 1.17     |
|  | =====       | =====      | =====       | =====       |
| Diluted earnings per share   |             |            |             |             |
| Numerator:   |             |            |             |             |
| Net Income .....   | \$1,156,000 | \$ 905,000 | \$2,569,000 | \$3,290,000 |
| Interest saved on assumed conversion<br>of convertible notes - net of tax..... | --          | --         | --          | 274,000     |
|  | -----       | -----      | -----       | -----       |
| Net Income .....   | \$1,156,000 | \$ 905,000 | \$2,569,000 | \$3,564,000 |
|  | -----       | -----      | -----       | -----       |
| Denominator:   |             |            |             |             |
| Weighted average shares outstanding ..   | 2,787,000   | 2,809,000  | 2,789,000   | 2,813,000   |
| Shares issued on assumed conversion of<br>convertible note .....               | --          | --         | --          | 236,000     |
|  | -----       | -----      | -----       | -----       |
| Weighted average shares and share<br>Equivalents .....                         | 2,787,000   | 2,809,000  | 2,789,000   | 3,049,000   |
|  | -----       | -----      | -----       | -----       |
| Earnings per share:  |             |            |             |             |
| Net Income .....   | \$ 0.41     | \$ 0.32    | \$ 0.92     | \$ 1.17     |
|  | =====       | =====      | =====       | =====       |

K. Segment Information

The Company is engaged in one business segment: multimedia. All operating units are located domestically, and substantially all revenues are domestic. The Company's operations include local telephone companies, a cable TV company, investment in PCS entities and investment in two network-affiliated television stations. The Company's primary operations are located in the states of Iowa, Kansas, Michigan, New Hampshire, New Mexico, New York, North Dakota, Utah and Wisconsin. 75% of the Company's telephone customers are residential. The remaining customers are businesses.

EBITDA (before corporate allocation) for operating segments is equal to operating profit before interest, taxes, depreciation, amortization and allocated corporate expenses. EBITDA is presented because it is a widely accepted financial indicator of value and ability to incur and service debt. Management uses EBITDA to evaluate the operating performance of the Company's operations. EBITDA is not a substitute for operating income or cash flows from operating activities in accordance with accounting principles generally accepted in the United States.

Operating profit is equal to revenues less operating expenses, including unallocated general corporate expenses and excluding, interest and income taxes. The Company allocates a portion of its general corporate expenses to its operating segment, such allocation was \$332,000 and \$328,000 for the three months ended June 30, 2003 and 2002, respectively; and \$665,000 from \$655,000 for the six months ended June 30, 2003 and 2002 respectively.

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|  | Three Months Ended<br>June 30, |           |         |
|--|--------------------------------|-----------|---------|
|  | 2003                           | 2002      |         |
|  |                                |           | (000's) |
| Sales and revenues: .....  | \$ 21,343                      | \$ 21,098 | \$ 4    |
|  | =====                          | =====     | =====   |
| EBITDA (before corporate allocation):  |                                |           |         |
| Operations .....   | \$ 10,706                      | \$ 9,993  | \$ 2    |
| Corporate expenses, gross .....  | (1,100)                        | (757)     | (       |
|  | -----                          | -----     | -----   |
| Combined total .....   | \$ 9,606                       | \$ 9,236  | \$ 1    |
|  | =====                          | =====     | =====   |
| Operating profit:  |                                |           |         |
| Operations .....   | \$ 5,463                       | \$ 4,890  | \$ 1    |
| Corporate expenses, net .....  | (770)                          | (433)     | (       |
|  | -----                          | -----     | -----   |
| Combined total .....   | \$ 4,693                       | \$ 4,457  | \$      |
|  | =====                          | =====     | =====   |
| Operating profit .....   | \$ 4,693                       | \$ 4,457  | \$      |
| Other income (expense):  |                                |           |         |
| Investment income .....  | 98                             | 235       |         |
| Interest expense .....   | (2,999)                        | (3,298)   | (       |
| Equity in earnings of affiliated companies .....   | 425                            | 224       |         |
|  | -----                          | -----     | -----   |
| Gain on sale of subsidiary stock .....   | --                             | --        | --      |
|  | -----                          | -----     | -----   |
| Income before income taxes, minority interests and operations of<br>Morgan Group Holding Co. distributed to shareholders ..... | \$ 2,217                       | \$ 1,618  | \$      |
|  | =====                          | =====     | =====   |

L. Litigation

Interactive and several other parties, including our Chief Executive Officer, and Fortunet Communications, L.P., which was Sunshine PCS Corporation's predecessor-in-interest, have been named as defendants in a lawsuit brought under the so-called "qui tam" provisions of the federal False Claims Act in the United States District Court for the District of Columbia. The complaint was filed under seal with the court on February 14, 2001. At the initiative of one of the defendants, the seal was lifted on January 11, 2002. Under the False Claims Act, a private plaintiff, termed a "relator," may file a civil action on the U.S. government's behalf against another party for violation of the statute. In return, the relator receives a statutory bounty from the government's litigation proceeds if he is successful.

The relator in this lawsuit is R.C. Taylor III, an individual who, to the best of our knowledge, has no relationship to any of the entities and affiliates that have been named parties in this litigation. Indeed at the time of his filings, and to the best of our knowledge, Mr. Taylor was a lawyer at Gardner, Carton & Douglas. Thereafter, we believe he was a lawyer with a Washington, D.C., law firm. We do not know his current status. We issued a press release dealing with this litigation on January 16, 2002.



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The main allegation in the case is that the defendants participated in the creation of "sham" bidding entities that allegedly defrauded the federal Treasury by improperly participating in certain Federal Communications Commission spectrum auctions restricted to small businesses, as well as obtaining bidding credits in other spectrum auctions allocated to "small" and "very small" businesses. The lawsuit seeks to recover an unspecified amount of damages, which would be subject to mandatory trebling under the statute.

-13-

Interactive strongly believes that this lawsuit is completely without merit, and intends to defend the suit vigorously. The U.S. Department of Justice has notified the court that it has declined to intervene in the case. Nevertheless, we cannot predict the ultimate outcome of the litigation, nor can we predict the effect that the lawsuit or its outcome will have on our business or plan of operation.

Interactive was formally served with the complaint on July 10, 2002. On September 19, 2002, Interactive filed two motions with the United States District Court for the District of Columbia: a motion to dismiss the lawsuit and a motion to transfer the action to the Southern District of New York. On November 25, 2002, the relator filed an opposition reply to our motion to dismiss and on December 5, 2002, Interactive filed a reply in support of its motion to dismiss.

In addition to the litigation described above, Interactive is a party to routine litigation incidental to its business. Based on information currently available, Interactive believes that none of this ordinary routine litigation, either individually or in the aggregate, will have a material effect on its financial condition and results of operations.

### Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

#### Sales and Revenues

Sales and Revenues for the three months ended June 30, 2003 increased by \$0.2 million or 1.2%, to \$21.3 million from the second quarter of 2002. Increases in the current quarter are primarily the result of additional inter-state regulated telephone revenues from the Company's telephone operations that are in the process of significant capital upgrade programs. Notwithstanding the overall increase in revenues for the period, lower intra-state revenues were recorded by certain operations during the second quarter of 2003.

Revenues for the six months ended June 30, 2003 increased by \$0.6 million or 1.4% from the six months ended June 30, 2002. Here again, high inter-state revenues have offset lower intra-state revenues.

#### Operating Profit

Operating profit for the three months ended June 30, 2003 increased by \$0.2 million to \$4.7 million from the second quarter of 2002. Last years second quarter included a \$0.7 million allowance for doubtful accounts provided in connection with the bankruptcies of MCI/Worldcom and Global Crossings. Absent this allowance, operating profit decreased as a result of the above noted lower intra-state revenues and higher depreciation associated with significant capital spending programs, as compared to the previous year. The Company's security operation in upstate New York recorded \$250,000 less amortization expense during

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the second quarter of 2003 as compared to the second quarter of 2002 as it changed the amortization period of customer lists from three to ten years in the fourth quarter of 2002. With regard to corporate expenses, the Company recorded a \$0.3 million bonus accrual in the second quarter of 2003 in accordance with its shareholder approved executive compensation plan. No accrual was made in the second quarter of 2002.

For the six month ended June 30, 2003, operating profit decreased by \$0.2 million from the six months ended June 30, 2003 basically reflecting all of the above factors.

### Other Income (Expense)

For the three months ended June 30, 2003 investment income was down by \$0.1 million from the same period in the prior year due to lower investment balances and absence of certain realized gains on available for sale securities. For the six months ended June 30, 2003, investment income was down by \$0.6 million for the same reasons.

-14-

Interest expense decreased by \$0.3 million in the second quarter of 2003 from the prior year due primarily to lower variable interest rates. In addition, in November 2002, the Company repurchased a \$10 million convertible note for which we previously accrued and paid an interest rate of 6% per annum. These decreases were offset by higher interest expense at certain telephone companies who drew on debt facilities to fund major capital expenditure program.

Interest expense decreased by \$0.6 million for the six months ended June 30, 2003 as compared to the prior year for the same reasons as the above.

During the first quarter of 2002, the Company sold its minority interest in a cellular telecommunications operation in New Mexico (RSA 1 (North)) for \$5.6 million resulting in a pre-tax gain of \$5.0 million.

Equity in earnings of affiliates for both the three-month and six-month periods ending June 30, 2003 increased due to significant earnings at the Company's New Mexico cellular operation (RSA 3 and 5).

### Income Tax Provision

The income tax provision includes federal as well as state and local taxes. The tax provision for the six months ended June 30, 2003 and 2002, represent effective tax rates of 40.8% and 39.2%, respectively. The difference between these effective rates and the federal statutory rate is principally due to state income taxes, including the effect of earnings and losses attributable to different state jurisdictions.

### Minority Interests

Minority interests decreased earnings by \$186,000 for the three months ended June 30, 2003 as compared to \$62,000 for the three months ended June 30, 2002. The change was due to the absence of minority interest affects on the losses incurred in 2003 on the company's security operation in upstate New York. For the six months ended June 30, 2003 minority interest decreased earnings by \$263,000 as compared to \$694,000 in the six months ended June 30, 2002 primarily due to minority interest recorded on the gain from the sale of the cellular property.

### Income from Continuing Operations and Net Income

Income from continuing operations and net income for the three months ended June 30, 2003 of \$1.2 million, or \$0.41 per share (basic and diluted), compared to

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income from continuing operations for the same period last year of \$0.9 million, or \$0.32 per share (basic and diluted) absence of the allowance for bad debts associated with MCI/WorldCom Global Crossing in 2002 was the primary cause of the increase.

Income from continuing operations for the six months ended June 30, 2003 was \$2.6 million or \$0.92 per share (basic and diluted) as reduced from the Income from continuing operations for the six months ended June 30, 2002 of \$5.2 million, or \$1.84 per basic share (\$1.79 per diluted share). The reduction is primarily due to the \$2.5 million or \$0.89 per basic share gain from the sale of the cellular property.

-15-

Net income for the six months ended June 30, 2003 was \$2.6 million, or \$0.92 per share (basic and diluted), as compared to net income of \$3.3 million, or \$1.17 per share (basic and diluted), in the same period last year. The increase is due to the Operating losses of Morgan of \$1.9 million, or \$0.67 per basic share, in the first quarter of 2002, offset by the gain on the sale of the cellular property.

### FINANCIAL CONDITION

#### Liquidity/ Capital Resources

As of June 30, 2003, the Company had current assets of \$38.7 million and current liabilities of \$48.6 million. Working capital deficiency was therefore \$9.9 million as compared to \$12.8 million at December 31, 2002. The addition of \$8.7 million of long-term debt was the primary cause of the decrease.

For the six months ended June 30, 2003, capital expenditures were \$9.9 million versus \$7.8 million for the same period last year. Full year capital expenditures are estimated at \$22 million versus \$23.8 million in 2002.

At June 30, 2003, total debt was \$191.0 million, which was \$1.5 million higher than the \$189.5 million at the end of 2002. At June 30, 2003, there was \$123.6 million of fixed interest rate debt averaging 7.0% and \$67.3 million of variable interest rate debt averaging 4.2%. Debt at year-end 2002 included \$124.7 million of fixed interest rate debt, at an average interest rate of 7.1%, and \$64.8 million of variable interest rate debt, at an average interest rate of 4.4%.

As of June 30, 2003, Interactive, the parent company, had \$1.7 million available under a \$10 million short-term line of credit facility, which expires on August 31, 2003. Management currently expects that this line of credit facility will be renewed but there is no assurance it will be.

Interactive and its predecessor have not paid any cash dividends on its common stock since 1989. The Company intends to reexamine its dividend policy more frequently in light of changing dynamics. While it is currently constrained by capital needs, if it is able to recapitalize its balance sheet, resources may become available to pay dividends. Future financings may limit or prohibit the payment of dividends.

Interactive has a high degree of financial leverage. As of June 30, 2003, the ratio of total debt to equity was 7.6 to 1. Certain subsidiaries also have high debt to equity ratios. In addition, the debt at subsidiary companies contains

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restrictions on the amount of readily available funds that can be transferred to the parent company.

The Company has a need for resources primarily to fund future long-term growth objectives. Interactive considers various alternative long-term financing sources: debt, equity, or sale of an investment asset. While management expects to obtain adequate financing to enable the Company to meet its obligations, there is no assurance that such financing will be readily obtained at reasonable costs.

The Company is obligated under long-term debt and lease agreements to make certain cash payments over the term of the agreements. The following table summarizes these contractual obligations for the period shown:

|                                    | Payments Due by Period |                  |                          |                  |                  |
|------------------------------------|------------------------|------------------|--------------------------|------------------|------------------|
|                                    | (In thousands)         |                  |                          |                  |                  |
|                                    | Total                  | 1 year (b)       | Less than<br>2 - 3 years | 4 - 5 years      | After 5 years    |
| Long-term Debt (a) .....           | \$179,339              | \$ 18,619        | \$ 46,923                | \$ 40,645        | \$ 73,152        |
| Operating Leases .....             | 1,163                  | 329              | 520                      | 314              | --               |
| Total Contractual Cash Obligations | <u>\$180,502</u>       | <u>\$ 18,948</u> | <u>\$ 47,443</u>         | <u>\$ 40,959</u> | <u>\$ 73,152</u> |

(a) Does not include interest payments on debt

-16-

The Company has certain financing commitments from banks and other financial institutions that provide liquidity. The following table summarizes the expiration of these commitments for the periods shown:

|   | Amount of Commitment Expiration |                     |             |             |              |
|---|---------------------------------|---------------------|-------------|-------------|--------------|
|   | Per Period                      |                     |             |             |              |
|   | Total<br>Amounts<br>Committed   | Less than<br>1 year | 1 - 3 years | 4 - 5 years | Over 5 years |
| Other Commercial Commitments<br>Lines of Credit ..... | \$11,623                        | \$11,623            | --          | --          | --           |
| Guarantees .....                                      | 3,750                           | 3,750               | --          | --          | --           |
| Total Commercial Commitments                          | <u>\$15,373</u>                 | <u>\$15,373</u>     | <u>--</u>   | <u>--</u>   | <u>--</u>    |

=====

At June 30, 2003, the Company's investment in Coronet Communications Company ("Coronet") was carried at a negative \$793,000, due to the Company's guarantee of \$3.8 million of Coronet's third party debt. The Company's investment in Capital Communications Company was carried at \$0 for all periods. Based upon a multiple of ten times broadcast cash flow, plus cash, less debt, Interactive estimates its value in these stations at almost \$12 million as compared to the net book value of these investments of a negative \$0.8 million. It is not assured that the results of these stations will continue at the current level or that they could be sold at ten times cash flow.

The Company has initiated an effort to monetize certain of its assets, including selling a portion or all of certain investments and/or certain of its operating entities. These may include minority interest in network affiliated television stations and certain telephone operations where growth opportunities are not readily apparent. There is no assurance that all or any part of this program can be effectuated on acceptable terms. In March 2002, the Company sold its 20.8% interest in the New Mexico cellular property, RSA 1 (North), to Verizon Wireless for \$5.6 million and repaid certain outstanding indebtedness to Verizon.

#### Critical Accounting Policies and Estimates

In the first quarter of 2003, the Company issued stock options to its President and Chief Operating Officer. The Company has elected to account for these options under the provisions of FASB Statement No. 123 "Accounting and Disclosure of Stock-Based Compensation" and FASB Statement No. 148 "Accounting for Stock-Based Compensation - Transition and Disclosure, an amendment of FASB Statement No. 123." Under the provisions of these two statements stock options are valued at fair value on the date of the grant and such amount is amortized as an expense over the vesting period.

#### General

Interactive's discussion and analysis of its financial condition and results of operations are based upon its consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires Interactive to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, Interactive evaluates its estimates, including those related to revenue recognition, carrying value of its investments in the spectrum entities and long-lived assets, purchase price allocations, and contingencies and litigation. Interactive bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

-17-

Interactive believes the following critical accounting policies affect its more significant judgments and estimates used in the preparation of its consolidated financial statements.

#### Revenue Recognition

The principal business of Interactive's telephone companies is to provide telecommunications services. These services fall into four major categories: local network, network access, long distance and other non-regulated telecommunications services. Toll service to areas outside franchised telephone

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service territory is furnished through switched and special access connections with intrastate and interstate long distance networks.

Local service revenues are derived from providing local telephone exchange services. Local service revenues are based on rates filed with various state telephone regulatory bodies.

Revenues from long distance network services are derived from providing certain long distance services to the Company's local exchange customers and are based on rates filed with various state regulatory bodies.

Revenue from intra-state access is generally billed monthly in arrears based on intra-state access rates filed with various state regulatory bodies. Interactive recognizes revenue from intrastate access service based on an estimate of the amounts billed to interexchange carriers in the subsequent month. Estimated revenues are adjusted monthly as actual revenues become known.

Revenue from interstate access is derived from settlements with the National Exchange Carrier Association ("NECA"). NECA was created by the FCC to administer interstate access rates and revenue pooling on behalf of small local exchange carriers who elect to participate in a pooling environment. Interstate settlements are determined based on the various subsidiaries' cost of providing interstate telecommunications service. Interactive recognizes interstate access revenue based on an estimate of the current year cost of providing service. Estimated revenue is adjusted to actual upon the completion of cost studies in the subsequent period.

Other ancillary revenues derived from the provision of directory advertising and billing and collection services are billed monthly based on rates under contract.

### Purchase Price Allocation

Interactive's business development strategy is to expand its existing operations through internal growth and acquisition. From 1989 through 2002, the Company has acquired fourteen telephone companies. Significant judgments and estimates are required to allocate the purchase price of acquisitions to the fair value of tangible assets acquired and identifiable intangible assets and liabilities assumed. Any excess purchase price over the above fair values is allocated to goodwill. Additional judgments and estimates are required to determine if identified intangible assets have finite or indefinite lives and the period of their lives.

### Depreciation and Amortization

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

-18-

Annually, the Company tests goodwill for impairment 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 impairment, if any. The Company performed the first of its required annual impairment tests of goodwill and other indefinite lived intangible assets.

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### Item 3. Quantitative and Qualitative Disclosure About Market Risk

The Company is exposed to market risk relating to changes in the general level of U.S. interest rates. Changes in interest rates affect the amounts of interest earned on the Company's cash and cash equivalents (\$25.5 million at June 30, 2003 and \$23.4 million at December 31, 2002).

The Company generally finances the debt portion of the acquisition of long-term assets with fixed rate, long-term debt. The Company generally maintains the majority of its debt as fixed rate in nature either by borrowing on a fixed long-term basis or, on a limited basis, entering into interest rate swap agreements. The Company does not use derivative financial instruments for trading or speculative purposes. Management does not foresee any significant changes in the strategies used to manage interest rate risk in the near future, although the strategies may be reevaluated as market conditions dictate.

At June 30, 2003, approximately \$67.3 million, or 35%, of the Company's long-term debt and notes payable bears interest at variable rates. Accordingly, the Company's earnings and cash flows are affected by changes in interest rates. Assuming the current level of borrowings for variable rate debt and assuming a one percentage point change in the 2003 average interest rate under these borrowings, it is estimated that the Company's 2003 three-month interest expense would have changed by less than \$0.1 million. In the event of an adverse change in interest rates, management would likely take actions to further mitigate its exposure. However, due to the uncertainty of the actions that would be taken and their possible effects, the analysis assumes no such actions. Further, the analysis does not consider the effects of the change in the level of overall economic activity that could exist in such an environment.

### Item 4. Controls and Procedures

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

-19-

### FORWARD LOOKING INFORMATION

Included in this Management Discussion and Analysis of Financial Condition and Results of Operations are certain forward looking financial and other information, including without limitation, the Company's effort to monetize

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certain assets, Liquidity and Capital Resources and Market Risk. It should be recognized that such information are estimates or forecasts based upon various assumptions, including the matters, risks, and cautionary statements referred to therein, as well as meeting the Registrant's internal performance assumptions regarding expected operating performance and the expected performance of the economy and financial markets as it impacts Registrant's businesses. As a result, such information is subject to uncertainties, risks and inaccuracies, which could be material.

-20-

### PART II. OTHER INFORMATION

#### Item 1. Legal Proceedings

Interactive and several other parties, including our Chief Executive Officer, and Fortunet Communications, L.P., which was Sunshine PCS Corporation's predecessor-in-interest, have been named as defendants in a lawsuit brought under the so-called "qui tam" provisions of the federal False Claims Act in the United States District Court for the District of Columbia. The complaint was filed under seal with the court on February 14, 2001. At the initiative of one of the defendants, the seal was lifted on January 11, 2002. Under the False Claims Act, a private plaintiff, termed a "relator," may file a civil action on the U.S. government's behalf against another party for violation of the statute. In return, the relator receives a statutory bounty from the government's litigation proceeds if he is successful.

The relator in this lawsuit is R.C. Taylor III, an individual who, to the best of our knowledge, has no relationship to any of the entities and affiliates that have been named parties in this litigation. Indeed at the time of his filings, and to the best of our knowledge, Mr. Taylor was a lawyer at Gardner, Carton & Douglas. Thereafter, we believe he was a lawyer with a Washington, D.C., law firm. We do not know his current status. We issued a press release dealing with this litigation on January 16, 2002.

The main allegation in the case is that the defendants participated in the creation of "sham" bidding entities that allegedly defrauded the Federal Treasury by improperly participating in certain Federal Communications Commission spectrum auctions restricted to small businesses, as well as obtaining bidding credits in other spectrum auctions allocated to "small" and "very small" businesses. The lawsuit seeks to recover an unspecified amount of damages, which would be subject to mandatory trebling under the statute.

Interactive strongly believes that this lawsuit is completely without merit, and intends to defend the suit vigorously. The U.S. Department of Justice has notified the court that it has declined to intervene in the case. Nevertheless, we cannot predict the ultimate outcome of the litigation, nor can we predict the effect that the lawsuit or its outcome will have on our business or plan of operation.

Interactive was formally served with the complaint on July 10, 2002. On September 19, 2002, Interactive filed two motions with the United States District Court for the District of Columbia: a motion to dismiss the lawsuit and a motion to transfer the action to the Southern District of New York. On November 25, 2002, the relator filed an opposition reply to our motion to dismiss and on December 5, 2002, Interactive filed a reply in support of its motion to dismiss.

In addition to the litigation described above, Interactive is a party to routine



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litigation incidental to its business. Based on information currently available, Interactive believes that none of this ordinary routine litigation, either individually or in the aggregate, will have a material effect on its financial condition and results of operations.

-21-

### Item 4. Submission of Matters to a Vote of Security Holders

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At the Annual Meeting of Stockholders of the Company held on May 8, 2003, the following persons were elected as Directors of with the following votes:

| Name                | Votes For | Votes Withheld |
|---------------------|-----------|----------------|
| ----                | -----     | -----          |
| Paul J. Evanson ... | 2,579,770 | 8,496          |
| John C. Ferrara ... | 2,579,760 | 8,506          |
| Mario J. Gabelli .. | 2,579,770 | 8,496          |
| Marc J. Gabelli ... | 2,579,750 | 8,516          |
| Daniel R. Lee ..... | 2,579,748 | 8,518          |
| David C. Mitchell . | 2,579,970 | 8,296          |
| Salvatore Muoio ... | 2,579,960 | 8,306          |
| Frederic V. Salerno | 2,579,424 | 8,842          |
| Vincent S. Tese ... | 2,579,718 | 8,548          |

### Item 6. Exhibits and Reports on Form 8-K

- (a) Exhibit 31.1 - Chief Executive Officer Section 302 Certification
- Exhibit 31.2 - Chief Financial Officer Section 302 Certification
- Exhibit 32.1 - Chief Executive Officer Section 906 Certification
- Exhibit 32.2 - Chief Financial Officer Section 906 Certification.
- (b) Current Reports on Form 8-K filed on April 30, 2003, and on May 16, 2003, reporting earnings for the first quarter ended March 31, 2003.

-22-

SIGNATURE

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

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LYNCH INTERACTIVE CORPORATION  
(Registrant)

By: /s/Robert E. Dolan

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Robert E. Dolan  
Chief Financial Officer

August 13, 2003

-23-