SONIC FOUNDRY INC
Form S-3/A
January 08, 2010
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As filed with the Securities and Exchange Commission on January 8, 2010

Registration No. 333-163701

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Amendment No. 1

to

FORM S-3

REGISTRATION STATEMENT

UNDER

THE SECURITIES ACT OF 1933

SONIC FOUNDRY, INC.

(Exact Name of Registrant as specified in its charter)

Maryland	**39-1783372**
(State of Incorporation)	**(I.R.S. Employer Identification No.)**

222 West Washington Avenue

Madison, WI 53703

(608) 443-1600

(Address, including zip code, and telephone number, including area code,

of Registrant s principal executive offices)

RIMAS BUINEVICIUS

Chairman and Chief Executive Officer

222 West Washington Avenue

Madison, WI 53703

(608) 443-1600

(Name, address, including zip code, and

telephone number, including area code,

of agent for service)

Copies to:

Frederick H. Kopko, Jr., Esq.

McBreen & Kopko

20 N. Wacker Dr., Suite 2520

Chicago, IL 60606

Approximate date of commencement of proposed sale to the public: From time to time after this Registration Statement becomes effective.

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If the only securities being registered on this Form are being offered pursuant to dividend or interest reinvestment plans, please check the following box. ¨

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered only in connection with dividend or interest reinvestment plans, check the following box. x

If this form is filed to register additional securities for an Offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same Offering. ¨

If this form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ¨

If this Form is at registration statement pursuant to General Instruction I.D. or a post-effective amendment thereto that shall become effective upon filing with the Commission pursuant to Rule 462(e) under the Securities Act, check the following box. ¨

If this Form is a post-effective amendment to a registration statement filed pursuant to General Instruction I.D. filed to register additional securities or additional classes of securities pursuant to Rule 413(b) under the Securities Act, check the following box. ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company. See the definitions of large accelerated filer , accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one)

¨ Large accelerated filer	¨ Accelerated filer	¨ Non- accelerated filer (Do not check if a smaller reporting company)	x Smaller reporting company

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CALCULATION OF REGISTRATION FEE

Title of Each Class of Securities to be Registered	Amount to be Registered	Proposed Maximum Aggregate Offering Price	Amount of Registration Fee
Common Stock $.01 par value (1)	900,000(2)(3)	$ 4,545,000(4)	$ 253.61(5)

(1) All share and price amounts set forth herein reflect a one-for-ten reverse split of the Registrant s common stock, effective November 16, 2009.
(2) On December 14, 2006, the commission declared effective Registration Number 333-138769 covering 1,200,000 of the Company s common stock. 900,000 shares remain unsold from that registration statement and are included in this filing.
(3) Pursuant to General Instructions I.B.6, the market value of securities to be registered in this offering is no more than one-third of the aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant. No securities were sold by or on behalf of the registrant pursuant to Instruction I.B.6 during the period of 12 calendar months preceding the date of this registration statement.
(4) Estimated solely for the purpose of calculating the registration fee pursuant to Rule 457(c), based on the average of the high and low sales price, of $5.05 as reported on the NASDAQ Capital Market on December 10, 2009.
(5) Previously paid in connection with Registration Statement No. 333-138769. See Note (2).

The registrant hereby amends this registration statement on such date or dates as may be necessary to delay its effective date until the registrant shall file a further amendment which specifically states that this registration statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the registration statement shall become effective, on such date as the Commission, acting pursuant to Section 8(a), may determine.

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The information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and it is not soliciting an offer to buy these securities in any state where this offer or sale is not permitted.

SUBJECT TO COMPLETION, DATED JANUARY 8, 2010

Prospectus

We may offer and sell from time to time up to an aggregate of 900,000 shares of our common stock, at prices and on terms that we will determine at the times of the offerings.

We will provide specific terms of the securities, including the offering prices, in one or more supplements to this prospectus. The supplements may also add, update or change information contained in this prospectus. You should read this prospectus and the prospectus supplement relating to the specific issue of securities carefully before you invest.

Our common stock is quoted on The Nasdaq Capital Market under the symbol SOFO .

Investing in our securities involves risks. See Risk Factors beginning on page 2.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The date of this Prospectus is January 8, 2010

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ABOUT THIS PROSPECTUS

Unless otherwise indicated or unless the context requires otherwise, all references in this prospectus to our company , we , our , us or similar references mean Sonic Foundry, Inc.

This prospectus is part of a registration statement that we filed with the Securities Exchange Commission, or SEC, utilizing a shelf registration process. Under this shelf process, we may, from time to time, sell up to 900,000 shares of our common stock in one or more offerings. We may not sell common stock until the registration statement filed with the SEC is effective. Each time we offer common stock, we will provide a prospectus supplement that will contain specific information about the terms of that offering. The prospectus supplement may also add, update or change information contained in this prospectus. You should read both this prospectus and any prospectus supplement together with additional information described under the heading Where You Can Find More Information .

You should rely only on the information contained or incorporated by reference in this prospectus and in any prospectus supplement. We have not authorized any other person to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it. We are not making offers to sell or solicitations to buy the securities in any jurisdiction in which an offer or solicitation is not authorized or in which the person making that offer or solicitation is not qualified to do so or to anyone to whom it is unlawful to make an offer or solicitation. You should not assume that the information in this prospectus or any prospectus supplement, as well as the information we previously filed with the SEC that we incorporate by reference in this prospectus supplement, is accurate as of any date other than its respective date. Our business, financial condition, results of operations and prospects may have changed since those dates.

RISK FACTORS

The occurrences or any of the following risks could materially and adversely affect our business, financial condition and operating results.

Economic conditions could materially adversely affect the Company.

The Company s operations and performance depend significantly on worldwide economic conditions. Uncertainty about current global economic conditions poses a risk as businesses, educational institutions and government entities may cancel or postpone spending in response to tighter credit, negative financial news, declines in income or asset values and/or reduced public sector funding, which could have a material negative effect on the demand for the Company s products and services and on the Company s financial condition and operating results.

The current financial turmoil affecting the banking system and financial markets have resulted in a tightening in the credit markets, a low level of liquidity in many financial markets, and extreme volatility in fixed income, credit, currency and equity markets. There could be a number of follow-on effects from the credit crisis on the Company s business, including insolvency of key suppliers resulting in products delays, inability of customers, including channel partners, to obtain credit to finance purchases of the Company s products and/or customer, including channel partner insolvencies; and inability of our channel partners and other customers to pay accounts receivable owed to us, or delays in the payment of such receivables. Additionally, if these economic conditions persist, our intangible assets may be impaired. If we determine that the fair value of intangible assets is less than its carrying value, we would then measure impairment based on a comparison of the implied fair value of the intangible assets with the carrying amount of the intangible assets. To the extent the carrying amount is greater than the implied fair value, we would record an impairment charge for the difference.

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Economic conditions may have a disproportionate affect on the sale of our products.

Many of our customers will look at the total A/V equipment and labor cost to outfit a typical conference room or lecture hall as one amount for budgetary purposes. Consequently, although our products represent only a portion of the total cost, the entire project of outfitting a room or conference hall may be considered excessive and may not survive budgetary constraints. Alternatively, our resellers may modify their quotes to end customers by eliminating our products or substituting less expensive competitive products in order to win opportunities within budget constraints. Event service partners may similarly suggest that customers eliminate recording and webcasting as a means of reducing event cost. Consequently, declines in spending by government, educational or corporate institutions due to budgetary constraints may have a disproportionate impact on the Company and result in a material adverse impact on our financial condition.

We may need to raise additional capital if we do not quickly become profitable.

At September 30, 2009 we had cash of $2.6 million and availability under our line of credit facility with Silicon Valley Bank of $0.8 million. The Company has historically financed its operations primarily through cash from sales of equity securities, cash from operations, and to a limited extent, through bank credit facilities. The Company has incurred losses from operations in each of the last three fiscal years. In response to the recurring operating losses, the Company initiated cost reduction efforts in January 2008. These efforts achieved a reduction in quarterly operating expenses of approximately 24%. The Company anticipates operating expenses to remain at or near these reduced levels in fiscal 2010. The Company achieved billings growth in fiscal 2009 of approximately 8% over 2008 and believes its cash position is adequate to accomplish its business plan through at least the next twelve months even if billings are unchanged from fiscal 2009.

We may evaluate further operating or capital lease opportunities to finance equipment purchases in the future and expect to utilize the Company s revolving line of credit to support working capital needs. While the Company anticipates that it will be in compliance with all provisions of the agreement, there can be no assurance that the existing Loan Agreement will remain available to the Company nor that additional financing will be available or on terms acceptable to the Company.

The business environment is not currently conducive to raising additional debt or equity financing and may not improve in the near term. If we borrow money, we may incur significant interest charges, which could harm our profitability. Holders of debt would also have rights, preferences or privileges senior to those of existing holders of our common stock. If we raise additional equity, the terms of such financing may dilute the ownership interests of current investors and cause our stock price to fall significantly. We may not be able to secure financing upon acceptable terms, if at all. If we cannot raise funds on acceptable terms, we may not be able to develop or enhance our products, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements, which could seriously harm our business, operating results, and financial condition.

We have a history of losses.

For the year ended September 30, 2009, we had a gross margin of $14.2 million on revenue of $18.6 million with which to cover selling, marketing, product development and general administrative costs. Our selling, marketing, product development and general administration costs have historically been a significant percentage of our revenue, due partly to the expense of developing leads and the relatively long period required to convert leads into sales associated with selling products that are not yet considered mainstream

technology investments. For the years ended September 30, 2009 and 2008 our cash used in operations was ($1.5) and ($3.9) million, respectively. Although we expect our operations to continue to improve in fiscal 2010, we may never achieve or sustain profitability on a quarterly or annual basis.

We could lose revenues if there are changes in the spending policies or budget priorities for government funding of colleges, universities, schools and other education providers.

Most of our customers and potential customers are public colleges, universities, schools and other education providers who depend substantially on government funding. Accordingly, any general decrease, delay or change in federal, state or local funding for colleges, universities, schools and other education providers could cause our current and potential customers to reduce their purchases of our products and services, or to decide not to renew service contracts, either of which could cause us to lose revenues. In addition, a specific reduction in governmental funding support for products such as ours would also cause us to lose revenues. The severe economic downturn experienced in the U.S. and globally has caused many of our clients to experience severe budgetary pressures, which has and will likely continue to have a negative impact on sales of our products. Continuing unfavorable economic conditions may result in further budget cuts and lead to lower overall spending, including information technology spending, by our current and potential clients, which may cause our revenues to decrease. In addition, our accounts receivable may increase and the relative aging of our receivables may deteriorate if our clients delay or are unable to make their payments due to the tightening of credit markets and the lack of available funding. Also, because many of our clients begin their fiscal year in July or later, easing of budgetary pressure may not occur until late fiscal 2010.

If we are unable to comply with NASDAQ s continued listing requirements, our common stock could be delisted from the NASDAQ Capital Market.

In March 2008, our common stock failed to maintain a minimum bid price of $1.00 for at least 10 consecutive days, which caused our stock price to fail to meet one of the minimum standards required by the NASDAQ Stock Market for continued listing as a NASDAQ Global Market security. On March 10, 2008 we received a letter from NASDAQ indicating that we need to regain compliance with the minimum bid price requirement by September 8, 2008 in order to remain on the NASDAQ Global Market. On September 9, 2008 we were notified by NASDAQ that we had failed to regain compliance with the minimum bid price during the 180 days provided and our securities were therefore subject to delisting from the NASDAQ Global Market. In response, we applied for and were notified on September 12, 2008 by NASDAQ that NASDAQ approved our request to transfer the listing of our shares to the NASDAQ Capital Market. Transfer to the NASDAQ Capital Market and compliance with its initial listing standards afforded an additional 180 day period for our stock to attain the minimum $1.00 bid price for at least 10 consecutive business days until March 9, 2009. We received notice from NASDAQ on October 22, 2008, December 23, 2008 and March 24, 2009 that NASDAQ had determined to extend the suspension of the minimum bid price for additional 90 day periods. On July 14, 2009, we received notice from NASDAQ that enforcement of the minimum bid price requirement would be reinstated on August 3, 2009. The Company had 141 calendar days remaining in its bid price compliance period when suspension began, extending the period in which to regain compliance to December 21, 2009. On November 2, 2009 the Company notified NASDAQ that it intended to execute a reverse split of its common shares in the ratio of one for ten, effective November 16, 2009. On December 2, 2009, the Company received notice from NASDAQ that the Company had regained compliance with the minimum bid requirement. While there is no pending listing compliance issue with NASDAQ, there is no assurance that the Company will not fail one or more listing requirements in the future. If our stock is delisted, it may have a material adverse effect on the price of our common stock and the levels of liquidity currently available to our stockholders. Delisting would also make it more difficult for us to raise capital in the future or impact customer confidence. If our common stock is removed from the NASDAQ Capital

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Market, an investor could find it more difficult to dispose of, or to obtain accurate quotations as to the market value of, our common shares. Additionally, our stock may then be subject to penny stock regulations.

If a sufficient number of customers do not accept our products, our business may not succeed.

We cannot predict how the market for our products will develop, and part of our strategic challenge will be to convince enterprise customers of the productivity, improved communications, cost savings, suitability and other benefits of our products. Our future revenue and revenue growth rates will depend in large part on our success in delivering these products effectively, creating market acceptance for these products, and meeting customer s needs for new or enhanced products. If we fail to do so, our products will not achieve widespread market acceptance, and we may not generate significant revenue to offset our product development and selling and marketing costs, which will hurt our business.

We may not be able to innovate to meet the needs of our target market.

Our future success will continue to depend upon our ability to develop new products or product enhancements that address future needs of our target markets and to respond to these changing standards and practices. Our revenue could be reduced if we do not capitalize on our current market leadership by timely developing innovative new products or product enhancements that will increase the likelihood that our products will be accepted in preference to the products of our current and future competitors.

Multiple unit sales may fail to materialize.

We need to sell multiple units to educational, corporate and government institutions in order to sell most efficiently and become profitable. In fiscal 2009, 62% of revenue was to existing customers compared to 59% in fiscal 2008. In particular, selling multiple units to corporate customers has lagged results achieved in the higher education market; consequently, we have allocated more resources to the higher education market. While we have addressed a strategy to leverage existing customers and close multiple unit transactions, a customer may choose not to make expected purchases of our products. The failure of our customers to make expected purchases will harm our business.

If our marketing and lead generation efforts are not successful, our business will be harmed.

We believe that continued marketing efforts will be critical to achieve widespread acceptance of our products. Our marketing campaign may not be successful given the expense required. For example, failure to adequately generate and develop sales leads could cause our future revenue growth to decrease. In addition, our inability to generate and cultivate sales leads into large organizations, where there is the potential for significant use of our products, could have a material effect on our business. We may not be able to identify and secure the number of strategic sales leads necessary to help generate marketplace acceptance of our products. If our marketing or lead-generation efforts are not successful, our business and operating results will be harmed.

The length of our sales and deployment cycle is uncertain, which may cause our revenue and operating results to vary significantly from quarter to quarter and year to year.

During our sales cycle, we spend considerable time and expense providing information to prospective customers about the use and benefits of our products without generating corresponding revenue. Our expense levels are relatively fixed in the short-term and based in part on our expectations of future revenue. Therefore, any delay in our sales cycle could cause significant variations in our operating results, particularly because a relatively small number of customer orders represent a large portion of our revenue.

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Our largest potential sources of revenue are educational institutions, large corporations and government entities that often require long testing and approval processes before making a decision to purchase our products, particularly when evaluating our products for inclusion in new buildings under construction or high dollar transactions. In general, the process of selling our products to a potential customer may involve lengthy negotiations, collaborations with consultants, designers and architects, time consuming installation processes and changes in network infrastructure in excess of what we or our VARs are able to provide. As a result, our sales cycle is unpredictable. Our sales cycle is also subject to delays as a result of customer-specific factors over which we have little or no control, including budgetary constraints and internal approval procedures.

Our products are aimed toward a broadened user base within our key markets and these products are relatively early in their product life cycles. We cannot predict how the market for our products will develop and part of our strategic challenge will be to convince targeted users of the productivity, improved communications, cost savings and other benefits. Accordingly, it is likely that delays in our sales cycles with these products will occur and this could cause significant variations in our operating results.

Sales of some of our products have experienced seasonal fluctuations which have affected sequential growth rates for these products, particularly in our first fiscal quarter. For example, there is generally a slowdown for sales of our products in the higher education and corporate markets in the first fiscal quarter of each year. Seasonal fluctuations could negatively affect our business, which could cause our operating results to fall short of anticipated results for such quarters.

Our operating results are hard to predict as a significant amount of our sales typically occur at the end of a quarter and the mix of product and service orders may vary significantly.

Revenue for any particular quarter is extremely difficult to predict with any degree of certainty. We typically ship products within a short time after we receive an order and therefore, we typically do not have an order backlog with which to estimate future revenue. In addition, orders from our channel partners are based on the level of demand from end-user customers. Any decline or uncertainty in end-user demand could negatively impact end-user orders, which could in turn significantly negatively affect orders from our channel partners in any given quarter. Accordingly, our expectations for both short and long-term future revenue is based almost exclusively on our own estimate of future demand based on the pipeline of sales opportunities we manage, rather than on firm channel partner orders. Our expense levels are based largely on these estimates. In addition, the majority of our orders are received in the last month of a quarter; thus, the unpredictability of the receipt of these orders could negatively impact our future results. We historically have received all or nearly all our channel partner orders in the last month of a quarter and often in the last few days of the quarter. Accordingly, any significant shortfall in demand for our products in relation to our expectations would have an adverse impact on our operating results.

We have experienced growing demand for our hosting and event services as well as a growing preference from our corporate customers in purchasing our solution as a service (SaaS). As a result, we expect that service billings as a percentage of total billings will continue to grow which we believe will ultimately lead to higher gross margins and more recurring revenue. The percentage of billings represented by service is also likely to fluctuate from quarter to quarter due to seasonality of event services and other factors. Since services are typically billed in advance of providing the service, revenue is initially deferred, leading to reduced current period revenue with a corresponding negative impact to profits or losses in periods of significant growth in billings for deferred services. An increase, or significant fluctuation, in service billings as a percentage of total billings may therefore lead to a temporary decline in our reported revenue.

We are subject to risks associated with our channel partners   product inventories and product sell-through.

We sell a significant amount of our products to Synnex, Starin and other channel partners who maintain their own inventory of our products for sale to dealers and end-users. If these channel partners are unable to sell an adequate amount of their inventory of our products in a given quarter to dealers and end-users or if channel partners decide to decrease their inventories for any reason, such as a recurrence of global economic uncertainty and downturn in technology spending, the volume of our sales to these channel partners and our revenue would be negatively affected. In addition, if channel partners decide to purchase more inventory, due to product availability or other reasons, than is required to satisfy end-user demand or if end-user demand does not keep pace with the additional inventory purchases, channel inventory could grow in any particular quarter, which could adversely affect product revenue in the subsequent quarter. In addition, we also face the risk that some of our channel partners have inventory levels in excess of future anticipated sales. If such sales do not occur in the time frame anticipated by these channel partners for any reason, these channel partners may substantially decrease the amount of product they order from us in subsequent periods, which would harm our business.

If stock balancing returns or price adjustments exceed our reserves, our operating results could be adversely affected.

We provide some of our distributors with stock balancing return rights, which generally permit our distributors to return products, subject to ordering an equal dollar amount of alternate products. We also provide price protection rights to most of our distributors. Price protection rights require that we grant retroactive price adjustments for inventories of our products held by distributors if we lower our prices for those products within a specified time period. To cover our exposure to these product returns and price adjustments, we establish reserves based on our evaluation of historical product trends and current marketing plans. However, we cannot be assured that our reserves will be sufficient to cover our future product returns and price adjustments. If we inadequately forecast reserves, our operating results could be adversely affected.

We depend in part on the success of our relationships with third-party resellers and integrators.

Our success depends on various third-party relationships, particularly with our international and events services operations. The relationships include third party resellers as well as system integrators that assist with implementations of our products and sourcing of our products and services. Identifying partners, negotiating and documenting relationships with them and maintaining their relationships require significant time and resources from us. In addition, our agreements with our resellers and integrators are typically non-exclusive and do not prohibit them from working with our competitors or form offering competing products or services. Our competitors may be effective in providing incentives to third parties to favor their products or services. If we are unsuccessful in establishing or maintaining our relationships with these third parties, our ability to compete in the marketplace or to maintain or grow our revenue could be impaired and our operating results would suffer.

Manufacturing disruption or capacity constraints would harm our business.

We subcontract the manufacture of our recorders to one third-party contract manufacturer and subcontract the manufacture of our rack-unit recorder and a proprietary component with another third-party contract manufacturer. Although we believe there are multiple sources of supply from other contract manufacturers as well as multiple suppliers of component parts required by the contract manufacturers, a short term disruption of supply of component parts or completed products near the end of a quarter would have a negative impact on our revenues. Moreover, any incapacitation of the manufacturing site due to

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destruction, natural disaster or similar events could result in a loss of product inventory. As a result of any of the foregoing, we may not be able to meet demand for our products, which could negatively affect revenues in the quarter of the disruption or longer depending upon the magnitude of the event, and could harm our reputation.

Our cash flow could fluctuate due to the potential difficulty of collecting our receivables.

A significant portion of our sales are fulfilled by VARs, regional distributors or master distributors. As an example, 29% of our billings in 2009 were to Synnex, a master distributor who fulfills demand from other distributors, VARs or end users. While our distributors and VARs typically maintain payment terms consistent with other end users, a delay in payment may occur as a result of a number of factors including changes in demand, general economic factors, financial performance, inventory levels or disputes over payments. Any delay from Synnex, or other large distributors or VARs could have a material impact on the collections of our receivables during a particular quarter.

Over the past year we have begun to expand the level of sales representation in Europe and Asia as well as other international regions. We offer credit terms to some of our international customers; however, payments tend to go beyond terms in certain countries. Therefore, as Europe, Asia and other international regions grow as a percentage of our revenue, accounts receivable balances will likely increase as compared to previous years.

Accounting regulations and related interpretations and policies, particularly those related to revenue recognition, cause us to defer revenue recognition into future periods for portions of our products and services.

Revenue recognition for our products and services is complex and subject to multiple sources of authoritative guidance as well as varied interpretations and implementation practices for such rules. These rules require us to defer revenue recognition in certain situations. Factors that are considered in revenue recognition include those such as vendor specific objective evidence (VSOE), the inclusion of other services and contingencies to payment terms. We expect that we will continue to defer portions of our product and service billings because of these factors. The amounts deferred may be significant and will vary each quarter depending on the mix of products sold in each market and geography, as well as the actual contract terms.

Additional changes in authoritative guidance or changes in practice in applying such rules could also cause us to defer the recognition of revenue to future periods or recognize lower revenue in a given period.

Because most of our service contracts are renewable on an annual basis, a reduction in our service renewal rate could significantly reduce our revenues.

Our clients have no obligation to renew their content hosting agreements, customer support contracts or other annual service contracts after the expiration of the initial period, which is typically one year, and some clients have elected not to do so. A decline in renewal rates could cause our revenues to decline. We have limited historical data with respect to rates of renewals, so we cannot accurately predict future renewal rates. Our renewal rates may decline or fluctuate as a result of a number of factors, including client dissatisfaction with our products and services, our failure to update our products to maintain their attractiveness in the market or budgetary constraints or changes in budget priorities faced by our clients.

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Because we generally recognize revenues ratably over the term of our service contracts, downturns or upturns in service transactions will not be fully reflected in our operating results until future periods.

We recognize most of our revenues from service contracts monthly over the terms of their agreements, which are typically 12 months, although terms can range from less than one month to over 36 months. As a result, much of the service revenue we report in each quarter is attributable to agreements entered into during previous quarters. Consequently, a decline in sales, client renewals, or market acceptance of our products in any one quarter will not necessarily be fully reflected in the revenues in that quarter, and will negatively affect our revenues and profitability in future quarters. This ratable revenue recognition also makes it difficult for us to rapidly increase our revenues through additional sales in any period, as revenues from new clients must be recognized over the applicable agreement term.

There is a great deal of competition in the market for our products, which could lower the demand for our products.

In the lecture capture and webcasting market we face competition from various companies that provide related, but different, communication technologies. These include:

- **Web conferencing** includes solutions from Adobe, Cisco (WebEx), Microsoft and Citrix. Although part of the overall online multimedia communications landscape, these solutions are designed primarily for collaborative communications versus one-to-many communications like Mediasite. Many organizations acknowledge that they need both technologies one-to-many webcasting and collaborative web conferencing to appropriately address their different communication requirements.

- **Video conferencing** includes solutions from Polycom, TANDBERG (now, Cisco) and Sony. These solutions are designed primarily for one-to-one or group communications with high levels of interactivity and collaboration. Like web conferencing, many organizations use both video conferencing and webcasting. Mediasite integrates with videoconferencing endpoints from Polycom and TANDBERG to record and manage interactive meetings, discussions and distance learning courses alongside other Mediasite content.

- **Authoring tools** include solutions like Accordent PresenterPLUS, Camtasia Studio and Microsoft Producer. Unlike webcasting, web conferencing or video conferencing, which are forms of online multimedia communication that capture and distribute/stream content, these solutions are production-oriented tools designed to create and edit multimedia content only. Some organizations will use these desktop tools to create training content by manually integrating existing audio, video, images, branding and other visual elements into a multimedia presentation which can then be published to a web or streaming server for distribution. This process can require a significant amount of production effort and user expertise in presentation authoring.

- **Online video services** and virtual meeting platforms include solutions from inXpo, Livestream, ON24, Stream57, Thomson Reuters, Unisfair and Wall Street Webcasting. These companies offer services or SaaS-based platforms that either allow audio and video to be captured from a presenter s computer (often with supporting materials uploaded in advance), produced streaming video services or 2D/3D virtual environments that may or may not include rich media webcasts.

Other vendors such as Echo360, Tegrity, Accordent Technologies and Panopto, provide lecture capture or webcasting capabilities, but differ in their technology approach, particularly in the lecture capture arena. Mediasite is an appliance- or room-based platform for lecture capture. It provides a full integrated system designed around an automated purpose-built recording appliance that captures, publishes and manages rich media content. Room-based appliances are capable of streaming live or on-demand and can leverage the full breadth of in-room audio/visual technology. Transparent recording automation means no presenter intervention which leads to the broadest end-user adoption across campus. A room-based platform like

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Mediasite also includes a complete content management platform for captured multimedia presentations. Other lecture capture solutions are implemented as software applications designed to capture and publish rich media content, but dependent upon a third-party content management platform, typically the institution s course management system. Software applications for lecture capture support on-demand streaming only and require in-room PC integration with varying levels of presenter intervention and recording knowledge which may lead to lower adoption rates throughout the campus. Lastly, laptop-resident desktop tools capture and publish non-rich media (limited video and presentation graphics). Like software applications they support on-demand streaming only and require a third-party content management platform. Desktop tools require the greatest degree of presenter intervention, technical confidence and support. While prevalent on many campuses, these three factors limit the practicality for campus-wide adoption.

The presence of these competitors could reduce the demand for our systems, and we may not have the financial resources to compete successfully.

If potential customers or competitors use open source software to develop products that are competitive with our products and services, we may face decreased demand and pressure to reduce the prices for our products.

The growing acceptance and prevalence of open source software may make it easier for competitors or potential competitors to develop software applications that compete with our products, or for customers and potential customers to internally develop software applications that they would otherwise have licensed from us. One of the aspects of open source software is that it can be modified or used to develop new software that competes with proprietary software applications, such as ours. Such competition can develop new software without the degree of overhead and lead time required by traditional proprietary software companies. As open source offerings become more prevalent, customers may defer or forego purchases of our products, which could reduce our sales and lengthen the sales cycle for our products or result in the loss of current customers to open source solutions. If we are unable to differentiate our products from competitive products based on open source software, demand for our products and services may decline, and we may face pressure to reduce the prices of our products, which would hurt our profitability.

Our customers may use our products to share confidential and sensitive information, and if our system security is breached, our reputation could be harmed and we may lose customers.

Our customers may use our products and services to share confidential and sensitive information, the security of which is critical to their business. Third parties may attempt to breach our security for customer hosted content or the networks of our customers. Customers may take inadequate security precautions with their sensitive information and may inadvertently make that information public. We may be liable to our customers for any breach in security, and any breach could harm our reputation and cause us to lose customers. In addition, customers are vulnerable to computer viruses, physical or electronic break-ins and similar disruptions, which could lead to interruptions, delays or loss of data. We may be required to expend significant capital and other resources to further protect against security breaches or to resolve problems caused by any breach, including litigation-related expenses if we are sued.

Operational failures in our network infrastructure could disrupt our remote hosting services, could cause us to lose clients and sales to potential clients and could result in increased expenses and reduced revenues.

Unanticipated problems affecting our network systems could cause interruptions or delays in the delivery of the hosting services we provide to some of our clients. We provide remote hosting through computer hardware, some of which is within our facility and some of which is currently located in a third-party co-

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location facility. We do not control the operation of this co-location facility. Lengthy interruptions in our hosting service could be caused by the occurrence of a natural disaster, power loss, vandalism or other telecommunications problems at the co-location facility or if this co-location facility were to close without adequate notice. We currently do not have adequate computer hardware and systems to provide alternative service for most of our hosted clients in the event of an extended loss of service at the co-location facility. We are not equipped to provide full disaster recovery to all of our hosted clients. If there are operational failures in our network infrastructure that cause interruptions, slower response times, loss of data or extended loss of service for our remotely hosted clients, we may be required to issue credits or pay penalties, current clients may terminate their contracts or elect not to renew them, and we may lose sales to potential clients. If we determine that we need additional hardware and systems, we may be required to make further investments in our network infrastructure.

The technology underlying our products and services is complex and may contain unknown defects that could harm our reputation, result in product liability or decrease market acceptance of our products.

The technology underlying our products is complex and includes software that is internally developed, software licensed from third parties and hardware purchased from third parties. These products may contain errors or defects, particularly when first introduced or when new versions or enhancements are released. We may not discover defects that affect our current or new applications or enhancements until after they are sold and our insurance coverage may not be sufficient to cover our complete liability exposure. Any defects in our products and services could:

- Damage our reputation;
- Cause our customers to initiate product liability suits against us;
- Increase our product development resources;
- Cause us to lose sales; and
- Delay market acceptance of our products.

If we are viewed only as a commodity supplier, our margins and valuations will shrink.

We need to provide value-added services in order to avoid being viewed as a commodity supplier. This entails building long-term customer relationships and developing features that will distinguish our products. Our technology is complex and is often confused with other products and technologies in the market place, including video conferencing, streaming and collaboration. If we fail to build long-term customer relationships and develop features that distinguish our products in the market place, our margins will shrink, and our stock may become less valued to investors.

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Our success depends upon the proprietary aspects of our technology.

Our success and ability to compete depend to a significant degree upon the protection of our proprietary technology. We currently have two U.S. patents that have been issued to us and four U.S. patent applications that are pending. We may seek additional patents in the future. Our current patent applications cover different aspects of the technology used in our products which is important to our ability to compete. However, it is possible that:

- our pending patent applications may not result in the issuance of patents;
- any patents acquired by or issued to us may not be broad enough to protect us;
- any issued patent could be successfully challenged by one or more third parties, which could result in our loss of the right to prevent others from exploiting the inventions claimed in those patents;
- current and future competitors may independently develop similar technology, duplicate our services or design around any of our patents; and
- effective patent protection, including effective legal-enforcement mechanisms against those who violate our patent-related assets, may not be available in every country in which we do or plan to do business.

We also rely upon trademarks, copyrights and trade secrets to protect our technology, which may not be sufficient to protect our intellectual property.

We also rely on a combination of laws, such as copyright, trademark and trade secret laws, and contractual restrictions, such as confidentiality agreements and licenses, to establish and protect our technology. We have registered seven U.S. and four foreign country trademarks. These forms of intellectual property protection are critically important to our ability to establish and maintain our competitive position. However,

- third parties may infringe or misappropriate our copyrights, trademarks and similar proprietary rights;
- laws and contractual restrictions may not be sufficient to prevent misappropriation of our technology or to deter others from developing similar technologies;
- effective trademark, copyright and trade secret protection, including effective legal-enforcement mechanisms against those who violate our trademark, copyright or trade secret assets, may be unavailable or limited in foreign countries;
- other companies may claim common law trademark rights based upon state or foreign laws that precede the federal registration of our marks; and
- policing unauthorized use of our services and trademarks is difficult, expensive and time-consuming, and we may be unable to determine the extent of any unauthorized use.

Reverse engineering, unauthorized copying or other misappropriation of our proprietary technology could enable third parties to benefit from our technology without paying us for it, which would significantly harm our business.

If other parties bring infringement or other claims against us, we may incur significant costs or lose customers.

Other companies may obtain patents or other proprietary rights that would limit our ability to conduct our business and could assert that our technologies infringe their proprietary rights. We could incur substantial costs to defend any legal proceedings, even if without merit, and intellectual property litigation could force us to cease using key technology, obtain a license, or redesign our products. In the course of our business, we

may sell certain systems to our customers, and in connection with such sale, we may agree to indemnify these customers from claims made against them by third parties for patent infringement related to these systems. In particular, claims are currently being made by holders of patents against educational institutions using streaming in their curriculum. We could be subject to similar claims, which could harm our business.

If we lose key personnel or fail to integrate replacement personnel successfully, our ability to manage our business could be impaired.

Our future success depends upon the continued service of our key management, technical, sales, and other critical personnel. Certain of our officers and certain of our other key personnel are employees-at-will, and we cannot assure that we will be able to retain them. Key personnel have left our company in the past, sometimes to accept employment with companies that sell similar products or services to existing or potential customers of ours. There will likely be additional departures of key personnel from time to time in the future and such departures could result in additional competition, loss of customers or confusion in the marketplace. The loss of any key employee could result in significant disruptions to our operations, including adversely affecting the timeliness of product releases, the successful implementation and completion of company initiatives, and the results of our operations. In particular, the loss of the services of our Chief Executive Officer, Rimas Buinevicius, or our co-founder and Chief Technology Officer, Monty Schmidt, would harm our business. Although we do have employment agreements with Messrs. Buinevicius and Schmidt, we do not have life insurance policies on any of our key employees. In addition, the integration of replacement personnel could be time consuming, may cause disruptions to our operations, and may be unsuccessful.

Because our business is susceptible to risks associated with international operations, we may not be able to maintain or increase international sales of our products.

International product and service billings ranged from 14% to 28% of our total billings in each of the past three years. Our international operations are expected to continue to account for a significant portion of our business in the future. However, in the future we may be unable to maintain or increase international sales of our products and services. International sales are subject to a variety of risks, including:

- difficulties in establishing and managing international distribution channels;
- difficulties in selling, servicing and supporting overseas products and in translating products into foreign languages;
- the uncertainty of laws and enforcement in certain countries relating to the protection of intellectual property or requirements for product certification or other restrictions;
- multiple and possibly overlapping tax structures;
- currency and exchange rate fluctuations; and
- economic or political changes in international markets.

We face risks associated with government regulation of the internet, and related legal uncertainties.

Currently, few existing laws or regulations specifically apply to the Internet, other than laws generally applicable to businesses. Many Internet-related laws and regulations, however, are pending and may be adopted in the United States, in individual states and local jurisdictions and in other countries. These laws may relate to many areas that impact our business, including encryption, network and information security, and the convergence of traditional communication services, such as telephone services, with Internet communications, taxes and wireless networks. These types of regulations could differ between countries and other political and geographic divisions both inside and outside the United States. Non-U.S. countries and political organizations may impose, or favor, more and different regulation than that which has been proposed in the United States, thus furthering the complexity of regulation. In addition,

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state and local governments within the United States may impose regulations in addition to, inconsistent with, or stricter than federal regulations. The adoption of such laws or regulations, and uncertainties associated with their validity, interpretation, applicability and enforcement, may affect the available distribution channels for, and the costs associated with, our products and services. The adoption of such laws and regulations may harm our business.

Exercise of outstanding options and warrants will result in further dilution.

The issuance of shares of common stock upon the exercise of our outstanding options and warrants will result in dilution to the interests of our stockholders, and may reduce the trading price of our common stock.

At September 30, 2009, we had 50 thousand of outstanding warrants and 767 thousand of outstanding stock options granted under our stock option plans, 466 thousand of which are immediately exercisable.

To the extent that these stock options or warrants are exercised, dilution to the interests of our stockholders will likely occur. Additional options and warrants may be issued in the future at prices not less than 85% of the fair market value of the underlying security on the date of grant. Exercises of these options or warrants, or even the potential of their exercise may have an adverse effect on the trading price of our common stock. The holders of our options or our warrants are likely to exercise them at times when the market price of the common stock exceeds the exercise price of the securities. Accordingly, the issuance of shares of common stock upon exercise of the options and warrants will likely result in dilution of the equity represented by the then outstanding shares of common stock held by other stockholders. Holders of our options and warrants can be expected to exercise or convert them at a time when we would, in all likelihood, be able to obtain any needed capital on terms, which are more favorable to us than the exercise terms provided, by these options and warrants.

We may need to make acquisitions or form strategic alliances or partnerships in order to remain competitive in our market, and potential future acquisitions, strategic alliances or partnerships could be difficult to integrate, disrupt our business and dilute stockholder value.

We may acquire or form strategic alliances or partnerships with other businesses in the future in order to remain competitive or to acquire new technologies. As a result of these acquisitions, strategic alliances or partnerships, we may need to integrate products, technologies, widely dispersed operations and distinct corporate cultures. The products, services or technologies of the acquired companies may need to be altered or redesigned in order to be made compatible with our software products and services, or the software architecture of our customers. These integration efforts may not succeed or may distract our management from operating our existing business. Our failure to successfully manage future acquisitions, strategic alliances or partnerships could seriously harm our operating results. In addition, our stockholders would be diluted if we finance the acquisition, strategic alliances or partnerships by incurring convertible debt or issuing equity securities.

Our ability to utilize our net operating loss carryforwards may be limited.

Our federal net operating loss carryforwards are subject to limitations on how much may be utilized on an annual basis. The use of the net operating loss carryforwards may have additional limitations resulting from certain future ownership changes or other factors under Section 382 of the Internal Revenue Code.

If our net operating loss carryforwards are further limited, and we have taxable income which exceeds the available net operating loss carryforwards for that period, we would incur an income tax liability even though net operating loss carryforwards may be available in future years prior to their expiration. Any

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such income tax liability may adversely affect our future cash flow, financial position and financial results.

Our corporate compliance program cannot guarantee that we are in compliance with all potentially applicable regulations.

As a publicly traded company we are subject to significant regulations, including the Sarbanes-Oxley Act of 2002. While we have developed and instituted a corporate compliance program based on what we believe are the current best practices and continue to update the program in response to newly implemented regulatory requirements and guidance, we cannot assure that we are or will be in compliance with all potentially applicable regulations. Although our non-affiliate market capitalization was less than $75 million at March 31, 2008 and 2009 and we were therefore not required to have an auditor attestation on our internal controls over financial reporting for fiscal 2008 or fiscal 2009, current SEC rules require us to have such an attestation at September 30, 2010. We cannot assure that in the future our management or, beginning in fiscal 2010, our auditors, will not find a material weakness in connection with their annual reviews of our internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act. We also cannot assure that we could correct any such weakness to allow our management to assess the effectiveness of our internal control over financial reporting as of the end of our fiscal year in time to enable our independent registered public accounting firm to attest that such assessment will have been fairly stated in our Annual Report on Form 10-K to be filed with the Securities and Exchange Commission or attest that we have maintained effective internal control over financial reporting as of the end of our fiscal year. If we fail to comply with any of these regulations, we could be subject to a range of regulatory actions, fines, or other sanctions or litigation. In addition, if we must disclose any material weakness in our internal control over financial reporting, our stock price may decline.

Provisions of our charter documents and Maryland law could also discourage an acquisition of our company that would benefit our stockholders.

Provisions of our articles of incorporation and by-laws may make it more difficult for a third party to acquire control of our company, even if a change in control would benefit our stockholders. Our articles of incorporation authorize our board of directors, without stockholder approval, to issue one or more series of preferred stock, which could have voting and conversion rights that adversely affect or dilute the voting power of the holders of common stock. Furthermore, our articles of incorporation provide for a classified board of directors, which means that our stockholders may vote upon the retention of only one or two of our seven directors each year. Moreover, Maryland corporate law restricts certain business combination transactions with interested stockholders and limits voting rights upon certain acquisitions of control shares.

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WHERE YOU CAN FIND MORE INFORMATION

We file reports, proxy statements and other documents with the Securities and Exchange Commission. You may read and copy any document we file at the SEC s public reference room at 100 F Street, N.E., Washington, D.C. 20549. You should call 1-800-SEC-0330 for more information on the public reference room. Our SEC filings are also available to you on the SEC s Internet site at http://www.sec.gov. Our corporate website is http://www.sonicfoundry.com. Electronic access to our filings is available at the Investor Information section of the website. However, the information on the website, other than documents specifically incorporated by reference as listed below, does not constitute a part of the Prospectus.

This prospectus is part of the registration statement and does not contain all of the information included in the registration statement. Whenever a reference is made in this prospectus to any contract or other document of Sonic Foundry, the reference may not be complete and you should refer to the exhibits that are a part of the registration statement for a copy of the contract or document.

INFORMATION INCORPORATED BY REFERENCE

The SEC allows us to incorporate by reference into this prospectus information that we file with the SEC in other documents. This means that we can disclose important information to you by referring to other documents that contain that information. The information incorporated by reference is considered to be part of this prospectus, and information that we file with the SEC in the future and incorporate by reference will automatically update and may supersede the information contained in this prospectus. We incorporate by reference the documents listed below and any future filings we make with the SEC under Sections 13(a), 13(c), 14 or 15(d) of the Securities Exchange Act of 1934, as amended, prior to the sale of all the shares covered by this prospectus.

Our Annual Report on Form 10-K for the fiscal year ended September 30, 2009;

Our Current Report on Form 8-K filed on November 19, 2009;

Our Current Report on Form 8-K filed on November 30, 2009;

The description of our common stock contained in our Exchange Act Registration Statement on Form 8-A, filed on April 20, 2000.

You may request free copies of these filings by writing or telephoning us at the following address: Investor Relations, 222 West Washington Avenue, Suite 775, Madison, WI 53703, Telephone (608) 443-1600.

FORWARD-LOOKING INFORMATION

This prospectus contains or incorporates forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act. You can identify these forward-looking statements by our use of the words believe , anticipate , plan , expect , may , will , intend , estimate and similar expressions, whether in the negative or affirmative. We cannot guarantee that we actually will achieve these plans, intentions or expectations. Actual results or events could differ materially from the plans, intentions and expectations disclosed in the forward-looking statements we make. We have included important factors in the cautionary statements in this prospectus, particularly under the heading Risk Factors , that we believe could cause our actual results to differ materially from the forward-looking statements that we make. The forward-looking statements do not reflect the potential impact of any future acquisitions, mergers or dispositions.

We do not assume any obligation to update any forward-looking statement we make.

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SONIC FOUNDRY, INC.

Company Overview

Sonic Foundry, Inc. is a web communications technology leader, providing webcasting, lecture capture and knowledge management solutions for higher education institutions, businesses and government agencies worldwide. Powered by our patented webcasting platform, Mediasite®, Sonic Foundry empowers people to transform the way they communicate. We help our customers connect within a dynamic, evolving world of shared knowledge and envision a future where learners and workers around the globe use webcasting to bridge time and distance; accelerate research, productivity and growth; and reduce the environmental impact of traditional education and business communications.

Sonic Foundry solutions include:

- Mediasite Recorders for capturing multimedia presentations
- Mediasite EX Server platform for streaming, archiving and managing online presentation content
- Sonic Foundry Event Services for turnkey event webcasting based on the Mediasite platform
- Sonic Foundry Services for hosting, installation, training and custom development
- Mediasite Customer Assurance for annual hardware and software maintenance and technical support

Today, nearly 1,800 customers using more than 3,500 Mediasite Recorders in presentation venues around the world are capturing hundreds of thousands of multimedia presentations with millions of viewers.

Sonic Foundry, Inc. was founded in 1991, incorporated in Wisconsin in March 1994 and merged into a Maryland corporation of the same name in October 1996. Our executive offices are located at 222 West Washington Ave., Madison, Wisconsin 53703 and our telephone number is (608) 443-1600. Our corporate website is www.sonicfoundry.com. In the Investor Information section of our website we make available, free of charge, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to reports required to be filed pursuant to Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, as soon as reasonably practicable after the filing of such reports with the Securities and Exchange Commission.

USE OF PROCEEDS

Unless otherwise indicated in an accompanying prospectus supplement, we expect to use the net proceeds from the sale of any securities offered by us for general corporate purposes including capital expenditures, support for our continuing research and development, business development activities, and working capital needs. The amounts and timing of the expenditures will depend on numerous factors, such as the extent of our research and development efforts, technological advances and the competitive environment for our products. We expect from time to time to evaluate the acquisition of businesses, products and technologies for which a portion of the net proceeds may be used although we currently are not planning or negotiating any such transactions. Until the net proceeds are used for these purposes, we may deposit them in interest-bearing accounts or invest them in short-term marketable securities. The specific allocations, if any, of the proceeds of any of the securities will be described in the prospectus supplement.

DESCRIPTION OF CAPITAL STOCK

The following description of our capital stock summarizes general terms and provisions that apply to the capital stock. Since this is only a summary, it does not contain all of the information that may be important to you. The summary is subject to and qualified in its entirety by reference to our

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articles of incorporation and bylaws, which are filed as exhibits to the registration statement of which this prospectus is a part and incorporated by reference into this prospectus. See Where You Can Find More Information.

General

Our articles of incorporation provide us with the authority to issue 10,000,000 shares of common stock, $.01 par value per share, and 1,500,000 shares of preferred stock, $.01 par value per share. We will disclose in an applicable prospectus supplement the number of shares of our common stock then outstanding. As of the date of this prospectus, no shares of our preferred stock were outstanding.

Our Common Stock

Each share of our common stock is entitled to dividends if, as and when dividends are declared by our board of directors and paid. We will pay any dividend so declared and payable in cash, capital stock or other property equally, share for share, on our common stock.

Each share of our common stock is entitled to one vote on all matters. No stockholder of our common stock has preemptive or other rights to subscribe for additional shares of our common stock. In the event of our liquidation, dissolution or winding up, holders of the shares of our common stock are entitled to share equally, share for share, in the assets available for distribution, subject to any liquidation preference on any outstanding shares of our preferred stock.

Our Preferred Stock

We will issue our preferred stock from time to time in one or more series as determined by our board of directors. Our board of directors is authorized to issue the shares of our preferred stock in one or more series and to fix the rights, preferences, privileges and restrictions thereof, including dividend rights, dividend rates, conversion rights, voting rights, terms of redemption, redemption prices, liquidation preferences and the number of shares constituting any series or the designation of such series, without further vote or action by the stockholders. The issuance of our preferred stock may have the effect of delaying, deferring or preventing a change in control of Sonic Foundry without further action by the stockholders and may adversely affect the voting and other rights of the holders of our common stock, including the loss of voting control to others.

Anti-Takeover Provisions

in Our Articles of Incorporation and By-Laws

Provisions of our articles of incorporation and bylaws may make it more difficult for a third party to acquire control of our company, even if a change in control would benefit our stockholders. Our articles of incorporation authorize our board of directors, without stockholder approval, to issue one or more series of preferred stock, which could have voting and conversion rights that adversely affect or dilute the voting power of the holders of common stock. Furthermore, our articles of incorporation provide for classified voting, which means that our stockholders may vote upon the retention of only one or two of our seven directors each year.

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Maryland Anti-Takeover Laws

Business Combinations

Maryland law prohibits business combinations between us and an interested stockholder or an affiliate of an interested stockholder for five years after the most recent date on which the interested stockholder becomes an interested stockholder. These business combinations include a merger, consolidation, share exchange, or, in circumstances specified in the statute, an asset transfer or issuance or reclassification of equity securities. Maryland law defines an interested stockholder as:

- any person who beneficially owns 10% or more of the voting power of our shares; or
- an affiliate or associate of ours who, at any time within the two-year period prior to the date in question, was the beneficial owner of 10% or more of the voting power of our then-outstanding voting shares.

A person is not an interested stockholder if our board of directors approved in advance the transaction by which the person otherwise would have become an interested stockholder. However, in approving a transaction, our board of directors may provide that its approval is subject to compliance, at or after the time of approval, with any terms and conditions determined by our board of directors.

After the five-year prohibition, any business combination between us and interested stockholder generally must be recommended by our board of directors and approved by the affirmative vote of at least:

- 80% of the votes entitled to be cast by holders of our then-outstanding shares of capital stock; and
- two-thirds of the votes entitled to be cast by holders of our voting shares other than shares held by (a) the interested stockholder with whom or with whose affiliate the business combination is to be effected and (b) shares held by an affiliate or associate of the interested stockholder.

These super-majority vote requirements do not apply if our common stockholders receive a minimum price, as defined under Maryland law, for their shares in the form of cash or other consideration in the same form as previously paid by the interested stockholder for its shares. The statute permits various exemptions from its provisions, including business combinations that are exempted by our board of directors before the time that the interested stockholder becomes an interested stockholder. The business combination statute may discourage others from trying to acquire control of us and increase the difficulty of consummating any offer.

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Control Share Acquisition

Maryland law provides that control shares of a corporation acquired in a control share acquisition have no voting rights unless the corporation s stockholders approve such voting rights by a vote of two-thirds of the votes entitled to be cast on the matter. Shares owned by the acquirer, or by officers or directors of the corporation who are also employees are excluded from shares entitled to vote on the matter. Control shares are voting shares which if aggregated with all other shares previously acquired by the acquiring person, or in respect of which the acquiring person is able to exercise or direct the exercise of voting power (except solely by virtue of a revocable proxy), would entitle the acquiring person to exercise voting power in electing directors within one of the following ranges of voting power:

- one-tenth or more but less than one-third of all voting power;
- one-third or more but less than a majority of all voting power; or
- a majority or more of all voting power.

Control shares do not include shares the acquiring person is then entitled to vote as a result of having previously obtained stockholder approval. A control share acquisition means the acquisition of control shares, subject to certain exceptions.

A person who has made or proposes to make a control share acquisition may compel our board of directors to call a special meeting of stockholders to be held within 50 days to consider the voting rights of the shares. The right to compel the calling of a special meeting is subject to the satisfaction of certain conditions, including providing a statement to us detailing, among other things, the acquiring person s identity and stock ownership and an undertaking to pay the expenses of the meeting. If no request for a meeting is made, we may present the question at any stockholders meeting.

If voting rights are not approved at the stockholders meeting or if the acquiring person does not deliver the statement required by Maryland law, then, subject to certain conditions and limitations, we may redeem any or all of the control shares, except those for which voting rights have previously been approved, at the fair market value of such shares. The control share acquisition statute does not apply to shares acquired in a merger, consolidation or share exchange if we are a party to the transaction, nor does it apply to acquisitions approved or exempted by our articles of incorporation or bylaws.

Indemnification of Directors and Officers

Our articles of incorporation limit the liability of our directors, in their capacity as directors but not in their capacity as officers, to the fullest extent permitted by the Maryland General Corporation Law, or MGCL. Accordingly, pursuant to the terms of the MGCL as presently in effect, we may indemnify any director unless it is established that:

- the act or omission of the director was material to the matter giving rise to the proceeding and was committed in bad faith or was the result of active and deliberate dishonesty;
- the director actually received an improper personal benefit in money, property or services;
- or in the case of any criminal proceeding, the director had reasonable cause to believe that the act or omission was unlawful.

In addition, our bylaws require us to indemnify each person who is or was a director or officer of ours to the fullest extent permitted by the laws of the State of Maryland in the event he is involved in legal proceedings by reason of the fact that he is or was a director or officer of ours, or is or was serving

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at our request as a director officer, partner or trustee of another corporation, partnership or other enterprise. We may also advance to such persons expenses incurred in defending a proceeding to which indemnification might apply, upon terms and conditions, if any, deemed appropriate by the Board of Directors upon receipt of an undertaking by or on behalf of such director or officer to repay all such advanced amounts if it is ultimately determined that he is not entitled to be indemnified as authorized by the laws of the State of Maryland. In addition, we carry director and officer liability insurance.

PLAN OF DISTRIBUTION

We may sell the offered securities in and outside the United States (1) through underwriters or dealers, (2) directly to purchasers, including our affiliates and shareholders, or in a rights offering, (3) through agents or (4) through a combination of any of these methods. The prospectus supplement will include the following information:

- the terms of the offering;
- the names of any underwriters, dealers or agents;
- the name or names of any managing underwriter or underwriters;
- the purchase price of the securities;
- the net proceeds from the sale of the securities;

In no event will any underwriter or dealer receive fees, commissions and markups which, in the aggregate, would exceed eight percent of the price of the shares being registered.

- any delayed delivery arrangements;
- any underwriting discounts, commissions and other items constituting underwriters   compensation;
- any initial public offering price;
- any discounts or concessions allowed or reallowed or paid to dealers; and
- any commissions paid to agents.

In addition, we may enter into derivative transactions with third parties, or sell securities not covered by this prospectus to third parties in privately negotiated transactions. If the applicable prospectus supplement indicates, in connection with those derivatives, the third parties may sell securities covered by this prospectus and the applicable prospectus supplement, including in short sale transactions. If so, the third parties may use securities pledged by us or borrowed from us or others to settle those sales or to close out any related open borrowings of stock, and may use securities received from us in settlement of those derivatives to close out any related open borrowings of stock. The third parties in such sale transactions will be underwriters and, if not identified in this prospectus, will be identified in the applicable prospectus supplement (or a post-effective amendment). We or one of our affiliates may loan or pledge securities to a financial institution or other third party that in turn may sell the securities using this prospectus. Such financial institution or third party may transfer its short position to investors in our securities or in

connection with a simultaneous offering of other securities offered by this prospectus or otherwise.

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Sale Through Underwriters or Dealers

If we use underwriters in the sale, the underwriters will acquire the securities on a firm commitment basis for their own account for resale to the public. The underwriters may resell the securities from time to time in one or more transactions, including negotiated transactions, at a fixed public offering price or at varying prices determined at the time of sale. Underwriters may offer securities to the public either through underwriting syndicates represented by one or more managing underwriters or directly by one or more firms acting as underwriters. Unless we inform you otherwise in the prospectus supplement, the obligations of the underwriters to purchase the securities will be subject to certain conditions, and the underwriters will be obligated to purchase all of the offered securities if they purchase any of them. The underwriters may change from time to time any initial public offering price and any discounts or concessions allowed or reallowed or paid to dealers.

Representatives of the underwriters through whom the offered securities are sold for public offering and sale may engage in over-allotment, stabilizing transactions, syndicate short covering transactions and penalty bids in accordance with Regulation M under the Securities Exchange Act of 1934. Over-allotment involves syndicate sales in excess of the offering size, which creates a syndicate short position. Stabilizing transactions permit bids to purchase the offered securities so long as the stabilizing bids do not exceed a specified maximum. Syndicate covering transactions involve purchases of the offered securities in the open market after the distribution has been completed in order to cover syndicate short positions. Penalty bids permit the representative of the underwriters to reclaim a selling concession from a syndicate member when the offered securities originally sold by such syndicate member are purchased in a syndicate covering transaction to cover syndicate short positions. Such stabilizing transactions, syndicate covering transactions and penalty bids may cause the price of the offered securities to be higher than it would otherwise be in the absence of such transactions. These transactions may be effected on a national securities exchange and, if commenced, may be discontinued at any time.

Some or all of the securities that we offer though this prospectus may be new issues of securities with no established trading market. Any underwriters to whom we sell our securities for public offering and sale may make a market in those securities, but they will not be obligated to do so and they may discontinue any market making at any time without notice. Accordingly, we cannot assure you of the liquidity of, or continued trading markets for, any securities that we offer.

If we use dealers in the sale of securities, we will sell the securities to them as principals. They may then resell those securities to the public at varying prices determined by the dealers at the time of resale. We will include in the prospectus supplement the names of the dealers and the terms of the transaction.

Direct Sales and Sales through Agents

We may sell the securities directly. In this case, no underwriters or agents would be involved. We may also sell the securities through agents designated from time to time. In the prospectus supplement, we will name any agent involved in the offer or sale of the offered securities, and we will describe any commissions payable to the agent. Unless we inform you otherwise in the prospectus supplement, any agent will agree to use its reasonable best efforts to solicit purchases for the period of its appointment.

We may sell the securities directly to institutional investors or others who may be deemed to be underwriters within the meaning of the Securities Act of 1933 with respect to any sale of those securities. We will describe the terms of any such sales in the prospectus supplement.

We may also make direct sales through subscription rights distributed to our existing shareholders on a pro rata basis that may or may not be transferable. In any distribution of subscription rights to our shareholders, if all of the underlying securities are not subscribed for, we may then sell the unsubscribed securities directly to third parties or we may engage the services of one or more underwriters, dealers or agents, including standby underwriters, to sell the unsubscribed securities to third parties.

Remarketing Arrangements

Offered securities may also be offered and sold, if so indicated in the applicable prospectus supplement, in connection with a remarketing upon their purchase, in accordance with a redemption or repayment pursuant to their terms, or otherwise, by one or more remarketing firms, acting as principals for their own accounts or as agents for us. Any remarketing firm will be identified and the terms of its agreements, if any, with us and its compensation will be described in the applicable prospectus supplement. Remarketing firms may be deemed to be underwriters, as that term is defined in the Securities Act of 1933, in connection with the securities remarketed.

Delayed Delivery Arrangements

If we so indicate in the prospectus supplement, we may authorize agents, underwriters or dealers to solicit offers from certain types of institutions to purchase securities from us at the public offering price under delayed delivery contracts. These contracts would provide for payment and delivery on a specified date in the future. The contracts would be subject only to those conditions described in the prospectus supplement. The prospectus supplement will describe the commission payable for solicitation of those contracts.

General Information

We may have agreements with the underwriters, dealers and agents to indemnify them against certain civil liabilities, including liabilities under the Securities Act of 1933, or to contribute with respect to payments that the underwriters, dealers or agents may be required to make.

Underwriters, dealers and agents may engage in transactions with, or perform services for, us in the ordinary course of our business.

LEGAL MATTERS

The legality of the issuance of the Shares offered in this prospectus will be passed upon for the Company by McBreen & Kopko, Chicago, Illinois. Frederick H. Kopko, Jr., a member of that firm and a director of the Company, beneficially owns 28,627 shares of our Common Stock and has options and warrants to purchase 8,000 shares of our Common Stock.

EXPERTS

The consolidated financial statements of Sonic Foundry, Inc. included in the Company s Annual Report on Form 10-K, incorporated by reference in this prospectus, have been audited by Grant Thornton LLP, an independent registered public accounting firm, as set forth in their report thereon. Such consolidated financial statements are incorporated herein by reference in reliance upon such report given on the authority of such firm as experts in accounting and auditing.

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PART II

INFORMATION NOT REQUIRED IN THE PROSPECTUS

Item 14. Other Expenses of Issuance and Distribution.

The following table sets forth the various expenses payable by the Registrant in connection with the issuance and distribution of the securities being registered hereby. All amounts are estimated except the Securities and Exchange Commission registration fee.

Securities and Exchange Commission registration fee	$
Legal fees and expenses	25,000
Accounting fees and expenses	5,000
Printing expenses	1,000
Blue Sky fees and expenses	NA
Miscellaneous	NA
Total	$ 31,000

Item 15. Indemnification of Directors and Officers.

Our Articles of Incorporation limit the liability of our directors, in their capacity as directors but not in their capacity as officers, to the fullest extent permitted by the Maryland General Corporation Law, or MGCL. Accordingly, pursuant to the terms of the MGCL as presently in effect, we may indemnify any director unless it is established that:

the act or omission of the director was material to the matter giving rise to the proceeding and was committed in bad faith or was the result of active and deliberate dishonesty;

the director actually received an improper personal benefit in money, property or services;

or in the case of any criminal proceeding, the directors had reasonable cause to believe that the act or omission was unlawful.

In addition, our Bylaws require us to indemnify each person who is or was, a director or officer of ours to the fullest extent permitted by the laws of the State of Maryland in the event he is involved in legal proceedings by reason of the fact that he is or was a director or officer of ours, or is or was serving at our request as a director, officer, partner or trustee of another corporation, partnership or other enterprise. We may also advance to such persons expenses incurred in defending a proceeding to which indemnification might apply, upon terms and conditions, if any, deemed appropriate by the Board of Directors upon receipt of an undertaking by or on behalf of such director or officer to repay all such advanced amounts if it is ultimately determined that he is not entitled to be indemnified as authorized by the laws of the State of Maryland. In addition, we carry director and officer liability insurance.

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Item 16. Exhibits.

Exhibit Number	Description of Document
1*	Form of Underwriting Agreement
4.1(1)	Amended and Restated Articles of Incorporation.
4.2(2)	Amended and Restated By-Laws.
5.1(3)	Opinion of McBreen & Kopko.
23.1(3)	Consent of McBreen & Kopko (see Exhibit 5.1).
23.2(3)	Consent of Grant Thornton LLP, Independent Registered Public Accounting Firm.
24.1(3)	Power of Attorney (see page II-4).

* To be filed as an exhibit to a Current Report on Form 8-K or other document to be incorporated by reference herein.
(1) Incorporated by reference from Exhibit 3.1 of Registrant s Annual Report on Form 10-K for the year ended September 30, 2009.
(2) Incorporated by reference from Registrant s Current Report on Form 8-K filed on November 19, 2009.
(3) Filed herewith.

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Item 17. Undertakings.

1. The undersigned registrant hereby undertakes:

(1) To file, during any period in which offers or sales are being made, a post-effective amendment to this registration statement;

(i) To include any prospectus required by Section 10(a)(3) of the Securities Act of 1933;

(ii) To reflect in the prospectus any facts or events arising after the effective date of the registration statement (or the most recent post-effective amendment thereof) which, individually or in the aggregate, represent a fundamental change in the information set forth in the registration statement. Notwithstanding the foregoing, any increase or decrease in volume of securities offered (if the total dollar value of the securities offered would not exceed that which was registered) and any deviation from the low or high end of the estimated maximum offering range may be reflected in the form of prospectus filed with the Commission pursuant to Rule 424(b) if, in the aggregate, the changes in volume and price represent no more than a 20 percent change in the maximum aggregate offering price set forth in the Calculation of Registration Fee table in the effective registration statement;

(iii) To include any material information with respect to the plan of distribution not previously disclosed in the registration statement or any material change to such information in the registration statement.

Provided, *however*, that paragraphs (1)(i), (1)(ii) and (1)(iii) do not apply if the information required to be included in a post-effective amendment by those paragraphs is contained in reports filed with or furnished to the Commission by the registrant pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 that are incorporated by reference in this Registration Statement.

(2) That, for the purpose of determining any liability under the Securities Act of 1933, each such post-effective amendment shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof.

(3) To remove from registration by means of a post-effective amendment any of the securities being registered which remain unsold at the termination of the offering.

(4) That, for the purpose of determining liability of the registrant under the Securities Act of 1933 to any purchaser in the initial distribution of the securities:

The undersigned registrant undertakes that in a primary offering of securities of the undersigned registrant pursuant to this registration statement, regardless of the underwriting method used to sell the securities to the purchaser, if the securities are offered or sold to such purchaser by means of any of the following communications, the undersigned registrant will be a seller to the purchaser and will be considered to offer or sell such securities to such purchaser:

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(i) Any preliminary prospectus or prospectus of the undersigned registrant relating to the offering required to be filed pursuant to Rule 424;

(ii) Any free writing prospectus relating to the offering prepared by or on behalf of the undersigned registrant or used or referred to by the undersigned registrant;

(iii) The portion of any other free writing prospectus relating to the offering containing material information about the undersigned registrant or its securities provided by or on behalf of the undersigned registrant; and

(iv) Any other communication that is an offer in the offering made by the undersigned registrant to the purchaser.

2. The undersigned registrant hereby undertakes that, for purposes of determining any liability under the Securities Act of 1933, each filing of the registrant s annual report pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (and, where applicable, each filing of an employee benefit plan s annual report pursuant to Section 15(d) of the Securities Exchange Act of 1934) that is incorporated by reference in the registration statement shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof.

3. If the securities to be registered are to be offered at competitive bidding, the undersigned registrant hereby undertakes: (1) to use its best efforts to distribute prior to the opening of bids, to prospective bidders, underwriters, and dealers, a reasonable number of copies of a prospectus which at that time meets the requirements of Section 10(a) of the Act, and relating to the securities offered at competitive bidding, as contained in the Registration Statement, together with any supplements thereto, and (2) to file an amendment to the Registration Statement reflecting the results of bidding, the terms of the reoffering and related matters to the extent required by the applicable form, not later than the first use, authorized by the issuer after the opening of bids, of a prospectus relating to the securities offered at competitive bidding, unless no further public offering of such securities by the issuer and no reoffering of such securities by the purchasers is proposed to be made.

4. Insofar as indemnification for liabilities arising under the Securities Act of 1933 may be permitted to directors, officers and controlling persons of the registrant pursuant to the foregoing provisions, or otherwise, the registrant has been advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Act and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment by the registrant of expenses incurred or paid by a director, officer or controlling person of the registrant in the successful defense of any action, suit or proceeding) is asserted by such director, officer or controlling person in connection with the securities being registered, the registrant will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Act and will be governed by the final adjudication of such issue.

5. The undersigned registrant hereby undertakes that

(1) for purposes of determining any liability under the Securities Act of 1933, the information omitted from the form of prospectus filed as part of this Registration Statement in reliance upon Rule 430A and contained in a form of prospectus filed by the

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registrant pursuant to Rule 424(b)(1) or (4) or 497(h) under the Securities Act shall be deemed to be part of this Registration Statement as of the time it was declared effective; and

(2) for the purpose of determining any liability under the Securities Act of 1933, each post-effective amendment that contains a form of prospectus shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof.

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SIGNATURES

Pursuant to the requirements of the Securities Act of 1933, the Registrant certifies that it has reasonable grounds to believe that it meets all of the requirements for filing on this Amendment No. 1 to Form S-3 and has duly caused this registration statement to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Madison, State of Wisconsin, on January 8, 2010.

SONIC FOUNDRY, INC.

By: /s/ Rimas Buinevicius
Rimas P. Buinevicius, Chairman,
Chief Executive Officer and Director

POWER OF ATTORNEY

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below hereby constitutes and appoints Rimas P. Buinevicius and Kenneth A. Minor, jointly and severally, his or her true and lawful attorneys-in-fact, each with full power of substitution, for him or her in any and all capacities, to sign any and all amendments (including post-effective amendments) to this Registration Statement, and to file the same, with all exhibits thereto and all documents in connection therewith, with the Securities and Exchange Commission, hereby ratifying and confirming all that each of said attorneys-in-fact or any of them, or his or their substitute or substitutes, may lawfully do or cause to be done or by virtue hereof.

Pursuant to the requirements of the Securities Act of 1933, this registration statement has been signed by the following persons in the capacities and on the dates indicated.

Signature

Date	Capacity
/s/ Rimas P. Buinevicius Rimas P. Buinevicius January 8, 2010	Chief Executive Officer and Chairman
/s/ Monty R. Schmidt Monty R. Schmidt January 8, 2010	Chief Technology Officer and Director
/s/ Kenneth A. Minor Kenneth A. Minor January 8, 2010	Chief Financial Officer, Chief Accounting Officer and Secretary

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/s/ Frederick H. Kopko, Jr. Frederick H. Kopko, Jr. January 8, 2010	Director
/s/ Arnold B. Pollard Arnold B. Pollard January 8, 2010	Director
/s/ David C. Kleinman David C. Kleinman January 8, 2010	Director
/s/ Gary R. Weis Gary R. Weis January 8, 2010	Director
/s/ Paul S. Peercy Paul S. Peercy January 8, 2010	Director

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Exhibit Index

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1*	Form of Underwriting Agreement
4.1(1)	Amended and Restated Articles of Incorporation.
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5.1(3)	Opinion of McBreen & Kopko.
23.1(3)	Consent of McBreen & Kopko (see Exhibit 5.1).
23.2(3)	Consent of Grant Thornton LLP, Independent Registered Public Accounting Firm.
24.1(3)	Power of Attorney (see page II-4).

* To be filed as an exhibit to a Current Report on Form 8-K or other document to be incorporated by reference herein.
(1) Incorporated by reference from Exhibit 3.1 of Registrant s Annual Report on Form 10-K for the year ended September 30, 2009.
(2) Incorporated by reference from Registrant s Current Report on Form 8-K filed on November 19, 2009.
(3) Filed herewith.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion. In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Citizens Communications Company and subsidiaries as of December 31, 2005 and 2004 and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles. As discussed in Note 2 to the consolidated financial statements, the Company adopted Statement of Financial Accounting Standards No. 143, "Accounting for Asset Retirement Obligations" as of January 1, 2003. We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Citizens Communications Company and subsidiaries internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control--Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 1, 2006 expressed an unqualified opinion on management's assessment of, and the effective operation of, internal control over financial reporting. /s/ KPMG LLP Stamford, Connecticut March 1, 2006 F-4 CITIZENS COMMUNICATIONS COMPANY AND SUBSIDIARIES CONSOLIDATED BALANCE SHEETS DECEMBER 31, 2005 AND 2004 ($ in thousands) 2005 2004 -------------- -------------- ASSETS ------ Current assets: Cash and cash equivalents $ 265,775 $ 163,759 Accounts receivable, less allowances of $32,408 and $35,996, respectively 229,107 233,690 Prepaid expenses 27,449 30,551 Other current assets 19,764 18,758 Assets of discontinued operations - 24,122 -------------- -------------- Total current assets 542,095 470,880 Property, plant and equipment, net 3,186,465 3,335,850 0 0 Goodwill, net 1,921,465 1,921,465 Other intangibles, net 558,733 685,111 Investments 19,136 23,062 Other assets 184,215 232,051 -------------- -------------- Total assets $ 6,412,109 $ 6,668,419 ============== ============== LIABILITIES AND SHAREHOLDERS' EQUITY ------------------------------------ Current liabilities: Long-term debt due within one year $ 227,734 $ 6,380 Accounts payable 152,081 169,754 Advanced billings 29,245 29,446 Income taxes accrued 5,776 27,446 Other taxes accrued 28,970 30,179 Interest accrued 101,030 82,534 Other current liabilities 71,806 71,046 Liabilities of discontinued operations - 735 -------------- -------------- Total current liabilities 616,642 417,520 Deferred income taxes 325,084

232,766 Other liabilities 429,198 388,895 Long-term debt 3,999,376 4,266,998 Shareholders' equity: Common stock, $0.25 par value (600,000,000 authorized shares; 328,168,000 and 339,633,000 outstanding and 343,956,000 and 339,635,000 issued at December 31, 2005 and 2004, respectively) 85,989 84,909 Additional paid-in capital 1,374,610 1,664,627 Accumulated deficit (85,344) (287,719) Accumulated other comprehensive loss, net of tax (123,242) (99,569) Treasury stock (210,204) (8) -------------- -------------- Total shareholders' equity 1,041,809 1,362,240 -------------- -------------- Total liabilities and shareholders' equity $ 6,412,109 $ 6,668,419 ============== ============== The accompanying Notes are an integral part of these Consolidated Financial Statements. F-5 CITIZENS COMMUNICATIONS COMPANY AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 and 2003 ($ in thousands, except for per-share amounts) 2005 2004 2003 --------------- -------------- -------------- Revenue $ 2,162,479 $ 2,168,422 $ 2,424,174 Operating expenses: Cost of services (exclusive of depreciation and amortization) 195,491 198,938 365,563 Other operating expenses 818,180 831,939 894,108 Depreciation and amortization 541,959 570,808 593,161 Recovery of telecommunications bankruptcies - - (4,377) Restructuring and other expenses - - 9,687 Loss on impairment - - 15,300 Management succession and strategic alternatives expenses (see Note 13) - 90,632 - --------------- -------------- -------------- Total operating expenses 1,555,630 1,692,317 1,873,442 --------------- -------------- -------------- Operating income 606,849 476,105 550,732 Investment income 18,236 33,616 10,418 Other income (loss), net (1,674) (53,359) 44,059 Interest expense 338,903 379,021 416,520 --------------- -------------- -------------- Income from continuing operations before income taxes, dividends on convertible preferred securities and cumulative effect of change in accounting principle 284,508 77,341 188,689 Income tax expense 84,340 10,422 64,776 --------------- -------------- -------------- Income from continuing operations before dividends on convertible preferred securities and cumulative effect of change in accounting principle 200,168 66,919 123,913 Dividends on convertible preferred securities, net of income tax benefit of $(3,853)* - - 6,210 --------------- -------------- -------------- Income from continuing operations before cumulative effect of change in accounting principle 200,168 66,919 117,703 Discontinued operations (see Note 8): Income from operations of discontinued conferencing business (including gain on disposal of $14,061 in 2005) 15,550 8,188 6,820 Income tax expense 13,343 2,957 2,440 --------------- -------------- -------------- Income from discontinued operations 2,207 5,231 4,380 --------------- -------------- -------------- Income before cumulative effect of change in accounting principle 202,375 72,150 122,083 Cumulative effect of change in accounting principle, net of tax of $0, $0 and $41,591, respectively - - 65,769 --------------- -------------- -------------- Net income available for common shareholders $ 202,375 $ 72,150 $ 187,852 =============== ============== ============== Basic income per common share: Income from continuing operations before cumulative effect of change in accounting principle $ 0.59 $ 0.22 $ 0.42 Income from discontinued operations 0.01 0.02 0.02 Income from cumulative effect of change in accounting principle - - 0.23 --------------- -------------- -------------- Net income per common share available for common shareholders $ 0.60 $ 0.24 $ 0.67 =============== ============== ============== Diluted income per common share: Income from continuing operations before cumulative effect of change in accounting principle $ 0.59 $ 0.22 $ 0.41 Income from discontinued operations 0.01 0.01 0.01 Income from cumulative effect of change in accounting principle - - 0.22 --------------- -------------- -------------- Net income per common share available for common shareholders $ 0.60 $ 0.23 $ 0.64 =============== ============== ============== * The consolidation of this item changed effective January 1, 2004 as a result of the application of a newly mandated accounting standard "FIN 46R." See Note 15 for a complete discussion. The accompanying Notes are an integral part of these Consolidated Financial Statements. F-6 CITIZENS COMMUNICATIONS COMPANY AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 and 2003 ($ in thousands, except for per-share amounts) Accumulated Common Stock Additional Retained Other Treasury Stock Total ------------------- Paid-In Earnings Comprehensive ----------------- Shareholders' Shares Amount Capital (Deficit) Income (Loss) Shares Amount Equity --------- --------- ------------ -------------- ------------- -------- ---------- ------------ Balance December 31, 2002 294,080 $ 73,520 $1,943,406 $ (553,033) $(102,169) (11,598) $ (189,585) $ 1,172,139 Stock plans 1,354 338 9,911 - - 873 14,450 24,699 Net income - - - 187,852 - - - 187,852 Other comprehensive income, net of tax and reclassifications adjustments - - - - 30,493 - - 30,493 --------- --------- ------------ -------------- ------------ --------- ---------- ------------ Balance December 31, 2003 295,434 73,858 1,953,317 (365,181) (71,676) (10,725) (175,135) 1,415,183 Stock plans 4,821 1,206 14,236 - - 6,407 106,823 122,265 Conversion of EPPICS 10,897 2,724 133,621 - - 725 11,646 147,991 Conversion of Equity Units 28,483 7,121 396,221 - - 3,591

56,658 460,000 Dividends on common stock of $2.50 per share - - (832,768) - - - - (832,768) Net income - - - 72,150 - - - 72,150 Tax benefit on equity forward contracts - - - 5,312 - - - 5,312 Other comprehensive loss, net of tax and reclassifications adjustments - - - - (27,893) - - (27,893) --------- --------- ------------ -------------- ----------- --------- ---------- ------------ Balance December 31, 2004 339,635 84,909 1,664,627 (287,719) (99,569) (2) (8) 1,362,240 Stock plans 2,096 524 24,039 - - 2,598 34,689 59,252 Conversion of EPPICS 2,225 556 24,308 - - 391 5,115 29,979 Dividends on common stock of $1.00 per share - - (338,364) - - - - (338,364) Shares repurchased - - - - - (18,775) (250,000) (250,000) Net income - - - 202,375 - - - 202,375 Other comprehensive loss, net of tax and reclassifications adjustments - - - - (23,673) - - (23,673) --------- --------- ------------ -------------- ------------ --------- ---------- ------------ Balance December 31, 2005 343,956 $ 85,989 $1,374,610 $ (85,344) $(123,242) (15,788) $ (210,204) $ 1,041,809 ========= ========= ============ ============== ============ ========= ========== ============ CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS) FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 and 2003 ($ in thousands, except for per-share amounts) 2005 2004 2003 ------------- ------------- ------------- Net income $ 202,375 $ 72,150 $ 187,852 Other comprehensive income (loss), net of tax and reclassifications adjustments* (23,673) (27,893) 30,493 ------------- ------------- ------------- Total comprehensive income $ 178,702 $ 44,257 $ 218,345 ============= ============= ============= * Consists of unrealized holding (losses)/gains of marketable securities, realized gains taken to income as a result of the sale of securities and minimum pension liability (see Note 21). The accompanying Notes are an integral part of these Consolidated Financial Statements. F-7 CITIZENS COMMUNICATIONS COMPANY AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 and 2003 ($ in thousands) 2005 2004 2003 --------------- --------------- ---------------- Cash flows provided by (used in) operating activities: Net income $ 202,375 $ 72,150 $ 187,852 Deduct: Gain on sale of discontinued operations (1,167) - - Income from discontinued operations (1,040) (5,231) (4,380) Cumulative effect of change in accounting principle for the adoption of SFAS No. 143 - - (65,769) Adjustments to reconcile income to net cash provided by operating activities: Depreciation and amortization expense 541,959 570,808 593,161 Gain on expiration/settlement of customer advance (681) (25,345) (6,165) Gain on capital lease termination/restructuring - - (69,512) Stock based compensation expense 8,427 47,581 8,956 Loss on debt exchange 3,175 - - Loss on extinguishment of debt - 66,480 10,851 Investment gains (492) (12,066) - Gain on sales of assets - 1,945 20,492 Loss on impairment - - 15,300 Other non-cash adjustments 20,481 30,397 20,091 Deferred taxes 100,636 24,016 74,508 Change in accounts receivable 4,583 11,895 69,619 Change in accounts payable and other liabilities (33,399) (67,499) (113,532) Change in other current assets (640) (3,694) 748 --------------- --------------- --------------- Net cash provided by operating activities 844,217 711,437 742,220 Cash flows provided from (used by) investing activities: Proceeds from sales of assets, net of selling expenses 24,195 30,959 388,079 Proceeds from sale of discontinued operations 43,565 - - Capital expenditures (268,459) (275,204) (277,371) Securities purchased - - (1,680) Securities sold 1,112 26,514 - Other asset (purchased) distributions received 5,724 (28,110) 68 --------------- --------------- --------------- Net cash provided from (used by) investing activities (193,863) (245,841) 109,096 Cash flows provided from (used by) financing activities: Repayment of customer advances for construction and contributions in aid of construction (1,662) (2,089) (10,030) Long-term debt borrowings - 700,000 - Debt issuance costs - (15,502) - Long-term debt payments (6,433) (1,214,018) (653,442) Premium to retire debt - (66,480) (10,851) Issuance of common stock 47,550 544,562 13,209 Shares repurchased (250,000) - - Dividends paid (338,364) (832,768) - --------------- --------------- ---------------- Net cash used by financing activities (548,909) (886,295) (661,114) Cash flows of discontinued operations Operating cash flows 578 1,361 956 Investing cash flows (7) (571) (644) Financing cash flows - (3) (20) --------------- --------------- --------------- 571 787 292 Increase (decrease) in cash and cash equivalents 102,016 (419,912) 190,494 Cash and cash equivalents at January 1, 163,759 583,671 393,177 --------------- --------------- ---------------- Cash and cash equivalents at December 31, $ 265,775 $ 163,759 $ 583,671 =============== ================ =============== Cash paid during the period for: Interest $ 318,638 $ 370,128 $ 418,561 Income taxes (refunds) $ 4,711 $ (4,901) $ (2,532) Non-cash investing and financing activities: Change in fair value of interest rate swaps $ (13,193) $ (6,135) $ (6,057) Conversion of EPPICS $ 29,980 $ 147,991 $ - Debt-for-debt exchange $ 2,171 $ - $ - Investment write-downs $ - $ 5,286 $ - The accompanying Notes are an integral part of these Consolidated Financial Statements. F-8 CITIZENS COMMUNICATIONS COMPANY AND SUBSIDIARIES Notes to Consolidated Financial Statements (1) Description of Business and Summary of Significant Accounting Policies: --- (a) Description of Business: ----------------------- Citizens

Communications Company and its subsidiaries are referred to as "we," "us," the "Company," or "our" in this report. We are a communications company providing services to rural areas and small and medium-sized towns and cities as an incumbent local exchange carrier, or ILEC. We offer our ILEC services under the "Frontier" name. In addition, we provide competitive local exchange carrier, or CLEC, services to business customers and to other communications carriers in certain metropolitan areas in the western United States through Electric Lightwave, LLC, or ELI, our wholly-owned subsidiary. In February 2006, we entered into a definitive agreement to sell ELI and we expect the sale to close in the third quarter of 2006. (b) Principles of Consolidation and Use of Estimates: -- Our consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). Certain reclassifications of balances previously reported have been made to conform to the current presentation. All significant intercompany balances and transactions have been eliminated in consolidation. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions which affect the amounts of assets, liabilities, revenue and expenses we have reported and our disclosure of contingent assets and liabilities at the date of the financial statements. Actual results may differ from those estimates. We believe that our critical estimates are depreciation rates, pension assumptions, calculations of impairment amounts, reserves established for receivables, income taxes and contingencies. (c) Cash Equivalents: ---------------- We consider all highly liquid investments with an original maturity of three months or less to be cash equivalents. (d) Revenue Recognition: -------------------- Frontier - Revenue is recognized when services are provided or when products are delivered to customers. Revenue that is billed in advance includes: monthly recurring network access services, special access services and monthly recurring local line charges. The unearned portion of this revenue is initially deferred as a component of other liabilities on our consolidated balance sheet and recognized in revenue over the period that the services are provided. Revenue that is billed in arrears includes: non-recurring network access services, switched access services, non-recurring local services and long-distance services. The earned but unbilled portion of this revenue is recognized in revenue in our statement of operations and accrued in accounts receivable in the period that the services are provided. Excise taxes are recognized as a liability when billed. Installation fees and their related direct and incremental costs are initially deferred and recognized as revenue and expense over the average term of a customer relationship. We recognize as current period expense the portion of installation costs that exceeds installation fee revenue. Electric Lightwave, LLC (ELI) - Revenue is recognized when the services are provided. Revenue from long-term prepaid network services agreements including Indefeasible Rights to Use (IRU), are deferred and recognized on a straight-line basis over the terms of the related agreements. Installation fees and their related direct and incremental costs are initially deferred and recognized as revenue and expense over the average term of a customer relationship. We recognize as current period expense the portion of installation costs that exceeds installation fee revenue. (e) Property, Plant and Equipment: ----------------------------- Property, plant and equipment are stated at original cost or fair market value for our acquired properties, including capitalized interest. Maintenance and repairs are charged to operating expenses as incurred. The gross book value of routine property, plant and equipment retired is charged against accumulated depreciation. F-9 (f) Goodwill and Other Intangibles: ------------------------------ Intangibles represent the excess of purchase price over the fair value of identifiable tangible assets acquired. We undertake studies to determine the fair values of assets and liabilities acquired and allocate purchase prices to assets and liabilities, including property, plant and equipment, goodwill and other identifiable intangibles. We annually (during the fourth quarter) examine the carrying value of our goodwill and trade name to determine whether there are any impairment losses and have determined for the year ended December 31, 2005 that there was no impairment (see Notes 2 and 7). All intangibles at December 31, 2005 are associated with the Frontier segment, which is the reporting unit. SFAS No. 142 also requires that intangible assets with estimated useful lives be amortized over those lives and be reviewed for impairment in accordance with SFAS No. 144, "Accounting for Impairment or Disposal of Long-Lived Assets" to determine whether any changes to these lives are required. We periodically reassess the useful life of our intangible assets with estimated useful lives to determine whether any changes to those lives are required. (g) Impairment of Long-Lived Assets and Long-Lived Assets to Be Disposed --- Of: --- We review long-lived assets to be held and used and long-lived assets to be disposed of, including intangible assets with estimated useful lives, for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Recoverability of assets to be held and used is measured by comparing the carrying amount of the asset to the future

undiscounted net cash flows expected to be generated by the asset. Recoverability of assets held for sale is measured by comparing the carrying amount of the assets to their estimated fair market value. If any assets are considered to be impaired, the impairment is measured by the amount by which the carrying amount of the assets exceeds the estimated fair value (see Note 5). (h) Derivative Instruments and Hedging Activities: -- We account for derivative instruments and hedging activities in accordance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended. SFAS No. 133, as amended, requires that all derivative instruments, such as interest rate swaps, be recognized in the financial statements and measured at fair value regardless of the purpose or intent of holding them. On the date we enter into a derivative contract that qualifies for hedge accounting, we designate the derivative as either a fair value or cash flow hedge. A hedge of the fair value of a recognized asset or liability or of an unrecognized firm commitment is a fair value hedge. A hedge of a forecasted transaction or the variability of cash flows to be received or paid related to a recognized asset or liability is a cash flow hedge. We formally document all relationships between hedging instruments and hedged items, as well as our risk-management objective and strategy for undertaking the hedge transaction. This process includes linking all derivatives that are designated as fair-value or cash flow hedges to specific assets and liabilities on the balance sheet or to specific firm commitments or forecasted transactions. We also formally assess, both at the hedge's inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items. If it is determined that a derivative is not highly effective as a hedge or that it has ceased to be a highly effective hedge, we would discontinue hedge accounting prospectively. All derivatives are recognized on the balance sheet at their fair value. Changes in the fair value of derivative financial instruments are either recognized in income or stockholders' equity (as a component of other comprehensive income), depending on whether the derivative is being used to hedge changes in fair value or cash flows. We have interest rate swap arrangements related to a portion of our fixed rate debt. These hedge strategies satisfy the fair value hedging requirements of SFAS No. 133, as amended. As a result, the fair value of the swaps is carried on the balance sheet in other current assets and the related hedged liabilities are also adjusted to fair value by the same amount. F-10 (i) Investments: ------------ Marketable Securities We classify our cost method investments at purchase as available-for-sale. We do not maintain a trading portfolio or held-to-maturity securities. Securities classified as available-for-sale are carried at estimated fair market value. These securities are held for an indefinite period of time, but might be sold in the future as changes in market conditions or economic factors occur. Net aggregate unrealized gains and losses related to such securities, net of taxes, are included as a separate component of shareholders' equity. Interest, dividends and gains and losses realized on sales of securities are reported in Investment income. We evaluate our investments periodically to determine whether any decline in fair value, below the cost basis, is other than temporary. To determine whether an impairment is other than temporary, we consider whether we have the ability and intent to hold the investment until a market price recovery and whether evidence indicating the cost of the investment is recoverable outweighs evidence to the contrary. Evidence considered in this assessment includes the reasons for the impairment, the severity and duration of the impairment, changes in value subsequent to year-end, and forecasted performance of the investee. If we determine that a decline in fair value is other than temporary, the cost basis of the individual investment is written down to fair value, which becomes the new cost basis. The amount of the write-down is transferred from other comprehensive income (loss) and included in the statement of operations as a loss. Investments in Other Entities Investments in entities that we do not control, but where we have the ability to exercise significant influence over operating and financial policies, are accounted for using the equity method of accounting. (j) Income Taxes and Deferred Income Taxes: -------------------------------------- We file a consolidated federal income tax return. We utilize the asset and liability method of accounting for income taxes. Under the asset and liability method, deferred income taxes are recorded for the tax effect of temporary differences between the financial statement basis and the tax basis of assets and liabilities using tax rates expected to be in effect when the temporary differences are expected to reverse. (k) Stock Plans: ------------ We have various stock-based compensation plans. Awards under these plans are granted to eligible officers, management, non-management employees and non-employee directors. Awards may be made in the form of incentive stock options, non-qualified stock options, stock appreciation rights, restricted stock or other stock based awards. As permitted by current accounting rules, we apply Accounting Principles Board Opinions (APB) No. 25 and related interpretations in accounting for the employee stock plans resulting in the use of the intrinsic value to value the stock. SFAS No. 123, "Accounting for Stock-Based Compensation" and SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure, an

amendment of SFAS No. 123," established accounting and disclosure requirements using a fair-value-based method of accounting for stock-based employee compensation plans. As permitted by existing accounting standards, we have elected to continue to apply the intrinsic-valued-based method of accounting described above, and have adopted only the disclosure requirements of SFAS No. 123, as amended. In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment," ("SFAS No. 123R"). SFAS 123R requires that stock-based employee compensation be recorded as a charge to earnings. In April 2005, the Securities and Exchange Commission required the adoption of SFAS No. 123R for annual periods beginning after June 15, 2005. Accordingly, we will adopt SFAS 123R commencing January 1, 2006 and expect to recognize approximately $2,800,000 of expense related to the non-vested portion of previously granted stock options for the year ended December 31, 2006. We provide pro forma net income and pro forma net income per common share disclosures for employee and non-employee director stock option grants based on the fair value of the options at the date of grant (see Note 18). For purposes of presenting pro forma information, the fair value of options granted is computed using the Black Scholes option-pricing model. F-11 Had we determined compensation cost based on the fair value at the grant date for the Management Equity Incentive Plan (MEIP), Equity Incentive Plan (EIP) and Directors' Deferred Fee Equity Plan, our pro forma net income and net income per common share available for common shareholders would have been as follows: 2005 2004 2003 --------------- ---------------- -------------- ($ in thousands) --------------- Net income available for common shareholders As reported $202,375 $72,150 $ 187,852 Add: Stock-based employee compensation expense included in reported net income, net of related tax effects 5,267 29,381 6,014 Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects (8,165) (38,312) (16,139) -------- --------- --------- Pro forma $199,477 $63,219 $ 177,727 ======== ========= ========= Net income per common share As reported: available for common shareholders Basic $ 0.60 $ 0.24 $ 0.67 Diluted 0.60 0.23 0.64 Pro forma: Basic $ 0.59 $ 0.21 $ 0.63 Diluted 0.59 0.20 0.61 In connection with the payment of the special, non-recurring dividend of $2.00 per common share on September 2, 2004, the exercise price and number of all outstanding options was adjusted such that each option had the same value to the holder after the dividend as it had before the dividend. In accordance with FASB Interpretation No. 44 (FIN 44), "Accounting for Certain Transactions Involving Stock Compensation" and EITF 00-23, "Issues Related to the Accounting for Stock Compensation under APB No. 25 and FIN 44," there is no accounting consequence for changes made to the exercise price and the number of shares of a fixed stock option or award as a direct result of the special, non-recurring dividend. (l) Net Income Per Common Share Available for Common Shareholders: -- Basic net income per common share is computed using the weighted average number of common shares outstanding during the period being reported on. Except when the effect would be antidilutive, diluted net income per common share reflects the dilutive effect of the assumed exercise of stock options using the treasury stock method at the beginning of the period being reported on as well as common shares that would result from the conversion of convertible debt. In addition, the related interest on debt (net of tax) is added back to income since it would not be paid if the debt was converted to common stock. (2) Recent Accounting Literature and Changes in Accounting Principles: -- Accounting for Asset Retirement Obligations --- In June 2001, the FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations." We adopted SFAS No. 143 effective January 1, 2003. As a result of our adoption of SFAS No. 143, we recognized an after tax non-cash gain of approximately $65,769,000. This gain resulted from the elimination of the cumulative cost of removal included in accumulated depreciation and is reflected as a cumulative effect of a change in accounting principle in our statement of operations in 2003, as we have no legal obligation to remove certain of our long-lived assets. F-12 Stock-Based Compensation ----------------------- In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure, an amendment of FASB Statement No. 123, "Accounting for Stock-Based Compensation." SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based compensation and amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements. This statement is effective for fiscal years ending after December 15, 2002. We have adopted the expanded disclosure requirements of SFAS No. 148. In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment," (SFAS No. 123R). SFAS No. 123R requires that stock-based employee compensation be recorded as a charge to earnings. In April 2005, the Securities and Exchange Commission required adoption of SFAS No. 123R for annual periods beginning after June 15, 2005. Accordingly, we will adopt SFAS 123R

commencing January 1, 2006 and expect to recognize approximately $2,800,000 of expense related to the non-vested portion of previously granted stock options for the year ended December 31, 2006. Variable Interest Entities ------------------------- In December 2003, the FASB issued FASB Interpretation No. 46 (revised December 2003) (FIN 46R), "Consolidation of Variable Interest Entities," which addresses how a business enterprise should evaluate whether it has a controlling financial interest in an entity through means other than voting rights and accordingly should consolidate the entity. FIN 46R replaces FASB Interpretation No. 46, "Consolidation of Variable Interest Entities," which was issued in January 2003. We are required to apply FIN 46R to variable interests in variable interest entities, or VIEs, created after December 31, 2003. For any VIEs that must be consolidated under FIN 46R that were created before January 1, 2004, the assets, liabilities and noncontrolling interests of the VIE initially would be measured at their carrying amounts with any difference between the net amount added to the balance sheet and any previously recognized interest being recognized as the cumulative effect of an accounting change. If determining the carrying amounts is not practicable, fair value at the date FIN 46R first applies may be used to measure the assets, liabilities and noncontrolling interest of the VIE. We reviewed all of our investments and determined that the Trust Convertible Preferred Securities (EPPICS), issued by our consolidated wholly-owned subsidiary, Citizens Utilities Trust and the related Citizens Utilities Capital L.P., were our only VIEs. Except as described in Note 15, the adoption of FIN 46R on January 1, 2004 did not have a material impact on our financial position or results of operations. Investments ----------- In March 2004, the FASB issued EITF Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" (EITF 03-1), which provides new guidance for assessing impairment losses on debt and equity investments. Additionally, EITF 03-1 includes new disclosure requirements for investments that are deemed to be temporarily impaired. In September 2004, the FASB delayed the accounting provisions of EITF 03-1; however, the disclosure requirements remain effective and were adopted for our year ended December 31, 2004. Although we have no material investments at the present time, we will evaluate the effect, if any, of EITF 03-1 when final guidance is released. Exchanges of Productive Assets ------------------------------ In December 2004, the FASB issued SFAS No. 153, "Exchanges of Nonmonetary Assets," an amendment of APB Opinion No. 29. SFAS No. 153 addresses the measurement of exchanges of certain non-monetary assets (except for certain exchanges of products or property held for sale in the ordinary course of business). The Statement requires that non-monetary exchanges be accounted for at the fair value of the assets exchanged, with gains or losses being recognized, if the fair value is determinable within reasonable limits and the transaction has commercial substance. SFAS No. 153 is effective for nonmonetary exchanges occurring in fiscal periods beginning after June 15, 2005. We do not expect the adoption of the new standard to have a material impact on our financial position, results of operations and cash flows. Accounting for Conditional Asset Retirement Obligations --- In March 2005, the FASB issued FIN 47, "Accounting for Conditional Asset Retirement Obligations," an interpretation of FASB No. 143. FIN 47 clarifies that the term conditional asset retirement obligation as used in FASB No. 143 refers to a legal obligation to perform an asset retirement activity in which the timing or method of settlement are conditional on a future event that may or may not be within the control of the entity. FIN F-13 47 also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. Although a liability exists for the removal of poles and asbestos, sufficient information is not available currently to estimate our liability, as the range of time over which we may settle theses obligations is unknown or cannot be reasonably estimated. The adoption of FIN 47 during the fourth quarter of 2005 had no impact on our financial position or results of operations. Accounting Changes and Error Corrections -- In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections," a replacement of APB Opinion No. 20 and FASB Statement No. 3. SFAS No. 154 changes the accounting for, and reporting of, a change in accounting principle. SFAS No. 154 requires retrospective application to prior period's financial statements of voluntary changes in accounting principle, and changes required by new accounting standards when the standard does not include specific transition provisions, unless it is impracticable to do so. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. Partnerships ------------ In June 2005, the FASB issued EITF No. 04-5, "Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights," which provides new guidance on how general partners in a limited partnership should determine whether they control a limited partnership. EITF No. 04-5 is effective for fiscal periods beginning after December 15, 2005. We do not expect the adoption of EITF No. 04-5 to have a material impact on our financial

position, results of operations or cash flows. (3) Accounts Receivable: -------------------- The components of accounts receivable at December 31, 2005 and 2004 are as follows: ($ in thousands) 2005 2004 ---------------- -------------- -------------- End user $ 226,717 $ 227,385 Other 34,798 42,301 Less: Allowance for doubtful accounts (32,408) (35,996) ------------- ------------- Accounts receivable, net $ 229,107 $ 233,690 ============= ============= We maintain an allowance for estimated bad debts based on our estimate of collectibility of our accounts receivable. Bad debt expense, which is recorded as a reduction of revenue, was $13,510,000, $17,906,000 and $21,540,000 for the years ended December 31, 2005, 2004, and 2003, respectively. (4) Property, Plant and Equipment: ------------------------------ The components of property, plant and equipment at December 31, 2005 and 2004 are as follows: Estimated ($ in thousands) Useful Lives 2005 2004 --------------- ------------------ ----------------- ----------------- Land N/A $ 20,748 $ 21,481 Buildings and leasehold improvements 30 to 41 years 359,339 357,983 General support 3 to 17 years 413,512 414,360 Central office/electronic circuit equipment 5 to 11 years 2,611,934 2,536,579 Cable and wire 15 to 60 years 3,085,338 2,972,919 Other 5 to 30 years 35,458 31,993 Construction work in progress 99,746 93,049 ---------------- ---------------- 6,626,075 6,428,364 Less: accumulated depreciation (3,439,610) (3,092,514) ---------------- ---------------- Property, plant and equipment, net $ 3,186,465 $ 3,335,850 ================ ================ F-14 Depreciation expense is principally based on the composite group method. Depreciation expense was $415,581,000, $444,288,000 and $466,323,000 for the years ended December 31, 2005, 2004 and 2003, respectively. Effective January 1, 2003, as a result of the adoption of SFAS No. 143, "Accounting for Asset Retirement Obligations," we ceased recognition of the cost of removal provision in depreciation expense and eliminated the cumulative cost of removal included in accumulated depreciation. Effective with the completion of an independent study of the estimated useful lives of our plant assets we adopted new lives beginning October 1, 2005. (5) Losses on Impairment: --------------------- During 2005 and 2004, we did not recognize any impairment charges. During 2003, we recognized non-cash pre-tax impairment losses of $15,300,000 related to our Vermont electric division assets held for sale in accordance with the provisions of SFAS No. 144. (6) Dispositions: ------------- Pre-tax gains (losses) in connection with the following transactions were recorded in other income (loss), net: 2005 ---- On February 1, 2005, we sold shares of Prudential Financial, Inc. for approximately $1,112,000 in cash, and we recognized a pre-tax gain of approximately $493,000. In June 2005, we sold for cash our interests in certain key man life insurance policies on the lives of Leonard Tow, our former Chairman and Chief Executive Officer, and his wife, a former director. The cash surrender value of the policies purchased by Dr. Tow totaled approximately $24,195,000, and we recognized a pre-tax gain of approximately $457,000. During 2005, we sold shares of Global Crossing Limited for approximately $1,084,000 in cash, and we recognized a pre-tax gain for the same amount. 2004 ---- In October 2004, we sold cable assets in California, Arizona, Indiana, and Wisconsin for approximately $2,263,000 in cash. The pre-tax gain on the sale was $40,000. During the third quarter of 2004, we sold our corporate aircraft for approximately $15,298,000 in cash. The pre-tax loss on the sale was $1,087,000. 2003 ---- On April 1, 2003, we completed the sale of approximately 11,000 telephone access lines in North Dakota for approximately $25,700,000 in cash. The pre-tax gain on the sale was $2,274,000. On April 4, 2003, we completed the sale of our wireless partnership interest in Wisconsin for approximately $7,500,000 in cash. The pre-tax gain on the sale was $2,173,000. (7) Other Intangibles: ----------------- Other intangibles at December 31, 2005 and 2004 are as follows: ($ in thousands) 2005 2004 ---------------- -------------- ------------- Customer base - amortizable over 96 months $ 994,605 $ 994,605 Trade name - non-amortizable 122,058 122,058 -------------- ------------- Other intangibles 1,116,663 1,116,663 Accumulated amortization (557,930) (431,552) -------------- ------------- Total other intangibles, net $ 558,733 $ 685,111 =============== ============== F-15 Amortization expense was $126,378,000, $126,520,000 and $126,838,000 for the years ended December 31, 2005, 2004 and 2003, respectively. Amortization expense, based on our estimate of useful lives, is estimated to be $126,380,000 per year through 2008 and $57,533,000 in 2009, at which point these assets will have been fully amortized. (8) Discontinued Operations: ----------------------- Conference Call USA ------------------- In February 2005, we entered into a definitive agreement to sell Conference-Call USA, LLC (CCUSA), our conferencing services business. On March 15, 2005, we completed the sale for $43,565,000 in cash, subject to adjustments under the terms of the agreement. The pre-tax gain on the sale of CCUSA was $14,061,000. Our after-tax gain was approximately $1,167,000. The book income taxes recorded upon sale are primarily attributable to a low tax basis in the assets sold. In accordance with SFAS No. 144, any component of our business that we dispose of or classify as held for sale that has operations and cash flows clearly distinguishable from operations, and for financial reporting purposes, and that will be eliminated from the ongoing operations, should

be classified as discontinued operations. Accordingly, we have classified the results of operations of CCUSA as discontinued operations in our consolidated statements of operations and have restated prior periods. CCUSA had revenues of approximately $24,600,000 and operating income of approximately $8,000,000 for the year ended December 31, 2004. At December 31, 2004, CCUSA's net assets totaled approximately $23,400,000. The company had no outstanding debt specifically identified with CCUSA and therefore no interest expense was allocated to discontinued operations. In addition, we ceased to record depreciation expense effective February 16, 2005. Summarized financial information for CCUSA (discontinued operations) is set forth below: ($ in thousands) For the years ended December 31, ---------------- --------------------------------------- 2005 2004 2003 ------------ ------------ ------------ Revenue $ 4,607 $ 24,558 $ 20,764 Operating income $ 1,489 $ 8,188 $ 6,820 Income taxes $ 449 $ 2,957 $ 2,440 Net income $ 1,040 $ 5,231 $ 4,380 Gain on disposal of CCUSA, net of tax $ 1,167 $ - $ - December 31, ($ in thousands) 2004 --------------- ---------------- Current assets $ 2,819 Net property, plant and equipment 2,450 Goodwill 18,853 ---------------- Total assets of discontinued operations $ 24,122 ================= Current liabilities $ 735 ---------------- Total liabilities of discontinued operations $ 735 ================= Public Utilities --------------- On April 1, 2004, we completed the sale of our Vermont electric distribution operations for approximately $13,992,000 in cash, net of selling expenses. With that transaction, we completed the divestiture of our public utilities services business pursuant to plans announced in 1999. Losses on the sales of our Vermont properties were included in the impairment charges recorded in 2003. F-16 (9) Investments: ------------ The components of investments at December 31, 2005 and 2004 are as follows: ($ in thousands) 2005 2004 --------------- --------------- --------------- Marketable equity securities $ 122 $ 2,336 Equity method investments 19,014 20,726 --------------- --------------- $19,136 $ 23,062 =============== =============== Marketable Securities As of December 31, 2005 and 2004, we owned 3,059,000 shares of Adelphia Communications Corp. (Adelphia) common stock. As a result of write downs recorded in 2002 and 2001, our "book cost basis" was reduced to zero and subsequent increases and decreases, except for those deemed other than temporary, are included in accumulated other comprehensive income (loss). During 2004, we sold our investments in D & E Communications, Inc. (D & E) and Hungarian Telephone and Cable Corp. (HTCC) for approximately $13,300,000 and $13,200,000 in cash, respectively. We recorded net realized gains of $12,066,000 in our statement of operations for the sale of these marketable securities. The following summarizes the adjusted cost, gross unrealized holding gains and losses and fair market value for marketable securities: ($ in thousands) Adjusted Unrealized Holding Aggregate Fair --------------- -------------------------------- Investment Classification Cost Gains (Losses) Market Value ------------------------ --------------- --------------- --------------- --------------- As of December 31, 2005 ---------------------- Available-for-Sale $ - $ 122 $ - $ 122 As of December 31, 2004 ---------------------- Available-for-Sale $ 1,138 $ 1,198 $ - $ 2,336 At December 31, 2005 and 2004, we did not have any investments that have been in a continuous unrealized loss position deemed to be temporary for more than 12 months. We determined that market fluctuations during the period are not other than temporary because the severity and duration of the unrealized losses were not significant. Investments in Other Entities During 2004, we reclassified our investments accounted for under the equity method from other assets to the investment caption in our consolidated balance sheets and conformed prior periods to the current presentation. Our investments in entities that are accounted for under the equity method of accounting consist of the following: (1) a 33% interest in the Mohave Cellular Limited Partnership which is engaged in cellular mobile telephone service in the Arizona area; (2) a 16.8% interest in the Fairmount Cellular Limited Partnership which is engaged in cellular mobile telephone service in the Rural Service Area (RSA) designated by the FCC as Georgia RSA No. 3; and (3) our investments in CU Capital and CU Trust with relation to our convertible preferred securities. The investments in these entities amounted to $19,014,000 and $20,726,000 at December 31, 2005 and 2004, respectively. (10) Fair Value of Financial Instruments: ---------------------------------- The following table summarizes the carrying amounts and estimated fair values for certain of our financial instruments at December 31, 2005 and 2004. For the other financial instruments, representing cash, accounts receivables, long-term debt due within one year, accounts payable and other accrued liabilities, the carrying amounts approximate fair value due to the relatively short maturities of those instruments. F-17 The fair value of our marketable securities and long-term debt is estimated based on quoted market prices at the reporting date for those financial instruments. Other securities and investments for which market values are not readily available are carried at cost. ($ in thousands) 2005 2004 --------------- --------------------------------- -------------------------------- Carrying Carrying Amount Fair Value Amount Fair Value --------------- ----------------- --------------- --------------- Investments $ 19,136 $ 19,136 $ 23,062

$ 23,062 Long-term debt (1) $ 3,999,376 $ 4,026,453 $ 4,266,998 $ 4,607,298 (1) 2005 and 2004 includes interest rate swaps of $(8,727,000) and $4,466,000, respectively. 2005 and 2004 includes EPPICS of $33,785,000 and $63,765,000, respectively. (11) Long-term Debt: -------------- The activity in our long-term debt from December 31, 2004 to December 31, 2005 is summarized as follows: Twelve Months Ended ------------------------------------- Interest Interest Rate* at December 31, Rate December 31, December 31, ($ in thousands) 2004 Payments Swap Other 2005 2005 ---------------- Rural Utilities Service Loan Contracts $ 29,108 $ (6,299) $ - $ - $ 22,809 6.070% Senior Unsecured Debt 4,131,803 - (13,193) 2,171 4,120,781 8.117% EPPICS** (reclassified as a result of adopting FIN 46R) 63,765 - - (29,980) 33,785 5.000% ELI Capital Leases 4,421 (134) - - 4,287 10.364% Industrial Development Revenue Bonds 58,140 - - - 58,140 5.559% ------------ ------------ ----------- ---------- ----------- TOTAL LONG TERM DEBT $4,287,237 $ (6,433) $(13,193) $(27,809) $4,239,802 ------------ ============ =========== ========== ----------- Less: Debt Discount (13,859) (12,692) Less: Current Portion (6,380) (227,734) ------------ ----------- $4,266,998 $3,999,376 ============ =========== * Interest rate includes amortization of debt issuance expenses, debt premiums or discounts. The interest rate for Rural Utilities Service Loan Contracts, Senior Unsecured Debt, and Industrial Development Revenue Bonds represent a weighted average of multiple issuances. ** In accordance with FIN 46R, the Trust holding the EPPICS and the related Citizens Utilities Capital L.P. are now deconsolidated (see Note 15). F-18 Additional information regarding our Senior Unsecured Debt at December 31, 2005 is as follows: Principal Interest ($ in thousands) Outstanding Rate ---------------- ---------------- ---------- Senior Notes: Due 8/17/2006 $ 51,770 6.750% Due 8/15/2008 698,470 7.625% Due 5/15/2011 1,044,256 9.250% Due 10/24/2011 200,000 6.270% Due 1/15/2013 698,537 6.250% Due 8/15/2031 748,006 9.000% ---------------- 3,441,039 Debentures due 2006 - 2046 643,742 7.263% Subsidiary Senior Notes due 12/1/2012 36,000 8.050% ---------------- Total $ 4,120,781 ================ In February 2006, our Board of Directors authorized us to repurchase up to $150.0 million of our outstanding debt securities over the following twelve-month period. These repurchases may require us to pay premiums, which would result in pre-tax losses to be recorded in other income (loss), net. For the year ended December 31, 2005, we retired an aggregate $36,412,000 of debt (including $29,980,000 of EPPICS conversions), representing approximately 1% of total debt outstanding at December 31, 2004. During the second quarter of 2005, we entered into two debt-for-debt exchanges of our debt securities. As a result, $50,000,000 of our 7.625% Notes due 2008 were exchanged for approximately $52,171,000 of our 9.00% Notes due 2031. The 9.00% Notes are callable on the same general terms and conditions as the 7.625% Notes exchanged. No cash was exchanged in these transactions, however a non-cash pre-tax loss of approximately $3,175,000 was recognized in accordance with EITF No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments" which is included in other income (loss), net. As of December 31, 2005, EPPICS representing a total principal amount of $177,971,000 had been converted into 14,237,807 shares of our common stock. Total future minimum cash payment commitments under ELI's long-term capital leases including interest amounted to $9,113,000 as of December 31, 2005. The total outstanding principal amounts of industrial development revenue bonds were $58,140,000 at December 31, 2005 and 2004. The earliest maturity date for these bonds is in August 2015. Under the terms of our agreements to sell our former gas and electric operations in Arizona, completed in 2003, we are obligated to call for redemption, at their first available call dates, three Arizona industrial development revenue bond series aggregating to approximately $33,440,000. These bonds' first call dates are in 2007. We expect to retire all called bonds with cash. In addition, holders of $11,150,000 principal amount of industrial development bonds may tender such bonds to us at par and we have the simultaneous option to call such bonds at par on August 7, 2007. We expect to call the bonds and retire them with cash. As of December 31, 2005 we had available lines of credit with financial institutions in the aggregate amount of $250,000,000 with a maturity date of October 29, 2009. Associated facility fees vary depending on our leverage ratio and were 0.375% as of December 31, 2005. During the term of the credit facility we may borrow, repay and re-borrow funds. The credit facility is available for general corporate purposes but may not be used to fund dividend payments. There have never been any borrowings under the facility. For the year ended December 31, 2004, we retired an aggregate $1,362,012,000 of debt (including $147,991,000 of EPPICS conversions), representing approximately 28% of total debt outstanding at December 31, 2003. F-19 On January 15, 2004, we repaid at maturity the remaining outstanding $80,955,000 of our 7.45% Debentures. On January 15, 2004, we redeemed at 101% the remaining outstanding $12,300,000 of our Hawaii Special Purpose Revenue Bonds, Series 1993A and Series 1993B. On May 17, 2004, we repaid at maturity the remaining outstanding $5,975,000 of ELI's 6.05% Notes. These Notes had been guaranteed by the Company. On July 15, 2004, we renegotiated and prepaid with $4,954,000 of cash the

entire remaining $5,524,000 ELI capital lease obligation to a third party. On July 30, 2004, we purchased $300,000,000 of the 6.75% notes that were a component of our equity units at 105.075% of par, plus accrued interest, at a premium of approximately $15,225,000 recorded in investment and other income (loss), net. During August and September 2004, we repurchased through a series of transactions an additional $108,230,000 of the 6.75% notes due 2006 at a weighted average price of 104.486% of par, plus accrued interest, at a premium of approximately $4,855,000 recorded in investment and other income (loss), net. On November 8, 2004, we issued an aggregate $700,000,000 principal amount of 6.25% senior notes due January 15, 2013 through a registered underwritten public offering. Proceeds from the sale were used to redeem our outstanding $700,000,000 of 8.50% Notes due 2006, which is discussed below. On November 12, 2004, we called for redemption on December 13, 2004 the entire $700,000,000 of our 8.50% Notes due 2006 at a price of 107.182% of the principal amount called, plus accrued interest, at a premium of approximately $50,300,000. As of December 31, 2004, EPPICS representing a total principal amount of $147,991,000 had been converted into 11,622,749 shares of our common stock. During the twelve months ended December 31, 2003, we executed a series of purchases in the open market of our outstanding debt securities. The aggregate principal amount of debt securities purchased was $94,895,000 and they generated a pre-tax loss on the early extinguishment of debt at a premium of approximately $3,117,000 recorded in other income (loss), net. Our principal payments and capital lease payments (principal only) for the next five years are as follows: ($ in thousands) --------------- Principal ELI Capital --------- ------------- Payments Lease Payments --------- ------------- 2006 227,693 41 2007 37,771 110 2008 700,938 126 2009 1,006 145 2010 4,387 165 (12) Derivative Instruments and Hedging Activities: -- Interest rate swap agreements are used to hedge a portion of our debt that is subject to fixed interest rates. Under our interest rate swap agreements, we agree to pay an amount equal to a specified variable rate of interest times a notional principal amount, and to receive in return an amount equal to a specified fixed rate of interest times the same notional principal amount. The notional amounts of the contracts are not exchanged. No other cash payments are made unless the agreement is terminated prior to maturity, in which case the amount paid or received in settlement is established by agreement at the time of termination and represents the market value, at the then current rate of interest, of the remaining obligations to exchange payments under the terms of the contracts. F-20 The interest rate swap contracts are reflected at fair value in our consolidated balance sheets and the related portion of fixed-rate debt being hedged is reflected at an amount equal to the sum of its book value and an amount representing the change in fair value of the debt obligations attributable to the interest rate risk being hedged. Changes in the fair value of interest rate swap contracts, and the offsetting changes in the adjusted carrying value of the related portion of the fixed-rate debt being hedged, are recognized in the consolidated statements of operations in interest expense. The notional amounts of interest rate swap contracts hedging fixed-rate indebtedness as of December 31, 2005 and December 31, 2004 were $500,000,000 and $300,000,000, respectively. Such contracts require us to pay variable rates of interest (average pay rates of approximately 8.60% and 6.12% as of December 31, 2005 and 2004, respectively) and receive fixed rates of interest (average receive rates of 8.46% and 8.44% as of December 31, 2005 and 2004, respectively). The fair value of these derivatives is reflected in other assets as of December 31, 2005 and 2004, in the amount of $(8,727,000) and $4,466,000, respectively. The related underlying debt has been decreased in 2005 and increased in 2004 by a like amount. The amounts received during the year ended December 31, 2005 and 2004 as a result of these contracts amounted to $2,522,000 and $9,363,000, respectively, and are included as a reduction of interest expense. During September 2005, we entered into a series of separate forward rate agreements with our swap counter-parties that fixed the underlying variable rate component of some of our swaps at the market rate as of the date of execution for certain future rate-setting dates. At December 31, 2005, the rates obtained under these forward rate agreements were below market rates. The fair value of these derivatives is reflected in other current assets as of December 31, 2005, in the amount of $1,129,000. A gain for the changes in the fair value of these forward rate agreements of $1,851,000 is included in other income (loss), net for the year ended December 31, 2005. As the result of our call of all of our 8.50% Notes in November 2004, we terminated five interest rate swaps involving an aggregate $250,000,000 notional amount of indebtedness. Proceeds from the swap terminations of approximately $3,026,000 and U.S. Treasury rate lock agreements of approximately $971,000 were applied against the cost to retire the debt, resulting in a net premium of approximately $46,277,000 recorded in other income (loss), net. We do not anticipate any nonperformance by counter-parties to our derivative contracts as all counter-parties have investment grade credit ratings. (13) Management Succession and Strategic Alternatives Expenses: --- On July 11, 2004, our Board of Directors announced that it had

completed its review of our financial and strategic alternatives, and on September 2, 2004, we paid a special, non-recurring dividend of $2.00 per common share and a quarterly dividend of $0.25 per common share to shareholders of record on August 18, 2004. Concurrently, Leonard Tow decided to step down from his position as chief executive officer, effective immediately, and resigned his position as Chairman of the Board on September 27, 2004. The Board of Directors named Mary Agnes Wilderotter president and chief executive officer in November 2004. In 2004, we expensed approximately $90,632,000 of costs related to management succession and our exploration of financial and strategic alternatives. Included are $36,618,000 of non-cash expenses for the acceleration of stock benefits, cash expenses of $19,229,000 for advisory fees, $19,339,000 for severance and retention arrangements and $15,446,000 primarily for tax reimbursements. F-21 (14) Other Income (Loss), net: ------------------------ The components of other income (loss), net for the years ended December 31, 2005, 2004 and 2003 are as follows: ($ in thousands) 2005 2004 2003 ---------------- ---------------- ---------------- ----------------- Legal contingencies $ (7,000) $ - $ - Gain on capital lease termination/restructuring - - 69,512 Gain on expiration/settlement of customer advances 681 25,345 6,165 Loss on exchange of debt (3,175) - - Premium on debt repurchases - (66,480) (10,851) Gain on forward rate agreements 1,851 - - Gain (loss) on sale of assets - (1,945) (20,492) Other, net 5,969 (10,279) (275) ---------------- ---------------- ---------------- Total other income (loss), net $ (1,674) $ (53,359) $ 44,059 ================ ================ ================ In the fourth quarter of 2005, we recorded $7,000,000 of expense was recorded in connection with a legal matter. In connection with our exchange of debt during the second quarter of 2005, we recognized a non-cash, pre-tax loss of approximately $3,175,000. 2005 also includes a gain for the changes in fair value of our forward rate agreements. During 2005, 2004 and 2003, we recognized income in connection with certain retained liabilities associated with customer advances for construction from our disposed water properties, as a result of some of these liabilities terminating. During 2003, we recognized gains in connection with the termination/restructuring of capital leases at ELI. Gain (loss) on sale of assets in 2004 is primarily attributable to the loss on the sale of our corporate aircraft during the third quarter. In 2003, the amount represents the sales of The Gas Company in Hawaii and our Arizona gas and electric divisions, access lines in North Dakota and our wireless partnership interest in Wisconsin, and our Plano, Texas office building. (15) Company Obligated Mandatorily Redeemable Convertible Preferred Securities: -- In 1996, our consolidated wholly-owned subsidiary, Citizens Utilities Trust (the Trust), issued, in an underwritten public offering, 4,025,000 shares of 5% Company Obligated Mandatorily Redeemable Convertible Preferred Securities due 2036 (EPPICS), representing preferred undivided interests in the assets of the Trust, with a liquidation preference of $50 per security (for a total liquidation amount of $201,250,000). These securities have an adjusted conversion price of $11.46 per Citizens common share. The conversion price was reduced from $13.30 to $11.46 during the third quarter of 2004 as a result of the $2.00 per share special, non-recurring dividend. The proceeds from the issuance of the Trust Convertible Preferred Securities and a Company capital contribution were used to purchase $207,475,000 aggregate liquidation amount of 5% Partnership Convertible Preferred Securities due 2036 from another wholly-owned subsidiary, Citizens Utilities Capital L.P. (the Partnership). The proceeds from the issuance of the Partnership Convertible Preferred Securities and a Company capital contribution were used to purchase from us $211,756,000 aggregate principal amount of 5% Convertible Subordinated Debentures due 2036. The sole assets of the Trust are the Partnership Convertible Preferred Securities, and our Convertible Subordinated Debentures are substantially all the assets of the Partnership. Our obligations under the agreements related to the issuances of such securities, taken together, constitute a full and unconditional guarantee by us of the Trust's obligations relating to the Trust Convertible Preferred Securities and the Partnership's obligations relating to the Partnership Convertible Preferred Securities. In accordance with the terms of the issuances, we paid the annual 5% interest in quarterly installments on the Convertible Subordinated Debentures in the four quarters of 2005, 2004 and 2003. Only cash was paid (net of investment returns) to the Partnership in payment of the interest on the Convertible Subordinated Debentures. The cash was then distributed by the Partnership to the Trust and then by the Trust to the holders of the EPPICS. As of December 31, 2005, EPPICS representing a total principal amount of $177,971,000 had been converted into 14,237,807 shares of our common stock. F-22 We adopted the provisions of FIN 46R (revised December 2003) (FIN 46R), "Consolidation of Variable Interest Entities," effective January 1, 2004. Accordingly, the Trust holding the EPPICS and the related Citizens Utilities Capital L.P. are deconsolidated. (16) Capital Stock: -------------- We are authorized to issue up to 600,000,000 shares of common stock. The amount and timing of dividends payable on common stock are within the sole discretion of our Board of

Directors. (17) Stock Plans: ------------ At December 31, 2005, we have four stock based compensation plans, which are described below. We apply APB Opinion No. 25 and related interpretations in accounting for the employee stock plans resulting in the use of the intrinsic value to value the stock option. Compensation cost has not generally been recognized in the financial statements for options issued pursuant to the Management Equity Incentive Plan (MEIP), the 1996 Equity Incentive Plan (1996 EIP) or the Amended and Restated 2000 Equity Incentive Plan (2000 EIP), as the exercise price for such options was equal to the market price of the stock at the time of grant. In connection with our Directors' Deferred Fee Equity Plan, compensation costs associated with the issuance of stock units was $1,069,000, $2,222,000 and $607,000 in 2005, 2004 and 2003, respectively. Cash compensation associated with this plan was $434,000, $642,000 and $374,000 in 2005, 2004 and 2003, respectively. These costs are recognized in other operating expenses. We have granted restricted stock awards to key employees in the form of our common stock. The number of shares issued as restricted stock awards during 2005, 2004 and 2003 were 352,000, 2,172,000 and 312,000, respectively. None of the restricted stock awards may be sold, assigned, pledged or otherwise transferred, voluntarily or involuntarily, by the employees until the restrictions lapse. The restrictions are time based. At December 31, 2005, 1,456,000 shares of restricted stock were outstanding. Compensation expense, recognized in operating expense, of $7,358,000, $45,313,000 and $8,552,000, for the years ended December 31, 2005, 2004 and 2003, respectively, has been recorded in connection with these grants. Management Equity Incentive Plan ------------------------------- Under the MEIP, awards of our common stock may be granted to eligible officers, management employees and non-management employees in the form of incentive stock options, non-qualified stock options, stock appreciation rights (SARs), restricted stock or other stock-based awards. The Compensation Committee of the Board of Directors administers the MEIP. Since the expiration date of the MEIP plan on June 21, 2000, no awards can be granted under the MEIP. The exercise price of stock options issued was equal to or greater than the fair market value of the underlying common stock on the date of grant. Stock options are generally not exercisable on the date of grant but vest over a period of time. Under the terms of the MEIP, subsequent stock dividends and stock splits have the effect of increasing the option shares outstanding, which correspondingly decreases the average exercise price of outstanding options. Equity Incentive Plans --------------------- In May 1996, our shareholders approved the 1996 EIP and in May 2001, our shareholders approved the 2000 EIP. Under the EIP plans, awards of our common stock may be granted to eligible officers, management employees and non-management employees in the form of incentive stock options, non-qualified stock options, SARs, restricted stock or other stock-based awards. Directors may receive awards under the 2000 EIP (other than options for annual retainer fees). SARs may be granted under the 1996 EIP. The Compensation Committee of the Board of Directors administers the EIP plans. The maximum number of shares of common stock, which may be issued pursuant to awards at any time for both plans, is 25,358,000 shares, which has been adjusted for subsequent stock dividends. No awards will be granted more than 10 years after the effective dates (May 23, 1996 and May 18, 2000) of the EIP plans. The exercise price of stock options and SARs generally shall be equal to or greater than the fair market value of the underlying common stock on the date of grant. Stock options are generally not exercisable on the date of grant but vest over a period of time. F-23 Under the terms of the EIP plans, subsequent stock dividends and stock splits have the effect of increasing the option shares outstanding, which correspondingly decrease the average exercise price of outstanding options. In connection with the payment of the special, non-recurring dividend of $2.00 per common share on September 2, 2004, the exercise price and number of all outstanding options was adjusted such that each option had the same value to the holder after the dividend as it had before the dividend. In accordance with FASB Interpretation No. 44 (FIN 44), "Accounting for Certain Transactions Involving Stock Compensation" and EITF 00-23, "Issues Related to the Accounting for Stock Compensation under APB No. 25 and FIN 44," there is no accounting consequence for changes made to the exercise price and the number of shares of a fixed stock option or award as a direct result of the special, non-recurring dividend. The following is a summary of share activity subject to option under the MEIP and EIP plans. Weighted Shares Average Subject to Option Price Option Per Share --- -------------------- ----------------- Balance at January 1, 2003 19,132,000 $11.66 Options granted 2,017,000 12.14 Options exercised (1,612,000) 7.97 Options canceled, forfeited or lapsed (1,572,000) 12.92 --- -------------------- Balance at December 31, 2003 17,965,000 11.94 Options granted - - Options exercised (7,411,000) 9.69 Options canceled, forfeited or lapsed (355,000) 12.14 Effect of special, non-recurring dividend 2,212,000 - --- -------------------- Balance at December 31, 2004 12,411,000 11.15 Options granted 183,000 11.58 Options exercised

(4,317,000) 10.52 Options canceled, forfeited or lapsed (292,000) 10.48 -- -------------------- Balance at December 31, 2005 7,985,000 $11.52 == ==================== The following table summarizes information about shares subject to options under the MEIP and EIP plans at December 31, 2005. Options Outstanding Options Exercisable --- ------------------------------- Weighted Average Weighted Number Range of Weighted Average Remaining Number Average Outstanding Exercise Prices Exercise Price Life in Years Exercisable Exercise Price ----------------- ------------------- ------------------- -------------------- ---------------- -------------- 517,000 $ 6.45 - 6.67 $ 6.54 2.64 517,000 $ 6.54 300,000 7.33 - 7.98 7.37 1.92 289,000 7.35 1,228,000 8.19 - 8.19 8.19 6.38 737,000 8.19 173,000 8.80 - 9.68 9.02 1.55 173,000 9.02 1,399,000 10.44 - 10.44 10.44 7.41 519,000 10.44 815,000 10.64 - 11.15 11.13 4.78 815,000 11.13 1,430,000 11.79 - 11.79 11.79 5.38 1,430,000 11.79 2,123,000 11.90 - 18.46 16.14 4.95 2,068,000 16.24 ----------------- ---------------- 7,985,000 $ 6.45 - 18.46 $11.52 5.32 6,548,000 $11.92 ================= ================ The number of options exercisable at December 31, 2004 and 2003 were 9,235,000 and 11,690,000, respectively. The weighted average fair value of options granted during 2005 was $2.98. There were no option grants made during 2004. The weighted average fair value of options granted during 2003 was $6.04. For purposes of the pro forma calculation, the fair value of each option grant is estimated on the date of grant using the Black Scholes option-pricing model with the following weighted average assumptions used for grants in 2005 and 2003: F-24 2005 2003 -------------------------- --------------------------- Dividend yield 7.72% - Expected volatility 46% 44% Risk-free interest rate 4.16% 2.94% Expected life 6 years 7 years -------------------------- -------------- -------------- Non-Employee Directors' Compensation Plan --- Upon commencement of his or her service on the Board of Directors, each non-employee director receives a grant of 10,000 stock options, which is awarded under our 2000 EIP. The price of these options, which are immediately exercisable, is set at the average of the high and low market prices of our common stock on the effective date of the director's initial election to the board. Annually, each non-employee director also receives a grant of 3,500 stock units under our Formula Plan, which commenced in 1997 and continues through May 22, 2007. Prior to April 20, 2004, each non-employee director received an award of 5,000 stock options. The exercise price of the options granted under the Formula Plan was set at 100% of the average of the high and low market prices of our common stock on the third, fourth, fifth, and sixth trading days of the year in which the options were granted. The options are exercisable six months after the grant date and remain exercisable for ten years after the grant date. In addition, on September 1, 1996, each non-employee director received a grant, under the Formula Plan, of options to purchase 2,500 shares of common stock. These options granted under the Formula Plan became exercisable six months after the grant date and remain exercisable for ten years after the grant date. Effective April 2004, the Formula Plan was amended to replace the annual grant of stock options with an annual grant of 3,500 stock units. The stock units are awarded on the first business day of each calendar year. Each non-employee director must elect, by December 31 of the preceding year, whether the stock units awarded under the Formula Plan will be redeemed in cash or stock upon the director's retirement or death, whichever occurs first. In addition, each non-employee director is also entitled to annually receive a retainer, meeting fees, and, when applicable, fees for serving as a committee chair or as Lead Director, which are awarded under the Non-Employee Directors' Deferred Fee Equity Plan. For 2005, each non-employee director had to elect, by December 31 of the preceding year, to receive $30,000 cash or 5,000 stock units as an annual retainer. Directors making a stock unit election must also elect to convert the units to either common stock (convertible on a one-to-one basis) or cash upon retirement or death. Prior to June 30, 2003, a director could elect to receive 20,000 stock options as an annual retainer in lieu of cash or stock units. The exercise price of the stock options was set at the average of the high and low market prices of our common stock on the date of grant. The options were exercisable six months after the date of grant and had a 10-year term. As of any date, the maximum number of shares of common stock which the Non-Employee Directors' Deferred Fee Equity Plan is obligated to deliver shall not be more than one percent (1%) of the total outstanding shares of our common stock as of June 30, 2003, subject to adjustment in the event of changes in our corporate structure affecting capital stock. There were 14 directors participating in the Directors' Plan during all or part of 2005. In 2005, the total options, plan units, and stock earned were 0, 64,000 and 0, respectively. In 2004, the total options, plan units, and stock earned were 50,000, 57,226 and 0, respectively. In 2003, the total options, plan units, and stock earned were 83,125, 46,034 and 0, respectively. At December 31, 2005, 473,252 options were exercisable at a weighted average exercise price of $9.80.

For 2005, each non-employee director received fees of $2,000 for each Board of Directors and committee meeting attended. The chairs of the Audit, Compensation, Nominating and Corporate Governance and Retirement Plan Committees were paid an additional annual fee of $25,000, $15,000, $7,500 and $5,000, respectively. In addition, the Lead Director, who heads the ad hoc committee of non-employee directors, received an additional annual fee of $17,000 (based on an annual fee that was changed from $20,000 to $15,000 mid-year). A director must elect, by December 31 of the preceding year, to receive meeting and other fees in cash, stock units, or a combination of both. All fees paid to the non-employee directors in 2005 were paid quarterly (except for the retainer which was paid at the beginning of the year. If the director elects stock units, the number of units credited to the director's account is determined as follows: the total cash value of the fees payable to the director are divided by 85% of the average of the high and low market prices of our common stock on the first trading day of the year the election is in effect. Units are credited to the director's account quarterly. F-25 We account for the Directors' Deferred Fee Equity Plan in accordance with APB Opinion No. 25, "Accounting for Stock Issued to Employees" and related interpretations. Compensation expense is recorded if cash or stock units are elected. If stock units are elected, the compensation expense is based on the market value of our common stock at the date of grant. If the stock option election is chosen, compensation expense is not recorded because the options are granted at the fair market value of our common stock on the grant date. We had also maintained a Non-Employee Directors' Retirement Plan providing for the payment of specified sums annually to our non-employee directors, or their designated beneficiaries, starting at the director's retirement, death or termination of directorship. In 1999, we terminated this Plan. The vested benefit of each non-employee director, as of May 31, 1999, was credited to the director's account in the form of stock units. Such benefit will be payable to each director upon retirement, death or termination of directorship. Each participant had until July 15, 1999 to elect whether the value of the stock units awarded would be payable in our common stock (convertible on a one-for-one basis) or in cash. As of December 31, 2005, the liability for such payments was $634,000 all of which will be payable in stock (based on the July 15, 1999 stock price). (18) Restructuring and Other Expenses: -------------------------------- 2005 and 2004 During 2005 and 2004, we did not recognize any restructuring and other expenses. We continue to review our operations, personnel and facilities to achieve greater efficiency. 2003 Restructuring and other expenses primarily consist of expenses related to reductions in personnel at our telecommunications operations and the write-off of software no longer useful. F-26 (19) Income Taxes: ------------- The following is a reconciliation of the provision for income taxes for continuing operations computed at federal statutory rates to the effective rates for the years ended December 31, 2005, 2004 and 2003: 2005 2004 2003 ------------ ----------- ----------- Consolidated tax provision at federal statutory rate 35.0 % 35.0 % 35.0 % State income tax provisions, net of federal income tax benefit 2.0 % 1.8 % 6.6 % Tax reserve adjustment (7.9)% (19.3)% (8.4)% All other, net 0.5 % (4.0)% 1.1 % ------------ ----------- ----------- 29.6 % 13.5 % 34.3 % ============ =========== =========== The components of the net deferred income tax liability (asset) at December 31 are as follows: ($ in thousands) 2005 2004 ---------------- ------------ ----------- Deferred income tax liabilities: ------------------------------- Property, plant and equipment basis differences $ 567,411 $ 578,501 Intangibles 168,703 161,955 Other, net 7,752 9,004 ------------ ----------- 743,866 749,460 ------------ ----------- Deferred income tax assets: --------------------------- Minimum pension liability 76,368 62,435 Tax operating loss carryforward 260,053 394,797 Alternate minimum tax credit carryforward 43,678 37,796 Employee benefits 66,853 55,566 Other, net 21,279 23,095 ------------ ----------- 468,231 573,689 Less: Valuation allowance (38,131) (43,503) ------------ ----------- Net deferred income tax asset 430,100 530,186 ------------ ----------- Net deferred income tax liability $ 313,766 $ 219,274 ============ =========== Deferred tax assets and liabilities are reflected in the following --- captions on the balance sheet: ------------------------------ Deferred income taxes $ 325,084 $ 232,766 Other current assets (11,318) (13,492) ------------ ----------- Net deferred income tax liability $ 313,766 $ 219,274 ============ =========== Our federal and state tax operating loss carryforwards as of December 31, 2005 are estimated at $584,476,000 and $1,409,983,000, respectively. Our federal loss carryforward will begin to expire in the year 2021. A portion of our state loss carryforward will begin to expire in 2006. Our alternative minimum tax credit as of December 31, 2005 can be carried forward indefinitely to reduce future regular tax liability. F-27 The provision (benefit) for federal and state income taxes, as well as the taxes charged or credited to shareholders' equity, includes amounts both payable currently and deferred for payment in future periods as indicated below: ($ in thousands) 2005 2004 2003 ---------------- ------------ ----------- ----------- Income taxes charged (credited) to the income statement for continuing operations: Current: Federal $ 16,708 $ (9,951) $ (12,632)

State (33,004) (3,643) 2,900 ------------ ----------- ----------- Total current (16,296) (13,594) (9,732) Deferred: Federal 96,163 26,586 77,794 Federal tax credits (18) (40) (3,128) State 4,491 (2,530) (158) ------------ ----------- ----------- Total deferred 100,636 24,016 74,508 ------------ ----------- ----------- Subtotal income taxes for continuing operations 84,340 10,422 64,776 Income taxes charged to the income statement for discontinued operations: Current: State - 3 - ------------ ----------- ----------- Total current - 3 - Deferred: Federal 12,156 2,816 2,358 State 1,187 138 82 ------------ ----------- ----------- Total deferred 13,343 2,954 2,440 ------------ ----------- ----------- Subtotal income taxes for discontinued operations 13,343 2,957 2,440 Income tax benefit on dividends on convertible preferred securities: Current: Federal - - (3,344) State - - (508) ------------ ----------- ----------- Subtotal income taxes on dividends on convertible preferred securities - - (3,852) Income taxes charged to the income statement for cumulative effect of change in accounting principle: Deferred: Federal - - 35,414 State - - 6,177 ------------ ----------- ----------- Subtotal income taxes for cumulative effect of change in accounting principle - - 41,591 ------------ ----------- ----------- Total income taxes charged to the income statement (a) 97,683 13,379 104,955 Income taxes charged (credited) to shareholders' equity: Deferred income taxes (benefits) on unrealized/realized gains or losses on securities classified as available- for-sale (411) (10,982) 5,539 Current benefit arising from stock options exercised and restrict (5,976) (13,765) (2,535) Deferred income taxes (benefits) arising from recognition of a minimum pension liability (13,933) (6,645) 13,373 ----------- ----------- ----------- Income taxes charged (credited) to shareholders' equity (b) (20,320) (31,392) 16,377 ------------ ----------- ----------- Total income taxes: (a) plus (b) $ 77,363 $(18,013) $ 121,332 ============ =========== =========== F-28 (20) Net Income Per Common Share: --------------------------- The reconciliation of the net income per common share calculation for the years ended December 31, 2005, 2004 and 2003 is as follows: ($ in thousands, except per-share amounts) -- 2005 2004 2003 ----------------- ----------------- ----------------- Net income used for basic and diluted earnings per common share: Income from continuing operations before cumulative effect of change in accounting principle $ 200,168 $ 66,919 $ 117,703 Income from discontinued operations 2,207 5,231 4,380 ----------------- ----------------- ----------------- Income before cumulative effect of change in accounting principle 202,375 72,150 122,083 Income from cumulative effect of change in accounting principle - - 65,769 ----------------- ----------------- ----------------- Total basic net income available for common shareholders $ 202,375 $ 72,150 $ 187,852 ================== ================== ================== Effect of conversion of preferred securities 1,255 - 6,210 ----------------- ----------------- ----------------- Total diluted net income available for common shareholders $ 203,630 $ 72,150 $ 194,062 ================== ================== ================== Basic earnings per common share: Weighted-average shares outstanding - basic 337,065 303,989 282,434 ----------------- ----------------- ----------------- Income from continuing operations before cumulative effect of change in accounting principle $ 0.59 $ 0.22 $ 0.42 Income from discontinued operations 0.01 0.02 0.02 ----------------- ----------------- ----------------- Income before cumulative effect of change in accounting principle 0.60 0.24 0.44 Income from cumulative effect of change in accounting principle - - 0.23 ----------------- ----------------- ----------------- Net income per share available for common shareholders $ 0.60 $ 0.24 $ 0.67 ================== ================== ================== Diluted earnings per common share: Weighted-average shares outstanding 337,065 303,989 282,434 Effect of dilutive shares 1,417 5,194 4,868 Effect of conversion of preferred securities 3,193 - 15,134 ----------------- ----------------- ----------------- Weighted-average shares outstanding - diluted 341,675 309,183 302,436 ================== ================== ================== Income from continuing operations before cumulative effect of change in accounting principle $ 0.59 $ 0.22 $ 0.41 Income from discontinued operations 0.01 0.01 0.01 ----------------- ----------------- ----------------- Income before cumulative effect of change in accounting principle 0.60 0.23 0.42 Income from cumulative effect of change in accounting principle - - 0.22 ----------------- ----------------- ----------------- Net income per share available for common shareholders $ 0.60 $ 0.23 $ 0.64 ================== ================== ================== Stock Options ------------- For the years ended December 31, 2005, 2004 and 2003 options of 1,930,000 and 2,495,000 (at exercise prices ranging from $13.09 to $18.46), and 10,190,000 (at exercise prices ranging from $9.18 to $21.47), respectively, issuable under employee compensation plans were excluded from the computation of diluted earnings per share (EPS) for those periods because the exercise prices were greater than the average market price of common shares and, therefore, the effect would be antidilutive. In connection with the payment of the special, non-recurring dividend of $2.00 per common share on September 2, 2004, the exercise price and number of all outstanding options was adjusted such that each option had the same value to the holder after the dividend as it had before the dividend. In accordance with

FASB Interpretation No. 44 (FIN 44), "Accounting for Certain Transactions involving Stock Compensation" and EITF 00-23, "Issues Related to the Accounting for Stock Compensation under APB No. 25 and FIN 44," there is no accounting consequence for changes made to the exercise price and the number of shares of a fixed stock option or award as a direct result of the special, non-recurring dividend. In addition, for the years ended December 31, 2005, 2004 and 2003, restricted stock awards of 1,456,000, 1,686,000 and 1,249,000 shares, respectively, are excluded from our basic weighted average shares outstanding and included in our dilutive shares until the shares are no longer contingent upon the satisfaction of all specified conditions. F-29 Equity Units and EPPICS ---------------------- On August 17, 2004 we issued 32,073,633 shares of common stock, including 3,591,000 treasury shares, to our equity unit holders in settlement of the equity purchase contract component of the equity units. With respect to the $460,000,000 Senior Note component of the equity units, we repurchased $300,000,000 principal amount of these Notes in July 2004. The remaining $160,000,000 of the Senior Notes were repriced and a portion was remarketed on August 12, 2004 as the 6.75% Notes due August 17, 2006. During 2004, we repurchased an additional $108,230,000 of the 6.75% Notes which, in addition to the $300,000,000 purchased in July, resulted in a pre-tax charge of approximately $20,080,000 during the third quarter of 2004. As a result of our July dividend announcement with respect to our common shares, our 5% Company Obligated Mandatorily Redeemable Convertible Preferred Securities due 2036 (EPPICS) began to convert into shares of our common stock. As of December 31, 2005, approximately 88% of the EPPICS outstanding, or about $177,971,000 aggregate principal amount of units, have converted to 14,237,807 shares of common stock, including 1,116,000 issued from treasury. At December 31, 2005 and 2004, we had 465,588 and 1,065,171 shares, respectively, of potentially dilutive EPPICS, which were convertible into common stock at a 4.36 to 1 ratio at an exercise price of $11.46 per share. As a result of the September 2004 special, non-recurring dividend, the EPPICS exercise price for conversion into common stock was reduced from $13.30 to $11.46. These securities have been included in the diluted income per common share calculation for the period ended December 31, 2005, however, they have not been included in the diluted income per share calculation for the period ended December 31, 2004 because their inclusion would have had an antidilutive effect. At December 31, 2003 we had 4,025,000 shares of potentially dilutive EPPICS that have been included in the diluted income per common share calculation for the period ended December 31, 2003. Stock Units ----------- At December 31, 2005, 2004 and 2003, we had 206,630, 464,879 and 427,475 stock units, respectively, issuable under our Directors' Deferred Fee Equity Plan and Non-Employee Directors' Retirement Plan. These securities have not been included in the diluted income per share calculation because their inclusion would have had an antidilutive effect. (21) Comprehensive Income (Loss): --------------------------- Comprehensive income consists of net income (loss) and other gains and losses affecting shareholder's investment and minimum pension liability that, under GAAP, are excluded from net income (loss). F-30 Our other comprehensive income (loss) for the years ended December 31, 2005, 2004 and 2003 is as follows: 2005 -- Before-Tax Tax Expense/ Net-of-Tax ($ in thousands) Amount (Benefit) Amount --------------- ------------- -------------- ------------ Net unrealized holding losses on securities arising during period $ (1,055) $ (395) $ (660) Minimum pension liability (36,416) (13,933) (22,483) Less: Reclassification adjustments for net gains on securities realized in net income (537) (7) (530) -------------- -------------- ------------- Other comprehensive loss $ (38,008) $ (14,335) $ (23,673) ============= ============== ============ 2004 -- Before-Tax Tax Expense/ Net-of-Tax ($ in thousands) Amount (Benefit) Amount --------------- ------------- -------------- ------------ Net unrealized holding losses on securities arising during period $ (1,901) $ (742) $ (1,159) Minimum pension liability (17,372) (6,645) (10,727) Less: Reclassification adjustments for net gains on securities realized in net income (26,247) (10,240) (16,007) ------------- -------------- ------------- Other comprehensive loss $ (45,520) $ (17,627) $ (27,893) ============= ============== ============ 2003 -- Before-Tax Tax Expense/ Net-of-Tax ($ in thousands) Amount (Benefit) Amount --------------- ------------- -------------- ------------ Net unrealized holding gains on securities arising during period $ 14,470 $ 5,539 $ 8,931 Minimum pension liability 34,935 13,373 21,562 ------------- -------------- ------------- Other comprehensive income $ 49,405 $ 18,912 $ 30,493 ============= ============== ============ (22) Segment Information: ------------------- We operate in two segments, Frontier and ELI (a CLEC). The Frontier segment provides both regulated and unregulated communications services to residential, business and wholesale customers and is typically the incumbent provider in its service areas. ELI provides telecommunications services, principally to businesses. ELI frequently obtains the "last mile" access to customers through arrangements with the applicable ILEC. As permitted by SFAS No. 131, we have

utilized the aggregation criteria in combining our markets because all of our Frontier properties share similar economic characteristics, in that they provide the same products and services to similar customers using comparable technologies in all of the states that we operate in. The regulatory structure is generally similar. Differences in the regulatory regime of a particular state do not impact the economic characteristics or operating results of a particular property. F-31 ($ in thousands) For the year ended December 31, 2005 ---------------- --- Total Frontier ELI Segments ---------------- --------------- ---------------- Revenue $ 2,003,318 $ 159,161 $ 2,162,479 Depreciation and Amortization 516,982 24,977 541,959 Operating Income 588,543 18,306 606,849 Capital Expenditures 252,213 16,099 268,312 Assets 5,805,423 168,342 5,973,765 ($ in thousands) For the year ended December 31, 2004 ---------------- -- Total Frontier ELI Electric Segments ---------------- --------------- ---------------- ------------- Revenue $ 2,002,657 $ 156,030 $ 9,735 $ 2,168,422 Depreciation and Amortization 546,747 24,061 - 570,808 Management Succession and Strategic Alternatives Expenses 87,279 3,353 - 90,632 Operating Income (Loss) 468,889 10,350 (3,134) 476,105 Capital Expenditures 263,193 11,644 - 274,837 Assets 6,077,424 173,369 - 6,250,793 ($ in thousands) For the year ended December 31, 2003 ---------------- -- Total Frontier ELI Gas Electric Segments ---------------- ---------------- --------------- ------------ ------------- Revenue $ 2,020,171 $ 165,389 $ 137,686 $ 100,928 $ 2,424,174 Depreciation and Amortization 569,651 23,510 - - 593,161 Reserve for Telecommunications Bankruptcies (5,524) 1,147 - - (4,377) Restructuring and Other Expenses 9,373 314 - - 9,687 Loss on Impairment - - - 15,300 15,300 Operating Income (Loss) 530,368 9,710 14,013 (3,359) 550,732 Capital Expenditures 243,445 9,496 9,877 13,984 276,802 Assets 6,399,953 184,559 - 23,130 6,607,642 The following table presents supplemental financial data for ELI. Summary Income Statement for ELI -- ($ in thousands) For the years ended December 31, ---------------- ---------------------------------- 2005 2004 ---------------- ----------------- Revenue $ 159,161 $ 156,030 Operating expenses 115,878 121,619 Depreciation expense 24,977 24,061 Non-operating expense, net 185 629 ---------------- ----------------- Income before income taxes $ 18,121 $ 9,721 ================= ================= F-32 The following tables are reconciliations of certain sector items to the total consolidated amount. Capital Expenditures 2005 2004 2003 --------------- --------------- ------------- Total segment capital expenditures $ 268,312 $ 274,837 $ 276,802 General capital expenditures 147 367 569 ---------------- ---------------- ------------- Consolidated reported capital expenditures $ 268,459 $ 275,204 $ 277,371 ================ =============== ============= Assets 2005 2004 --------------- --------------- Total segment assets $ 5,973,765 $ 6,250,793 General assets 438,344 393,504 Discontinued operations assets - 24,122 ---------------- --------------- Consolidated reported assets $ 6,412,109 $ 6,668,419 =============== ================ (23) Quarterly Financial Data (Unaudited): ------------------------------------ ($ in thousands, except per share amounts) --- 2005 First quarter Second quarter Third quarter Fourth quarter ---- ------------- -------------- ------------- ------------- Revenue $ 537,223 $ 531,798 $ 537,346 $ 556,112 Operating income 145,112 146,897 141,617 173,223 Net income 42,634 44,584 38,376 76,781 Net income available for common shareholders per basic share $ 0.13 $ 0.13 $ 0.11 $ 0.23 Net income available for common shareholders per diluted share $ 0.12 $ 0.13 $ 0.11 $ 0.23 2004 ---- Revenue $ 552,311 $ 537,796 $ 539,188 $ 539,127 Operating income 137,598 126,014 70,087 142,406 Net income (loss) 42,868 23,792 (11,290) 16,780 Net income (loss) available for common shareholders per basic share $ 0.15 $ 0.08 $ (0.04) $ 0.05 Net income (loss) available for common shareholders per diluted shares $ 0.15 $ 0.08 $ (0.04) $ 0.05 The quarterly net income (loss) per common share amounts are rounded to the nearest cent. Annual net income (loss) per common share may vary depending on the effect of such rounding. 2005 Transactions ----------------- On February 1, 2005, we sold shares of Prudential Financial, Inc. for approximately $1,112,000 in cash, and we recognized a pre-tax gain of approximately $493,000 that is included in other income (loss), net. On March 15, 2005, we completed the sale of our conferencing business for approximately $43,565,000 million in cash. The pre-tax gain on the sale of CCUSA was $14,061,000. The after-tax gain was approximately $1,167,000. In June 2005, the Company sold for cash its interests in certain key man life insurance policies on the lives of Leonard Tow, our former Chairman and Chief Executive Officer, and his wife, a former director. The cash surrender value of the policies purchased by Dr. Tow totaled approximately $24,195,000, and we recognized a pre-tax gain of approximately $457,000 that is included in other income (loss), net. During 2005, we sold shares of Global Crossing Limited for approximately $1,084,000 in cash, and we recognized a pre-tax gain for the same amount that is

included in other income (loss), net. 2004 Transactions ---------------- On April 1, 2004, we completed the sale of our Vermont electric distribution operations for approximately $13,992,000 in cash, net of selling expenses. F-33 During the third quarter of 2004, we sold our corporate aircraft for approximately $15,298,000 in cash. The pre-tax loss on the sale was $1,087,000. In October 2004, we sold cable assets in California, Arizona, Indiana, and Wisconsin for approximately $2,263,000 in cash. The pre-tax gain on these sales was $40,000. (24) Retirement Plans: ---------------- We sponsor a noncontributory defined benefit pension plan covering a significant number of our employees and other postretirement benefit plans that provide medical, dental, life insurance benefits and other benefits for covered retired employees and their beneficiaries and covered dependents. The benefits are based on years of service and final average pay or career average pay. Contributions are made in amounts sufficient to meet ERISA funding requirements while considering tax deductibility. Plan assets are invested in a diversified portfolio of equity and fixed-income securities and alternative investments. The accounting results for pension and postretirement benefit costs and obligations are dependent upon various actuarial assumptions applied in the determination of such amounts. These actuarial assumptions include the following: discount rates, expected long-term rate of return on plan assets, future compensation increases, employee turnover, healthcare cost trend rates, expected retirement age, optional form of benefit and mortality. We review these assumptions for changes annually with its outside actuaries. We consider our discount rate and expected long-term rate of return on plan assets to be our most critical assumptions. The discount rate is used to value, on a present value basis, our pension and postretirement benefit obligation as of the balance sheet date. The same rate is also used in the interest cost component of the pension and postretirement benefit cost determination for the following year. The measurement date used in the selection of our discount rate is the balance sheet date. Our discount rate assumption is determined annually with assistance from our actuaries based on the duration of our pension and postretirement benefit liabilities, the pattern of expected future benefit payments and the prevailing rates available on long-term, high quality corporate bonds that approximate the benefit obligation. In making this determination we consider, among other things, the yields on the Citigroup Pension Discount Curve and Bloomberg Finance. This rate can change from year-to-year based on market conditions that impact corporate bond yields. The expected long-term rate of return on plan assets is applied in the determination of periodic pension and postretirement benefit cost as a reduction in the computation of the expense. In developing the expected long-term rate of return assumption, we considered published surveys of expected market returns, 10 and 20 year actual returns of various major indices, and our own historical 5-year and 10-year investment returns. The expected long-term rate of return on plan assets is based on an asset allocation assumption of 30% to 45% in fixed income securities, 45% to 55% in equity securities and 5% to 15% in alternative investments. We review our asset allocation at least annually and make changes when considered appropriate. In 2005, we did not change our expected long-term rate of return from the 8.25% used in 2004. Our pension plan assets are valued at actual market value as of the measurement date. The measurement date used to determine pension and other postretirement benefit measures for the pension plan and the postretirement benefit plan is December 31. Accounting standards require that we record an additional minimum pension liability when the plan's "accumulated benefit obligation" exceeds the fair market value of plan assets at the pension plan measurement (balance sheet) date. In the fourth quarter of 2005, mainly due to a decrease in the year-end discount rate, we recorded an additional minimum pension liability in the amount of $36,416,000 with a corresponding charge to shareholders' equity of $22,483,000, net of taxes of $13,933,000. In the fourth quarter of 2004, mainly due to a decrease in the year-end discount rate, we recorded an additional minimum pension liability in the amount of $17,372,000 with a corresponding charge to shareholders' equity of $10,727,000, net of taxes of $6,645,000. These adjustments did not impact our net income or cash flows for either year. If discount rates and the equity markets performance decline, we would be required to increase our minimum pension liabilities and record additional charges to shareholder's equity in the future. F-34 Actual results that differ from our assumptions are added or subtracted to our balance of unrecognized actuarial gains and losses. For example, if the year-end discount rate used to value the plan's projected benefit obligation decreases from the prior year-end, then the plan's actuarial loss will increase. If the discount rate increases from the prior year-end then the plan's actuarial loss will decrease. Similarly, the difference generated from the plan's actual asset performance as compared to expected performance would be included in the balance of unrecognized gains and losses. The impact of the balance of accumulated actuarial gains and losses are recognized in the computation of pension cost only to the extent this balance exceeds 10% of the greater of the plan's projected benefit obligation or market value of plan assets. If this occurs, that portion of gain or loss that is in excess of 10% is amortized over the estimated future service period of plan participants as a component

of pension cost. The level of amortization is affected each year by the change in actuarial gains and losses and could potentially be eliminated if the gain/loss activity reduces the net accumulated gain/loss balance to a level below the 10% threshold. F-35 Pension Plan ----------- The following tables set forth the plan's benefit obligations and fair values of plan assets as of December 31, 2005 and 2004 and net periodic benefit cost for the years ended December 31, 2005, 2004 and 2003. ($ in thousands) 2005 2004 ---------------- ------------- -------------- Change in benefit obligation --------------------------- Benefit obligation at beginning of year $ 799,458 $ 761,683 Service cost 6,117 5,748 Interest cost 46,416 46,468 Actuarial loss 48,750 44,350 Benefits paid (58,139) (58,791) ------------- -------------- Benefit obligation at end of year $ 842,602 $ 799,458 ============= ============== Change in plan assets --------------------- Fair value of plan assets at beginning of year $ 761,168 $ 719,622 Actual return on plan assets 59,196 80,337 Employer contribution - 20,000 Benefits paid (58,139) (58,791) ------------- -------------- Fair value of plan assets at end of year $ 762,225 $ 761,168 ============= ============== (Accrued)/Prepaid benefit cost ------------------------------ Funded status $ (80,377) $ (38,290) Unrecognized prior service cost (1,745) (1,988) Unrecognized net actuarial loss 223,525 183,481 ------------- -------------- Prepaid benefit cost $ 141,403 $ 143,203 ============= ============== Amounts recognized in the statement of financial position --- Accrued benefit liability $ (58,250) $ (20,034) Other comprehensive income 199,653 163,237 ------------- -------------- Net amount recognized $ 141,403 $ 143,203 ============= ============== ($ in thousands) 2005 2004 2003 ---------------- ------------- -------------- --------------- Components of net periodic benefit cost -------------------------------------- Service cost $ 6,117 $ 5,748 $ 6,479 Interest cost on projected benefit obligation 46,416 46,468 49,103 Return on plan assets (60,371) (57,203) (53,999) Amortization of prior service cost and unrecognized net obligation (244) (244) (172) Amortization of unrecognized loss 9,882 8,806 11,026 ------------- -------------- --------------- Net periodic benefit cost 1,800 3,575 12,437 Curtailment/settlement charge - - 6,585 ------------- -------------- --------------- Total periodic benefit cost $ 1,800 $ 3,575 $ 19,022 ============= ============== =============== The plan's weighted average asset allocations at December 31, 2005 and 2004 by asset category are as follows: 2005 2004 ---- ---- Asset category: --------------- Equity securities 50% 57% Debt securities 34% 32% Alternative investments 13% 8% Cash and other 3% 3% ------ ------ Total 100% 100% ====== ====== F-36 The plan's expected benefit payments by year are as follows: ($ in thousands) ---------------- Year Amount ------------- -------------- 2006 $ 55,350 2007 57,171 2008 58,523 2009 61,394 2010 62,006 2011 - 2015 319,075 -------------- Total $ 613,519 ============== Our required contribution to the plan in 2006 is $0. The accumulated benefit obligation for the plan was $820,475,000 and $781,202,000 at December 31, 2005 and 2004, respectively. Assumptions used in the computation of pension and postretirement benefits other than pension costs/year-end benefit obligations were as follows: 2005 2004 ---- ---- Discount rate 6.00%/5.625% 6.25%/6.00% Expected long-term rate of return on plan assets 8.25%/8.25% 8.25%/8.25% Rate of increase in compensation levels 4.0%/4.0% 4.0%/4.0% F-37 Postretirement Benefits Other Than Pensions -- The following table sets forth the plan's benefit obligations, fair values of plan assets and the postretirement benefit liability recognized on our balance sheets at December 31, 2005 and 2004 and net periodic postretirement benefit costs for the years ended December 31, 2005, 2004 and 2003: In 2005, we approved changes to certain retiree medical plans. The plan changes (reflected as amendments in the table below) and the related impact are included in the accumulated postretirement benefit obligation (APBO) as of December 31, 2005. The plan changes resulted in a reduction in the APBO of $59,798,000 which will be amortized as a reduction of retiree medical expense over the average remaining service life. ($ in thousands) 2005 2004 ---------------- ------------- -------------- Change in benefit obligation --------------------------- Benefit obligation at beginning of year $ 217,380 $ 223,337 Service cost 1,046 1,128 Interest cost 12,055 12,698 Plan participants' contributions 3,461 4,118 Actuarial (gain) loss 3,770 (1,706) Amendments (59,798) (3,045) Benefits paid (16,992) (19,150) ------------- -------------- Benefit obligation at end of year $ 160,922 $ 217,380 ============= ============== Change in plan assets -------------------- Fair value of plan assets at beginning of year $ 15,126 $ 27,493 Actual return on plan assets 397 987 Benefits paid (13,530) (15,032) Employer contribution 9,431 1,678 ------------- -------------- Fair value of plan assets at end of year $ 11,424 $ 15,126 ============= ============== Accrued benefit cost -------------------- Funded status $(149,498) $(202,254) Unrecognized prior service cost (61,161) (2,617) Unrecognized loss 42,325 44,319 ------------- -------------- Accrued benefit cost $(168,334) $(160,552) ============= ============== ($ in thousands) ---------------- 2005 2004 2003 ------------- -------------- --------------- Components of net periodic postretirement benefit cost -- Service cost $ 1,046 $ 1,128 $ 1,387 Interest

cost on projected benefit obligation 12,055 12,698 13,606 Return on plan assets (1,248) (2,268) (2,133) Amortization of prior service cost and transition obligation (1,255) (204) 26 Amortization of unrecognized (gain)/loss 6,615 5,238 3,985 ------------- -------------- --------------- Net periodic postretirement benefit cost $ 17,213 $ 16,592 $ 16,871 ============= ============== =============== The plan's weighted average asset allocations at December 31, 2005 and 2004 by asset category are as follows: 2005 2004 --------- -------- Asset category: --------------- Equity securities 0% 0% Debt securities 100% 100% Cash and other 0% 0% --------- -------- Total 100% 100% ========= ======== F-38 The plan's expected benefit payments by year are as follows: ($ in thousands) ---------------- Gross Medicare D Year Benefits Subsidy Total --------------- -------------- ------------- -------------- 2006 $ 9,847 $ 676 $ 9,171 2007 10,375 712 9,663 2008 10,843 742 10,101 2009 11,282 770 10,512 2010 11,656 793 10,863 2011 - 2015 60,619 4,049 56,570 -------------- ------------- -------------- Total $ 114,622 $ 7,742 $ 106,880 ============== ============= ============== Our expected contribution to the plan in 2006 is $9,847,000. For purposes of measuring year-end benefit obligations, we used, depending on medical plan coverage for different retiree groups, a 9.5% annual rate of increase in the per-capita cost of covered medical benefits, gradually decreasing to 5% in the year 2015 and remaining at that level thereafter. The effect of a 1% increase in the assumed medical cost trend rates for each future year on the aggregate of the service and interest cost components of the total postretirement benefit cost would be $1,306,000 and the effect on the accumulated postretirement benefit obligation for health benefits would be $13,397,000. The effect of a 1% decrease in the assumed medical cost trend rates for each future year on the aggregate of the service and interest cost components of the total postretirement benefit cost would be $(1,068,000) and the effect on the accumulated postretirement benefit obligation for health benefits would be $(11,480,000). In December 2003, the Medicare Prescription Drug Improvement and Modernization Act of 2003 (the Act) became law. The Act introduces a prescription drug benefit under Medicare. It includes a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to the Medicare Part D benefit. The amount of the federal subsidy will be based on 28% of an individual beneficiary's annual eligible prescription drug costs ranging between $250 and $5,000. We have determined that the Company-sponsored postretirement healthcare plans that provide prescription drug benefits are actuarially equivalent to the Medicare Prescription Drug benefit. The impact of the federal subsidy has been incorporated in the December 31, 2005 measurement date. 401(k) Savings Plans -------------------- We sponsor an employee retirement savings plan under section 401(k) of the Internal Revenue Code. The Plan covers substantially all full-time employees. Under the Plan, we provide matching and certain profit-sharing contributions. Employer contributions were $7,181,000, $8,403,000 and $9,724,000 for 2005, 2004 and 2003, respectively. (25) Commitments and Contingencies: ------------------------------ The City of Bangor, Maine, filed suit against us on November 22, 2002, in the U.S. District Court for the District of Maine (City of Bangor v. Citizens Communications Company, Civ. Action No. 02-183-B-S). The City alleged, among other things, that we are responsible for the costs of cleaning up environmental contamination alleged to have resulted from the operation of a manufactured gas plant owned by Bangor Gas Company from 1852-1948 and by us from 1948-1963. In acquiring the operation in 1948 we acquired the stock of Bangor Gas Company and merged it into the Company. The City alleged the existence of extensive contamination of the Penobscot River and asserted that money damages and other relief at issue in the lawsuit could exceed $50,000,000. The City also requested that punitive damages be assessed against us. We filed an answer denying liability to the City, and asserted a number of counterclaims against the City. In addition, we identified a number of other potentially responsible parties that may be liable for the damages alleged by the City and joined them as parties to the lawsuit. These additional parties include Honeywell Corporation, Guilford Transportation (operating as Maine Central Railroad), UGI Utilities, Inc. and Centerpoint Energy Resources Corporation. The Court dismissed all but two of the City's claims, including its claims for joint and several liability under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) and the claim against us for punitive damages. Trial was conducted in September and October 2005 for the first (liability) phase of the case, and a decision from the court is anticipated by the end of the first quarter of 2006. We intend to continue to defend ourselves vigorously against the City's lawsuit. We have demanded that various of our insurance carriers defend and indemnify us with respect to the City's lawsuit, and on December 26, 2002, we filed a declaratory judgment action against those insurance carriers in the Superior Court of Penobscot County, Maine, for the purpose of establishing their obligations to us with respect to the City's lawsuit. We intend to vigorously pursue this lawsuit to obtain from our insurance carriers indemnification for any damages that may be assessed against us in the City's lawsuit as well as to recover the costs of our defense of

that lawsuit. F-39 On June 7, 2004, representatives of Robert A. Katz Technology Licensing, LP, contacted us regarding possible infringement of several patents held by that firm. The patents cover a wide range of operations in which telephony is supported by computers, including obtaining information from databases via telephone, interactive telephone transactions, and customer and technical support applications. We were cooperating with the patent holder to determine if we are currently using any of the processes that are protected by its patents but have not had any communication with them on this issue since mid-2004. If we determine that we are utilizing the patent holder's intellectual property, we expect to commence negotiations on a license agreement. On June 24, 2004, one of our subsidiaries, Frontier Subsidiary Telco Inc., received a "Notice of Indemnity Claim" from Citibank, N.A., that is related to a complaint pending against Citibank and others in the U.S. Bankruptcy Court for the Southern District of New York as part of the Global Crossing bankruptcy proceeding. Citibank bases its claim for indemnity on the provisions of a credit agreement that was entered into in October 2000 between Citibank and our subsidiary. We purchased Frontier Subsidiary Telco, Inc., in June 2001 as part of our acquisition of the Frontier telephone companies. The complaint against Citibank, for which it seeks indemnification, alleges that the seller improperly used a portion of the proceeds from the Frontier transaction to pay off the Citibank credit agreement, thereby defrauding certain debt holders of Global Crossing North America Inc. Although the credit agreement was paid off at the closing of the Frontier transaction, Citibank claims the indemnification obligation survives. Damages sought against Citibank and its co-defendants could exceed $1,000,000,000. In August 2004, we notified Citibank by letter that we believe its claims for indemnification are invalid and are not supported by applicable law. We have received no further communications from Citibank since our August 2004 letter. We are party to other legal proceedings arising in the normal course of our business. The outcome of individual matters is not predictable. However, we believe that the ultimate resolution of all such matters, after considering insurance coverage, will not have a material adverse effect on our financial position, results of operations, or our cash flows. For 2006, we expect our capital expenditures to increase in order to build wireless data networks and expand the capabilities of our data networks. Although we from time to time make short-term purchasing commitments to vendors with respect to these expenditures, we generally do not enter into firm, written contracts for such activities. F-40 We conduct certain of our operations in leased premises and also lease certain equipment and other assets pursuant to operating leases. The lease arrangements have terms ranging from 1 to 99 years and several contain rent escalation clauses providing for increases in monthly rent at specific intervals. When rent escalation clauses exist, we record total expected rent payments on a straight-line basis over the lease term. Certain leases also have renewal options. Renewal options that are reasonably assured are included in determining the lease term. Future minimum rental commitments for all long-term noncancelable operating leases and future minimum capital lease payments for continuing operations as of December 31, 2005 are as follows: ($ in thousands) ---------------- ELI Capital Operating Leases Leases ---------- ---------- Year ending December 31: 2006 $ 179 $ 19,062 2007 549 12,605 2008 555 11,840 2009 561 10,416 2010 566 8,891 Thereafter 6,703 29,274 --------- ----------- Total minimum lease payments 9,113 $ 92,088 =========== Less amount representing interest (rates range from 9.75% to 10.65%) (4,826) --------- Present value of net minimum capital lease payments 4,287 Less current installments of obligations under capital leases (41) -------- Obligations under capital leases, excluding current installments $4,246 ======== Total rental expense included in our results of operations for the years ended December 31, 2005, 2004 and 2003 was $24,146,000, $26,349,000 and $33,801,000, respectively. Until March 1, 2005, we sublet certain office space in our corporate office to a charitable foundation formed by our former Chairman. We are a party to contracts with several unrelated long distance carriers. The contracts provide fees based on traffic they carry for us subject to minimum monthly fees. At December 31, 2005, the estimated future payments for obligations under our noncancelable long distance contracts and service agreements are as follows: ($ in thousands) ---------------- Year ILEC / ELI ---------------- --------------- 2006 $ 30,619 2007 18,337 2008 11,017 2009 10,244 2010 1,052 thereafter 5,115 -------------- Total $ 76,384 =============== F-41 We sold all of our utility businesses as of April 1, 2004. However, we have retained a potential payment obligation associated with our previous electric utility activities in the state of Vermont. The Vermont Joint Owners (VJO), a consortium of 14 Vermont utilities, including us, entered into a purchase power agreement with Hydro-Quebec in 1987. The agreement contains "step-up" provisions that state that if any VJO member defaults on its purchase obligation under the contract to purchase power from Hydro-Quebec the other VJO participants will assume responsibility for the defaulting party's share on a pro-rata basis. Our pro-rata share of the purchase power obligation is 10%. If any member of the VJO defaults on its obligations under the Hydro-Quebec agreement, then the remaining members of the VJO, including us, may be required to pay for a

substantially larger share of the VJO's total power purchase obligation for the remainder of the agreement (which runs through 2015). Paragraph 13 of FIN 45 requires that we disclose "the maximum potential amount of future payments (undiscounted) the guarantor could be required to make under the guarantee." Paragraph 13 also states that we must make such disclosure "... even if the likelihood of the guarantor's having to make any payments under the guarantee is remote..." As noted above, our obligation only arises as a result of default by another VJO member, such as upon bankruptcy. Therefore, to satisfy the "maximum potential amount" disclosure requirement we must assume that all members of the VJO simultaneously default, a highly unlikely scenario given that the two members of the VJO that have the largest potential payment obligations are publicly traded with credit ratings equal to or superior to ours, and that all VJO members are regulated utility providers with regulated cost recovery. Regardless, despite the remote chance that such an event could occur, or that the State of Vermont could or would allow such an event, assuming that all the members of the VJO defaulted on January 1, 2007 and remained in default for the duration of the contract (another 9 years), we estimate that our undiscounted purchase obligation for 2007 through 2015 would be approximately $1,264,000,000. In such a scenario the Company would then own the power and could seek to recover its costs. We would do this by seeking to recover our costs from the defaulting members and/or reselling the power to other utility providers or the northeast power grid. There is an active market for the sale of power. We could potentially lose money if we were unable to sell the power at cost. We caution that we cannot predict with any degree of certainty any potential outcome. At December 31, 2005, we have outstanding performance letters of credit as follows: ($ in thousands) ---------------- CNA $19,404 State of New York 2,993 ELI projects 50 ----------- Total $22,447 =========== CNA serves as our agent with respect to general liability claims (auto, workers compensation and other insured perils of the Company). As our agent, they administer all claims and make payments for claims on our behalf. We reimburse CNA for such services upon presentation of their invoice. To serve as our agent and make payments on our behalf, CNA requires that we establish a letter of credit in their favor. CNA could potentially draw against this letter of credit if we failed to reimburse CNA in accordance with the terms of our agreement. The value of the letter of credit is reviewed annually and adjusted based on claims history. None of the above letters of credit restrict our cash balances. (26) Subsequent Event: ---------------- In February 2006, we entered into a definitive agreement to sell all of the outstanding membership interests in ELI, our CLEC business, to Integra Telecom Holdings, Inc. (Integra), for $247,000,000, including $243,000,000 in cash plus the assumption of approximately $4,000,000 in capital lease obligations, subject to customary adjustments under the terms of the agreement. This transaction is expected to close during the third quarter of 2006 and is subject to regulatory and other customary approvals and conditions, as well as the funding of Integra's fully committed financing. We expect that for periods subsequent to December 31, 2005, ELI will be accounted for as a discontinued operation. F-42 CITIZENS COMMUNICATIONS COMPANY AND SUBSIDIARIES Report of Independent Registered Public Accounting Firm -- The Board of Directors and Shareholders Citizens Communications Company: Under date of March 1, 2006, we reported separately on the consolidated balance sheets of Citizens Communications Company and subsidiaries as of December 31, 2005 and 2004, and the related consolidated statements of operations, shareholders' equity, comprehensive income (loss) and cash flows for each of the years in the three-year period ended December 31, 2005. In connection with our audits of the aforementioned consolidated financial statements, we have also audited the related financial statement schedule. The financial statement schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statement schedule based on our audits. In our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein. Our report refers to the adoption of Statement of Financial Accounting Standards No. 143, "Accounting for Asset Retirement Obligations" as of January 1, 2003. /s/ KPMG LLP Stamford, Connecticut March 1, 2006 F-43 Schedule II CITIZENS COMMUNICATIONS COMPANY AND SUBSIDIARIES Valuation and Qualifying Accounts ($ In thousands) Additions ------------------------------- Balance at Charges to Charged to other Balance at beginning of costs and accounts - End of Accounts period expenses Revenue Deductions Period ----------------------------- -- Allowance for doubtful accounts 2003 38,871 21,540 32,240 (45,342) 47,309 2004 47,309 17,906 13,446 (42,665) 35,996 2005 35,996 13,510 10,791 (27,889) 32,408 F-44