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October 12, 2005

VIA OVERNIGHT DELIVERY

Florida Public Service Commission
Commission Clerk & Administration Services
2540 Shumard Oak Blvd.
Gunter Bldg.
Tallahassee, Florida 32399-0850
(850) 413-6770

050802 -TX

Re: Inter-Tel NetSolutions, Inc.

To Whom It May Concern:

Enclosed please find one original and six (6) copies of Inter-Tel NetSolutions, Inc.'s (Inter-Tel) Application for Authority to Provide Local Exchange Telecommunications Service Within the State of Florida.

Payment was previously submitted on 9/28/05 (see document #09241-05).

Please return a stamped copy of the extra copy of this letter in the enclosed preaddressed prepaid envelope.

If you have any questions regarding this matter, please do not hesitate to call me. Thank you for your attention to this matter.

Sincerely,

Lance J.M. Steinhart, Esq.
Attorney for Inter-Tel NetSolutions, Inc.

Enclosures
cc: Jon Brinton

DOCUMENT NUMBER-DATE
09847 OCT 13 05
FPSC-COMMISSION CLERK

**** FLORIDA PUBLIC SERVICE COMMISSION ****

DIVISION OF REGULATORY OVERSIGHT
CERTIFICATION SECTION

APPLICATION FORM for AUTHORITY TO PROVIDE ALTERNATIVE LOCAL EXCHANGE SERVICE WITHIN THE STATE OF FLORIDA

Instructions

This form is used as an application for an original certificate and for approval of the assignment or transfer of an existing certificate. In the case of an assignment or transfer, the information provided shall be for the assignee or transferee (See Page 12).

Print or type all responses to each item requested in the application and appendices. If an item is not applicable, please explain why.

Use a separate sheet for each answer which will not fit the allotted space.

Once completed, submit the original and six (6) copies of this form along with a non-refundable application fee of **$250.00** to:

Florida Public Service Commission
Division of Records and Reporting
2540 Shumard Oak Blvd.
Tallahassee, Florida 32399-0850
(850) 413-6770

If you have questions about completing the form, contact:

Florida Public Service Commission
Division of Regulatory Oversight
Certification Section
2540 Shumard Oak Blvd.
Tallahassee, Florida 32399-0850
(850) 413-6480

APPLICATION

1. **This is an application for √ (check one):**

   (x) **Original certificate** (new company).

   (   ) **Approval of transfer of existing certificate:** Example, a non-certificated company purchases an existing company and desires to retain the original certificate of authority.

   (   ) **Approval of assignment of existing certificate:** Example, a certificated company purchases an existing company and desires to retain the certificate of authority of that company.

   (   ) **Approval of transfer of control:** Example, a company purchases 51% of a certificated company. The Commission must approve the new controlling entity.

2. **Name of company:**

   Inter-Tel NetSolutions, Inc.

3. **Name under which the applicant will do business (fictitious name, etc.):**

4. **Official mailing address (including street name & number, post office box, city, state, zip code):**

   4310 East Cotton Center Blvd. Suite A-100

   Phoenix Arizona 85040

5. **Florida address (including street name & number, post office box, city, state, zip code):**

None

6. **Structure of organization:**

( ) Individual
(x) Foreign Corporation
( ) General Partnership
( ) Other ______
( ) Corporation
( ) Foreign Partnership
( ) Limited Partnership

7. **<u>If individual,</u> provide:**

Name: ______

Title: ______

Address: ______

City/State/Zip: ______

Telephone No.: ______ Fax No.: ______

Internet E-Mail Address: ______

Internet Website Address: ______

8. **<u>If incorporated in Florida,</u> provide proof of authority to operate in Florida:**

(a) **The Florida Secretary of State corporate registration number:**

______

9. **<u>If foreign corporation,</u> provide proof of authority to operate in Florida:**

(a) The Florida Secretary of State corporate registration number:
P33309
____

10. **<u>If using fictitious name-d/b/a,</u> provide proof of compliance with fictitious name statute (Chapter 865.09, FS) to operate in Florida:**

(a) The Florida Secretary of State fictitious name registration number:
____

11. **<u>If a limited liability partnership</u>, provide proof of registration to operate in Florida:**

(a) The Florida Secretary of State registration number:
____

12. **<u>If a partnership</u>, provide name, title and address of all partners and a copy of the partnership agreement.**

Name:______________________________

Title:______________________________

Address:______________________________

City/State/Zip:______________________________

Telephone No.:______________ Fax No.:______________

Internet E-Mail Address:______________________________

Internet Website Address:______________________________

13. **<u>If a foreign limited partnership,</u> provide proof of compliance with the foreign limited partnership statute (Chapter 620.169, FS), if applicable.**

(a) The Florida registration number:______________________________

14. **Provide <u>F.E.I. Number</u>(if applicable):** 76-0311713

15. **Indicate if any of the officers, directors, or any of the ten largest stockholders have previously been:**

(a) adjudged bankrupt, mentally incompetent, or found guilty of any felony or of any crime, or whether such actions may result from pending proceedings. Provide explanation.

No

(b) an officer, director, partner or stockholder in any other Florida certificated telephone company. If yes, give name of company and relationship. If no longer associated with company, give reason why not.

No

16. **Who will serve as liaison to the Commission with regard to the following?**

(a) The application:

Name: Lance J.M. Steinhart
Title: Regulatory Counsel
Address: 1720 Windward Concourse, Suite 250
City/State/Zip: Alpharetta, Georgia 30005
Telephone No.: (770) 232-9200 Fax No.: (770) 232-9208
Internet E-Mail Address: lsteinhart@telecomcounsel.com
Internet Website Address:

(b) Official point of contact for the ongoing operations of the company:

Name: Jon Brinton
Title: President
Address: 4310 East Cotton Center Blvd. Suite A-100
City/State/Zip: Phoenix Arizona 85040
Telephone No.: (602) 253-6004 Fax No.: (602) 532-4128

Internet E-Mail Address: jon_brinton@inter-tel.com
Internet Website Address: www.inter-tel.com

(c) Complaints/Inquiries from customers:

Name: Allison Dunmire

Title: Customer Service Manager

Address: 4310 East Cotton Center Blvd. Suite A-100

City/State/Zip: Phoenix Arizona 85040

Telephone No.: (602) 253-6004 Fax No.: (602) 532-4128

Internet E-Mail Address: allison_dunmire@inter-tel.com
Internet Website Address: www.inter-tel.com

17. List the states in which the applicant:

(a) has operated as an alternative local exchange company.

Illinois, Missouri, New York and Texas

(b) has applications pending to be certificated as an alternative local exchange company.

None.

(c) is certificated to operate as an alternative local exchange company.

Colorado, Georgia, Illinois, Missouri, New Jersey, New York and Texas

(d) has been denied authority to operate as an alternative local exchange company and the circumstances involved.

The Company had its Florida ALEC authority revoked.

See attached letter.

(e) has had regulatory penalties imposed for violations of telecommunications statutes and the circumstances involved.

See (d) above.

(f) has been involved in civil court proceedings with an interexchange carrier, local exchange company or other telecommunications entity, and the circumstances involved.

None

18. Submit the following:

A. Managerial capability: give resumês of employees/officers of the company that would indicate sufficient managerial experiences of each.

See Attached biographical information.

B. Technical capability: give resumes of employees/officers of the company that would indicate sufficient technical experiences or indicate what company has been contracted to conduct technical maintenance.

See Attached biographical information. In addition, the company will rely upon its underlying facilities-based carriers for technical maintenance.

C. Financial capability.

The application **<u>should contain</u>** the applicant's audited financial statements for the most recent 3 years. If the applicant does not have audited financial statements, it shall so be stated.

The unaudited financial statements should be signed by the applicant's chief executive officer and chief financial officer <u>affirming that the financial statements are true and correct</u> and should include:

1. the balance sheet:

2. income statement: and

3. statement of retained earnings.

NOTE: *This documentation may include, but is not limited to, financial statements, a projected profit and loss statement, credit references, credit bureau reports, and descriptions of business relationships with financial institutions.*

Further, the following (which includes supporting documentation) should be provided:

1. **<u>written explanation</u>** that the applicant has sufficient financial capability to provide the requested service in the geographic area proposed to be served.

2. **<u>written explanation</u>** that the applicant has sufficient financial capability to maintain the requested service.

3. **<u>written explanation</u>** that the applicant has sufficient financial capability to meet its lease or ownership obligations.

THIS PAGE MUST BE COMPLETED AND SIGNED

APPLICANT ACKNOWLEDGMENT STATEMENT

1. **REGULATORY ASSESSMENT FEE:** I understand that all telephone companies must pay a regulatory assessment fee in the amount of .15 of one percent of gross operating revenue derived from intrastate business. Regardless of the gross operating revenue of a company, a minimum annual assessment fee of $50 is required.

2. **GROSS RECEIPTS TAX:** I understand that all telephone companies must pay a gross receipts tax of two and one-half percent on all intra and interstate business.

3. **SALES TAX:** I understand that a seven percent sales tax must be paid on intra and interstate revenues.

4. **APPLICATION FEE:** I understand that a non-refundable application fee of $250.00 must be submitted with the application.

UTILITY OFFICIAL:

Jon Brinton	
Print Name	**Signature**
President	9/1/2005
Title	**Date**
(602) 253-6004	(602) 532-4128
Telephone No.	**Fax No.**

Address: 4310 East Cotton Center Blvd. Suite A-100
Phoenix Arizona 85040

FL ALEC App

FORM PSC/CMU 8 (11/95)
Required by Commission Rule Nos. 25-24.805, 25-24.810, and 25-24.815

THIS PAGE MUST BE COMPLETED AND SIGNED

AFFIDAVIT

By my signature below, I, the undersigned officer, attest to the accuracy of the information contained in this application and attached documents and that the applicant has the technical expertise, managerial ability, and financial capability to provide alternative local exchange company service in the State of Florida. I have read the foregoing and declare that, to the best of my knowledge and belief, the information is true and correct. I attest that I have the authority to sign on behalf of my company and agree to comply, now and in the future, with all applicable Commission rules and orders.

Further, I am aware that, pursuant to Chapter 837.06, Florida Statutes, "Whoever knowingly makes a false statement in writing with the intent to mislead a public servant in the performance of his official duty shall be guilty of a misdemeanor of the second degree, punishable as provided in s. 775.082 and s. 775.083."

UTILITY OFFICIAL:

Jon Brinton	
Print Name	**Signature**
President	9/1/2005
Title	**Date**
(602) 253-6004	(602) 532-4128
Telephone No.	**Fax No.**

Address: 4310 East Cotton Center Blvd. Suite A-100
Phoenix Arizona 85040

FL ALEC App

FORM PSC/CMU 8 (11/95)
Required by Commission Rule Nos. 25-24.805, 25-24.810, and 25-24.815

LIST OF ATTACHMENTS

FINANCIAL INFORMATION

MANAGEMENT INFORMATION

STATEMENT OF FINANCIAL CAPABILITY

STATEMENT REGARDING PREVIOUS ALEC REVOCATION

FINANCIAL INFORMATION

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q
QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarter ended June 30, 2005

Commission File Number: 0-10211

INTER-TEL, INCORPORATED

Incorporated in the State of Arizona

I.R.S. No. 86-0220994

1615 S. 52nd Street
Tempe, Arizona 85281

(480) 449-8900

Title of Class	Outstanding as of June 30, 2005
Common Stock, no par value	26,078,154

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 periods that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☑ No ☐

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

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INTER-TEL, INCORPORATED AND SUBSIDIARIES

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

INTER-TEL, INCORPORATED AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share amounts)	June 30, 2005 (Unaudited)	December 31, 2004 (Note A)
ASSETS		
CURRENT ASSETS		
Cash and equivalents	$ 94,018	$152,330
Short-term investments	62,799	52,644
TOTAL CASH AND SHORT-TERM INVESTMENTS	156,817	204,974
Accounts receivable, net of allowances of $9,016 in 2005 and $9,921 in 2004	43,897	45,176
Inventories	19,696	16,055
Net investment in sales-leases, net of allowances of $974 in 2005 and $886 in 2004	19,407	17,151
Income taxes receivable	2,208	4,017
Deferred income taxes	12,653	9,905
Prepaid expenses and other assets	8,954	7,194
TOTAL CURRENT ASSETS	263,632	304,472
LONG-TERM INVESTMENTS	—	9,900
PROPERTY, PLANT & EQUIPMENT	28,423	27,840
GOODWILL	26,549	19,890
PURCHASED INTANGIBLE ASSETS	25,997	10,987
NET INVESTMENT IN SALES-LEASES, net of allowances of $2,019 in 2005 and $1,810 in 2004	36,559	33,877
TOTAL ASSETS	$381,160	$406,966
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	$ 35,380	$ 30,801
Other current liabilities	45,083	52,196
TOTAL CURRENT LIABILITIES	80,463	82,997
DEFERRED TAX LIABILITY	66,700	65,234
LEASE RECOURSE LIABILITY	13,532	12,241
OTHER LIABILITIES	6,964	7,063
SHAREHOLDERS' EQUITY		
Common stock, no par value-authorized 100,000,000 shares; issued–27,161,823 shares; outstanding–26,078,154 at June 30, 2005 and 26,125,799 shares at December 31, 2004	120,071	116,598
Retained earnings	110,873	134,455
Accumulated other comprehensive income	399	924
	231,343	251,977
Less: Treasury stock at cost – 1,083,669 shares at June 30, 2005 and 1,036,024 shares at December 31, 2004	(17,842)	(12,546)
TOTAL SHAREHOLDERS' EQUITY	213,501	239,431
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$381,160	$406,966

See accompanying notes.

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INTER-TEL, INCORPORATED AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

(In thousands, except per share amounts)	Three Months Ended June 30, 2005	Three Months Ended June 30, 2004	Six Months Ended June 30, 2005	Six Months Ended June 30, 2004
NET SALES				
Telecommunications systems, software and related	$101,647	$ 90,666	$194,306	$176,715
Resale of local, long distance and network services	13,905	12,242	26,953	24,224
TOTAL NET SALES	115,552	102,908	221,259	200,939
COST OF SALES				
Telecommunications systems, software and related	46,904	41,138	90,301	80,013
Resale of local, long distance and network services	8,316	7,471	16,572	14,529
TOTAL COST OF SALES	55,220	48,609	106,873	94,542
GROSS PROFIT	60,332	54,299	114,386	106,397
Research and development	8,713	7,144	17,168	13,179
Selling, general and administrative	40,252	34,337	78,975	69,341
Amortization of purchased intangible assets	1,122	436	1,884	881
Write-off of in-process research and development costs	—	—	2,600	—
	50,087	41,917	100,627	83,401
OPERATING INCOME	10,245	12,382	13,759	22,996
Interest and other income	920	570	1,867	1,076
Foreign currency transaction gains (losses)	88	(113)	141	(274)
Interest expense	(23)	(42)	(46)	(88)
INCOME BEFORE INCOME TAXES	11,230	12,797	15,721	23,710
INCOME TAXES	4,237	4,680	6,793	8,773
NET INCOME	$ 6,993	$ 8,117	$ 8,928	$ 14,937
NET INCOME PER SHARE — BASIC	$ 0.27	$ 0.32	$ 0.34	$ 0.58
NET INCOME PER SHARE — DILUTED	$ 0.26	$ 0.30	$ 0.33	$ 0.55
DIVIDENDS PER SHARE	$ 0.08	$ 0.06	$ 1.16	$ 0.12
Average number of common shares outstanding — Basic	26,301	25,715	26,337	25,629
Average number of common shares outstanding — Diluted	27,069	27,262	27,429	27,306

See accompanying notes.

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INTER-TEL, INCORPORATED AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

(In thousands)	Six Months Ended June 30, 2005	2004
OPERATING ACTIVITIES		
Net income	$ 8,928	$ 14,937
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation of fixed assets	4,712	3,976
Amortization of patents included in R&D expenses	111	111
Amortization of purchased intangible assets	1,884	881
Purchased in-process research and development	2,600	—
Provision for losses on receivables	846	1,050
Provision for losses on leases	1,814	1,795
Provision for inventory valuation	464	258
Decrease in other liabilities	(442)	(1,786)
Loss on sale of property and equipment	22	3
Deferred income taxes	218	7,010
E-Rate settlement	(8,461)	—
Changes in operating assets and liabilities	(640)	(1,435)
NET CASH PROVIDED BY OPERATING ACTIVITIES	12,056	26,800
INVESTING ACTIVITIES		
Purchases of available for sale short-term investments	(20,578)	(36,827)
Maturities and sales of available for sale investments	19,498	49,831
Purchases of held-to-maturity investments	—	(12,730)
Maturities and sales of held-to-maturity investments	825	—
Additions to property, plant and equipment	(4,267)	(4,066)
Proceeds from disposal of property, plant and equipment	16	21
Cash used in acquisitions	(27,765)	(100)
NET CASH USED IN INVESTING ACTIVITIES	(32,271)	(3,871)
FINANCING ACTIVITIES		
Cash dividends paid	(30,674)	(3,064)
Treasury stock purchases	(13,777)	—
Payments on term debt	(23)	(28)
Proceeds from stock issued under the Employee Stock Purchase Plan	582	500
Proceeds from exercise of stock options	6,320	4,433
NET CASH (USED IN) PROVIDED BY FINANCING ACTIVITIES	(37,572)	1,841
EFFECT OF EXCHANGE RATE CHANGES	(525)	167
(DECREASE) INCREASE IN CASH AND EQUIVALENTS	(58,312)	24,937
CASH AND EQUIVALENTS AT BEGINNING OF PERIOD	152,330	115,197
CASH AND EQUIVALENTS AT END OF PERIOD	$ 94,018	$140,134

See accompanying notes.

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INTER-TEL, INCORPORATED AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)
June 30, 2005

NOTE A—BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles applicable to interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of the results for the interim periods presented have been included. Operating results for the quarter ending June 30, 2005 are not necessarily indicative of the results that may be expected for the year ended December 31, 2005. The balance sheet at December 31, 2004 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. For further information, refer to the consolidated financial statements and notes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2004.

Certain prior year amounts have been reclassified to conform with the current period presentation.

Stock-Based Compensation

In 2002, the Financial Accounting Standards Board ("FASB") issued Statement No. 148 "Accounting for Stock-Based Compensation—Transition and Disclosure, an amendment of FASB Statement No. 123" ("SFAS No. 148"), which provides alternative methods of transition for an entity that voluntarily changes to the fair value based method of accounting for stock-based employee compensation. It also amends the disclosure provisions of SFAS No. 123 to require prominent disclosure about the effects on reported net income of an entity's accounting policy decisions with respect to stock-based employee compensation. Finally, this statement amends APB Opinion No. 28, "Interim Financial Reporting," to require disclosure about those effects in interim financial information. We adopted SFAS No. 148 in the fourth quarter of 2002. Since we have not changed to a fair value method of stock-based compensation, the applicable portion of this statement only affects our footnote disclosures.

We do not recognize compensation expense relating to employee stock options because we only grant options with an exercise price equal to the fair value of the stock on the effective date of grant. At June 30, 2005, the Company has four stock-based employee and director incentive plans and an employee stock purchase plan. The Company accounts for these plans under the recognition and measurement principles of APB No. 25, "Accounting for Stock Issued to Employees," and related interpretations. Stock-based employee compensation costs are not reflected in net income, as all options granted under the plans had an exercise price equal to the market value of the underlying common stock on the date of grant. If we had elected to recognize compensation expense using a fair value approach, and therefore determined the compensation based on the value as determined by the modified Black-Scholes option pricing model, the pro forma net income and earnings per share would have been as follows:

(In thousands, except per share amounts)	Three Months Ended June 30, 2005	Three Months Ended June 30, 2004	Six Months Ended June 30, 2005	Six Months Ended June 30, 2004
Net income, as reported	$ 6,993	$8,117	$ 8,928	$14,937
Deduct: total stock-based compensation expense, determined under fair value based method for all awards, net of tax	(6,518)	(837)	(7,243)	(1,620)
Pro forma net income	$ 475	$7,280	$ 1,685	$13,317
Earnings per share of common stock:				
Basic – as reported	$ 0.27	$ 0.32	$ 0.34	$ 0.58

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(In thousands, except per share amounts)	Three Months Ended June 30, 2005	2004	Six Months Ended June 30, 2005	2004
Basic – pro forma	$0.02	$0.28	$0.06	$0.52
Diluted – as reported	$0.26	$0.30	$0.33	$0.55
Diluted – pro forma	$0.02	$0.27	$0.06	$0.49

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. The option pricing model utilized the following weighted average assumptions for 2005 and 2004: risk free interest rates of 3.75% for 2005 and 3.31% for 2004; dividend yields of 1.52% for 2005 and 0.82% for 2004; volatility factors of the expected market price of our stock averaged 0.413 for 2005 and 0.485 for 2004. Employee stock options granted through June 30, 2005 vest over three to five year periods and director options vest at the end of six months from the grant date.

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 Company's 1994 Long Term Incentive Plan, 1997 Long Term Incentive 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 next 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 will be 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 above by $5.4 million for the quarter and six months ended June 30, 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. As currently drafted, Statement of Financial Accounting Standards No. 123 (Revised 2004) or SFAS 123R will require the Company to treat unvested stock options as an expense effective with the fiscal quarter ending March 31, 2006.

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. 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 pending litigation and revise our estimates. Such revisions in our estimates of the potential liability could materially impact our results of operations and financial position. However, at June 30, 2005, management did not believe that the ultimate impact of various claims and pending litigation would have a materially adverse impact on the Company.

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

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administered "E-Rate program" to connect schools and libraries to the Internet. In connection with the Civil Settlement, Technologies agreed to pay a penalty of $6,740,450 and forego the collection of certain accounts receivable of $259,540 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 agreed to pay a fine of $1,721,000 and observe a three-year probationary period, which, among other things, required Technologies to implement a comprehensive corporate compliance program. The penalties and fines described above were paid during the first quarter of 2005.

In addition, on January 21, 2005, Inter-Tel Technologies received notification from the Federal Communications Commission that Technologies was temporarily suspended from participation in the E-Rate program pending a proposed 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 2004 relating to Technologies' participation in the E-Rate program were not significant.

The existence and disclosure of the Civil Settlement, Plea Agreement and FCC Notice may have already caused competitive harm to Inter-Tel, and these matters may further harm Inter-Tel's business.

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 recently 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 are in the process of reviewing our compliance and taking appropriate corrective measures with respect to these potential variances, and have 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. There can be no assurance that our actual costs, including fines and penalties, if any, associated with this matter will not be more or less than our estimate. The total sales potentially subject to the GSA agreements were approximately $7.2 million during the period from March 28, 2001 through June 10, 2005. Our current contract with the GSA expires in March 2006. There can be no assurance that the contract will be renewed at that time. Further, there can be no assurance that the existence or disclosure of our noncompliance will not cause additional competitive or other harm to the Company.

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.

Recent Accounting Pronouncements

In December 2004, the FASB issued SFAS No. 123R *"Share Based Payment."* This statement is a revision to SFAS No. 123, supersedes APB No. 25, *"Accounting for Stock Issued to Employees,"* and amends SFAS No. 95, *"Statement of Cash Flows."* This statement will require us to expense the cost of employee services received in exchange for an award of equity instruments. This statement also provides guidance on valuing and expensing these awards, as well as disclosure requirements, and is effective for Inter-Tel for the first interim reporting period that begins January 1, 2006. SFAS No. 123R permits public companies to choose between the following two adoption methods:

1. A "modified prospective" method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of SFAS No. 123R for all share-based payments granted after the effective date and (b) based on the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of SFAS No. 123R that remain unvested on the effective date, or
2. A "modified retrospective" method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously

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recognized under SFAS No. 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

As permitted by SFAS No. 123, we currently account for share-based payments to employees using the APB No. 25 intrinsic value method and recognize no compensation cost for employee stock options or the employee stock purchase plan shares. As proposed, companies would be required to recognize an expense for compensation costs related to share-based payment arrangements, including stock options and employee stock purchase plans. The impact of the adoption of SFAS No. 123R cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. However, valuation of employee stock options under SFAS No. 123R is similar to SFAS No. 123, with some exceptions. For information about what our reported results of operations and earnings per share would have been had we adopted SFAS No. 123, see the table above under the heading "Stock Based Compensation." The adoption of SFAS No. 123R's fair value method will have a significant impact on our results of operations, although it will have no impact on our overall financial position. Due to timing of the release of SFAS No. 123R, we have not yet completed the analysis of the ultimate impact that this new pronouncement will have on the results of operations, nor the method of adoption for this new standard.

NOTE B—EARNINGS PER SHARE

Diluted earnings per share assume that outstanding common shares were increased by shares issuable upon the exercise of all outstanding stock options for which the market price exceeds exercise price, less shares which could have been purchased with related proceeds, if the effect would not be antidilutive.

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

(In thousands, except per share amounts)	Three Months Ended June 30, 2005	Three Months Ended June 30, 2004	Six Months Ended June 30, 2005	Six Months Ended June 30, 2004
Numerator: Net income	$ 6,993	$ 8,117	$ 8,928	$14,937
Denominator:				
Denominator for basic earnings per share – weighted average shares	26,301	25,715	26,337	25,629
Effect of dilutive securities:				
Employee and director stock options	768	1,547	1,092	1,677
Denominator for diluted earnings per share – adjusted weighted average shares and assumed conversions	27,069	27,262	27,429	27,306
Basic earnings per share	$ 0.27	$ 0.32	$ 0.34	$ 0.58
Diluted earnings per share	$ 0.26	$ 0.30	$ 0.33	$ 0.55
Options excluded from diluted net earnings per share calculations (1)	669,100	189,500	252,000	64,000

(1) At June 30, 2005 and 2004, options to purchase shares 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 C — ACQUISITIONS, TECHNOLOGY INVESTMENTS 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

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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 $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 $6.6 million of goodwill, which is non-amortizable.

Lake, based in Dublin, Ireland, is a provider of converged communications products in the under 40 user market, including EncoreCX® 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 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 are being 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 $3.2 million, respectively. The purchased intangible is being amortized over five years. During the second quarter of 2005, additional payments totaling $400,000 were accrued and paid to the seller as a result of milestones being achieved. As of June 30, 2005, there is $600,000 of potential additional earnout payments that could ultimately be payable to the seller if certain milestones are accomplished, which have not been accrued as they are not yet probable. 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 $750,000 for the year ended December 31, 2004 were achieved and expensed as research and development costs. Technological feasibility of the underlying technology has not yet been achieved to provide for viable product sales. During the quarter ended June 30, 2004, development costs and milestone bonuses totaling $541,000 have been expensed or paid related to this arrangement. During the six months ended June 30, 2004, development costs and milestone bonuses totaling $1,050,000 have been expensed or paid related to this arrangement. During the quarter and six-month period ended June 30, 2005, no additional amounts have been expensed or paid related to this arrangement. As of June 30, 2005, the remaining milestone bonus of $250,000 is dependent on future events and is not considered to be probable or reasonably estimable.

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 June 30, 2005 and December 31, 2004 was approximately 7.45 years and 6.8 years for each period, respectively. The

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weighted-average amortization period as of June 30, 2005 and December 31, 2004 for developed technology was approximately 7.23 and 7.0 years for each period, respectively, and 7.74 and 5.0 years respectively for customer lists and non-compete agreements.

Each of the acquisitions discussed above were not material business acquisitions either individually or collectively and each 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 the acquisitions.

Executone Restructuring Charge. During the second quarter of 2000, we recognized a restructuring charge related to acquired Executone operations. We 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 as identified in the table below. Accrued costs associated with this plan were estimates, although the original estimates made for the second quarter of 2000 for reserve balances have not changed significantly through June 30, 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 2005. We entered into sublease agreements with third parties to sublease portions of the facility and equipment through that date. The reserve activity for lease and other contractual obligations is identified in the table below.

The total restructuring charge from this event totaled $50.9 million. The following table summarizes 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 June 30, 2005. Activity represents payments made or amounts written off.

Description	Cash/ Non-Cash	Restructuring Charge	Activity Through 2004	2005 Activity	Reserve Balance At 6/30/05
Personnel Costs:					
Severance and termination costs	Cash	$ (1,583)	$ 1,583	$—	$ —
Other plant closure costs	Cash	(230)	230	—	—
Lease termination and other contractual obligations (net of anticipated recovery):					
Building and equipment leases	Cash	(7,444)	7,436	8	—
Other contractual obligations	Cash	(1,700)	1,700	—	—
Impairment of Assets:					
Inventories	Non-Cash	(3,454)	3,454	—	—
Prepaid inventory and other expenses	Non-Cash	(2,485)	2,485	—	—
Accounts receivable	Non-Cash	(1,685)	1,685	—	—
Fixed assets	Non-Cash	(3,151)	3,034	3	114
Net intangible assets	Non-Cash	(29,184)	29,184	—	—
Total		**$(50,916)**	**$50,791**	**$11**	**$114**

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NOTE D — 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 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, Australia, 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 resale of local, long distance and 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.

For the quarters and six month periods ended June 30, 2005 and 2004, we generated income from business segments as follows:

	Three Months Ended June 30, 2005		
(In thousands, except per share amounts)	Principal Segment	Resale of Local, Long Distance and Network Services	Total
Net sales	$101,647	$13,905	$115,552
Gross profit	54,743	5,589	60,332
Operating income	7,909	2,336	10,245
Interest and other income	883	37	920
Foreign currency transaction gains	88	—	88
Interest expense	(19)	(4)	(23)
Net income	$ 5,487	$ 1,506	$ 6,993
Net income per diluted share (1)	$ 0.20	$ 0.06	$ 0.26
Weighted average diluted shares (1)	27,069	27,069	27,069
Goodwill	$ 24,414	$ 2,135	$ 26,549
Total assets	370,467	10,693	381,160
Depreciation and amortization	$ 3,616	$ 22	$ 3,638

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(In thousands, except per share amounts)	Three Months Ended June 30, 2004 Principal Segment	Resale of Local, Long Distance and Network Services	Total
Net sales	$ 90,666	$12,242	$102,908
Gross profit	49,528	4,771	54,299
Operating income	10,332	2,050	12,382
Interest and other income	526	44	570
Foreign currency transaction losses	(113)	—	(113)
Interest expense	(42)	—	(42)
Net income	$ 6,800	$ 1,317	$ 8,117
Net income per diluted share (1)	$ 0.25	$ 0.05	$ 0.30
Weighted average diluted shares (1)	27,262	27,262	27,262
Goodwill	$ 15,726	$ 2,135	$ 17,861
Total assets	359,388	20,126	379,514
Depreciation and amortization	$ 2,578	$ 8	$ 2,586

(In thousands, except per share amounts)	Six Months Ended June 30, 2005 Principal Segment	Resale of Local, Long Distance and Network Services	Total
Net sales	$194,306	$26,953	$221,259
Gross profit	104,005	10,381	114,386
In-process research and development	2,600	—	2,600
Operating income	9,677	4,082	13,759
Interest and other income	1,789	78	1,867
Foreign currency transaction gains	141	—	141
Interest expense	(42)	(4)	(46)
Net income	$ 6,272	$ 2,656	$ 8,928
Net income per diluted share (1)	$ 0.23	$ 0.10	$ 0.33
Weighted average diluted shares (1)	27,429	27,429	27,429
Goodwill	$ 24,414	$ 2,135	$ 26,549
Total assets	370,467	10,693	381,160
Depreciation and amortization	$ 6,677	$ 30	$ 6,707

(In thousands, except per share amounts)	Six Months Ended June 30, 2004 Principal Segment	Resale of Local, Long Distance and Network Services	Total
Net sales	$176,715	$24,224	$200,939
Gross profit	96,702	9,695	106,397
Operating income	18,774	4,222	22,996
Interest and other income	976	100	1,076
Foreign currency transaction losses	(274)	—	(274)
Interest expense	(87)	(1)	(88)
Net income	$ 12,215	$ 2,722	$ 14,937
Net income per diluted share (1)	$ 0.45	$ 0.10	$ 0.55
Weighted average diluted shares (1)	27,306	27,306	27,306
Goodwill	$ 15,726	$ 2,135	$ 17,861
Total assets	359,388	20,126	379,514
Depreciation and amortization	$ 4,945	$ 22	$ 4,967

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(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.

Our revenues are generated predominantly in the United States. Total revenues generated from U.S. customers totaled $104.6 million, or 90.5% of total revenues, and $99.7 million, or 96.8% of total revenues for the three months ended June 30, 2005 and 2004, respectively. In the six months ended June 30, 2005 and 2004, revenues from customers located internationally accounted for 7.7% and 3.2% of total revenues, respectively. Refer to the tables below for additional geographical revenue data.

Source of net sales	Quarter Ended June 30, 2005 $	%	Quarter Ended June 30, 2004 $	%
Domestic	$104,566	90.5%	$ 99,662	96.8%
Lake Communications	7,907	6.8%	—	—%
Other International	3,079	2.7%	3,246	3.2%
Total net sales	$115,552	100.0%	$102,908	100.0%

Source of net sales	Six Months Ended June 30, 2005 $	%	Six Months Ended June 30, 2004 $	%
Domestic	$204,319	92.3%	$194,443	96.8%
Lake Communications	10,497	4.7%	—	—%
Other International	6,443	2.9%	6,496	3.2%
Total net sales	$221,259	100.0%	$200,939	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.

Our applicable long-lived assets at June 30, 2005, included Property, Plant & Equipment; Goodwill; and Purchased Intangible Assets. The net amount located in the United States was $55.3 million and the amount in foreign countries was $25.7 million at June 30, 2005. At December 31, 2004, the net amount located in the United States was $56.1 million and the amount in foreign countries was $2.6 million. The increase in foreign assets relates to the acquisition of Lake.

NOTE E — NET INVESTMENT IN SALES-LEASES

Net investment in sales-leases represents the value of sales-leases presently held under our Total Solution program. We currently sell the rental payments due to us from most of the sales-leases. We maintain reserves against our estimate of potential credit losses for the balance of sales-leases held and for the balance of sold rental payments remaining unbilled. The following table provides detail on the total net balances in sales-leases:

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(in thousands)	June 30, 2005	December 31, 2004
Lease balances included in consolidated accounts receivable, net of allowances of $1,044 in 2005, and $1,177 in 2004	$ 6,033	$ 6,390
Net investment in Sales-Leases:		
Current portion, net of allowances of $974 in 2005, and $886 in 2004	19,407	17,151
Long-term portion, includes residual amounts of $713 in 2005 and, $510 in 2004, net of allowances of $2,019 in 2005, and $1,810 in 2004	36,559	33,877
Total investment in Sales-Leases, net of allowances of $4,037 in 2005, and $3,873 in 2004	61,999	57,418
Sold rental payments remaining unbilled (subject to limited recourse provisions), net of allowances of $13,532 in 2005, and $12,241 in 2004	244,988	229,163
Total balance of sales-leases and sold rental payments remaining unbilled, net of allowances	$306,987	$286,581
Total allowances for entire lease portfolio (including limited recourse liabilities)	$ 17,569	$ 16,114

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 that we believe are 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 against 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 are as follows:

(In thousands)	Six Months Ended June 30, 2005	Year Ended December 31, 2004
Sales of rental payments	$ 60,640	$113,172
Sold payments remaining unbilled at end of period	258,520	241,404

Sales of rental payments represent 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 period represent the total balance of leases that is 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.

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 June 30, 2005, the Company has one outstanding agreement in place to sell cash flow streams with a present value of $25.0 million in December 2005 at an interest rate to the financial institution of 6.05 percent. Should interest rates decrease substantially, the Company has the option to pay $500,000 to the financial institution to cancel the commitment.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This Quarterly Report to Shareholders on Form 10-Q ("10-Q") contains forward-looking statements that involve risks and uncertainties. The statements contained in this 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, including without limitation statements regarding our expectations, beliefs, intentions or strategies for the future. All forward-looking statements included in this document are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements. The cautionary statements made in this 10-Q should be read as being applicable to all related forward-looking statements wherever they appear in this document. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including those set forth under "Factors That May Affect Future Operating Results" below and elsewhere in this document.

Overview

Inter-Tel (Nasdaq: INTL), incorporated in 1969, is a single point of contact, full service provider of converged voice and data business communications systems, voice mail systems and networking applications. Our customers include business enterprises, federal, state and local government agencies and non-profit organizations. We market and sell the following products and services:

- Inter-Tel Axxess® and Inter-Tel 5000 Network Communications Solutions converged voice and data business communication systems,
- Lake Communications converged voice and data business communication systems, including those sold in the US under the EncoreCX® brand,
- integrated voice mail, voice processing and unified messaging systems,
- managed services, including voice and data network design and traffic provisioning, custom application development, and financial solutions packages (leasing),
- networking applications, including the design and implementation of voice and data networks,
- local and long distance calling services, voice circuits, data circuits and other communications services and peripheral products,
- call accounting software, computer-telephone integration (CTI) applications, and
- maintenance and support services for our products.

We have developed a distribution network of direct sales offices, dealers and value added resellers (VARs), which sell our products to organizations throughout the United States and internationally, primarily targeting small-to-medium enterprises, service organizations and governmental agencies. As of June 30, 2005, we had fifty-nine (59) direct sales offices in the United States and a network of hundreds of dealers and VARs, primarily in the United States, that purchase directly from us. Included in our sales office in Phoenix is the primary location for our national and government accounts division, as well as our local, long distance and network services divisions. Our wholesale distribution center is located in Tempe, Arizona, which is the primary location from which we distribute products to our network of direct sales offices, dealers and VARs in North America. In addition, we maintain a wholesale distribution office in the United Kingdom that supplies Inter-Tel's dealers and distributors throughout the UK and other parts of Europe, and we have dealers in South Africa and Japan. We also maintain research and development and software sales offices in Tucson, Arizona and in the United Kingdom. As a result of the closing of the Lake acquisition identified below, we also maintain a wholesale distribution office in Dublin, Ireland that supplies Inter-Tel's dealers and distributors in the UK, Ireland, other parts of Europe and Australia.

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

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operators 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 communications products to the Company in the ordinary course of its business.

On October 14, 2004, Inter-Tel announced the purchase by an operating subsidiary of selected assets and assumption of certain liabilities of Converging Technologies, Inc. and Linktivity, Inc. The acquired assets primarily include Web-based conferencing solutions, notably Linktivity® software. These solutions provide real-time communications and remote control software to enable instantaneous, browser-to-browser Web conferencing and help desk support solutions. We expect the acquisition of these selected assets to enable Inter-Tel to continue to expand its Presence Management and Collaboration tools. Linktivity offers its products and services through its international distributors and certified North American resellers. On that same date, Inter-Tel also announced the license of intellectual property from eDial, a division of Alcatel USA Marketing, Inc., and provider of Session Initiation Protocol (SIP) audio conferencing and collaboration solutions for enterprises and service providers. The eDial and Linktivity technologies were selected to complement Inter-Tel's Converged Business Communication systems and to allow Inter-Tel to further enhance its presence management, conferencing and collaboration products.

Key performance indicators that we use in order to manage our business and evaluate our financial and operating performance include revenues, costs and gross margins, and cash flows.

Inter-Tel recognizes revenue from the following significant sources of revenue:

- *End-user sales and sales-type leases through our direct sales offices and government and national accounts division.* We recognize revenue from sales of systems and services to end-user customers upon installation of the systems and performance of the services, respectively, allowing for use by our customers of these systems. We defer pre-payments for communications services and recognize these pre-payments as revenue as the communications services are provided. For our sales-type lease accounting, 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 as discussed above for sales to end user customers, and upon receipt of the executed lease documents. 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 also recorded as net sales.
- *Dealer and VAR sales.* For shipments to dealers and other distributors, our revenue is recognized as products are shipped to the dealers and VARs and services are rendered, because the sales process is complete. Title to these products passes when goods are shipped (free-on-board 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.
- *Resale of long distance.* We recognize revenue from long distance resale services as services are provided.
- *Software Sales.* We recognize revenues from sales of software, such as our new Linktivity products discussed above upon shipment to dealers or end-users.
- *Maintenance and software support.* Maintenance and software support revenue is recognized ratably over the term of the maintenance or support agreement.

Costs and gross margins. Our costs of products sold primarily consist of materials, labor and overhead. Our costs of services performed consist primarily of labor, materials and service overhead. Total costs of goods and services sold increased 13.6%, or $6.6 million, to $55.2 million for the quarter ended June 30, 2005, compared to $48.6 million for the corresponding period in 2004. Our consolidated gross margin percentage was 52.2% in the second quarter of 2005 compared to 52.8% in the second quarter of 2004. The increase in the dollar amount of the cost of goods sold was primarily attributable to the higher volume of net sales, resulting in part from the Lake acquisition in March of 2005. However, the decrease in gross margin percentage in 2005 compared to 2004 was principally attributable to lower margins on the Lake revenues, significant pricing pressures and product discounts, in particular for larger transactions, offset in part, by the effect of higher recurring revenues from existing customers. The gross

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margin percentage was also lower as a result of the effects of accruals for GSA pricing issues as discussed in Note A of notes to the Condensed Consolidated Financial Statements. Other factors affecting both the increases in costs of goods sold and reductions in overall gross margin percentage are described in greater detail in "Results of Operations" below.

Sales of systems through our direct sales organization typically generate higher gross margins than sales through our dealers and VARs, primarily because we recognize both the wholesale and retail margins on these sales. Conversely, sales of systems through our dealers and VARs typically generate lower gross margins than sales through our direct sales organization, although direct sales typically require higher levels of selling, general and administrative expenses. In addition, our long distance services and Datanet products typically generate lower gross margins than sales of software and system products. For revenues recognized under sales-leases, we record the costs of systems installed as costs of sales. Our margins may vary from period to period depending upon the representation of various distribution channels, products and software as relative percentages of our total sales. In the event that sales through our direct sales offices increase as a percentage of net sales, our overall gross margin could improve. Conversely, in the event net sales to dealers or sales of long distance services increase as a percentage of net sales, our overall gross margin could decline.

Additionally, our operating results depend upon a variety of factors, including the volume and timing of orders received during a period, general economic conditions and world events impacting businesses, patterns of capital spending by customers, the timing of new product announcements and releases by us and our competitors, pricing pressures, the cost and impact of acquisitions and the availability and cost of products and components from our suppliers. Historically, a substantial portion of our net sales in a given quarter has been recorded in the third month of the quarter, with a concentration of such net sales in the last two weeks of the quarter. There are several factors which attribute to this pattern, including the following:

- Customer leases generally expire at end of the month and commence at the beginning of the month, which naturally leads to end-of-period sales. These factors apply to both end-user and dealer sales.
- Internal sales compensation programs for our sales personnel are linked to revenues and the sales commissions generally increase at accelerated rates as sales volumes increase. Sales performance bonuses are also frequently tied to quarter-end and year-end performance targets, providing incentives to sales personnel to close business before the end of each quarter.
- Some price discounting to our dealer channel occurs during the last month of a quarter or year, and some dealers purchase consistently to take advantage of potential pricing discounts or end-of-quarter promotions. Dealer buying habits have been consistently applied for years.

In addition, we are subject to seasonal variations in our operating results, as net sales for the first and third quarters are frequently less than those experienced during the fourth and second quarters, respectively. Net sales from the second quarter of 2005 followed this historical pattern, as sales increased compared to the first quarter of 2005, and we do not anticipate a significant change in the historical trend.

Cash Flows. At June 30, 2005, Inter-Tel's cash and short-term investments totaled $156.8 million. We also maintain a $10 million unsecured, revolving line of credit with BankOne, NA, which is available through June 1, 2006 and ordinarily used to support international letters of credit to suppliers, if necessary. As of June 30, 2005, none of the credit line was used. Historically, our primary source of cash has come from net income plus non-cash charges for depreciation and amortization expenses. We have generated cash from continuing operations in every year since 1986. In 1993, 1995 and 1997, the Company received net proceeds from stock offerings, offset in part by cash expended to repurchase the Company's common stock in these and other periods. In addition, Inter-Tel historically has paid cash for capital expenditures relating to property and equipment or acquisitions. Inter-Tel has also received cash proceeds from the exercise of stock options and our Employee Stock Purchase Plan. We believe our working capital and credit facilities, together with cash generated from operations, will be sufficient to develop and expand our business operations, to finance acquisitions of additional resellers of telephony products and other strategic acquisitions or corporate alliances, to fund quarterly dividends to shareholders, to repurchase shares of the

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Company's common stock pursuant to a Board approved repurchase program and to provide adequate working capital for the foreseeable future. In February 2005, the Board approved the repurchase of up to $75 million of the Company's common stock. As of June 30, 2005, we have expended $13.8 million to repurchase 716,500 shares under this plan. The Company stock repurchases in the second quarter were funded primarily by existing cash balances.

Our consolidated net sales for the quarters ended June 30, 2005 and 2004 were $115.6 million and $102.9 million, respectively. The 12.3% increase in revenue in the second quarter of 2005 compared to the second quarter of 2004 was primarily attributable to acquisitions completed in the second half of 2004 and the Lake acquisition in March 2005 (as the sales from these acquired entities were not included in the 2004 second quarter results), as well as higher net sales in our core business, including our local, long distance resale, network services and direct sale (including lease financing) divisions. We cannot provide assurance that the recent increase in revenue will continue in the future, as we believe businesses may be reluctant to significantly increase spending on enterprise communications systems in the near future. In addition, we believe uncertainty exists in the marketplace caused by the transition of communication systems from circuit-switch to packet-switch architectures, including voice over Internet Protocol (VoIP) systems, and this uncertainty may cause some organizations to delay making investments in new systems.

We believe that enterprises continue to be concerned about their ability to increase revenues and profitability, in part due to the continued uncertain economic environment and slowdown in the past few years. To maintain or improve profitability, we believe that businesses have attempted to reduce costs and capital spending. We expect continued pressure on our ability to generate or expand sales and it is not clear whether business communications spending will increase in the near term. We cannot predict the nature, timing and extent of future business investments in communications systems and as a result, if and when our net sales will increase.

The markets in which we compete have been characterized by rapid technological changes and increasing customer requirements. We have sought to address these requirements through the development of software enhancements and improvements to existing systems and the introduction of new systems, products, and applications. Inter-Tel's research and development efforts over the last several years have been focused primarily on the development of, and enhancements to, the Inter-Tel 5000 Network Communications Solutions, our Axxess system, including adding new applications, enhancing our IP convergence applications and IP endpoints, developing Unified Communications applications, developing presence management applications, developing Session Initiation Protocol (SIP) applications, and developing speech-recognition and text-to-speech applications. More recently, Inter-Tel's research and development efforts have been focused on the development of converged systems and software, including the Inter-Tel 5000 Network Communications Solutions, Session Initiation Protocol (SIP) interfaces and applications, new converged systems and features from the Lake organization, as well as the development of a new line of multi-protocol SIP IP endpoints. In addition, in October 2004, we acquired selected assets and assumed certain liabilities of Linktivity, which develops Web-based conferencing solutions, notably Linktivity® software, and announced an agreement to license certain intellectual property from eDial. These solutions are designed to provide real-time communications and remote control software to enable instantaneous, browser-to-browser Web conferencing and help desk support solutions. We intend to further develop this technology and integrate the applications and solutions into our product offerings.

We offer our customers a package of lease financing and other services under the name Total Solution. Total Solution provides our customers lease financing, maintenance and support services, fixed price upgrades and other benefits. We finance this program through the periodic resale of lease rental streams to financial institutions. Refer to Note E of Notes to Condensed Consolidated Financial Statements for additional information regarding our program.

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Results of Operations

The following table sets forth certain statement of operations data expressed as a percentage of net sales for the periods indicated:

	Three Months Ended June 30, 2005	2004	Six Months Ended June 30 2005	2004
NET SALES				
Telecommunications systems, software and related	88.0%	88.1%	87.8%	87.9%
Resale of local, long distance and network services	12.0	11.9	12.2	12.1
TOTAL NET SALES	100.0%	100.0%	100.0%	100.0%
COST OF SALES				
Telecommunications systems, software and related	40.6	40.0	40.8	39.8
Resale of local, long distance and network services	7.2	7.3	7.5	7.2
TOTAL COST OF SALES	47.8	47.2	48.3	47.1
GROSS PROFIT	52.2	52.8	51.7	52.9
Research and development	7.5	6.9	7.8	6.6
Selling, general and administrative	34.8	33.4	35.7	34.5
Amortization of intangibles	1.0	0.4	0.9	0.4
Write-off of in-process research and development costs	—	—	1.2	0.0
OPERATING INCOME	8.9	12.0	6.2	11.4
Interest and other income	0.8	0.6	0.8	0.5
Foreign currency transaction gains (losses)	0.1	(0.1)	0.1	(0.1)
Interest expense	0.0	(0.0)	0.0	(0.0)
INCOME BEFORE INCOME TAXES	9.7	12.4	7.1	11.8
INCOME TAXES	3.7	4.5	3.1	4.4
NET INCOME	6.1%	7.9%	4.0%	7.4%

Net Sales. Net sales increased 12.3%, or $12.6 million, to $115.6 million in the second quarter of 2005 from $102.9 million in the second quarter of 2004. Net sales increased 10.1%, or $20.3 million, to $221.3 million in the first six months of 2005 from $200.9 million in the first six months of 2004. Excluding the Lake acquisition in the first quarter of 2005, non-GAAP net sales increased 4.6%, or $4.7 million, for the second quarter of 2005 compared to net sales for the corresponding prior year period. Sales from our direct sales offices (including revenues from lease financing) increased 7.5%, or $4.1 million, in the second quarter of 2005, and 6.3%, or $6.9 million, in the first six months of 2005 compared to the corresponding periods in 2004. Sales attributable to our dealer network decreased by 2.8%, or $0.7 million, in the second quarter of 2005, and 0.6%, or $0.3 million, in the first six months of 2005 compared to the corresponding periods in 2004. Sales from our local and long distance resale and network services division increased by 13.6%, or $1.7, million in the second quarter of 2005 and 11.3%, or $2.7 million, in the first six months of 2005 compared to the corresponding periods in 2004. Sales from our DataNet division decreased 2.3%, or $0.1 million, in the second quarter of 2005 and increased 9.3%, or $0.6 million, for the first six months of 2005, compared to the corresponding periods in 2004. Sales from our government and national accounts division decreased 2.7%, or $0.1 million, in the second quarter of 2005 and 0.8%, or $0.1 million, for the first six months of 2005, compared to the corresponding periods in 2004. International revenues excluding the Lake acquisition decreased by 5.1%, or $0.2 million, in the second quarter of 2005 and 0.8%, or $0.1 million, for the first six months of 2005 compared to the corresponding periods in 2004. Lake sales totaled $7.9 million in the second quarter of 2005 and $10.5 million for the six months ended June 30, 2005.

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The increase in net sales for the second quarter and first six months of 2005 compared to the corresponding period in 2004 from our direct sales offices was primarily attributable to acquisitions completed in the second half of 2004, offset in part by continued competitive pricing pressures which led to discounting and some delayed buying decisions during the first six months. We believe that the announcement of the E-Rate settlement also resulted in some deferred or lost sales. The increases in net sales were also a result of higher volumes of systems sold. In some instances, prices of various telecommunications systems decreased, and discounts or other promotions were offered to customers to generate sales in both our direct and indirect channels. Recurring revenues from existing customers increased on a percentage basis and dollar volume relative to sales to new customers in our direct sales channel during the second quarter and first six months of 2005.

Sales from our local, long distance resale and network services divisions (NetSolutions® and Network Services Agency) increased in the second quarter and first six months of 2005 as compared to the corresponding periods in 2004. Sales from NetSolutions® increased 10.8%, or $1.2 million, to $12.7 million in the second quarter of 2005, compared to $11.4 million in the corresponding period in 2004 and increased 8.9%, or $2.0 million to $24.7 million in the first six months of 2005 despite downward pricing pressure and significant competition. Increased sales volume has allowed NetSolutions ® to offer more competitive pricing, which improved sales to our existing customer base. Net sales from Network Services Agency, a commission-based sales unit within the local, long distance resale and network services division acting as an agent to sell services for selected RBOC's and CLEC's, increased $0.4 million, to $1.2 million in the quarter ended June 30, 2005 compared to $0.8 million in the corresponding period in 2004 and increased $0.7 million to $2.3 million in the first six months of 2005 compared to $1.6 million in the corresponding period in 2005. Sales decreased slightly in DataNet in the second quarter of 2005 but increased in the first six months of 2005 compared to the corresponding periods in 2004 primarily due to additional sales to a few customers. See Note D of Notes to Condensed Consolidated Financial Statements for additional segment reporting information.

Gross Profit. Gross profit for the second quarter of 2005 increased 11.1% to $60.3 million, or 52.2% of net sales, from $54.3 million, or 52.8% of net sales, in the second quarter of 2004. Gross profit for the first six months of 2005 increased 7.5% to $114.4 million, or 51.7% of net sales, from $106.4 million, or 52.9% of net sales, in the corresponding period of 2004. The increase in gross profit dollars in the second quarter of 2005 resulted primarily from a higher volume of consolidated net sales. The decrease in gross profit as a percentage of sales was primarily a result of lower margins on Lake revenues and industry pricing pressures, leading to discounting and special promotions on telephone system sales and the effects of accruals for GSA pricing issues as discussed in Note A of notes to the Condensed Consolidated Financial Statements. Increased sales from the resale of local and long distance services also had the effect of decreasing the consolidated gross profit percentage, as these revenues typically generate lower gross margins. Higher relative recurring revenues from existing customers partially offset the decreases in gross profit percentage.

During the second quarter and first six months of 2005, recurring revenues increased in gross dollars and as a percentage of sales from existing customers in our direct sales, DataNet and national and government accounts channels increased from these same channels relative to the first six months of 2004. Existing customers accounted for a significant portion and higher relative component of our net sales from maintenance and other services, software additions and/or upgrades, and other peripheral products, such as video conferencing, call logging solutions, wireless endpoints, power protection, wired and wireless headsets, audio conferencing units and networking products, during the second quarter and first six months of 2005 compared to the same periods in 2004. Our business communications platforms allow for system migration without the complete replacement of hardware, enabling us to offer enhancements and new solutions through software-only upgrades to our existing customers. Consequently, our gross margins are generally higher with recurring revenues because we incur less materials costs relative to new installations.

Sales from NetSolutions® increased by 10.8%, or $1.2 million, in the second quarter of 2005 as compared to the second quarter of 2004. Gross margins are generally lower in this division than our consolidated margins. Sales from Network Services Agency, increased 52.6%, or $0.4 million, for the second quarter of 2005 compared to the corresponding period in 2004. This division generally receives

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commissions on network services we sell as an agent for Regional Bell Operating Companies. Sales from this division carry little to no equipment costs and generated margins of 88.5% during the second quarter of 2005. Accordingly, the increase in sales from this division offset in part our decrease in consolidated gross profit percentage.

We cannot accurately predict future consolidated gross margins because of period-to-period variations in a number of factors, including among others, competitive pricing pressures, sales of systems, software and services through different distribution channels, supplier and agency agreements, and the mix of systems, software and services we sell.

Research and Development. Research and development expenses for the second quarter of 2005 increased 22.0% to $8.7 million, or 7.5% of net sales, from $7.1 million, or 6.9% of net sales, for the second quarter of 2004. Included in research and development expenses in both the second quarter of 2005 and the second quarter of 2004 was amortization of patents totaling $55,000 in each period. Research and development expenses for the six months ended June 30, 2005 increased 30.3% to $17.2 million from $13.2 million for the corresponding period in 2004. The increase in research and development expenses for the second quarter and six months ended June 30, 2005 was primarily attributable to the Lake and Linktivity acquisitions. Costs incurred in connection with our development of convergence applications and new SIP and IP endpoint technology were also a factor in this increase. In the second quarter ended June 30, 2005, research and development expenses were directed principally toward the continued development of converged systems and software, including the Inter-Tel 5000, DEI hardware, unified messaging and voice processing software, speech recognition and text-to-speech applications, call center applications, unified communications applications, IP endpoint development, and certain CTI and IVR applications and SIP applications. Through 2005, we expect that research and development expenses will increase in absolute dollars and as a percentage of net sales relative to 2004 due primarily to research and development costs from the acquired Lake and Linktivity operations, and our efforts to continue to develop and enhance existing and new technologies and products.

Selling, general and administrative. In the second quarter of 2005, selling, general and administrative expenses increased 17.2% to $40.3 million, or 34.8% of net sales, from $34.3 million, or 33.4% of net sales, in the second quarter of 2004. For the six months ended June 30, 2005 selling, general and administrative expenses increased 13.9% to $79 million, or 35.7% of net sales, from $69.3 million or 34.5% of net sales, compared to the corresponding period in 2004. The increases were primarily attributable to higher net sales volume and higher costs associated with our Lake acquisition in March 2005, additional costs associated with our Linktivity acquisition in October 2004 as well as the establishment of new direct sales offices. In addition, we accrued costs related to the GSA pricing and trade agreement matters discussed in greater detail in Note A of Notes to the Condensed Consolidated Financial Statements. We also incurred additional marketing expenses related to the introduction and launch of new products, including our new Inter-Tel 5000 platform. The increase in SG&A was also attributable in part to additional legal costs incurred and to implement and maintain a more comprehensive corporate compliance program in connection with our E-Rate settlement. We expect that for the foreseeable future selling, general and administrative expenses may vary in absolute dollars and as a percentage of net sales.

Amortization of purchased intangible assets. We adopted Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" ("SFAS 142") effective in the beginning of fiscal 2002. In accordance with SFAS 142, we ceased amortizing goodwill. We are required to perform goodwill impairment tests on an annual basis and between annual tests in certain circumstances. As of June 30, 2005, no impairment of goodwill has been recognized in 2005. We face the risk that future goodwill impairment tests may result in charges to earnings.

Amortization of purchased intangible assets included in operating expenses was $1.1 million in the second quarter of 2005, compared to $436,000 in the second quarter of 2004. In addition, $55,000 of amortization was included in research and development expenses for the second quarter of 2005 and the second quarter of 2004. Amortization of purchased intangible assets included in operating expenses was $1.9 million in the six months ended June 30, 2005, compared to $881,000 for the same period in 2004. In addition, $111,000 of amortization was included in research and development expenses for the first six months of 2005 and 2004. The increase in the amortization of purchased intangible assets for the second quarter and first six months of fiscal 2005 compared to the same periods in 2004 was primarily related to the additional amortization from recent acquisitions, primarily the Lake and Linktivity acquisitions. For

additional information regarding purchased intangible assets, see Note C "Acquisitions, Technology Investments and Restructuring Charges" to the Condensed Consolidated Financial Statements.

Write-off of in-process research and development (IPRD) costs. During the first quarter of 2005, Inter-Tel completed the acquisition of Lake (see NOTE C). The aggregate purchase price of the Lake acquisition was allocated to the fair value of the assets and liabilities acquired, of which $2.6 million, or $0.09 per diluted share, was written-off as purchased IPRD. Without this write-off, the Company would have reported non-GAAP net income of $11.5 million ($0.42 per diluted share) for the six months ended June 30, 2005 instead of the $8.9 million ($0.33 per diluted share) reported.

Interest and Other Income. Interest and other income in 2005 and 2004 consisted primarily of interest income and foreign currency transaction gains or losses. The net increase in interest and other income of $350,000 in the second quarter of 2005 compared to the corresponding period in 2004 was due primarily to higher levels of invested funds, as well as higher interest rates. Foreign currency transaction gains in the first six months of 2005 were $141,000 compared to losses of $274,000 in the first six months of 2004. Interest expense was relatively nominal in both periods, totaling $46,000 in the first six months of 2005 compared to $88,000 the first six months of 2004.

Income Taxes. Inter-Tel's income tax rate for the second quarter of 2005 was 37.7% compared to 36.6% for the second quarter of 2004, and 43.2% in the first six months of 2005 compared to 37.0% for the same period in 2004. The increase in the rate was primarily attributable to the write-off of in-process research and development costs in connection with our Lake acquisition and the accrual for non-deductible expenses anticipated in connection with GSA contract pricing and trade agreement issues discovered during the second quarter of 2005. Inter-Tel currently expects the full-year 2005 tax rate to be approximately 39.2%, subject to prospective changes in the tax laws or other factors. Excluding the acquisition of Lake, the non-GAAP pro forma full-year rate for 2005 is currently projected to be approximately 37.0%. The 2005 rate is subject to change based on the projected results of operations, including the Lake acquisition and other factors identified above.

Net Income. Net income for the second quarter of 2005 was $7.0 million ($0.26 per diluted share), a decrease of 13.8% compared to net income of $8.1 million ($0.30 per diluted share) in the second quarter of 2004. Net income for the six months ended June 30,2005 was $8.9 million ($0.33 per diluted share), a decrease of 40.2% compared to net income of $14.9 million ($0.55 per diluted share) for the six months ending June 30, 2004.

The decrease in net income for the first six months of 2005 compared to the corresponding period in 2004 was primarily attributable to the write-off of IPRD costs in connection with the Lake acquisition, lower gross margins as a result of competitive pressures, GSA price and trade agreement adjustments and product discounting, higher research and development expenses, higher selling, general and administrative expenses, and higher amortization expenses, offset in part by operating profits from higher relative net sales. Excluding the write-off of IPRD, the Company would have reported net income of $11.5 million ($0.42 per diluted share) for the six months ended June 30, 2005. Additional information regarding other items is described in further detail above.

Inflation/Currency Fluctuation

Inflation and currency fluctuations have not previously had a material impact on Inter-Tel's operations. Inter-Tel's International procurement agreements have traditionally been denominated in U.S. currency. Moreover, a significant amount of contract manufacturing has been or may be moved to alternative sources. The expansion of international operations in the United Kingdom and Europe, and increased international sales, if any, as a result of the 2005 Lake acquisition could result in higher international sales as a percentage of total revenues; however, international revenues do not currently represent a significant portion of our total revenues.

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Liquidity and Capital Resources

(In thousands)	Six Months Ended June 30, 2005	2004
Net cash provided by operating activities	$ 12,056	$ 26,800
Net cash used in investing activities	(32,271)	(3,871)
Net cash (used in) provided by financing activities	(37,572)	1,841
Effect of exchange rate changes	(525)	167
Increase (decrease) in cash and equivalents	(58,312)	24,937
Cash and equivalents at beginning of period	152,330	115,197
Cash and equivalents at end of period	$ 94,018	$140,134

At June 30, 2005, cash and equivalents and short-term investments totaled $156.8 million, a decrease of approximately $48.2 million from the balance at December 31, 2004. The primary reasons for the decrease are the regular and special dividends paid, and cash used for acquisitions, common stock repurchases and the E-Rate settlement, each of which is discussed below. In addition, long-term investments in marketable debt securities were reduced to $0 at June 30, 2005, resulting in a decrease of $9.9 million from the balance at December 31, 2004. We maintain a $10 million unsecured, revolving line of credit with Bank One, NA that is available through June 1, 2006. Under the credit facility, we have the option to borrow at a prime rate or adjusted LIBOR interest rate. Historically, we have used the credit facility primarily to support international letters of credit to suppliers. As of June 30, 2005, none of the credit line was used. The remaining cash balances may be used for acquisitions, strategic alliances, working capital, dividends, common stock repurchases and general corporate purposes.

Net cash provided by operating activities totaled $12.1 million for the six months ended June 30, 2005, compared to $26.8 million for the corresponding period in 2004. Cash provided by operating activities in the first six months of 2005 primarily resulted from net income plus non-cash charges for depreciation and amortization expenses, purchased in process research and development charge, and provisions for losses on receivables and leases, offset primarily by cash expended for the E-Rate settlement of $8.5 million. Cash generated by the increase in deferred taxes in the first six months of 2005 totaled $218,000 compared to $7.0 million for the same period in 2004. Cash used in changes in operating assets and liabilities was $0.6 million in the first six months of 2005, compared to $1.4 million for the same period in 2004. Other factors for cash used in operating activities in the first six months of 2005 included increases in inventories and investments in sales leases, offset by decreases in accounts receivable and prepaid expenses and other assets. We expect to expand sales through our direct sales offices and dealer networks, which is expected to require the expenditure of working capital for increased accounts receivable, inventories and net investment in sales-leases.

Net cash used in investing activities totaled $32.3 million for the six months ended June 30, 2005, primarily in the form of $27.8 million used in acquisitions and $4.3 million used in capital expenditures, compared to $3.9 million used in investing activities for the six months ended June 30, 2004. Cash used to purchase available for sale investments totaled $20.6 million in the first six months of 2005, offset by $20.3 million in maturities and sales of available for sale and held-to-maturity investments. Cash used for capital expenditures and acquisitions totaled $4.1 million and $100,000, respectively, in the first six months of 2004. Cash generated from maturities and sales of available for sale and held-to-maturity investments totaled $49.8 million in the first six months of 2004, offset by cash used to purchase available for sale and held-to-maturity investments totaling $49.6 million.

Net cash used in financing activities totaled $37.6 million for the six months ended June 30, 2005, compared to cash provided by financing activities of $1.8 million for the corresponding period in 2004. Net cash used for cash dividends, including a special $1 per share dividend, totaled $30.7 million in the first six months of 2005 compared to $3.1 million in the same period for 2004. During the second quarter of 2005, we expended $13.8 million to repurchase 716,500 shares of the Company's common stock pursuant to a stock repurchase program under which the Board of Directors authorized the repurchase of up to $75 million of the Company's common stock. The Company's stock repurchases in the second quarter were funded primarily by existing cash balances. Net cash provided by proceeds from the exercise of stock options and Employee Purchase Plan (ESPP) shares totaled $6.9 million in the first six months of 2005

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compared to $4.9 million in the same period for 2004. During the first six months of 2005 we reissued treasury shares through stock option and ESPP exercises and issuances, with the proceeds received totaling less than the cost basis of the treasury stock reissued. Accordingly, the difference was recorded as a decrease to retained earnings of $1.6 million. During the first six months of 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 of $0.8 million.

We offer to our customers lease financing and other services, including our Total Solution (formerly Totalease) program, through our Inter-Tel Leasing, Inc. subsidiary. We fund our Total Solution program in part through the sale to financial institutions of rental payment streams under the leases. Sold lease rentals totaling $258.5 million and $241.4 million remained unbilled at June 30, 2005 and December 31, 2004, respectively. We are obligated to repurchase such income streams in the event of defaults by lease customers and, accordingly, maintain reserves based on loss experience and past due accounts. Although, to date, we have been able to resell the rental streams from leases under the Total Solution program profitably and on a substantially current basis, the timing and profitability of lease resales could impact our business and operating results, particularly in an environment of fluctuating interest rates and economic uncertainty. If we are required to repurchase rental streams and realize losses thereon in amounts exceeding our reserves, our operating results will be adversely affected.

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 June 30, 2005, the Company has one outstanding agreement in place to sell cash flow streams with a present value of $25.0 million in December 2005 at an interest rate to the financial institution of 6.05 percent. Should interest rates decrease substantially, the Company has the option to pay $500,000 to the financial institution to cancel the commitment.

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 agreed to pay a penalty of $6,740,450 and forego the collection of certain accounts receivable of $259,540 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 agreed to pay a fine of $1,721,000 and observe a three-year probationary period, which will, among other things, require Technologies to implement a comprehensive corporate compliance program. The penalties and fines described above were paid in the first quarter of 2005.

In addition, on January 21, 2005, Inter-Tel Technologies (Technologies) received notification from the Federal Communications Commission that Technologies was temporarily suspended from participation in the E-Rate program pending a proposed 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 2004 relating to Technologies' participation in the E-Rate program were not significant.

The existence and disclosure of the Civil Settlement, Plea Agreement and FCC Notice may have already caused competitive harm to Inter-Tel, and these matters may further harm Inter-Tel's business.

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 recently 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 are in the process of reviewing our compliance and taking appropriate corrective measures with respect to these potential variances, and have accrued $1.8

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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. There can be no assurance that our actual costs, including fines and penalties, if any, associated with this matter will not be more or less than our estimate. The total sales potentially subject to the GSA agreements were approximately $7.2 million during the period from March 28, 2001 through June 10, 2005. Our current contract with the GSA expires in March 2006. There can be no assurance that the contract will be renewed at that time. Further, there can be no assurance that the existence or disclosure of our noncompliance will not cause additional competitive or other harm to the Company.

We believe our working capital and credit facilities, together with cash generated from operations, will be sufficient to develop and expand our business operations, to finance acquisitions of additional resellers of telephony products and other strategic acquisitions or corporate alliances, to fund quarterly dividends to shareholders, to repurchase additional shares of the Company's common stock pursuant to the Board-approved $75 million repurchase program, of which $61.2 million remains authorized, and to provide adequate working capital for the foreseeable future. However, to the extent additional funds are required in the future to address working capital needs and to provide funding for capital expenditures, expansion of the business or additional acquisitions, we will seek additional financing. There can be no assurance additional financing will be available when required or on acceptable terms.

Off-Balance Sheet Arrangements

As part of our ongoing business, we do not participate in transactions that involve unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. However, we offer to our customers lease financing and other services through our Inter-Tel Leasing, Inc. subsidiary. We fund our Total Solution program in part through the sale to financial institutions of rental payment streams under the leases. Such financial institutions have the option to require us to repurchase such income streams, subject to limitations, in the event of defaults by lease customers and, accordingly, we maintain reserves based on loss experience and past due accounts. For more information regarding our lease portfolio and financing, please see "Liquidity and Capital Resources" and Note E of Notes to Condensed Consolidated Financial Statements.

Critical Accounting Policies and Estimates

The methods, estimates and judgments we use in applying our most critical accounting policies have a significant impact on the results we report in our condensed consolidated financial statements. We evaluate our estimates and judgments on an on-going basis. We base our estimates on historical experience and on assumptions that we believe to be reasonable under the circumstances. Our experience and assumptions form the basis for our judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may vary from what we anticipate and different assumptions or estimates about the future could change our reported results. We believe the following accounting policies are the most critical to us, in that they are important to the portrayal of our financial statements and they require our most difficult, subjective or complex judgments in the preparation of our condensed consolidated financial statements:

Revenue Recognition. In December 2003, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 104 (SAB 104), "Revenue Recognition." The Company applies the provisions of SAB 104 to all revenue transactions. SAB 104 supersedes SAB 101, "Revenue Recognition in Financial Statements." The primary purpose of SAB 104 is to rescind accounting guidance contained in SAB 101 related to multiple element revenue arrangements, superseded as a result of the issuance of EITF 00-21. Additionally, SAB 104 rescinded the SEC's Revenue Recognition in Financial Statements Frequently Asked Questions and Answers ("the FAQ") issued with SAB 101 that had been codified in SEC Topic 13, Revenue Recognition. Selected portions of the FAQ have been incorporated into SAB 104. While the wording of SAB 104 has changed to reflect the issuance of EITF 00-21, the revenue recognition principles of SAB 101 remain largely unchanged by the issuance of SAB 104. The issuance of SAB 104 did not have a material impact on the Company's financial position, results of operations or cash flows.

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End-user sales through our direct sales offices and government and national 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. We do not generally allow sales returns either by the terms of our contracts or in practice, except for returns related to warranty provisions.

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 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 do not generally allow sales returns either by the terms of our contracts or in practice, except for returns related to warranty provisions. 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.

Maintenance revenues. We recognize maintenance revenue ratably over the term of applicable maintenance 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 above for sales to end user customers. 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 long-term liabilities on our balance sheet for off-balance sheet leases.

Historically, our reserves have been adequate to cover write-offs. Our total reserve for losses related to the entire lease portfolio, including amounts classified as accounts receivable in our balance sheet, increased from 5.32% at December 31, 2004 to 5.41% at June 30, 2005, primarily as a result of reviews of our write-off experience and accounts receivable agings. Should the financial condition of our customers deteriorate in the future, additional reserves in amounts that could be material to the financial statements could be required.

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 that are accounted for as purchases 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.

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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. As of June 30, 2005, Inter-Tel had gross goodwill of $31.6 million and accumulated amortization of $5.0 million. Inter-Tel completed one acquisition through June 30, 2005 and five in 2004 and has not recorded any amortization for these acquisitions on amounts allocated to goodwill in accordance with SFAS No. 141.

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, 2004 and determined that goodwill is not impaired and it is not necessary to record any impairment losses related to goodwill. At June 30, 2005 and December 31, 2004, $24.5 million and $17.8 million, respectively, of the Company's goodwill, net of amortization, relates to the Company's principal segment and $2.1 million relates to the Resale of Local, Long Distance and 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, 2004, 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 had occurred. This allocated market capitalization value far exceeded the net carrying value of the goodwill included in the financial statements. Therefore, the second step for potential impairment was unnecessary.

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. As of June 30, 2005, Inter-Tel had gross purchased intangible assets of $36.1 million and accumulated amortization of $10.1 million.

At June 30, 2005 and December 31, 2004, goodwill, net of accumulated amortization, totaled $26.5 million and $19.9 million, respectively. Other acquisition-related intangibles, net of accumulated amortization, totaled $26.0 million at June 30, 2005 and $11.0 million at December 31, 2004. Accumulated amortization through June 30, 2005 was $15.1 million, including $5.0 million of accumulated amortization attributable to goodwill and $10.1 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. Other acquisition-related intangibles, 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.

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 above 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 June 30, 2005, our allowance for doubtful accounts for accounts receivable were $9.0 million of our $52.9 million in gross accounts receivable. If the financial condition of our customers or

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channel partners were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

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 the reserve for obsolete or excess inventory and we make our assessment primarily on a significant product-by-product basis for 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 and we reserve for our excess and possible obsolete inventory. Historically, sales of scrap have not been material and have not affected our profit margins. If actual customer demand, product life cycles, changing technologies and market conditions are less favorable than those projected by management, additional inventory reserves may be required in the future.

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 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 June 30, 2005, management did not believe that the ultimate impact of various claims and pending litigation would have a materially adverse impact on the Company. Refer to Note A to the Condensed Consolidated Financial Statements for details of specific contingencies.

FACTORS THAT MAY AFFECT FUTURE OPERATING RESULTS

This Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended. Actual results could differ materially from those projected in the forward-looking statements as a result of many risk factors including, without limitation, those set forth under "Factors That May Affect Future Results Of Operations" below. In evaluating Inter-Tel's business, shareholders and prospective investors should consider carefully the following factors in addition to the other information set forth in this document.

Risks Related to Our Business

Our operating results have historically depended on a number of factors, and these factors may cause our operating results to fluctuate in the future.

Our quarterly operating results have historically depended on, and may fluctuate in the future as a result of, many factors including:

- volume and timing of orders received during the quarter;
- gross margin fluctuations associated with the mix of products sold;
- the mix of distribution channels;
- general economic conditions and the condition of the markets our business addresses;
- patterns of capital spending by customers;
- the timing of new product announcements and releases by us and our competitors and other competitive factors;
- pricing pressures;
- the cost and effect of acquisitions;
- the availability and cost of products and components from our suppliers, including shipping and manufacturing problems associated with subcontracted vendors;

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- the impact of the E-Rate settlement, possible FCC debarment, and expected fines and penalties associated with the GSA variances and noncompliance which could affect both our government business and our commercial business;
- the potential impact of new accounting pronouncements such as FAS 123R;
- national and regional weather patterns; and
- threats of or outbreaks of war, hostilities, terrorist acts or other civil disturbances.

In addition, we have historically operated with a relatively small backlog, with sales and operating results in any quarter depending principally on orders booked and shipped in that quarter. In the past, we have recorded a substantial portion of our net sales for a given quarter in the third month of that quarter, with a concentration of such net sales in the last two weeks of the quarter. Market demand for investment in capital equipment such as business communications systems and associated call processing and voice processing software applications depends largely on general economic conditions and can vary significantly as a result of changing conditions in the economy as a whole, as well as heightened competitive pressures. We cannot assure you that we can continue to be successful operating with a small backlog or whether historical backlog trends will continue in the future.

Our expense levels are based in part on expectations of future sales and, if sales levels do not meet expectations, our operating results could be harmed. In addition, because sales of business communications systems through our dealers typically produce lower gross margins than sales through our direct sales organization, operating results have varied, and will continue to vary based upon the mix of sales through direct and indirect channels. In addition, in the recent past we have derived a significant part of our revenue from recurring revenue streams, which typically produce higher gross margins. If we do not maintain recurring revenue streams at current or historic levels, our operating results would suffer unless we significantly increased sales to new customers. Moreover, particularly in an environment of fluctuating interest rates, the timing and profitability of lease resales from quarter to quarter could impact operating results. Long distance and DataNet sales, which typically carry lower gross margins than our core business, have grown in recent periods at a faster rate than our overall net sales, although gross margins may fluctuate in these divisions from period to period. Consolidated gross margins could be harmed if long distance calling services continue to increase as a percentage of net sales or if gross margins from this division decline. We also experience seasonal fluctuations in our operating results, as net sales for the first quarter is frequently less than the fourth quarter, and net sales for the third quarter is frequently less than the second quarter. As a result of these and other factors, we have historically experienced, and could continue to experience in the future, fluctuations in net sales and operating results on a quarterly basis.

Our market is subject to rapid technological change and to compete successfully, we must continually introduce new and enhanced products and services that achieve broad market acceptance.

The market for our products and services is characterized by rapid technological change, evolving industry standards and vigorous customer demand for new products, applications and services. To compete successfully, we must continually enhance our existing telecommunications products, related software and customer services, and develop new technologies and applications in a timely and cost-effective manner. If we fail to introduce new products and services that achieve broad market acceptance and on a timely basis, or if we do not adapt our existing products and services to customer demands or evolving industry standards, our business could be significantly harmed. Problems and delays associated with new product development have in the past contributed to lost sales. In addition, current competitors or new market entrants may offer products, applications or services that are better adapted to changing technology or customer demands and that could render our products and services unmarketable or obsolete.

In addition, if the markets for computer-telephony applications, Internet Protocol network products, SIP products and applications, or related products fail to develop or continue to develop more slowly than we anticipate, or if we are unable for any reason to capitalize on any of these emerging market opportunities, our business, financial condition and operating results could be significantly harmed.

Our future success largely depends on increased commercial acceptance of our Inter-Tel 5000 Network Communications Solutions, Axxess® system, the Lake OfficeLink product (branded EncoreCX® in North America), speech recognition, Interactive Voice Response, presence

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management, collaboration, messaging products, Session Initiation Protocol (SIP) applications, and related computer-telephony products.

Over the past 18 to 24 months, we have introduced a number of new products and platforms, including: Enterprise® Conferencing and Enterprise® Instant Messaging software, a SIP-based web and audio conferencing application; Inter-Tel Webconferencing and Inter-Tel Remote support (collaboration) solutions; Model 8500 series digital endpoints; Model 8600 series Multi-protocol SIP endpoints; ; the Inter-Tel 5000 Network Communications Platform; enhanced convergence features on the Axxess system, including support of standard Session Initiation Protocol (SIP) endpoints and trunk gateways; integrated web collaboration and video conferencing capabilities into our Unified Communicator application, and several other telephony-related products. In recent history, sales of our Axxess business communications systems and related software have comprised a substantial portion of our net sales. Our future success depends, in large part, upon increased commercial acceptance and adoption of the products or platforms identified above, including the Axxess system, the Inter-Tel 5000 Network Communications products, the Unified Communicator and related computer-telephony products, the Linktivity collaboration technology, the Lake Communications converged systems and software, SIP standards-based applications and devices, new speech recognition and Interactive Voice Response products, and future upgrades and enhancements to these products and networking platforms. We cannot assure you that these products or platforms will achieve commercial acceptance in the future.

Our products are complex and may contain errors or defects that are detected only after their release, which may cause us to incur significant unexpected expenses and lost sales.

Our telecommunications products and software are highly complex. Although our new products and upgrades are examined and tested prior to release, they can only be fully tested when used by a large customer base. Consequently, our customers have in the past and may in the future discover program errors, or "bugs," or other defects after new products and upgrades have been released. Some of these bugs may result from defects contained in component parts or software from our suppliers or other third parties that are intended to be compatible with our products and over which we have little or no control. Although we have test procedures and quality control standards in place designed to minimize the number of errors and defects in our products, we cannot assure you that our new products and upgrades will be free of bugs when released. If we are unable to quickly or successfully correct bugs identified after release, we could experience the following, any of which would harm our business:

- costs associated with the remediation of any problems;
- costs associated with design modifications;
- loss of or delay in revenues;
- loss of customers;
- damage to our reputation;
- failure to achieve market acceptance or loss of market share;
- increased service and warranty costs;
- liabilities to our customers; and
- increased insurance costs.

The complexity of our products could cause delays in the development and release of new products and services. As a result, customer demand for our products could decline, which could harm our business.

Due to the complexity of our products and software, we have in the past experienced and expect in the future to experience delays in the development and release of new products or product enhancements. If we fail to introduce new software, products or services in a timely manner, or fail to release upgrades to our existing systems or products and software on a regular and timely basis, customer demand for our products and software could decline, which would harm our business.

Business acquisitions, new business ventures, dispositions or joint ventures entail numerous risks and may disrupt our business, dilute shareholder value and distract management attention.

As part of our business strategy, we consider acquisitions of, or significant investments in, businesses that offer products, services and technologies complementary to ours. Such acquisitions could materially

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adversely affect our operating results and/or the price of our common stock. Acquisitions also entail numerous risks, some of which we have experienced and may continue to experience, including:

- unanticipated costs and liabilities;
- difficulty of assimilating the operations, products and personnel of the acquired business;
- difficulties in managing the financial and strategic position of acquired or developed products, services and technologies;
- difficulties in maintaining customer relationships;
- difficulties in servicing and maintaining acquired products, in particular where a substantial portion of the target's sales were derived from our competitor's products and services;
- difficulty of assimilating the vendors and independent contractors of the acquired business;
- the diversion of management's attention from the core business;
- inability to maintain uniform standards, controls, policies and procedures; and
- impairment of relationships with acquired employees and customers occurring as a result of integration of the acquired business.

In particular, in prior years our operating results were materially adversely affected by several of the factors described above, including substantial operating losses and impairment charges resulting from Executone and Inter-Tel.NET. Refer to Note C to the Condensed Consolidated Financial Statements for additional information concerning our acquisitions.

We completed two acquisitions in 2002, one acquisition and one technology investment in 2003, five acquisitions and one technology investment in 2004, and one acquisition in 2005. The 2002 acquisitions included certain assets and liabilities of an operating company and the stock of a United Kingdom technology company. In 2003, we acquired selected assets and assumed certain liabilities of a former Inter-Tel dealer and we acquired the rights to certain developed technology. In 2004, we acquired certain assets and assumed certain liabilities of four former Inter-Tel dealers. In addition, we completed one technology related acquisition, coupled with a license of technology in 2004. In March of 2005, we acquired all of the outstanding stock of Lake and its several related entities in Ireland. These entities are similar in nature to our wholesale operations and also include significant technology-related assets. These acquisitions are subject to risks and uncertainties including, but not limited to, those indicated above.

Finally, to the extent that shares of our stock or the rights to purchase stock are issued in connection with any future acquisitions, dilution to our existing shareholders will result and our earnings per share may suffer. Any future acquisitions may not generate additional revenue or provide any benefit to our business, and we may not achieve a satisfactory return on our investment in any acquired businesses.

We may not be able to adequately protect our proprietary technology and may be infringing upon third-party intellectual property rights.

Our success depends in part upon protecting our proprietary technology. As of June 30, 2005, we held twenty-seven (27) U.S. patents for telecommunication and messaging products, systems and processes and had applied to the U.S. Patent and Trademark Office for fifteen (15) additional patents. We also rely on copyright and trade secret law and contractual provisions to protect our intellectual property. Despite these precautions, third parties could copy or otherwise obtain and use our technology without authorization, or develop similar technology independently.

Any patent, trademark or copyright that we own or have applied to own is subject to being invalidated, circumvented or challenged by a third party. Effective protection of intellectual property rights may be unavailable or limited in foreign countries. The telecommunications and networking industries are heavily patented and we cannot assure that the protection of our proprietary rights will be adequate or that competitors will not independently develop similar technology, duplicate our services or design around any patents or other intellectual property rights we hold. Litigation may be necessary in the future to enforce our intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others, or to defend against claims of infringement or invalidity. Litigation could be costly, absorb significant management time and harm our business.

Many of our competitors have large patent portfolios and we are subject to or could become subject to third party claims that our current or future products or services infringe upon the rights of others. For example, we are subject to claims initiated by Avaya and Lucent, two of our primary competitors, alleging

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that certain of our key products infringe upon their intellectual property rights, including patents, trademarks, copyrights or other intellectual property rights. We have viewed presentations from Avaya and Lucent alleging that our Axxess business communications system, associated applications and related 3rd party products that we distribute utilize inventions covered by certain of their patents. We have also made claims against Avaya for infringement of our patents. We are continuing the process of investigating these matters. The ultimate outcomes by their nature are uncertain and we cannot assure you that these matters, individually or collectively, would not have a material adverse impact on our financial position and future results of operations.

When any such claims are asserted against us, among other means to resolve the dispute, we may seek to license the third party's intellectual property rights. Purchasing such licenses can be expensive, and we cannot assure you that a license will be available on prices or other terms acceptable to us, if at all. Alternatively, we could resort to litigation to challenge such a claim. Litigation could require us to expend significant sums of cash and divert our management's attention. In the event a court renders an enforceable decision with respect to our intellectual property, we may be required to pay significant damages, develop non-infringing technology or acquire licenses to the technology subject to the alleged infringement. Any of these actions or outcomes could harm our business. If we are unable or choose not to license technology, or decide not to challenge a third party's rights, we could encounter substantial and costly delays in product introductions. These delays could result from efforts to design around asserted third party rights or our discovery that the development, manufacture or sale of products requiring these licenses could be foreclosed.

We have many competitors and expect new competitors to enter our market, which could increase price competition and spending on research and development and which may impair our ability to compete successfully.

The markets for our products and services are extremely competitive and we expect competition to increase in the future. Our current and potential competitors in our primary business segments include:

- PABX, converged systems and IP-PBX providers, distributors, or resellers such as Alcatel, Altigen, Avaya, Cisco Systems, Comdial, 3Com, EADS Telecom, Iwatsu, Interactive Intelligence, Lucky Goldstar, Mitel, NEC, Nortel, Panasonic, Samsung, ShoreTel, Siemens, Toshiba, Vertical Networks/ArtiSoft and Vodavi;
- large data routing and convergence companies such as 3Com, Adtran and Cisco Systems;
- voice processing applications providers such as ADC, InterVoice-Brite, Active Voice (a subsidiary of NEC America), Avaya, and Captaris (formerly AVT);
- web collaboration product and service providers, such as Centra, eDial (a division of Alcatel), IBM, Microsoft, Raindance Communications, and WebEx;
- long distance services providers such as AT&T, MCI, Qwest and Sprint;
- large computer and software corporations such as IBM, HP, Intel and Microsoft;
- regional Bell operating companies, or RBOCs, competitive local exchange companies (CLECs); cable television companies, IP Centrex service providers, and satellite and other wireless and wireline broadband service providers offering IP centrex services such as AT&T, Covad, Level-3, Qwest, SBC, and Time-Warner Telecom; and
- independent leasing companies that provide telecom equipment financing.

These and other companies may form strategic relationships with each other to compete with us. These relationships may take the form of strategic investments, joint-marketing agreements, licenses or other contractual arrangements. Strategic relationships and business combinations could increase our competitors' ability to address customer needs with their product and service offerings.

Many of our competitors and potential competitors have substantially greater financial, customer support, technical and marketing resources, larger customer bases, longer operating histories, greater name recognition and more established relationships in the industry than we do. We cannot be sure that we will have the resources or expertise to compete successfully. Compared to us, our competitors may be able to:

- develop and expand their product and service offerings more quickly;
- offer greater price discounts or make substantial product promotions;
- adapt to new or emerging technologies and changing customer needs faster;

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- take advantage of acquisitions and other opportunities more readily;
- negotiate more favorable licensing agreements with vendors;
- devote greater resources to the marketing and sale of their products; and
- address customers' service-related issues more adequately.

Some of our competitors may also be able to provide customers with additional benefits at lower overall costs or to reduce their gross margins aggressively in an effort to increase market share. We cannot be sure we will be able to match cost reductions by our competitors. In recent periods, due to competitive pressures, we have discounted pricing on our telephone systems and offered promotions. In addition, we believe there is likely to be further consolidation in our markets, which could lead to having even larger and more formidable competition and other forms of competition that could cause our business to suffer.

Our reliance on a limited number of suppliers for key components and our dependence on contract manufacturers could impair our ability to manufacture and deliver our products and services in a timely and cost-effective manner.

We currently obtain certain key components for our digital communication platforms, including certain microprocessors, integrated circuits, power supplies, voice processing interface cards and IP telephony cards, from a limited number of suppliers and manufacturers. Our reliance on these limited suppliers and contract manufacturers involves risks and uncertainties, including the possibility of a shortage or delivery delay for some key components. We currently manufacture our products, including products manufactured for Lake, through third-party subcontractors located in the United States, Mexico, the People's Republic of China and the United Kingdom. Foreign manufacturing facilities are subject to changes in governmental policies, imposition of tariffs and import restrictions and other factors beyond our control. We have experienced occasional delays in the supply of components and finished goods that have harmed our business. If inventory levels are not adequately maintained and managed we are at risk of not having the appropriate inventory quantities on hand to meet sales demand. We may experience similar delays in the future.

Our reliance on third party manufacturers and OEM partners involves a number of additional risks, including reduced control over delivery schedules, quality assurance and costs. Our business may be harmed by any delay in delivery or any shortage of supply of components or finished goods from a supplier caused by any number of factors, including but not limited to the acquisition of the vendor by another company (which has recently occurred with one of our primary suppliers). Our business may also be harmed if we are unable to develop alternative or additional supply sources as necessary. To date, we have been able to obtain supplies of components and products in a timely manner even though we do not have long-term supply contracts with any of our contract manufacturers. However, we cannot assure you we will be able to continue to obtain components or finished goods in sufficient quantities or quality or on favorable pricing or delivery terms in the future.

We derive a substantial portion of our net sales from our dealer network and if these dealers do not effectively promote and sell our products, our business and operating results could be harmed.

We derive a substantial portion of our net sales through our network of independent dealers. We face intense competition from other telephone, voice processing, and voice and data router system manufacturers for these dealers' business, as most of our dealers carry other products that compete with our products. Our dealers may choose to promote the products of our competitors to our detriment. We have developed programs and expended capital as incentives to our dealers to promote our products, and we cannot assure you that these techniques will continue to be successful. The loss of any significant dealer or group of dealers, or any event or condition harming our dealer network, could harm our business, financial condition and operating results.

We have been the subject of government investigations, which have resulted in convictions and civil penalties and may cause further competitive and financial harm to our business.

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-

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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 agreed to pay a penalty of $6,740,450 and forego the collection of certain accounts receivable of $259,540 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 agreed to pay a fine of $1,721,000 and observe a three-year probationary period, which will, among other things, require Technologies to implement a comprehensive corporate compliance program. The penalties and fines described above were paid during the first quarter of 2005.

In addition, on January 21, 2005, Inter-Tel Technologies received notification from the Federal Communications Commission that Technologies was temporarily suspended from participation in the E-Rate program pending a proposed 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 2004 relating to Technologies' participation in the E-Rate program were not significant.

The existence and disclosure of the Civil Settlement, Plea Agreement and FCC Notice may have already caused competitive harm to Inter-Tel, and these matters may further harm Inter-Tel's business.

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 recently 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 are in the process of reviewing our compliance and taking appropriate corrective measures with respect to these potential variances, and have 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. There can be no assurance that our actual costs, including fines and penalties, if any, associated with this matter will not be more or less than our estimate. The total sales potentially subject to the GSA agreements were approximately $7.2 million during the period from March 28, 2001 through June 10, 2005. Our current contract with the GSA expires in March 2006. There can be no assurance that the contract will be renewed at that time. Further, there can be no assurance that the existence or disclosure of our noncompliance will not cause additional competitive or other harm to the Company.

Inter-Tel is also subject to litigation in the ordinary course of business. We cannot assure you that any adverse outcome in connection with such litigation would not impair our business or financial condition.

Managing our international sales efforts may expose us to additional business risks, which may result in reduced sales or profitability in our international markets.

We are currently expending resources to maintain and expand our international dealer network in the countries in which we already have a presence and in new countries and regions. International sales are subject to a number of risks, including changes in foreign government regulations and telecommunication standards, export license requirements, tariffs and taxes, other trade barriers, difficulties in protecting our intellectual property, fluctuations in currency exchange rates, difficulty in collecting receivables, difficulty in staffing and managing foreign operations, and political and economic instability. In particular, the terrorist acts of September 11, 2001, continued hostilities in Iraq and turmoil in the Middle East and North Korea have created an uncertain international economic environment and we cannot predict the impact of these acts, any future terrorist acts or any related military action on our efforts to expand our international sales. Fluctuations in currency exchange rates could cause our products to become relatively more expensive to customers in a particular country, leading to a reduction in sales or profitability in that country. In addition, the costs associated with developing international sales or an international dealer network may not be offset by increased sales in the short term, or at all. Any of these risks could cause our products to become relatively more expensive to customers in a particular country, leading to reduced sales or profitability in that country.

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During the past year, Inter-Tel has been in the process of establishing a new dealer relationship in South Africa and launched that relationship in 2005. It is possible that this business many not materialize as soon as expected and may require additional support expenses to reach the expected revenue levels.

In December 2004, we wrote off our Japan operations. As a result, Inter-Tel assigned selected assets and the customer base of the Inter-Tel Japan direct sales office to a new dealer in Japan that will sell and support Inter-Tel products to our Japan customers. We may continue to incur expenses related to the winding down of our direct presence over the next few quarters.

The Lake acquisition closed in March 2005. Among other acquisition-related risks, we face risks of deterioration of international sales during the integration process, loss of key customers or that projected growth could be delayed or may not materialize at all.

If we lose key personnel or are unable to hire additional qualified personnel as necessary, we may not be able to achieve our objectives.

We depend on the continued service of, and our ability to attract and retain, qualified technical, marketing, sales and managerial personnel, many of whom would be difficult to replace. Competition for qualified personnel is intense, and we have historically had difficulty in hiring employees in the timeframe we desire, particularly skilled engineers or sales personnel. The loss of any of our key personnel or our failure to effectively recruit additional key personnel could make it difficult for us to manage our business, complete timely product introductions or meet other critical business objectives. Moreover, our operating results could be impaired if we lose a substantial number of key employees from recent acquisitions, including personnel from acquisitions identified in Note B to the Consolidated Financial Statements. We cannot assure you we will be able to continue to attract and retain the qualified personnel necessary for the development of our business.

Our IP network products may be vulnerable to viruses, other system failure risks and security concerns, which may result in lost customers or slow commercial acceptance of our IP network products.

Inter-Tel's IP telephony and network products may be vulnerable to computer viruses or similar disruptive problems. Computer viruses or problems caused by third parties could lead to interruptions, delays or cessation of service that could harm our operations and revenues. In addition, we may lose customers if inappropriate use of the Internet or other IP networks by third parties jeopardizes the security of confidential information, such as credit card or bank account information or the content of conversations over the IP network. In addition, user concerns about privacy and security may cause IP networks in general to grow more slowly, and impair market acceptance of our IP network products in particular, until more comprehensive security technologies are developed and deployed industry-wide.

We may be unable to achieve or manage our growth effectively, which may harm our business.

The ability to operate our business in an evolving market requires an effective planning and management process. Our efforts to achieve growth in our business have placed, and are expected to continue to place, a significant strain on our personnel, management information systems, infrastructure and other resources. In addition, our ability to manage any potential future growth effectively will require us to successfully attract, train, motivate and manage new employees, to integrate new employees into our overall operations and to continue to improve our operational, financial and management controls and procedures. Furthermore, we expect we will be required to manage an increasing number of relationships with suppliers, manufacturers, customers and other third parties. If we are unable to implement adequate controls or integrate new employees into our business in an efficient and timely manner, our operations could be adversely affected and our growth could be impaired.

The introduction of new products and services has lengthened our sales cycles, which may result in significant sales and marketing expenses.

In the past few years, we introduced IP telephony enhancements to the Axxess® system as well as presence management and collaboration applications, which are typically sold to larger customers at a

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higher average selling price and often represent a significant expenditure in communications infrastructure by the prospective enterprise customer. Accordingly, the purchase of our products typically involves numerous internal approvals relating to the evaluation, testing, implementation and acceptance of new technologies. This evaluation process frequently results in a lengthy sales process, which can range from a few months to more than 12 months, thereby subjecting our sales cycle to a number of significant uncertainties concerning budgetary constraints and internal acceptance reviews. The length of our sales cycle also may vary substantially from customer to customer and along product lines. While our customers are evaluating our products before placing an order with us, we may incur substantial sales and marketing expenses and expend significant management effort. In addition, installation of multiple systems for large, multi-site customers may occur over an extended period of time, and depending on the contract terms with these customers, revenues may be recognized over more than one quarter, as systems are completed in separate phases and accepted by the customers. Consequently, if sales forecasted from a specific customer for a particular quarter are not realized in that quarter, our operating results could be materially adversely affected.

We rely heavily upon third-party packaged software systems to manage and run our business processes, to provide certain products and services and to produce our financial statements. From time to time we upgrade these systems to ensure continuation of support and to expand the functionality of the systems to meet our business needs. The risks associated with the upgrade process include disruption of our business processes, which could harm our business.

We currently run third-party applications for data processing in our distribution center operations, shipping, materials movement, customer service, invoicing, sales functions, financial record keeping and reporting, and for other operations and administrative functions. The nature of the software industry is to upgrade software systems to make architectural changes, increase functionality, improve controls and address software bugs. Over time, older versions of the software become less supported or unsupported by our vendors for financial and other reasons and eventually become obsolete. Oracle, the primary supplier of our third-party applications, provides notice of the dates that Oracle will de-support the software and companies are expected to either make plans to upgrade to newer versions or operate without Oracle support. While Oracle and other third-party vendors may provide advanced notice of product upgrade schedules and take other steps to make the upgrade process as straightforward as possible, we are subject to risks associated with the process, and in some cases we may choose to continue to utilize and maintain the unsupported third-party software using our own information systems personnel. Our software systems could become unstable following an upgrade process and impact our ability to process data properly in these systems, including timely and accurate shipment of products, invoicing our customers properly and the production of accurate and timely financial statements. There are risks associated with failing to apply necessary security upgrades intended to resolve vulnerabilities. While we strive to take necessary precautions and properly test security-related upgrades before applying these upgrades, we must weigh the risks of not applying the upgrade against the risks of vulnerabilities being exploited for malicious purposes by an outside entity. Should a security vulnerability be exploited, our systems could become unstable and/or data could be compromised, thereby adversely affecting our business. We expect to affect software upgrades in the future and cannot assure you these software upgrades or enhancements will operate as intended or be free from bugs or that we will be able to operate effectively using unsupported third-party software using our existing personnel and resources. If we are unable to successfully integrate new software into our information systems, our operations, customer service and financial reporting could be adversely affected and could harm our business.

Our stock price has been and may continue to be volatile, impairing your ability to sell your shares at or above purchase price.

The market price for our common stock has been highly volatile. The volatility of our stock could be subject to continued wide fluctuations in response to many risk factors listed in this section, and others beyond our control, including:

- announcements of developments relating to our business;
- fluctuations in our operating results;
- the impact of our dividend announcements, repurchase program or sales of stock by officers and directors;

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- shortfalls in revenue or earnings relative to securities analysts' expectations;
- announcements of technological innovations or new products or enhancements by us or our competitors, including product delays;
- announcements of acquisitions or planned acquisitions of other companies or businesses;
- investors' reactions to acquisition announcements or any forecasts of our future results;
- general economic conditions in the telecommunications industry;
- the market for Internet-related voice and data products and services;
- changes in the national or worldwide economy;
- changes in legislation or regulation affecting the telecommunications industry;
- developments relating to our intellectual property rights and the intellectual property rights of third parties;
- litigation or governmental investigations of our business practices;
- the impact of the E-Rate settlement and possible FCC debarment, which could affect both our government business and our commercial business.
- changes in our relationships with our customers and suppliers, including shipping and manufacturing problems associated with subcontracted vendors;
- national and regional weather patterns; and
- threats of or outbreaks of war, hostilities, terrorist acts or other civil disturbances;

In addition, stock prices of technology companies in general, and for voice and data communications companies in particular, have experienced extreme price fluctuations in recent years which have often been unrelated to the operating performance of affected companies. We cannot assure you the market price of our common stock will not experience significant fluctuations in the future, including fluctuations unrelated to our performance.

Our CEO controls 19.9% of our Common Stock and is able to significantly influence matters requiring shareholder approval.

Steven G. Mihaylo, Inter-Tel's Chief Executive Officer and member of the Board of Directors, beneficially owned approximately 19.9% of the existing outstanding shares of the common stock of Inter-Tel as of June 30, 2005. As a result, he has the ability to exercise significant influence over all matters requiring shareholder approval. In addition, the concentration of ownership could have the effect of delaying or preventing a change in control of Inter-Tel.

Changes in stock option accounting rules may adversely impact our reported operating results prepared in accordance with generally accepted accounting principles, our stock price and our competitiveness in the employee marketplace.

Technology companies like ours have a history of using broad based employee stock option programs to hire, provide incentives for and retain our workforce in a competitive marketplace. Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123") allowed companies the choice of either using a fair value method of accounting for options, which would result in expense recognition for all options granted, or using an intrinsic value method, as prescribed by Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" (APB 25), with a pro forma disclosure of the impact on net income (loss) of using the fair value option expense recognition method. We have elected to apply APB 25 and accordingly we generally do not recognize any expense with respect to employee stock options as long as such options are granted at exercise prices equal to the fair value of our Common Stock on the date of grant.

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 based on their fair values beginning with the Company's fiscal year beginning January 1, 2006. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition.

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Under SFAS 123R, we must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at date of adoption. The transition methods include prospective and retroactive adoption options. Under the retroactive option, prior periods may be restated either as of the beginning of the year of adoption or for all periods presented. The prospective method requires that compensation expense be recorded for all unvested stock options and restricted stock at the beginning of the first quarter of adoption of SFAS 123R, while the retroactive methods would record compensation expense for all unvested stock options and restricted stock beginning with the first period restated. 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.

We have not yet determined the method of adoption or the effect of adopting SFAS 123R, and we have not determined whether the adoption will result in amounts that are similar to the current pro forma disclosures under SFAS 123. 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.

Risks Related to Our Industry

Reductions in spending on enterprise communications equipment may materially and adversely affect our business.

The overall economic slowdown of the last several years has had and may continue to have a harmful effect on the market for enterprise communications equipment. Our customers have reduced significantly their capital spending on communications equipment in an effort to reduce their own costs and bolster their revenues. The market for enterprise communications equipment may only grow at a modest rate or possibly not grow at all, and our financial performance has been and may continue to be materially and adversely affected by the reductions in spending on enterprise communications equipment.

The emerging market for IP network telephony is subject to market risks and uncertainties that could cause significant delays and expenses.

The market for IP network voice communications products has begun to develop only recently, is evolving rapidly and is characterized by an increasing number of market entrants who have introduced or developed products and services for Internet or other IP network voice communications. As is typical of a new and rapidly evolving industry, the demand for and market acceptance of, recently introduced IP network products and services are highly uncertain. We cannot assure you that IP voice networks will become widespread. Even if IP voice networks become more widespread in the future, we cannot assure that our products, including the IP telephony features of the *Axxess* systems and Inter-Tel 5000 Network Communication Solutions, our IP endpoints and IP applications will successfully compete against other market players and attain broad market acceptance.

Moreover, the adoption of IP voice networks and importance of development of products using industry standards such as MGCP and SIP, generally require the acceptance of a new way of exchanging information. In particular, enterprises that have already invested substantial resources in other means of communicating information may be reluctant or slow to adopt a new approach to communications. If the market for IP network voice communications fails to develop or develops more slowly than we anticipate, our IP network telephony products could fail to achieve market acceptance, which in turn could significantly harm our business, financial condition and operating results. This growth may be inhibited by a number of factors, such as quality of infrastructure; security concerns; equipment, software or other technology failures; regulatory encroachments; inconsistent quality of service; poor voice quality over IP networks as compared to circuit-switched networks; and lack of availability of cost-effective, high-speed network capacity. Moreover, as IP-based data communications and telephony usage grow, the infrastructure used to support these IP networks, whether public or private, may not be able to support the demands placed on them and their performance or reliability may decline. The technology that allows voice and facsimile communications over the Internet and other data networks, and the delivery of other value-added services, is still in the early stages of development.

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Government regulation of third party long distance and network service entities on which we rely may harm our business.

Our supply of telecommunications services and information depends on several long distance carriers, RBOCs, local exchange carriers, or LECs, and competitive local exchange carriers, or CLECs. We rely on these carriers to provide local and long distance services, including voice and data circuits, to our customers and to provide us with billing information. Long distance services are subject to extensive and uncertain governmental regulation on both the federal and state level. We cannot assure you that the increase in regulations will not harm our business. Our current contracts for the resale of services through long distance carriers include multi-year periods during which we have minimum use requirements and/or costs. The market for long distance services is experiencing, and is expected to continue to experience significant price competition, and this may cause a decrease in end-user rates. We cannot assure you that we will meet minimum use commitments, that we will be able to negotiate lower rates with carriers if end-user rates decrease or that we will be able to extend our contracts with carriers at favorable prices. If we are unable to secure reliable Network Services from certain long distance carriers, RBOCs, LECs and CLECs, or if these entities are unwilling or unable to provide telecommunications services and billing information to us on favorable terms, our ability to expand our own Network Services will be harmed. Carriers that provide telecommunications services to us may also experience financial difficulties, up to and including bankruptcies, which could harm our ability to offer telecommunications services.

Consolidation within the telecommunications industry could increase competition and adversely affect our business.

There has been a trend in the telecommunications industry toward consolidation and we expect this trend to continue as the industry evolves. As a result of this consolidation trend, new stronger companies may emerge that have improved financial resources, enhanced research and development capabilities and a larger and more diverse customer base. The changes within the telecommunications industry may adversely affect our business, operating results and financial condition.

Terrorist activities and resulting military and other actions could harm our business.

Terrorist attacks in New York and Washington, D.C. in September of 2001 disrupted commerce throughout the world. The continued threat of terrorism, the conflict in Iraq and the potential for additional military action and heightened security measures in response to these threats may continue to cause significant disruption to commerce throughout the world. To the extent that disruptions result in a general decrease in corporate spending on information technology or advertising, our business and results of operations could be harmed. We are unable to predict whether the conflict in Iraq and its aftermath, the threat of terrorism or the responses thereto will result in any long-term commercial disruptions or if such activities or responses will have a long-term adverse effect on our business, results of operations or financial condition. Additionally, if any future terrorist attacks were to affect the operation of the Internet or key data centers, our business could be harmed. These and other developments arising out of the potential attacks may make the occurrence of one or more of the factors discussed herein more likely to occur.

We Are Exposed To Increased Costs And Risks Associated With Compliance With Changing Laws, Regulations And Standards In General, and Specifically With Increased And New Regulation Of Corporate Governance And Disclosure Standards.

We are spending an increased amount of management time and external resources to comply with existing and changing laws, regulations and standards in general, and specifically relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new SEC regulations, PCAOB and Nasdaq Stock Market rules, as well as commercial dealings with other government entities. In particular, Section 404 of the Sarbanes-Oxley Act of 2002 requires management's annual review and evaluation of our internal control systems, and attestations of the effectiveness of these systems by our management and by our independent auditors. We completed our documentation and testing of our internal control systems and procedures as required for 2004 and continue to monitor our internal controls during 2005. This process required us to hire additional personnel and use outside advisory services and resulted in additional accounting and legal expenses. The results of the documentation and testing for

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2004 indicated that we had adequate internal controls over financial reporting, and we believe that such controls have continued to be effective during 2005. However, if in the future our chief executive officer, chief financial officer or independent auditors determine that our controls over financial reporting are not effective as defined under Section 404, investor perceptions of Inter-Tel may be adversely affected and could cause a decline in the market price or our stock. Failure to comply with other existing and changing laws, regulations and standards could also adversely affect the Company.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The following discussion about our market risk disclosures involves forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements. We are exposed to market risk related to changes in interest rates and foreign currency exchange rates. We do not use derivative financial instruments.

INVESTMENT PORTFOLIO. We do not use derivative financial instruments in our non-trading investment portfolio. Inter-Tel maintains a portfolio of highly liquid cash equivalents. Inter-Tel places its investments in instruments that meet high credit quality standards, as specified in our investment policy guidelines.

The Company also maintains short-term investments. Those investments that are classified as available for sale have been recorded at fair value, which approximates cost. Those investments that are classified as held-to-maturity have been recorded at cost and amortized to face value. Short-term investments include certificates of deposit, auction rate certificates, auction rate preferred securities, municipal preferred securities, federal agency issues and mutual funds. The auction rate securities 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-four (34) years. The 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. Given the short-term nature of the majority of these investments, and that we have no borrowings outstanding, we are not subject to significant interest rate risk.

LEASE PORTFOLIO. We offer to our customers lease financing and other services, including our Total Solutions program, through our Inter-Tel Leasing subsidiary. We fund these programs in part through the sale to financial institutions of rental payment streams under the leases. Upon the sale of the rental payment streams, we continue to service the leases and maintain limited recourse on the leases. We maintain reserves for loan losses on all leases based on historical loss experience, past due accounts and specific account analysis. Although to date we have been able to resell the rental streams from leases under our lease programs profitably and on a substantially current basis, the timing and profitability of lease resales could impact our business and operating results, particularly in an environment of fluctuating interest rates and economic uncertainty. If we were required to repurchase rental streams and realize losses thereon in amounts exceeding our reserves, our operating results could be materially adversely affected. See "Liquidity and Capital Resources" and "Critical Accounting Policies and Estimates" in Management's Discussion and Analysis for more information regarding our lease portfolio and financing.

IMPACT OF FOREIGN CURRENCY RATE CHANGES. We invoice the customers of our international subsidiaries primarily in the local currencies of our subsidiaries for product and service revenues. Inter-Tel is exposed to foreign exchange rate fluctuations as the financial results of foreign subsidiaries are translated into U.S. dollars in consolidation. The impact of foreign currency rate changes have historically been insignificant.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of disclosure controls and procedures. Except as discussed in the following paragraph, our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and

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15d-15(e) under the Securities Exchange Act of 1934, as amended, or the "Exchange Act") as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our management, including our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are designed, and are effective to give reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms and to ensure that information required to be disclosed in the reports filed or submitted under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, in a manner that allows timely decisions regarding required disclosure.

On February 28, 2005, the Company completed the acquisition of Lake. The recorded cost of the acquisition including capitalized transaction costs was $28.7 million. Net revenues from the Lake subsidiary included in the consolidated net income for the quarter were $7.9 million. See Note C to the Condensed Consolidated Financial Statements for further discussion of this acquisition. We have not completed our evaluation of the design and operation of the disclosure controls and procedures for this consolidated subsidiary as of June 30, 2005. We expect to complete such evaluation prior to the end of 2005.

Changes in internal controls over financial reporting. There were no changes in our internal controls over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting. However, management did identify a control deficiency related to our compliance with certain terms included in our contract with the U.S. General Services Administration (GSA). We are implementing changes to and refining our controls and processes for complying with the terms of the GSA agreement in order to correct the deficiency. See further discussion in Note A of notes to the Condensed Consolidated Financial Statements included herein.

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INTER-TEL, INCORPORATED AND SUBSIDIARIES

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are involved from time to time in litigation incidental to our business. We believe that the outcome of current litigation will not have a material adverse effect upon our business, financial condition or results of operations and will not disrupt our normal operations.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Board Authorization to Repurchase up to $75 Million of Inter-Tel Stock. On February 15, 2005, Inter-Tel announced that its Board of Directors approved a stock repurchase program, with no stated expiration date, in which Inter-Tel may purchase up to $75 million of its Common Stock in the open market from time to time, depending upon general market conditions, the 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. The Company repurchased 716,500 shares of its Common Stock pursuant to the Plan during the Company's second fiscal quarter of 2005.

ISSUER PURCHASES OF EQUITY SECURITIES

Period	(a) Total Number of Shares (or Units) Purchased	(b) Average Price Paid per Share (or Unit)	(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
April 1 to April 30	None	N/A	None	
May 1 to May 31	716,500	$19.228	716,500	
June 1 to June 30	None	N/A	None	
Total	716,500	$19.228	716,500	$61,223,000(1)

(1) On February 15, 2005, the Board of Directors approved and the Company announced a plan to repurchase up to $75 million of the common stock of the Company.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES - Not Applicable

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Our Annual Meeting of Shareholders was held April 26, 2005 (the Annual Meeting). On March 23, 2005 we mailed a Proxy Statement, pursuant to Regulation 14A under the Securities Exchange Act of 1934, as amended, to our shareholders to solicit their votes regarding the following matters that were discussed and approved by our shareholders at our Annual Meeting:

1. Election of Directors: Steven G. Mihaylo, J. Robert Anderson, Alexander L. Cappello, Jerry W. Chapman, Gary D. Edens, C. Roland Haden and Agnieszka Winkler were elected to serve as directors until the 2006 Annual Meeting of Shareholders. The votes were as follows:

Nominee	For:	Against:	Abstain:
Steven G. Mihaylo	25,091,538	201,099	—
J. Robert Anderson	25,157,084	135,553	—
Alexander L. Cappello	25,165,771	126,866	—

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Nominee	For:	Against:	Abstain:
Jerry W. Chapman	23,370,781	1,921,856	—
Gary D. Edens	24,751,348	541,289	—
C. Roland Haden	25,093,143	199,494	—
Agnieszka Winkler	25,166,863	125,774	—

2. The shareholders voted on and approved a proposal to ratify the appointment of Ernst & Young LLP to act as the independent auditors to audit our and our subsidiaries' financial statements for the year 2005. The votes were as follows:

	For:	Against:	Abstain:
Proposal to ratify the appointment of independent auditors	25,090,625	193,504	8,508

3. The shareholders also voted on and approved a proposal to transact such other business as may properly come before the meeting or any adjournment thereof.

	For:	Against:	Abstain:
Proposal to transact such other business that may come before the meeting or adjournment thereof	14,283,367	10,864,673	144,597

ITEM 5. OTHER INFORMATION - Not Applicable.

ITEM 6. EXHIBITS:

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

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

Exhibit 32.1: Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Exhibit 32.2: Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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SIGNATURES

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

INTER-TEL, INCORPORATED

August 8, 2005

/s/ Steven G. Mihaylo
Steven G. Mihaylo
Chief Executive Officer

August 8, 2005

/s/ Kurt R. Kneip
Kurt R. Kneip
Senior Vice President and
Chief Financial Officer

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EXHIBIT INDEX

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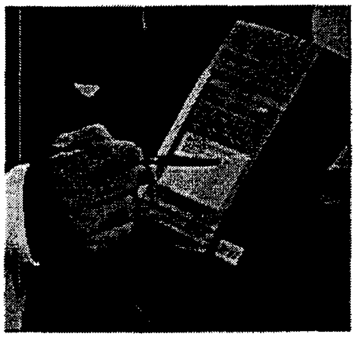
MANAGEMENT INFORMATION

investor relations | Executives



Steven G. Mihaylo

Chairman of the Board and Chief Executive Officer

Steven G. Mihaylo founded Inter-Tel in Phoenix in 1969, beginning the 35-year odyssey that is Inter-Tel—evolving from simply providing business telephone systems to offering full-fledged managed services, helping businesses facilitate communications that increase business service and productivity.

Mr. Mihaylo's philosophy has always been to focus on the needs of the customer, growing Inter-Tel from a one-man shop to a global organization employing nearly 1900 people, and servicing more than 500,000 business customers through a network of 59 direct sales offices and over 350 authorized providers worldwide. In 1981, common shares of Inter-Tel stock were offered and are quoted on the NASDAQ national market system under the symbol INTL.

Mr. Mihaylo was born in Los Angeles, California. Industrious and determined even as a young boy, he landed his first job as a paper boy for the *Los Angeles Herald Examiner*—his penchant for selling taking root.

During three years of service in the United States Army, Mr. Mihaylo trained with the Southeast Signal School, the Army radio and radar technicians' school. Upon his discharge in 1964, he moved to Tempe, Arizona, and began working for Western Electric, the manufacturing arm of AT&T. Eventually promoted to field services engineer, Mr. Mihaylo worked on hardened-L carrier sites throughout the West. Returning to California in1966, Mr. Mihaylo attended Orange Coast College and California State University, Fullerton, completing a bachelor degree in accounting and finance in only 30 months.

In addition to his professional career, Mr. Mihaylo has served on the board of numerous community organizations including the Arizona Heart Foundation, Junior Achievement of Arizona, Arizona Museum of Science and Technology and the Arizona State University College of Business Dean's Council of 100. Mr. Mihaylo is also involved in the Karl Eller School of Entrepreneurial Studies at the University of Arizona and is on the advisory board of Junior Achievement of Central Arizona.

Craig W. Rauchle
Chief Operating Officer, Co-Chief Executive Officer and President
Mr. Rauchle was elected chief operating officer of Inter-Tel in August 2001, and is

responsible for all day-to-day operations of the company including sales, operations, customer service, order fulfillment, training, engineering, product direction and marketing.

Mr. Rauchle originally joined Inter-Tel in 1979 as branch general manager of the Denver Direct Sales Office, prior to which he was director of sales and marketing for American Business Communications—then an Inter-Tel competitor. In 1983 Mr. Rauchle was appointed the central region vice president and then western regional vice president and subsequently given the responsibility of directing all direct sales activities nationally. During this time he identified and acquired in excess of thirty direct sales and service offices, creating a nationwide presence for Inter-Tel; standardized the operations of these same offices; and transitioned Inter-Tel into a national company supporting customer needs across the United States thus increasing the awareness of Inter-Tel products nationally.

In 1990, Mr. Rauchle was appointed president of TCI Industries, a former wholly-owned subsidiary of Inter-Tel, Incorporated. He was named senior vice president in 1992, and in 1994 was named executive vice president. Currently, in addition to his role as COO, Mr. Rauchle is president of Inter-Tel Technologies, Inc., a wholly-owned sales subsidiary. He holds a bachelor of arts degree in Communications from the University of Denver.

Norman Stout

Chief Administrative Officer, Co-Chief Executive Officer, and Chief Strategy Officer

Mr. Stout began his tenure at Inter-Tel in 1994 as a director. Four years later, he joined Inter-Tel as executive vice president, chief administrative officer and president of Inter-Tel Software and Services. In his role, Mr. Stout leads the support functions (accounting, finance, internal audit, HR, legal, MIS and e-Business), R&D and technology, wholesale operations (including inventory design, procurement and distribution), international operations and leasing. In addition, he heads up financial analyst relations and strategic planning, including acquisitions.

Prior to his work with Inter-Tel, Mr. Stout served as chief operating officer for Oldcastle Architectural Products, and arrived in Phoenix to serve as president of Oldcastle West and Superlite Block, subsidiaries of Oldcastle Architectural Products. From 1986 to 1990, Mr. Stout served as chief executive officer for Boorhem-Fields Inc. of Dallas.

Mr. Stout, a certified public accountant, holds a masters of business administration degree from the University of Texas and a bachelor's degree in Accounting from Texas A&M, and is on the Board of Directors of Hypercom Corp., and is a former member of the Arizona Chamber of Commerce Board of Directors.

Jeff Ford

Chief Technology Officer and Division President

Mr. Ford began his career with Inter-Tel in 1983, while still in his senior year at Arizona State University. After graduating in 1984 with a bachelor's degree in Computer Systems Engineering, Mr. Ford worked as a software engineer and was on the development team of the GX-120, ESP and ESPDX. From 1989 through 1996, he led the software development of Inter-Tel's flagship Axxess® and Eclipse^{2TM} product lines, and beginning in 1996, Mr. Ford led Inter-Tel's entry into convergent technology with patented VoIP technology.

Mr. Ford's work progressed through engineering management and, in 1997 he was named chief technology officer. In 1998, he was additionally named president of Inter-Tel Integrated Systems, Inter-Tel's development, production and wholesale distribution arm. In addition to his engineering degree, Mr. Ford holds an SEP certificate from the Stanford Graduate School of Business.

Kurt Kneip
Chief Financial Officer
Mr. Kneip joined Inter-Tel in May 1992 as a director of Corporate Tax. In September 1993, he was promoted to vice president and chief financial officer, and in 1994, he was elected secretary and treasurer. In 1996, he was elected assistant treasurer.

Before joining Inter-Tel, Mr. Kneip, a certified public accountant, spent seven years with the accounting firms of Ernst & Young and KPMG Peat Marwick. He holds a master's degree in professional accountancy from the University of South Dakota and a bachelor's degree in commercial economics from South Dakota State University.

Jon Klassen
Chief Information Officer
Mr. Klassen joined Inter-Tel as the chief information officer in 1999. Prior to that, he spent five years as a senior manager at Salt River Project. He also served as Worldcom's director of application development for seven years. Before joining the technology sector, Mr. Klassen worked in the aerospace industry.

He holds a computer science bachelor's degree from Brandon University in Brandon, Manitoba, Canada.

STATEMENT OF FINANCIAL CAPABILITY
Inter-Tel NetSolutions, Inc.

Applicant has sufficient financial capability to provide the requested service in the State of Florida and has sufficient financial capability to maintain the requested service and to meet its lease or ownership obligations. In support of Applicant's stated financial capability, a copy of Inter-Tel Incorporated' s Form 10-Q for the quarter ended June 30, 2005 is attached to its application. Applicant is a wholly owned operating subsidiary of Inter-Tel Incorporated. Applicant intends to fund the provision of service through internally generated cash flow. Applicant also has the ability to borrow funds, if required, based upon its financial capabilities, to provide service in the State of Florida.

STATEMENT REGARDING PREVIOUS ALEC REVOCATION

Applicant's previous ALEC certification was granted in Docket No. 971196 pursuant to final order, dated December 12, 1997. The Commission initiated Docket No. 981979, Cancellation by Florida Public Service Commission of Alternative Local Exchange Telecommunications Certificate No. 5285 issued to Inter-Tel NetSolutions, Inc. for violation of Rule 25-4.0161, F.A.C., Regulatory Assessment Fees; Telecommunications Companies. Applicant paid all past due fees, including penalties and interest, and paid a settlement amount to the Commission, and the Docket was closed on August 17, 1999, and certificate was not cancelled.

On February 22, 2000, Staff Initiated show cause proceedings against Inter-Tel NetSolutions, Inc. for apparent violation of Rule 25-4.043, FAC, Response to Commission Staff Inquiries. The Docket No. 000228-TX was amended to failure to provide Commission with access to information in accordance with Section 364.183. On May 30, 2000, Applicant's ALEC certificate was cancelled and the Docket was closed.

Please note that the Company has never operated in the State of Florida as a competitive local exchange company. Applicant was granted a certificate to interexchange telecommunications service in Docket No. 91-0155. The Applicant has been in compliance with all Commission orders, rules and regulations related to its interexchange certificate.

The Applicant will continue to be in compliance with Florida requirements if it is granted a new ALEC certificate, in the same manner in which it has complied with IXC certificate requirements. The compliance functions have been reorganized, and the company is aware of its ongoing obligations, and commits to the Commission to abide by such obligations.

In order to resolve all outstanding issues in Docket No. 000228-TX, Applicant is willing to offer a settlement in the amount of $7,500 to the Commission.