INTER TEL (DELAWARE), INC
Form 10-Q
August 08, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF

THE SECURITIES EXCHANGE ACT OF 1934

For the quarter ended June 30, 2007	Commission File Number: 0-10211

INTER-TEL (DELAWARE), INCORPORATED

Incorporated in the State of Delaware	**I.R.S. No. 86-0220994**

1615 S. 52nd Street

Tempe, Arizona 85281

(480) 449-8900

Title of Class	**Outstanding as of June 30, 2007**
Common Stock, par value $0.001	27,307,175

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

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

Large Accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

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

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

INTER-TEL (DELAWARE), INCORPORATED AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share amounts)	June 30, 2007 (unaudited)	December 31, 2006
ASSETS		
CURRENT ASSETS		
Cash and equivalents	$ 198,922	$ 141,899
Short-term investments	7,940	64,388
TOTAL CASH AND SHORT-TERM INVESTMENTS	206,862	206,287
Accounts receivable, net of allowances of $7,192 in 2007 and $6,319 in 2006	47,157	49,027
Inventories	24,075	25,287
Net investment in sales-leases, net of allowances of $1,123 in 2007 and $1,112 in 2006	19,774	19,617
Income taxes receivable		3,035
Deferred income taxes	2,037	599
Prepaid expenses and other assets	14,180	12,476
TOTAL CURRENT ASSETS	314,085	316,328
PROPERTY, PLANT & EQUIPMENT	24,171	25,858
GOODWILL	41,366	42,865
PURCHASED INTANGIBLE ASSETS	17,316	19,570
NET INVESTMENT IN SALES-LEASES, net of allowances of $1,883 in 2007 and $1,763 in 2006	33,175	31,113
OTHER ASSETS	984	1,147
TOTAL ASSETS	$ 431,097	$ 436,881
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES		
Accounts payable	$ 34,421	$ 34,261
Acquisition payable		13,000
Deferred income taxes	6,258	12,246
Other current liabilities	51,207	55,145
TOTAL CURRENT LIABILITIES	91,886	114,652
DEFERRED INCOME TAXES	42,756	47,712
LEASE RECOURSE LIABILITY	14,284	14,682
LONG TERM INCOME TAXES PAYABLE	9,374	
OTHER LIABILITIES	6,839	7,179
STOCKHOLDERS EQUITY		
Common stock, $0.001 par value-authorized 100,000,000 shares; issued 27,307,175 shares at June 30, 2007 and 27,161,823 shares at December 31, 2006; outstanding 27,307,175 at June 30, 2007 and 26,895,360 shares at December 31, 2006	27	27
Additional Paid-In Capital	131,867	127,044
Retained earnings	130,853	127,787
Accumulated other comprehensive income	3,211	2,178

	265,958	257,036
Less: Treasury stock at cost 266,463 shares at December 31, 2006		(4,380)
TOTAL STOCKHOLDERS EQUITY	265,958	252,656
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 431,097	$ 436,881

See accompanying notes to Condensed Consolidated Financial Statements.

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INTER-TEL (DELAWARE), INCORPORATED AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

(In thousands, except per share amounts)	Three Months Ended June 30 2007	Three Months Ended June 30 2006	Six Months Ended June 30 2007	Six Months Ended June 30 2006
NET SALES				
Telecommunications systems, software and related	$ 98,429	$ 100,921	$ 192,295	$ 193,164
Resale of local, long distance and network services	15,982	15,004	31,581	29,684
TOTAL NET SALES	114,411	115,925	223,876	222,848
COST OF SALES				
Telecommunications systems, software and related	48,616	49,628	94,562	94,111
Resale of local, long distance and network services	10,555	9,535	20,684	18,697
TOTAL COST OF SALES	59,171	59,163	115,246	112,808
GROSS PROFIT	55,240	56,762	108,630	110,040
Research and development	8,388	8,799	16,632	17,106
Selling, general and administrative	40,063	38,081	81,415	76,236
Amortization of purchased intangible assets	1,112	1,185	2,227	2,316
Proxy contest and related costs	3,094	2,087	3,661	2,464
Legal settlement costs				1,311
	52,657	50,163	103,935	99,433
OPERATING INCOME	2,583	6,599	4,695	10,607
Interest and other, net	2,027	1,528	3,849	2,787
Foreign currency transaction losses	(124)	(358)	(106)	(362)
INCOME BEFORE INCOME TAXES	4,486	7,769	8,438	13,032
INCOME TAXES	1,497	2,984	2,821	5,045
NET INCOME	$ 2,989	$ 4,785	$ 5,617	$ 7,987
NET INCOME PER SHARE - BASIC	$ 0.11	$ 0.18	$ 0.21	$ 0.30
NET INCOME PER SHARE - DILUTED	$ 0.11	$ 0.18	$ 0.20	$ 0.29
DIVIDENDS PER SHARE		$ 0.08	$ 0.08	$ 0.16
Average number of common shares outstanding - Basic	27,166	26,534	27,055	26,421
Average number of common shares outstanding - Diluted	27,910	27,227	27,762	27,103

See accompanying notes to Condensed Consolidated Financial Statements.

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INTER-TEL (DELAWARE), INCORPORATED AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

	Six Months Ended June 30,	
(In thousands)	**2007**	**2006**
OPERATING ACTIVITIES		
Net income	$ 5,617	$ 7,987
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation of fixed assets	4,370	4,496
Amortization of patents included in R&D expenses	32	9
Amortization of purchased intangible assets	2,227	2,316
Provision for losses on receivables	2,363	323
Provision for losses on leases	45	1,389
Provision for inventory valuation	1,562	653
Share based compensation expense	2,014	2,135
Excess tax benefits from stock options exercised	(706)	(1,090)
Increase (decrease) in other liabilities	8,550	(1,146)
Loss (gain) on sale of property and equipment	47	(9)
Deferred income taxes	(10,789)	(555)
Changes in operating assets and liabilities	(2,700)	(3,295)
NET CASH PROVIDED BY OPERATING ACTIVITIES	12,632	13,213
INVESTING ACTIVITIES		
Purchases of short-term investments	(38,993)	(38,762)
Maturities and sales of short-term investments	95,442	38,570
Additions to property, plant and equipment	(2,757)	(3,391)
Proceeds from disposal of property, plant and equipment	27	31
Cash used in acquisitions	(13,000)	(9)
NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES	40,719	(3,561)
FINANCING ACTIVITIES		
Cash dividends paid	(4,313)	(4,212)
Payments on term debt	(26)	(24)
Proceeds from Stock issued under the Employee Stock Purchase Plan	480	542
Proceeds from exercise of stock options	5,792	3,820
Excess tax benefits from stock options exercised	706	1,090
NET CASH PROVIDED BY FINANCING ACTIVITIES	2,639	1,216
EFFECT OF EXCHANGE RATE CHANGES	1,033	1,390
INCREASE IN CASH AND EQUIVALENTS	57,023	12,258
CASH AND EQUIVALENTS AT BEGINNING OF PERIOD	141,899	103,774
CASH AND EQUIVALENTS AT END OF PERIOD	$ 198,922	$ 116,032

See accompanying notes to Condensed Consolidated Financial Statements.

INTER-TEL (DELAWARE), INCORPORATED AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

June 30, 2007

NOTE A BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles applicable to interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of the results for the interim periods presented have been included. Operating results for the quarter and six month periods ending June 30, 2007 are not necessarily indicative of the results that may be expected for the year ended December 31, 2007. The balance sheet at December 31, 2006 has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. For further information, refer to the consolidated financial statements and notes thereto included in the Company s annual report on Form 10-K for the year ended December 31, 2006.

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

Contingencies

We are a party to various claims and litigation in the normal course of business. Management s current estimated range of liability related to various claims and pending litigation is based on claims for which our management can estimate the amount or range of loss. Because of the uncertainties related to both the amount or range of loss on the remaining pending claims and litigation, management is unable to make a reasonable estimate of the liability that could result from an unfavorable outcome. As additional information becomes available, we will assess the potential liability related to our claims and pending litigation, revise our estimates and accrue for any losses to the extent that they are probable and the amount is estimable. Such revisions in our estimates of the potential liability could materially impact our results of operations and financial position. However, at June 30, 2007 management did not believe that the ultimate impact of various claims and pending litigation would have a materially adverse effect on the financial condition, cash flows and results of operations of the Company.

In March 2006, certain prior Executone dealers filed a complaint in Columbus, Ohio similar to the complaint in the Florida trial resolved in 2006. While Inter-Tel is in the process of conducting discovery and evaluating the complaint, Inter-Tel believes that the claims are without merit and Inter-Tel intends to vigorously defend against the complaint.

In the first quarter of 2006, the Company settled a legal matter in connection with a longstanding dispute with a former international dealer that existed as of December 31, 2005. The Company recorded an accrual for the settlement amount and related fourth quarter legal fees as of December 31, 2005. The settlement plus related fourth quarter legal fees totaled $1.6 million. Additional legal fees totaling approximately $1.3 million were recorded as period costs during the first quarter of 2006 relating to this matter.

On April 30, 2007, two shareholder class action lawsuits were filed in the Superior Court of the State of Arizona, County of Maricopa, against Inter-Tel and the Board of Directors: *Joel Gerber v. Inter-Tel Incorporated, et al.*, Case No. CV2007-007444 (the *Gerber* Action), and *Farr v. Inter-Tel, Inc., et al.*, Case No. CV2007-007655 (the *Farr* Action) and another was filed on May 22, 2007, *Suan Investments, Inc. v. Stout, et al.*, Case No. CV2007-009603 (the *Suan* Action) (collectively the Arizona Shareholder Actions.) The actions combined allege that the Board of Directors breached their fiduciary duties of loyalty and due care in connection with the proposed merger with Mitel Networks Corporation (Mitel) by purportedly standing on both sides of the transaction, engaging in self-dealing, obtaining unspecified personal benefits, approving the merger without regard to the fairness of the transaction to Inter-Tel stockholders, failing to exercise independent business judgment, and imprudently accepting and relying upon advice as to the fairness of the consideration for the proposed merger with Mitel from a financial advisor with allegedly conflicted interests. The actions further allege that the proposed merger is a product of a flawed process that was not designed to ensure the sale of Inter-Tel for the highest value. The *Gerber* action requests an injunction prohibiting Inter-Tel from consummating the proposed merger, as well as attorneys fees and costs. The *Farr* action seeks an injunction prohibiting Inter-Tel from consummating the proposed merger with Mitel and, to the extent consummated, rescission of the proposed merger with Mitel and any of the terms of the Mitel merger agreement, as well as the imposition of a constructive trust for improper benefits allegedly received by defendants. The complaint also requests attorneys fees and costs. The *Suan* action seeks an injunction prohibiting Inter-Tel from consummating the merger, rights of rescission against the merger agreement entered into with Mitel, an accounting for plaintiff s alleged damages, and attorneys fees and costs. On June 15, 2007, the Court granted the Company s motion to stay the Arizona Shareholder Actions pending resolution of the Delaware Stockholder Action (described below), and ruled that the plaintiffs motions to expedite the proceedings were, accordingly, moot. The plaintiffs then sought to intervene in the Delaware Stockholder Action and on June 22, 2007, the Delaware Court of Chancery granted the plaintiffs motion to intervene. Inter-Tel believes that the claims are without merit and Inter-Tel intends to vigorously defend against all claims brought in the Arizona Shareholder Actions.

Inter-Tel and certain members of the Board of Directors are defendants in a stockholder class action suit filed on June 15, 2006, entitled *Mercier v. Inter-Tel (Delaware), Inc., et al.*, No. 2226-VCS, in the Court of Chancery of the State of Delaware (Delaware Stockholder Action). On March 27, 2007, the plaintiff filed a Second Amended Complaint (SAC) and on May 25, 2007, the plaintiff filed supplement to the SAC alleging that the defendants breached their fiduciary duties because they failed to properly pursue a higher bid for sale of Inter-Tel. The proposed supplement to the SAC sought an injunction prohibiting Inter-Tel from consummating the proposed merger with Mitel and sought an order requiring the defendants to conduct an auction of Inter-Tel open to Steven G. Mihaylo, Vector Capital Corporation, and all other potentially interested bidders. It further sought an injunction against enforcement of Inter-Tel s business combination charter amendment approved by stockholders on May 31, 2006 (the BCCA) or, alternatively, a declaration that Mitel is an interested stockholder under the BCCA and that the proposed merger with Mitel cannot be consummated because the required vote cannot be obtained. Finally, it sought a declaration that representations and covenants in the merger agreement with Mitel are invalid, and damages in an unspecified amount. On May 24, 2007, the plaintiff filed motions seeking a preliminary injunction and summary judgment on the claims in the SAC. On June 4, 2007, the Court denied the plaintiff s Motion For Expedited Proceedings, which sought to set a briefing schedule for a preliminary injunction and allow discovery on an expedited basis regarding alleged failure of Inter-Tel s Board of Directors to maximize stockholder value, among other claims. On July 12, 2007, the plaintiffs (now including the Arizona Shareholder Action plaintiffs) filed a Second Supplement to the Second Amended Complaint alleging, in addition to their prior claims, that it was improper for the stockholder meeting scheduled for June 29, 2007, to be rescheduled for August 2, 2007. On July 19, 2007, the plaintiffs filed a motion for preliminary injunction, and the parties have conducted expedited discovery. The motion seeks to enjoin the consummation of the merger on the grounds that Inter-Tel improperly rescheduled the stockholder vote. The motion is set to be heard on August 8, 2007. Inter-Tel believes that all of the plaintiffs claims in the Delaware Stockholder Action are without merit, and intends to vigorously defend against them.

On January 5, 2005, the Company received court approval of a civil settlement agreement (the Civil Settlement) and a criminal plea agreement (the Plea Agreement) with the United States of America, each dated as of December 8, 2004 and disclosed on that same date. The court approval of the Civil Settlement and Plea Agreement resolves the investigation of the Department of Justice into the participation of Inter-Tel Technologies, Inc., the Company s wholly-owned subsidiary (Technologies) in a federally administered E-Rate program to connect schools and libraries to the Internet. In connection with the Civil Settlement, Technologies paid a penalty of $6.7 million and forgave the collection of certain accounts receivable of $0.3 million related to Technologies participation in the E-Rate program. In connection with the Plea Agreement, Technologies entered guilty pleas to charges of mail fraud and an antitrust violation. Under the Plea Agreement, Technologies paid a fine of $1.7 million and is observing a three-year probationary period, which has, among other things, required Technologies to implement a comprehensive corporate compliance program. On December 20, 2005, in connection with the Civil Settlement, Technologies paid outside counsel for the plaintiffs in that action $0.1 million in settlement of their demand for attorney s fees and costs. On March 10, 2006, Technologies agreed to pay an additional $0.4 million to plaintiffs inside counsel in settlement of their separate demand for fees and costs. Inter-Tel has incurred additional costs and suffered revenue losses, including uncompensated E-Rate work, accounts receivable forgiveness, and related attorneys fees and other expenses. The payments constituting the primary components of the settlement and fines were not tax deductible.

In addition, on January 21, 2005, Technologies received notification from the Federal Communications Commission (the FCC) that the Technologies subsidiary was temporarily suspended from participation in the E-Rate program pending a final hearing to determine a possible debarment of three (3) years or more. Technologies contested the scope and length of the proposed debarment from the E-Rate program. The Company was notified on June 30, 2006 that on or about June 21, 2006, the FCC issued its final decision on the matter and imposed upon the Technologies subsidiary a debarment from the E-Rate program of one (1) year from June 30, 2006, and which terminated on or about June 30, 2007. Reasons for the shorter period were, among other factors, that Technologies had instituted a compliance program and been cooperative in the investigation and ongoing hearings with the Department of Justice. The FCC order further clarified that the parent and other subsidiaries were not debarred. The Company recorded no revenues since January 21, 2005 relating to Inter-Tel Technologies participation in the E-Rate program.

During the second quarter of 2005, we identified variances in our sales processes as they relate to certain terms included in the U.S. General Services Administration (GSA) pricing and trade agreement requirements applicable to our business. As a result of this identification, Inter-Tel made voluntary self-disclosure of the matter to the Inspector General of the GSA. We took appropriate corrective measures with respect to these potential variances at the time and continue to review our compliance. In the second quarter of 2005, we accrued $1.8 million in estimated pre-tax adjustments, including reductions in net sales and increases to costs, fines and penalties that may be incurred to correct this issue, of which we have paid $1.2 million through June 30, 2007. Our estimate at June 30, 2007 remains the same as the total identified as of the end of the second quarter of 2005. Our current contract with the GSA expires in September 2007, and we have requested and expect to receive a new contract prior to expiration. However, there can be no assurance that the GSA will issue such contract.

Our NetSolutions subsidiary pays various federal, state and local taxes and regulatory fees in numerous jurisdictions throughout the United States. There is often uncertainty and complexity regarding the tax and regulatory treatment of NetSolutions services and, consequently, uncertainty about what fees and taxes are due from NetSolutions or its customers and what amounts may ultimately be payable to the various jurisdictions. The Company accrues estimates for these potential regulatory fees and taxes in the normal course of business. In the first quarter of 2007, NetSolutions changed billing platforms and determined that additional potential regulatory fees and taxes were probable of being paid in excess of prior accruals. As a result, the Company increased its accrued liabilities for such regulatory fees and taxes during the quarter ended March 31, 2007 by $1.8 million.

Inventories

We value our inventories at the lower of cost (principally on a standard cost basis, which approximates the first-in, first-out (FIFO) method) or market.

Recent Accounting Pronouncements

Uncertain Tax Positions - In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes by prescribing the recognition threshold a tax position is required to meet before being recognized in the financial statements. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The Company adopted the provisions of FIN 48 effective January 1, 2007.

As a result of the implementation of FIN 48, the Company recorded an increase in the liability for unrecognized tax benefits of $181,000, which was accounted for as a reduction to retained earnings. As of June 30, 2007, the total long-term liability for unrecognized tax benefits is $8.7 million, of which $1.3 million, if recognized, would result in a reduction of the Company s effective tax rate. In accordance with our accounting policy, the Company recognizes accrued interest and penalties related to unrecognized tax benefits as a component of income tax expense. At January 1, 2007 accrued interest and penalties totaled $1.1 million. At June 30, 2007, the accrued interest and penalties totaled approximately $1.3 million.

We are subject to U.S. federal tax as well as income tax of multiple state and local jurisdictions and the foreign jurisdictions of Australia, Ireland and the United Kingdom. The Internal Revenue Service has examined the federal taxes through December 31, 2003; however 2001 and forward remain open for carryforward attributes and the 2003 tax year is open by statute. With limited exception, the state and local jurisdictions are no longer subject to income tax audit for years prior to 2002. Australia and the United Kingdom are subject to examination for the years ended December 31, 2005 to current and Ireland has five open years from 2001 forward.

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There are no uncertain tax positions for which it is reasonably possible that the unrecognized tax benefits will significantly increase or decrease within twelve months. In addition, there were no material changes related to unrecognized tax benefits in the second quarter of 2007.

Fair Value Option - In 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, to permit entities to choose to measure many financial instruments at fair value with subsequent changes in fair value to be reported in net income for the period. This choice is made for each individual financial instrument, is irrevocable and, after implementation, must be determined when the entity first commits to or recognizes the financial instrument. Implementation is required in the first quarter of 2008 with any changes in the measurement of existing financial instruments to be reported as an adjustment to the opening balance of retained earnings. The Company is presently evaluating these new requirements to determine whether the fair value election will be used for various financial assets and liabilities at implementation or for financial assets and liabilities acquired subsequently.

Fair value measurements - In 2006, the FASB issued SFAS No. 157, Fair Value Measurements, to expand disclosures about fair value measurements and to clarify how to measure fair value by focusing on the price that would be received when selling an asset or paid to transfer a liability. Implementation is required in the first quarter of 2008 with any changes to the fair values of assets or liabilities to be reported generally in net income or, for fixed maturities and equity securities held for sale and derivatives that hedge future cash flows, in accumulated other comprehensive income (loss) for the period. The Company is presently evaluating these new requirements to determine whether any changes to the fair value measurements of its assets and liabilities will result at implementation.

NOTE B EARNINGS PER SHARE

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

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

	Three Months Ended June 30,		**Six Months Ended June 30,**	
(In thousands, except per share amounts)	**2007**	**2006**	**2007**	**2006**
Numerator: Net income	$ 2,989	$ 4,785	$ 5,617	$ 7,987
Denominator:				
Denominator for basic earnings per share weighted average shares	27,166	26,534	27,055	26,421
Effect of dilutive securities:				
Employee and director stock options	744	693	707	682
Denominator for diluted earnings per share adjusted weighted average shares and assumed conversions	27,910	27,227	27,762	27,103
Basic earnings per share	$ 0.11	$ 0.18	$ 0.21	$ 0.30
Diluted earnings per share	$ 0.11	$ 0.18	$ 0.20	$ 0.29
Options excluded from diluted net earnings per share calculations (1)	157	1,120	173	1,120

(1) At June 30, 2007 and 2006, options to purchase shares of Inter-Tel stock were excluded from the calculation of diluted net earnings per share because the exercise price of these options was greater than the average market price of the common shares for the respective periods, and therefore the effect would have been antidilutive.

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NOTE C ACQUISITIONS AND INTANGIBLE ASSETS

Lake. On February 28, 2005, Inter-Tel Lake Ltd., a wholly owned Irish subsidiary of Inter-Tel (Delaware), Incorporated executed an agreement for the purchase of 100% of the issued share capital of Lake Communications Limited and certain affiliated entities (collectively, Lake) for $28.7 million (including capitalized transaction costs of $0.7 million), plus a potential earn-out to be based upon certain targets relating to operating results for Lake through the first eighteen months following the closing date of the transaction. The final earn-out amount of $13.0 million was determined and recorded in December 2006 and paid in April 2007. The transaction closed on March 4, 2005. In total, the Company has recorded $19.3 million of purchased intangible assets of which a total of $2.6 million was charged to expense in the first quarter of 2005 as in-process research and development costs with the balance being amortized over eight years. Additionally, we recorded $20.2 million of goodwill.

Lake, based in Dublin, Ireland, is a provider of converged communications products in the under 40 user market, including the Inter-Tel 3000 (formerly the Inter-Tel EncoreCX®) and the Embarq Connection Central products currently being distributed in the United States. Lake designs and develops its products for sale through a distribution network of telecom operators and distributors, including Inter-Tel in the United States. Lake out-sources its manufacturing to third-party suppliers.

Intangible Assets. The weighted-average amortization period for total purchased intangibles as of June 30, 2007 and December 31, 2006 was approximately 7.9 years and 7.8 years, respectively. The weighted-average amortization period as of June 30, 2007 and December 31, 2006 for developed technology was approximately 8.0 and 7.8 years for each period, respectively, and 7.8 years for both periods for customer lists and non-compete agreements.

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

NOTE D SEGMENT INFORMATION

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

We view our operations as primarily composed of two segments: (1) our principal segment, which includes sales of telephone systems, telecommunications software, hardware and related services, and (2) network services, including resale of local and long distance calling services, voice circuits and data circuits through NetSolutions®, as well as commissions earned by Network Services Agency, our division serving as an agent selling local and network services such as T-1 access, frame relay and other voice and data circuit services on behalf of Regional Bell Operating Companies (RBOCs) and local exchange carriers (collectively, Network Services). Sales of these systems, software, related services and Network Services are provided through the Company s direct sales offices and dealer network to business customers in North America, and in parts of Europe, Australia, South Africa and Asia. As a result, financial information disclosed represents substantially all of the financial information related to the Company s two principal operating segments. Results of operations for the resale of local, long distance and network services segment, if the operations were not included as part of the consolidated group, could differ materially, as the operations are integral to the total telephony solution offered by us to our customers.

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For the three and six month periods ended June 30, 2007 and 2006, we generated income from business segments as follows:

	Three Months Ended June 30, 2007		
(In thousands, except per share amounts)	**Principal Segment**	**Resale of Local, Long Distance and Network Services**	**Total**
Net sales	$ 98,429	$ 15,982	$ 114,411
Gross profit	49,813	5,427	55,240
Operating income	1,208	1,375	2,583
Interest and other, net	1,929	98	2,027
Foreign currency transaction losses	(124)		(124)
Income tax provision	967	530	1,497
Net income	$ 2,046	$ 943	$ 2,989
Net income per diluted share (1)	$ .07	$ .03	$ .11
Weighted average diluted shares (1)	27,910	27,910	27,910
Goodwill	$ 39,231	$ 2,135	$ 41,366
Total assets	411,241	19,856	431,097
Depreciation and amortization	$ 3,325	$ 15	$ 3,340

	Three Months Ended June 30, 2006		
(In thousands, except per share amounts)	**Principal Segment**	**Resale of Local, Long Distance and Network Services**	**Total**
Net sales	$ 100,921	$ 15,004	$ 115,925
Gross profit	51,293	5,469	56,762
Operating income	4,640	1,959	6,599
Interest and other, net	1,491	37	1,528
Foreign currency transaction losses	(358)		(358)
Income tax provision	2,025	959	2,984
Net income	$ 3,748	$ 1,037	$ 4,785
Net income per diluted share (1)	$ 0.14	$ 0.04	$ 0.18
Weighted average diluted shares (1)	27,227	27,227	27,227
Goodwill	$ 27,705	$ 2,135	$ 29,840
Total assets	398,772	13,843	412,615
Depreciation and amortization	$ 3,437	$ 19	$ 3,456

	Six Months Ended June 30, 2007		
(In thousands, except per share amounts)	**Principal Segment**	**Resale of Local, Long Distance and Network Services**	**Total**
Net sales	$ 192,295	$ 31,581	$ 223,876
Gross profit	97,733	10,897	108,630
Operating income	3,426	1,269	4,695
Interest and other, net	3,682	167	3,849
Foreign currency transaction losses	(106)		(106)
Income tax provision	2,333	488	2,821
Net income	$ 4,669	$ 948	$ 5,617
Net income per diluted share (1)	$ 0.17	$ 0.03	$ 0.20
Weighted average diluted shares (1)	27,762	27,762	27,762
Goodwill	$ 39,231	$ 2,135	$ 41,366
Total assets	411,241	19,856	431,097

Depreciation and amortization	$ 6,596	$ 33	$ 6,629

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(In thousands, except per share amounts)	Six Months Ended June 30, 2006 Principal Segment	Resale of Local, Long Distance and Network Services	Total
Net sales	$ 193,164	$ 29,684	$ 222,848
Gross profit	99,053	10,987	110,040
Operating income	5,767	4,840	10,607
Interest and other, net	2,702	85	2,787
Foreign currency transaction losses	(362)		(362)
Income tax provision	3,042	2,003	5,045
Net income	$ 5,065	$ 2,922	$ 7,987
Net income per diluted share (1)	$ 0.18	$ 0.11	$ 0.29
Weighted average diluted shares (1)	27,103	27,103	27,103
Goodwill	$ 27,705	$ 2,135	$ 29,840
Total assets	398,772	13,843	412,615
Depreciation and amortization	$ 6,782	$ 39	$ 6,821

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

Our revenues are generated predominantly in the United States. Total revenues generated from U.S. customers totaled $101.1 million, or 88.4% of total revenues, and $103.9 million, or 89.7% of total revenues for the three months ended June 30, 2007 and 2006, respectively. For the six months ended June 2007 and 2006, revenues generated from U.S. customers totaled $199.5 million or 89.1% and $201.6 million or 90.5% of total revenues, respectively. Refer to the table below for additional geographical revenue data.

	Three Months Ended			
	June 30, 2007		June 30, 2006	
Source of net sales	$	%	$	%
Domestic	$ 101,099	88.4%	$ 103,941	89.7%
Lake Communications	7,462	6.5	7,242	6.2
Other International	5,850	5.1	4,742	4.1
Total net sales	$ 114,411	100.0%	$ 115,925	100.0%

	Six Months Ended			
	June 30, 2007		June 30, 2006	
Source of net sales	$	%	$	%
Domestic	$ 199,504	89.1%	$ 201,645	90.5%
Lake Communications	13,344	6.0	13,116	5.9
Other International	11,028	4.9	8,087	3.6
Total net sales	$ 223,876	100.0%	$ 222,848	100.0%

In the three months ended June 30 2007 and 2006, revenues from customers located internationally accounted for 11.6% and 10.3% of total revenues, respectively. In the six month periods ended June 30, of 2007 and 2006, revenues from customers located internationally accounted for 10.9% and 9.5% of total revenues, respectively. Other International revenues identified in the table above primarily consist of revenues from Inter-Tel s UK operations, including sales from Swan Solutions. Our UK office sells predominantly into the United Kingdom and other European countries. The principal segment generated substantially all of our foreign revenues for 2007 and 2006. For the quarters ended June 30, 2007 and 2006, $2.1 million and $1.6 million, respectively of income before income taxes were generated from our foreign operations. For the six month periods ended June 30, 2007 and 2006, $3.0 million and $2.0 million, respectively of income before income taxes were generated from our foreign operations. All sales made between Inter-Tel divisions are eliminated and are not represented in the above amounts or in the Consolidated Statements of Income.

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Our applicable long-lived assets at June 30, 2007, included Property, Plant & Equipment; Goodwill; and Purchased Intangible Assets. The net amount located in the United States was $48.0 million and the amount in foreign countries was $34.8 million at June 30, 2007. At December 31, 2006, the net amount located in the United States was $50.5 million and the amount in foreign countries was $37.8 million.

NOTE E NET INVESTMENT IN SALES-LEASES

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

(in thousands)	June 30, 2007	December 31, 2006
Lease balances included in consolidated accounts receivable, net of allowances of $2,382 in 2007, and $1,586 in 2006	$ 10,116	$ 11,024
Net investment in Sales-Leases:		
Current portion, net of allowances of $1,123 in 2007, and $1,112 in 2006	19,774	19,617
Long-term portion, includes residual amounts of $909 in 2007 and, $803 in 2006, net of allowances of $1,883 in 2007, and $1,763 in 2006	33,174	31,113
Total investment in Sales-Leases, net of allowances of $5,388 in 2007, and $4,461 in 2006	63,064	61,754
Sold rental payments remaining unbilled (subject to limited recourse provisions), net of allowances of $14,284 in 2007, and $14,682 in 2006	251,622	259,003
Total balance of sales-leases and sold rental payments remaining unbilled, net of allowances	$ 314,686	$ 320,757
Total allowances for entire lease portfolio (including limited recourse liabilities)	$ 19,672	$ 19,143

Reserve levels are established based on portfolio size, loss experience, levels of past due accounts and periodic, detailed reviews of the portfolio. Recourse on the sold rental payments is contractually limited to a percentage of the net credit losses in a given annual period as compared to the beginning portfolio balance for a specific portfolio of sold leases. While our recourse is limited, we maintain reserves at a level that we believe is sufficient to cover all anticipated credit losses. The aggregate reserve for uncollectible lease payments and recourse liability represents the reserve for the entire lease portfolio.

These reserves are either netted against consolidated accounts receivable, netted against current or long-term investment in sales-leases or included in long-term liabilities for sold rental payments remaining unbilled. Sales of rental payments per period are as follows:

(In thousands)	Six Months Ended June 30, 2007	Year Ended December 31, 2006
Sales of rental payments	$ 42,882	$ 101,644
Sold payments remaining unbilled at end of period	$ 265,907	$ 273,685

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Sales of rental payments represent the gross selling price or total present value of the payment stream on the sale of the rental payments to third parties. Sold payments remaining unbilled at the end of the period represent the total balance of leases that is not included in our balance sheet. We do not expect to incur any significant losses in excess of reserves from the recourse provisions related to the sale of rental payments.

NOTE F STOCK BASED COMPENSATION

At June 30, 2007, the Company had four active share-based employee compensation plans. The Company s Employee Stock Purchase Plan expired during the second quarter, after ten years in existence. Stock option awards granted from the active plans are granted at the fair market value on the date of grant, and vest over a period determined at the time the options are granted, ranging from six months to five years, and generally have a maximum term of ten years. Certain options provide for accelerated vesting if there is a change in control (as defined in the plans). When options are exercised, treasury shares, if available, are re-issued. If treasury shares have all been re-issued, as was the case during the second quarter of 2007, new shares of the Company s common stock are issued.

The total value of the stock options awards is expensed ratably over the service period of the employees receiving the awards. As of June 30, 2007, total unrecognized compensation cost related to stock option awards was approximately $8.2 million and the related weighted-average period over which it is expected to be recognized is approximately 2.8 years.

Total estimated share-based compensation expense and the effect on net income and income per share, related to all of the Company s share-based awards, recognized for the three months and six months ended June 30, 2007 and June 30, 2006 respectively, was comprised as follows (in thousands, except per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Cost of revenues	$ 78	$ 50	$ 139	$ 123
Research and development	218	282	553	571
Selling, general and administrative	621	752	1,322	1,441
Share-based compensation expense before income taxes	917	1,084	2,014	2,135
Related income tax benefits	14	198	155	447
Share-based compensation expense, net of taxes	$ 903	$ 886	$ 1,859	$ 1,688
Net share-based compensation expense, per common share:				
Basic	$ 0.03	$ 0.03	$ 0.07	$ 0.06
Diluted	$ 0.03	$ 0.03	$ 0.07	$ 0.06

A summary of stock options activity within the Company s share-based compensation plans and changes for the six months ended June 30, 2007 is as follows:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Balance at December 31, 2006	3,825,508	$ 18.14		
Granted	594,000	$ 23.61		
Exercised	(385,832)	$ 15.01		
Terminated/expired	(93,741)	$ 19.58		
Balance at June 30, 2007	3,939,935	$ 18.28	6.0	$ 22,261,000
Exercisable at June 30, 2007	2,550,020	$ 17.81	5.2	$ 15,606,000

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The intrinsic value of options exercised during the six months ended June 30, 2007 was $3,905,000.

The fair value of each stock option award is estimated on the date of the grant using the Black-Scholes option pricing model with the following assumptions:

	Six Months Ended June 30, 2007	Six Months Ended June 30, 2006
Expected dividend yield	1.34%	1.37%-1.53%
Expected stock price volatility	0.39	0.41-0.53
Risk-free interest rate	4.73%	4.76%-4.98%
Expected life of options	4 Years	3-5 Years

The expected dividend yield is based on expected annual dividends to be paid by the Company as a percentage of the market value of the Company s stock as of the date of grant. The Company determined volatility using historical volatility. The risk-free interest rate is based on the U.S. treasury security rate in effect as of the date of grant. The expected lives of options are based on historical data of the Company, adjusted for expected future activity. The weighted average fair value of stock options granted during the six months ended June 30, 2007 and June 30, 2006 was $7.94 and $8.49, respectively.

Performance Shares

During 2006, the Company began granting performance shares. For the three months ended June 30, 2007, no performance shares were issued. For the six months ended June 30, 2007 and the year ended December 31, 2006, the Company granted performance shares of 78,750 and 80,000, respectively. Except as provided for change of control provisions, each of the performance share awards by their terms vest primarily in connection with the achievement by the Company of certain earnings per share (EPS) targets over the Company s following two fiscal years ended December 31, with 50% vesting each year, only if such targets are achieved. For options granted in 2006, the EPS targets are based on fiscal 2007 and 2008 results. For options granted in 2007, the EPS targets are based on 2008 and 2009 results. In the event either year s target is missed, the applicable shares for that year do not vest and are forfeited. The market price of the Company s common stock on the date of grant was $23.86 for the 2007 grant and ranged from $21.23 to $23.44 for the 2006 grants. As of December 31, 2006, the Company had deemed probable the likelihood of attaining only the 2007 EPS goals (not the 2008 EPS goals) as set forth in the awards; accordingly, stock-based compensation was accrued through December 31, 2006 related to these awards. However, during the second quarter of 2007, based on revised 2007 EPS forecasts, the achievement of the performance share targets was not deemed probable, and all performance share expenses that were previously accrued were reversed. Accordingly, on a cumulative basis as of June 30, 2007, no compensation expense has been recorded related to these awards.

Employee Stock Purchase Plan

Under the Employee Stock Purchase Plan (the Purchase Plan), through May 30, 2007, employees were granted the right to purchase shares of Common Stock at a price per share that is 85% of the lesser of the fair market value of the shares at: (i) the participant s entry date into each six-month offering period, or (ii) the end of each six-month offering period. Employees were allowed to designate up to 10% of their compensation for the purchase of stock. Included in the share based compensation expense for the three months ended June 30, 2007 and June 30, 2006 is $118,000 and $36,000, respectively, and included in the share based compensation expense for the six months ended June 30, 2007 and 2006, is $170,000 and $97,000 respectively, for the expense related to the Purchase Plan. The Purchase Plan expired after ten years in the normal course following the Offering Period ending in May 2007. In the event the merger with Mitel is not consummated, the Company intends to submit a proposal for a new employee stock purchase plan to the Company s stockholders for approval at the next annual shareholders meeting.

NOTE G MITEL MERGER AGREEMENT

On April 26, 2007, the Company signed a definitive merger agreement with Mitel whereby Mitel has agreed to acquire all of the outstanding capital stock of Inter-Tel for $25.60 per share in cash, representing a total purchase price of approximately $723 million. The boards of directors of both companies have approved the transaction and Inter-Tel stockholders approved the transaction at a Special Stockholder meeting on August 2, 2007, which was one of the required closing conditions. However, the merger is also

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subject to (1) other customary closing conditions, including regulatory approvals, and (2) a hearing scheduled for August 8, 2007 in the Delaware Chancery Court to rule on a request by a third-party plaintiff for an injunction prohibiting the merger. The transaction is expected to close in the third quarter of 2007. However, as of the date hereof, the merger has not been consummated and there is no guarantee the merger will be consummated in the third quarter of 2007 or otherwise.

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

The following discussion involves forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements. For further information regarding forward-looking statements, see Forward Looking Statements in Item IA, Risk Factors.

Overview

Inter-Tel (Delaware), Incorporated (Nasdaq: INTL) (Inter-Tel), originally incorporated in Arizona in 1969 and reincorporated in Delaware in 2006, is a single point of contact, full-service provider of IP and converged voice, video and data business communications systems. The Company also provides a wide range of managed services, including voice and data network design and traffic provisioning, local and long distance calling services, custom application development, maintenance, leasing, and support services for our products. Our customers include business enterprises, federal, state and local government agencies and non-profit organizations. We market and sell the following products, services and applications:

Inter-Tel 7000, Inter-Tel 5000 and Inter-Tel Axxess Network Communications Solutions (converged voice and data business communication systems);

Lake Communications converged voice and data business communication systems, including those sold in the US under the Inter-Tel 3000 (formerly the Inter-Tel EncoreCX®) and the Embarq Connection Central brands;

integrated voice mail, voice processing and unified messaging systems;

presence management, collaboration, web conference, and audio conferencing applications,;

multi-media contact center applications;

call accounting software, computer-telephone integration (CTI) applications,

related third-party products, applications, and services,

managed services, including voice and data network design, traffic provisioning, and financial solutions packages (leasing);

local and long distance calling services, voice circuits, data circuits and other communications services and peripheral products;

networking applications, including the design and implementation of voice and data networks, and maintenance and support services for our products.

We have developed a distribution network of direct sales offices, dealers and value added resellers (VARs), which sell our products to organizations throughout the United States and internationally, primarily targeting small-to-medium enterprises, service organizations and governmental agencies. As of June 30, 2007, we had fifty-seven (57) direct sales offices in the United States and a network of hundreds of dealers and VARs primarily in the United States that purchase directly from us or through distributors. Our sales office in Phoenix is the primary location for our national, government and education accounts division, as well as our local, long distance and network services divisions. Our wholesale distribution center is located in Tempe, Arizona, which is the primary location from which we distribute products to our network of direct sales offices, dealers and VARs in North America. In February 2006, we made a strategic change relative to our sales channels. Prior to 2006, the retail and wholesale sales functions were managed separately. In an effort to provide higher levels of support and cooperation between all channels, the two sales channels now both report to our vice president of sales. In addition, we maintain wholesale distribution offices in Ireland and the United Kingdom that supply Inter-Tel s dealers and distributors throughout the United Kingdom, Ireland, other parts of Europe, Australia and South Africa. We also have a dealer in Japan. We also maintain research and development and software sales offices in Tucson, Arizona; Frederick, Maryland; Ireland and the United Kingdom.

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

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

End-user sales and sales-type leases through our direct sales offices and national, government and education accounts division. We recognize revenue from sales of systems and services to end-user customers upon installation of the systems and performance of the services, respectively, allowing for use by our customers of these systems. We defer pre-payments for communications services and recognize these pre-payments as revenue as the communications services are provided. For our sales-type lease accounting, we record the discounted present values of minimum rental payments under sales-type leases as sales, net of provisions for continuing administration and other expenses over the lease period. We record the lease sales at the time of system sale and installation as discussed above for sales to end user customers, and upon receipt of the executed lease documents. The net rental streams are sold to funding sources on a regular basis with the income streams discounted by prevailing like-term rates at the time of sale. Gains or losses resulting from the sale of net rental payments from such leases are also recorded as net sales. Furthermore, when the initial term of the lease is concluded, customers have the option to renew the lease at a payment and term less than the original lease.

Dealer and VAR sales. For shipments to dealers, value added resellers and other distributors, our revenue is recognized as products are shipped and services are rendered, because at such points the sales process is complete. Title to these products passes when goods are shipped (free-on-board shipping point). However, shipments to one international dealer, with whom we established a relationship as a result of our Lake acquisition, are initially held by that dealer on a consignment basis. Such inventory is owned by Inter-Tel until the inventory is sold through to third parties, at which time the revenue is recorded.

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

Software Sales. We generally recognize revenues from sales of software upon shipment to dealers or upon downloading of such software from the Internet by such dealers, as applicable, or upon installation at end-user sites, depending on the distribution channel.

Maintenance and software support. Maintenance and software support revenue is recognized ratably over the term of the maintenance or support agreement.

Costs and gross margins. Our costs of products sold primarily consist of materials, labor and overhead. Our costs of services performed consist primarily of labor, materials and service overhead. Total costs of goods and services sold remained relatively flat for the quarter ended June 30, 2007, compared to the corresponding period in 2006; however, our consolidated gross margin percentage decreased to 48.3% in the second quarter of 2007 compared to 49.0% in the second quarter of 2006. The slight decrease in gross margin percentage in 2007 compared to 2006 was primarily attributable to the mix of products sold through the various Inter-Tel divisions, with a lower percentage of sales recognized in the Company s direct sales offices (including Lease financing), which typically generates higher gross margins than most other divisions within Inter-Tel. Higher relative percentages of net sales were recognized in the Company s local, long distance and network services divisions, Datanet operations, and international dealer operations, which typically generate lower gross margins than other divisions. Other factors affecting both the costs of goods sold and reductions in overall gross margin percentage are described in greater detail in Results of Operations below.

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

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

Customer leases generally expire at the end of the month and commence at the beginning of the month, which naturally leads to end-of-period sales. These factors apply to both end-user and dealer sales.

Quarterly sales of lease rental streams typically occur near the end of the third month of the quarter. Additionally interest rate fluctuations may impact the gain or loss on sale of such rental streams.

Internal sales compensation programs for our sales personnel are linked to revenues and the sales commissions generally increase at accelerated rates as sales volumes increase. Sales performance bonuses are also frequently tied to quarter-end and year-end performance targets, providing incentives to sales personnel to close business before the end of each quarter.

Historically, some price discounting to our dealer channel occurred during the last month of a quarter or year, and some dealers have purchased consistently to take advantage of potential product specific pricing discounts or end-of-quarter promotions. However, such promotions are subject to change at any time.

In addition, we are subject to seasonal variations in our operating results, as net sales for the first and third quarters are frequently lower than those experienced during the fourth and second quarters, respectively; although the announcement of the proposed Mitel merger and the continuing proxy contest may have an impact on this historical trend in 2007.

Cash Flows. At June 30, 2007, Inter-Tel s cash and short-term investments totaled $206.9 million. Historically, our primary source of cash has come from net income plus non-cash charges for depreciation and amortization expenses. We have generated cash from continuing operations in every full fiscal year from 1986 to 2006. In 1993, 1995 and 1997, the Company received net proceeds from stock offerings, offset in part by cash expended to repurchase the Company s common stock in these and other periods. In addition, Inter-Tel historically has paid cash for capital expenditures relating to property and equipment or acquisitions. Inter-Tel has also received cash proceeds from the exercise of stock options and our Employee Stock Purchase Plan. We believe our working capital, together with cash generated from operations, will be sufficient to develop and expand our business operations, and to provide adequate working capital for the foreseeable future. In addition, we believe we will be able to meet the minimum cash-on-hand required by the Mitel merger agreement, upon the prospective closing of the transaction. Refer to Note G of notes to the condensed consolidated financial statements and Mitel Merger Announcement. The announcement of, and/or the failure to complete, the proposed merger with Mitel could negatively affect the market price of Inter-Tel securities, as well as adversely affect its business in Risk Factors.

Our consolidated net sales for the quarters ended June 30, 2007 and 2006 were $114.4 million and $115.9 million, respectively. The 1.3% decrease in net sales in the second quarter of 2007 compared to the second quarter of 2006 was due in part to lower revenues from our dealer network and distribution channel, as well as our direct sales offices (including lease finance revenues), and our national, government and education accounts division, offset in part by increases in revenues from our international operations, primarily our UK operations. Sales also increased in our local, long distance resale and network services division, our DataNet division, and our Lake operations. We cannot predict whether recent trends in revenue will continue in the future. In addition, we believe uncertainty exists in the marketplace caused by the transition of communication systems from circuit-switch to packet-switch architectures, including Voice over Internet Protocol (VoIP) systems, and this uncertainty may cause some organizations to delay making investments in new systems. Accordingly, we believe businesses may be reluctant to significantly increase spending on enterprise communications systems in the near future.

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

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The markets we serve have been characterized by rapid technological changes and the increasing sophistication of customer requirements. We have sought to address these requirements through the development of software enhancements and improvements to existing systems and the introduction of new systems, products, and applications. Research and development expenses for the second quarter of 2007 decreased 4.7% to $8.4 million, or 7.3% of net sales, compared to $8.8 million, or 7.6% of net sales, for the second quarter of 2006. Inter-Tel s research and development efforts over the last several years have been focused on the development of the Inter-Tel 5000 and Inter-Tel 7000 platforms as well as enhancements to the Inter-Tel Axxess and Lake communications platforms. In addition, we have also been engaged in adding new features and system scalability improvements, enhancing and developing new IP convergence applications and IP endpoints, developing Unified Communications applications, developing and enhancing presence management applications, and developing and integrating audio and web collaboration tools. We expect that research and development expenses may vary in absolute dollars and as a percentage of net sales relative to the prior year as we continue to develop and enhance existing products and leverage new technologies to provide innovative solutions that will address our customer s business communications needs.

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

Results of Operations

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
NET SALES				
Telecommunications systems, software and related	86.0%	87.1%	85.9%	86.7%
Resale of local, long distance and network services	14.0	12.9	14.1	13.3
TOTAL NET SALES	100	100	100	100
COST OF SALES				
Telecommunications systems, software and related	42.5	42.8	42.2	42.2
Resale of local, long distance and network services	9.2	8.2	9.2	8.4
TOTAL COST OF SALES	51.7	51.0	51.5	50.6
GROSS PROFIT	48.3	49.0	48.5	49.4
Research and development	7.3	7.6	7.4	7.7
Selling, general and administrative	35.0	32.8	36.4	34.2
Amortization of intangibles	1.0	1.0	1.0	1.0
Proxy contest and related costs	2.7	1.8	1.6	1.1
Legal judgment and settlement				0.6
OPERATING INCOME	2.3	5.7	2.1	4.8
Interest and other, net	1.8	1.3	1.7	1.3
Foreign currency transaction gains (losses)	(0.1)	(0.3)	0.0	(0.2)
INCOME BEFORE INCOME TAXES	3.9	6.7	3.8	5.8
INCOME TAXES	1.3	2.6	1.3	2.3
NET INCOME	2.6%	4.1%	2.5%	3.6%

Net Sales. Net sales decreased 1.3%, or $1.5 million, to $114.4 million in the second quarter of 2007, from $115.9 million in the second quarter of 2006. The decrease in net sales was primarily attributable to lower net sales in our direct sales offices (including Lease financing), dealer network and our national, government and educational accounts division offset in part by increases in net sales in our international operations in the United Kingdom, DataNet operations, the resale of local, long distance and network services, and Lake operations. International revenues increased by 23.4%, or $1.1 million, in the second quarter of 2007, compared to the corresponding period in 2006, primarily attributable to the increasing success of our products in the United Kingdom (24.5% increase). Sales from our Irish subsidiary increased by 3.1%, or $0.2 million, in the second quarter of 2007, compared to the corresponding period in 2006. Sales from our DataNet division, which sells networking products through our direct sales offices, national, government and education accounts division and dealer channel, increased 12.3%, or $0.8 million, in the second quarter of 2007, compared to the corresponding period in 2006. Sales from our direct sales offices (including revenues from lease financing), decreased 2.6%, or $1.4 million, in the second quarter of 2007 compared to the corresponding period in 2006. Sales attributable to our dealer network decreased by 9.3%, or $2.1 million, in the second quarter of 2007, compared to the corresponding period in 2006. Sales from our national, government and educational accounts division decreased 9.3%, or $1.1 million, in the second quarter of 2007 compared to the corresponding period in 2006. Lower net sales were in part due to the sale of relatively fewer larger line size systems in the second quarter of 2007 compared to 2006.

Sales from local and long distance and network services (NSG), which includes Inter-Tel NetSolutions (NetSolutions) and Network Services Agency (NSA), increased by 6.5% or $1.0 million in the second quarter of 2007, compared to the corresponding period in 2006. Sales from NetSolutions increased 6.9%, or $0.9 million, in the second quarter of 2007 compared to the corresponding period in 2006. This continued an upward trend of NetSolutions sales despite pricing pressures and significant competition. Sales from NSA, a commission-based sales unit within the local, long distance resale and network services division acting as an agent to sell services for selected RBOC s (Regional Bell Operating Companies) and CLEC s (Competitive Local Exchange Carriers), did not change significantly in the second quarter of 2007 compared to the corresponding period in 2006.

Gross Profit. Gross profit for the second quarter of 2007 decreased 2.7% to $55.2 million, or 48.3% of net sales, from $56.8 million, or 49.0% of net sales, in the second quarter of 2006. The decline in gross margin percentage in the second quarter of 2007 compared to the comparable period in 2006 was primarily attributable to the mix of products sold through the various Inter-Tel divisions, with a lower percentage of sales recognized in the Company s direct sales offices (including Lease financing) which typically generates higher gross margins than most other divisions within Inter-Tel A higher relative percentage of net sales were recognized in the Company s local, long distance and network services divisions, Datanet operations, and international dealer operations, which typically generate lower gross margins than other divisions. The gross margin percentage was also affected by sales of fewer larger line systems, which traditionally have a higher relative percentage of software content.

During the second quarter of 2007, recurring revenues from existing customers in our direct sales, DataNet and national, government and education accounts channels decreased $0.7 million, or 2.5%, compared to the second quarter of 2006. Historically, existing customers accounted for a significant portion of our net sales from maintenance and other services, software additions and/or upgrades, and other peripheral products such as video conferencing, call logging solutions, wireless endpoints, power protection, wired and wireless headsets, audio conferencing units and networking products. Our business communications platforms allow for system migration without the complete replacement of hardware, enabling us to offer enhancements and new solutions through software-only upgrades to our existing customers. Consequently, our gross margins are generally higher with recurring revenues because we incur less materials costs relative to new installations.

Sales from NSG, which includes Inter-Tel NetSolutions (NetSolutions) and Network Services Agency (NSA), increased by 6.5%, or $1.0 million, in the second quarter of 2007 as compared to the second quarter of 2006. Although gross margins are generally lower in our long distance division compared to our consolidated gross margins, our gross margins on commissions on network services through NSA generally exceed our consolidated gross margins. Sales from NetSolutions increased 6.9%, or $0.9 million, in the second quarter of 2007 compared to the corresponding period in 2006. This continued an upward trend of NetSolutions sales despite pricing pressure and significant competition. Sales from NSA did not change significantly in the second quarter of 2007 compared to the corresponding period in 2006. This division generally receives commissions on network services we sell as an agent for RBOCs and these sales carry little to no equipment cost and generated margins of approximately 87.9% in the second quarter of 2007 compared to 90.1% in the corresponding period in 2006.

We cannot accurately predict future consolidated gross margins because of period-to-period variations in a number of factors, including among others, competitive pricing pressures, sales of systems, software and services through different distribution channels, supplier and agency agreements, and the mix of systems, software and services we sell. In the event that sales through our direct sales offices increase as a percentage of net sales, our overall gross margin could improve. Conversely, in the event net sales to domestic and international dealers, or sales of DataNet or long distance services increase as a percentage of net sales, our overall gross margin could decline.

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Research and Development. Research and development expenses for the second quarter of 2007 decreased 4.7% to $8.4 million, or 7.3% of net sales, compared to $8.8 million, or 7.6% of net sales, for the second quarter of 2006. In the quarter ended June 30, 2007, research and development expenses were directed principally toward the continued development of converged systems and software, including the Inter-Tel 5000 and Inter-Tel 7000 software and systems, contact center, presence and collaboration applications, and IP endpoint development. Inter-Tel s research and development efforts over the last several years have also been focused on the development of the Inter-Tel 5000 and Inter-Tel 7000 platforms as well as enhancements to the Inter-Tel Axxess and Lake communications platforms. We have also been engaged in adding new features and system scalability improvements, enhancing and developing new IP convergence applications and IP endpoints, developing Unified Communications applications, developing and enhancing presence management applications, and developing and integrating audio and web collaboration tools. We expect that research and development expenses may vary in absolute dollars and as a percentage of net sales relative to the prior year as we continue to develop and enhance existing products and leverage new technologies to provide innovative solutions that will address our customer s business communications needs.

Selling, general and administrative (SG&A). In the second quarter of 2007, selling, general and administrative expenses increased 7.4% to $43.2 million, or 37.7% of net sales, from $40.2 million, or 34.7% of net sales, in the second quarter of 2006. SG&A expenses in the second quarter of 2007 included FAS 123R expenses and proxy contest, merger and related costs totaling $3.7 million as compared to $2.9 million for the same period in 2006.

In addition to the increase in combined FAS 123R, proxy contest, merger and related expenses, SG&A expenses also increased in absolute dollars due to higher compensation costs and health and medical expenses resulting from an increase in the number of personnel, primarily in sales and marketing. To a lesser extent, the increase in SG&A expenses was due to increased bad debt expenses, partially offset by a slight decrease in depreciation expense. We expect that for the foreseeable future selling, general and administrative expenses may vary in absolute dollars and as a percentage of net sales, depending on the volume of net sales and the impact of proxy and merger related costs.

Amortization of purchased intangible assets. We are required to perform goodwill impairment tests on an annual basis and between annual tests in certain circumstances. As of June 30, 2007, no impairment of goodwill has been recognized for 2007. We face the risk that future goodwill impairment tests may result in charges to earnings.

Amortization of purchased intangible assets included in operating expenses was $1.1 million in the second quarter of 2007 compared to $1.2 million in the second quarter of 2006. In addition, $16,000 of amortization was included in research and development expenses for the second quarter of 2007 compared to $5,000 in the second quarter of 2006. The decrease in amortization of purchased intangible assets was the result of previously purchased intangible assets becoming fully amortized. For additional information regarding purchased intangible assets, see Note C Acquisitions and Intangible Assets to the Condensed Consolidated Financial Statements.

Interest and Other Income. Interest and other income in 2007 and 2006 consisted primarily of interest income and foreign currency transaction gains or losses. The increase in interest and other, net of $493,000 in the second quarter of 2007 compared to the corresponding period in 2006 was primarily due to higher rates of return and slightly higher levels of invested funds. Interest expense was nominal in both periods. Net foreign currency transaction losses in the second quarter of 2007 were $124,000 compared to losses of $358,000 in the second quarter of 2006.

Income Taxes. The Company s effective tax rate for the second quarter of 2007 was 33.4% compared to 38.4% for the second quarter of 2006. The decrease in rate was primarily attributable to the increase in income of our foreign subsidiaries, which have lower foreign tax rates, the increase in tax-exempt interest income as a percentage of projected net income, and the reenactment of the research and development tax credit during the second half of 2006. The annual effective tax rate is subject to change based on the projected results of operations and a number of other factors, such as tax-exempt interest, foreign tax rates and the research and development tax credit discussed above.

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Net Income. Net income for the second quarter of 2007 was $3.0 million ($0.11 per diluted share), a decrease of 37.5% compared to net income of $4.8 million ($0.18 per diluted share) in the second quarter of 2006. The decrease in net income was primarily due to a reduction in revenues, combined with an increase in proxy and merger related costs.

Inflation/Currency Fluctuation

Inflation and currency fluctuations have not previously had a material impact on Inter-Tel s operations. However, during 2006 and 2007 international activities have increased as a percentage of our total business. The expansion of international operations in the United Kingdom and Europe and increased sales in Ireland, Europe and Australia as a result of the 2005 Lake acquisition resulted in increased international sales to 11.6% of total consolidated revenues in the second quarter of 2007. In addition, international procurement agreements for purchases of inventory to supply our U.S. operations have traditionally been denominated in U.S. currency and a significant amount of contract manufacturing has been or may be moved to alternative sources. However, we invoice the customers of our international subsidiaries primarily in the local currencies of our subsidiaries for product and service revenues. Inter-Tel is exposed to foreign exchange rate fluctuations as the financial results of foreign subsidiaries are translated into U.S. dollars in consolidation. Although currency rate changes have not historically had a material impact on Inter-Tel s operations, the increase in the above activities may impact our operating results and financial statements in the future.

Liquidity and Capital Resources

	Six Months Ended June 30,	
(In thousands)	**2007**	**2006**
Net cash provided by operating activities	$ 12,632	$ 13,213
Net cash provided by (used in) investing activities	40,719	(3,561)
Net cash used in financing activities	2,639	1,216
Effect of exchange rate changes	1,033	1,390
Increase in cash and equivalents	57,023	12,258
Cash and equivalents at beginning of period	141,899	103,774
Cash and equivalents at end of period	$ 198,922	$ 116,032

At June 30, 2007, cash and equivalents ($198.9 million) and short-term investments ($8.0 million) totaled $206.9 million, which represented an increase of approximately $0.6 million from the $206.3 million total at December 31, 2006. Cash balances may be used for the Mitel merger, other acquisitions, strategic alliances, working capital, dividends, and general corporate purposes.

Net cash provided by operating activities totaled $12.6 million for the six months ended June 30, 2007, compared to $13.2 million provided by operating activities for the corresponding period in 2006. Cash provided by operating activities in the first six months of 2007 was primarily the result of an $8.6 million increase in other liabilities, cash from profitable operations, and adding back non-cash items such as depreciation, amortization, and provisions for losses, partially offset by a $2.7 million change in operating assets and liabilities and reduced net deferred taxes of $10.8 million. Cash provided by the change in operating assets and liabilities totaled $3.3 million in the first six months of 2006 primarily due to reduced net investment in sales-leases, partially offset by increased receivables, inventory and accrued expenses. We expect to expand sales through our direct sales offices and dealer networks, which may require the expenditure of working capital for increased accounts receivable, inventories and net investment in sales-leases.

Net cash provided by investing activities totaled $40.7 million for the six months ended June 30, 2007, compared to cash used in investing activities of $3.6 million for the corresponding period in 2006. The change from 2006 to 2007 was primarily a result of investing matured and sold investment in cash and cash equivalents instead of short term investments. Cash generated by the net increase resulting from $95.4 million in maturities and sales of available for sale and held-to-maturity investments in the first six months of 2007 compared to sales and maturities of $38.6 million in the first six months of 2006, was partially offset by payment of a previously accrued $13.0 million earnout payment related to the Lake acquisition, and cash used for capital expenditures totaling $2.8 million in the first six months of 2007 compared to total cash used for capital expenditures and acquisitions of $3.4 million for the corresponding period in 2006.

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Net cash provided by financing activities totaled $2.6 million for the six months ended June 30, 2007, compared to $1.2 million for the corresponding period in 2006. Net cash used for cash dividends totaled $4.3 million in the first six months of 2007 compared to $ 4.2 million for the same period for 2006. Net cash provided by proceeds from the exercise of stock options totaled $5.8 million in the first six months of 2007 compared to $3.8 million in the same period for 2006. During the first six months of 2007 and 2006, we reissued treasury shares, to the extent available, to satisfy stock option exercises and stock issuances. The proceeds received from the reissued treasury stock totaled less than the cost basis of the treasury stock reissued. Accordingly, the differences were recorded as reductions to retained earnings of $0.2 million and $1.5 million in 2007 and 2006, respectively.

We offer to our customers lease financing and other services, including our TotalSolution program, through our Inter-Tel Leasing, Inc. subsidiary. We fund our TotalSolution program in part through the sale to financial institutions of rental payment streams under the leases. Sold lease rentals totaling $265.9 million and $273.7 million remained unbilled at June 30, 2007 and December 31, 2006, respectively. We are obligated to repurchase such income streams in the event of defaults by lease customers and, accordingly, maintain reserves based on loss experience and past due accounts. Although, to date, we have been able to resell the rental streams from leases under the TotalSolution program profitably and on a substantially current basis, the timing and profitability of lease resales could impact our business and operating results, particularly in an environment of fluctuating interest rates and economic uncertainty. If we are required to repurchase rental streams and realize losses thereon in amounts exceeding our reserves, our operating results will be adversely affected.

We believe our working capital and credit facilities, together with cash generated from operations, will be sufficient to develop and expand our business operations, and to provide adequate working capital for the foreseeable future. In addition, we believe we will be able to meet the minimum cash-on-hand required by the Mitel merger agreement, upon the prospective closing of the transaction. Refer to Note G of notes to the condensed consolidated financial statements and Mitel Merger Announcement. The announcement of, and/or the failure to complete, the proposed merger with Mitel could negatively affect the market price of Inter-Tel securities, as well as adversely affect its business in Risk Factors. However, to the extent additional funds are required in the future to address working capital needs and to provide funding for capital expenditures, expansion of the business or additional acquisitions, we will seek additional financing. There can be no assurance additional financing will be available when required or on acceptable terms.

Off-Balance Sheet Arrangements

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

Critical Accounting Policies and Estimates

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

Revenue Recognition. In December 2003, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 104 (SAB 104), Revenue Recognition. The Company applies the provisions of SAB 104 to all revenue transactions.

End-user sales through our direct sales offices and government and national accounts division. Revenue is recognized when all four of the following criteria are met: (i) persuasive evidence that arrangement exists; (ii) delivery of the products and/or services has occurred; (iii) the selling price is both fixed and determinable and; (iv) collectibility is reasonably probable. Revenue derived from sales of systems and services to end-user customers is recognized upon primary installation of the systems and performance of the services, respectively, allowing for use by our customers of these systems. Pre-payments for communications services are deferred and recognized as revenue as the communications services are provided. We do not generally allow sales returns either by the terms of our contracts or in practice, except for returns related to warranty provisions.

Dealer and VAR sales. For shipments to dealers and other distributors, our revenues are recorded as products are shipped and services are rendered, when the sales process is complete. These shipments are primarily to third-party dealers and distributors, and title passes when goods are shipped (free-on-board shipping point). However, in connection with our recent Lake acquisition, shipments to one international dealer are initially held by that dealer on a consignment basis. Such inventory is owned by Inter-Tel and reported on Inter-Tel s books and records until the inventory is sold to third parties, at which time the revenue is recorded. We do not generally allow sales returns either by the terms of our contracts or in practice, except for returns related to warranty provisions. We provide a number of incentives, promotions and awards to certain dealers and other distributors. These incentives primarily represent discounts (which are recognized as a reduction of sales), advertising allowances and awards (which are recognized as marketing expense) and management assistance (which is expensed as incurred).

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

Maintenance revenues. We recognize maintenance revenue ratably over the term of applicable maintenance agreements.

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

Historically, our reserves have been adequate to cover write-offs. Our total reserve for losses related to the entire lease portfolio, including amounts classified as accounts receivable in our balance sheet, increased from 5.7% at December 31, 2006 to 5.9% at June 30, 2007, primarily as a result of reviews of our write-off experience and accounts receivable agings. Should the financial condition of our customers deteriorate in the future, additional reserves in amounts that could be material to the financial statements could be required.

Share Based Compensation. Effective January 1, 2006, the Company adopted SFAS No. 123R using the modified prospective method.

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Goodwill and Other Intangible Assets. Purchase prices of acquired businesses that are accounted for as purchases have been allocated to the assets and liabilities acquired based on the estimated fair values on the respective acquisition dates. Based on these values, the excess purchase prices over the fair value of the net assets acquired were allocated to goodwill.

As of June 30, 2007, Inter-Tel had gross goodwill of $46.4 million and accumulated amortization of $5.0 million. Inter-Tel did not complete any acquisitions through June 30, 2007. The Company performs an annual impairment test on Goodwill using the two-step process prescribed in SFAS No. 142. The first step is a screen for potential impairment, while the second step measures the amount of the impairment, if any. In addition, the Company will perform impairment tests during any reporting period in which events or changes in circumstances indicate that an impairment may have occurred. Inter-Tel performed the first step of the required impairment tests for goodwill as of December 31, 2006 and determined that goodwill was not impaired and as of that date it was not necessary to record any impairment losses related to goodwill. At June 30, 2007, $39.3 million, of the Company s goodwill, net of amortization, related to the Company s principal segment, compared to $40.8 million, of the Company s goodwill, net of amortization, related to the Company s principal segment at December 31, 2006, and $2.1 million related to the Resale of Local, Long Distance and Network Services segment in both periods. The reduction in goodwill was due to an adjustment to the goodwill associated with the Lake acquisition. A deferred tax valuation allowance of $1.5 million recorded at the time of the acquisition was reversed during the second quarter of 2007, resulting in the reduction of goodwill for a corresponding amount. There is only one reporting unit (i.e., one component) as defined in paragraph 30 of SFAS 142 within each of the Company s two operating segments as defined in paragraph 10 of SFAS 131. Therefore the reporting units are identical to the segments. Fair value has been determined for each segment in order to determine the recoverability of the recorded goodwill. At December 31, 2006, the Company primarily considered the cash flows for each reporting unit in determining that no impairment has occurred. The test resulted in values that exceeded the net carrying value of each of the reporting units. Therefore, the second step for potential impairment was unnecessary.

The Company evaluates the remaining useful lives of its purchased intangible assets, all of which are subject to amortization, each reporting period. Any changes to estimated remaining lives prospectively effect the remaining period of amortization. In addition, the purchased intangible assets are reviewed for possible impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. A loss would be recognized for any excess of the carrying amount over the estimated fair value. As of June 30, 2007, Inter-Tel had gross purchased intangible assets of $36.7 million and accumulated amortization of $19.4 million.

At June 30, 2007, goodwill, net of accumulated amortization, totaled $41.4 million, compared to $42.9 million at December 31, 2006. Other acquisition-related intangibles, net of accumulated amortization, totaled $17.3 million at June 30, 2007 and $19.6 million at December 31, 2006. Accumulated amortization through June 30, 2007 was $24.4 million, including $5.0 million of accumulated amortization attributable to goodwill and $19.4 million of accumulated amortization of other acquisition-related intangibles. Accumulated amortization through December 31, 2006 was $22.1 million, including $5.0 million of accumulated amortization attributable to goodwill and $17.1 million of accumulated amortization of other acquisition-related intangibles. Other acquisition-related intangibles, comprised primarily of developed technology (5-10 year lives), customer lists (5-8 year lives) and non-competition agreements (2-8 year lives), are amortized on a straight-line basis. The useful lives for developed technology are based on the remaining lives of patents acquired or the estimated useful life of the technology, whichever is shorter. The useful lives of the customer lists are based on the expected period of value for such lists. The useful lives for non-competition agreements are based on the contractual terms of the agreements.

Allowance for Doubtful Accounts. We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. Additional reserves or allowances for doubtful accounts are recorded for our sales-type leases, discussed above in Sales-Leases. We establish and maintain reserves against estimated losses based upon historical loss experience, past due accounts and specific account analysis. Management reviews the level of the allowances for doubtful accounts on a regular basis and adjusts the level of the allowances as needed. In evaluating our allowance we consider accounts in excess of 60 days old as well as other risks in the more current portions of the accounts included. At June 30, 2007, our allowance for doubtful accounts for accounts receivable was $7.2 million. If the financial condition of our customers or channel partners were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

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

Contingencies. We are a party to various claims and litigation in the normal course of business. Management s current estimated range of liability related to various claims and pending litigation is based on claims for which our management can estimate the amount and range of loss, or can estimate a minimum amount of a loss. Because of the uncertainties related to both the amount and range of loss on the remaining pending claims and litigation, management is unable to make a reasonable estimate of the liability that could result from an unfavorable outcome. As additional information becomes available, we will assess the potential liability related to our claims and pending litigation, revise our estimates and accrue for any losses to the extent that they are probable and the amount is estimable. Such revisions in our estimates of the potential liability could materially impact our results of operations and financial position. However, at June 30, 2007 management did not believe that the ultimate impact of various claims and pending litigation would have a materially adverse impact on the Company.

In March 2006, certain prior Executone dealers filed a complaint in Columbus, Ohio similar to the complaint in the Florida trial resolved in 2006. While Inter-Tel is in the process of conducting discovery and evaluating the complaint, Inter-Tel believes that the claims are without merit and Inter-Tel intends to vigorously defend against the complaint.

In the first quarter of 2006, the Company settled a legal matter in connection with a longstanding dispute with a former international dealer that existed as of December 31, 2005. The Company recorded an accrual for the settlement amount and related fourth quarter legal fees as of December 31, 2005. The settlement plus related fourth quarter legal fees totaled $1.6 million. Additional legal fees totaling approximately $1.3 million were recorded as period costs during the first quarter of 2006 relating to this matter.

On April 30, 2007, two shareholder class action lawsuits were filed in the Superior Court of the State of Arizona, County of Maricopa, against Inter-Tel and the Board of Directors: *Joel Gerber v. Inter-Tel Incorporated, et al.*, Case No. CV2007-007444 (the *Gerber* Action), and *Farr v. Inter-Tel, Inc., et al.*, Case No. CV2007-007655 (the *Farr* Action) and another was filed on May 22, 2007, *Suan Investments, Inc. v. Stout, et al.*, Case No. CV2007-009603 (the *Suan* Action) (collectively the Arizona Shareholder Actions.) The actions combined allege that the Board of Directors breached their fiduciary duties of loyalty and due care in connection with the proposed merger with Mitel Networks Corporation by purportedly standing on both sides of the transaction, engaging in self-dealing, obtaining unspecified personal benefits, approving the merger without regard to the fairness of the transaction to Inter-Tel stockholders, failing to exercise independent business judgment, and imprudently accepting and relying upon advice as to the fairness of the consideration for the proposed merger with Mitel from a financial advisor with allegedly conflicted interests. The actions further allege that the proposed merger is a product of a flawed process that was not designed to ensure the sale of Inter-Tel for the highest value. The *Gerber* action requests an injunction prohibiting Inter-Tel from consummating the proposed merger, as well as attorneys fees and costs. The *Farr* action seeks an injunction prohibiting Inter-Tel from consummating the proposed merger with Mitel and, to the extent consummated, rescission of the proposed merger with Mitel and any of the terms of the Mitel merger agreement, as well as the imposition of a constructive trust for improper benefits allegedly received by defendants. The complaint also requests attorneys fees and costs. The *Suan* action seeks an injunction prohibiting Inter-Tel from consummating the merger, rights of rescission against the merger agreement entered into with Mitel, an accounting for plaintiff s alleged damages, and attorneys fees and costs. On June 15, 2007, the Court granted the Company s motion to stay the Arizona Shareholder Actions pending resolution of the Delaware Stockholder Action (described below), and ruled that the plaintiffs motions to expedite the proceedings were, accordingly, moot. The plaintiffs then sought to intervene in the Delaware Stockholder Action and on June 22, 2007, the Delaware Court of Chancery granted the plaintiffs motion to intervene. Inter-Tel believes that the claims are without merit and Inter-Tel intends to vigorously defend against all claims brought in the Arizona Shareholder Actions.

Inter-Tel and certain members of the Board of Directors are defendants in a stockholder class action suit filed on June 15, 2006, entitled *Mercier v. Inter-Tel (Delaware), Inc., et al.*, No. 2226-VCS, in the Court of Chancery of the State of Delaware (Delaware Stockholder Action). On March 27, 2007, the plaintiff filed a Second Amended Complaint (SAC) and on May 25, 2007, the plaintiff filed supplement to the SAC alleging that the defendants breached their fiduciary duties because they failed to properly pursue a higher bid for sale of Inter-Tel. The proposed supplement to the SAC sought an injunction prohibiting Inter-Tel from consummating the proposed merger with Mitel and sought an order requiring the defendants to conduct an auction of Inter-Tel open to Steven G. Mihaylo, Vector Capital Corporation, and all other potentially interested bidders. It further sought an injunction against enforcement of the BCCA or, alternatively, a declaration that Mitel is an interested stockholder under the BCCA and that the proposed merger with Mitel cannot be consummated because the required vote cannot be obtained. Finally, it sought a declaration that representations and covenants in the merger agreement with Mitel are invalid, and damages in an unspecified amount. On May 24, 2007, the plaintiff filed motions seeking a preliminary injunction and summary judgment on the claims in the SAC. On June 4, 2007, the Court denied the plaintiff s Motion For Expedited Proceedings, which sought to set a briefing schedule for a preliminary injunction and allow discovery on an expedited basis regarding alleged failure of Inter-Tel s Board of Directors to maximize stockholder value, among other claims. On July 12, 2007, the plaintiffs (now including the Arizona Shareholder Action plaintiffs) filed a Second Supplement to the Second Amended Complaint alleging, in addition to their prior claims, that it was improper for the stockholder meeting scheduled for June 29, 2007, to be rescheduled for August 2, 2007. On July 19, 2007, the plaintiffs filed a motion for preliminary injunction, and the parties have conducted expedited discovery. The motion seeks to enjoin the consummation of the merger on the grounds that Inter-Tel improperly rescheduled the stockholder vote. The motion is set to be heard on August 8, 2007. Inter-Tel believes that all of the plaintiffs claims in the Delaware Stockholder Action are without merit, and intends to vigorously defend against them.

On January 5, 2005, the Company received court approval of a civil settlement agreement (the Civil Settlement) and a criminal plea agreement (the Plea Agreement) with the United States of America, each dated as of December 8, 2004 and disclosed on that same date. The court approval of the Civil Settlement and Plea Agreement resolves the investigation of the Department of Justice into the participation of Inter-Tel Technologies, Inc., the Company s wholly-owned subsidiary (Technologies) in a federally administered E-Rate program to connect schools and libraries to the Internet. In connection with the Civil Settlement, Technologies paid a penalty of $6.7 million and forgave the collection of certain accounts receivable of $0.3 million related to Technologies participation in the E-Rate program. In connection with the Plea Agreement, Technologies entered guilty pleas to charges of mail fraud and an antitrust violation. Under the Plea Agreement, Technologies paid a fine of $1.7 million and is observing a three-year probationary period, which has, among other things, required Technologies to implement a comprehensive corporate compliance program. On December 20, 2005, in connection with the Civil Settlement, Technologies paid outside counsel for the plaintiffs in that action $0.1 million in settlement of their demand for attorney s fees and costs. On March 10, 2006, Technologies agreed to pay an additional $0.4 million to plaintiffs inside counsel in settlement of their separate demand for fees and costs. Inter-Tel has incurred additional costs and suffered revenue losses, including uncompensated E-Rate work, accounts receivable forgiveness, and related attorneys fees and other expenses. The payments constituting the primary components of the settlement and fines were not tax deductible.

In addition, on January 21, 2005, Technologies received notification from the Federal Communications Commission (the FCC) that the Technologies subsidiary was temporarily suspended from participation in the E-Rate program pending a final hearing to determine a possible debarment of three (3) years or more. Technologies contested the scope and length of the proposed debarment from the E-Rate program. The Company was notified on June 30, 2006 that on or about June 21, 2006, the FCC issued its final decision on the matter and imposed upon the Technologies subsidiary a debarment from the E-Rate program of one (1) year from June 30, 2006, and which terminated on or about June 30, 2007. Reasons for the shorter period were, among other factors, that Technologies had instituted a compliance program and been cooperative in the investigation and ongoing hearings with the Department of Justice. The FCC order further clarified that the parent and other subsidiaries were not debarred. The Company recorded no revenues since January 21, 2005 relating to Inter-Tel Technologies participation in the E-Rate program.

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During the second quarter of 2005, we identified variances in our sales processes as they relate to certain terms included in the U.S. General Services Administration (GSA) pricing and trade agreement requirements applicable to our business. As a result of this identification, Inter-Tel made voluntary self-disclosure of the matter to the Inspector General of the GSA. We took appropriate corrective measures with respect to these potential variances at the time and continue to review our compliance. In the second quarter of 2005, we accrued $1.8 million in estimated pre-tax adjustments, including reductions in net sales and increases to costs, fines and penalties that may be incurred to correct this issue, of which we have paid $1.2 million through June 30, 2007. Our estimate at June 30, 2007 remains the same as the total identified as of the end of the second quarter of 2005. Our current contract with the GSA expires in September 2007, and we have requested and expect to receive a new contract prior to expiration. However, there can be no assurance that the GSA will issue such contract.

Our NetSolutions subsidiary pays various federal, state and local taxes and regulatory fees in numerous jurisdictions throughout the United States. There is often uncertainty and complexity regarding the tax and regulatory treatment of NetSolutions services and, consequently, uncertainty about what fees and taxes are due from NetSolutions or its customers and what amounts may ultimately be payable to the various jurisdictions. The Company accrues estimates for these potential regulatory fees and taxes in the normal course of business. In the first quarter of 2007, NetSolutions changed billing platforms and determined that additional potential regulatory fees and taxes were probable of being paid in excess of prior accruals. As a result, the Company increased its accrued liabilities for such regulatory fees and taxes during the quarter ended March 31, 2007 by $1.8 million.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

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

The Company also maintains short-term investments. Those investments, which are classified as available for sale, have been recorded at fair value, which approximates cost. Short-term investments at June 30, 2007 consist of auction rate securities and commercial paper. The auction rate securities are adjustable-rate securities with dividend rates that are reset periodically by bidders through periodic Dutch auctions generally conducted every 28 to 35 days by a trust company or broker/dealer on behalf of the issuer. The Company believes these securities are highly liquid investments through the related auctions; however, the collateralizing securities have stated terms of up to twenty-eight (28) years. The investment instruments are rated A or higher by Standard & Poor s Ratings Group, or equivalent. The Company s investments are intended to establish a high-quality portfolio that preserves principal, meets liquidity needs, avoids inappropriate concentrations and delivers an appropriate yield in relationship to the Company s investment guidelines and market conditions. Given the short-term nature of the majority of these investments, and that we have no borrowings outstanding, we are not subject to significant interest rate risk.

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

IMPACT OF FOREIGN CURRENCY RATE CHANGES. International procurement agreements for purchases of inventory to supply our U.S. operations have traditionally been denominated in U.S. currency and a significant amount of contract manufacturing has been or may be moved to alternative sources. However, we invoice the customers of our international subsidiaries primarily in the local currencies of our subsidiaries for product and service revenues. Inter-Tel is exposed to foreign exchange rate fluctuations as the financial results of foreign subsidiaries are translated into U.S. dollars in consolidation. The impact of foreign currency rate changes has historically been insignificant, although international revenues have become a larger percentage of consolidated revenue in recent years due in large part to our Lake acquisition. Accordingly, our exposure to foreign exchange rate fluctuations has increased.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of disclosure controls and procedures. Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, or the Exchange Act) as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our management, including our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are designed, and are effective to give reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms and to ensure that information required to be disclosed in the reports filed or submitted under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, in a manner that allows timely decisions regarding required disclosure.

Changes in internal controls over financial reporting. There were no changes in our internal controls over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

INTER-TEL, INCORPORATED AND SUBSIDIARIES

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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

ITEM 1A. RISK FACTORS

FACTORS THAT MAY AFFECT FUTURE OPERATING RESULTS

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

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Risks Related to Our Business

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

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

public announcements, including the announcement of and/or the failure to complete the proposed merger with Mitel, could negatively affect the market price of Inter-Tel securities, as well as adversely affect its business (refer to Mitel Merger Announcement. The announcement of, and/or the failure to complete, the proposed merger with Mitel could negatively affect the market price of Inter-Tel securities, as well as adversely affect its business below);

reactions of competitors, customers and/or suppliers to the 2007 proxy contest initiated by Steven G. Mihaylo.

volume and timing of orders received during the quarter;

gross margin fluctuations associated with the mix of products and services sold and the mix of new and recurring customers;

the mix of sales through the different distribution channels;

general economic conditions, including interest rates and the condition of the markets our business addresses;

patterns of capital spending by customers and the relative size of our customers, in particular at times when we are introducing new systems and software targeted to and designed for larger customers;

the timing and acceptance of new product announcements and releases by us and our competitors and other competitive factors;

pricing pressures;

the cost and effects of acquisitions, dispositions or business ventures;

the availability and cost of products and components from our suppliers, including shipping and manufacturing problems associated with subcontracted vendors;

the impact of expected fines and penalties associated with our former GSA variances and noncompliance, which could affect both our government business and our commercial business;

the impact of settlements, continuing litigation, proceedings and other contingencies, which could affect our business;

the impact of costs and uncertainties resulting from stockholder actions, including actual or potential proxy contests or acquisition proposals;

fluctuations in interests rates, and the timing, availability, terms and volume of sales of leases to third party funding sources;

the potential impact of accounting pronouncements, such as FIN 48 or FAS 123R;

compliance with federal and state regulatory filings, including timely collection and remittance of appropriate taxes and fees on such filings;

national and regional weather patterns; and

threats of or outbreaks of war, hostilities, terrorist acts or other civil disturbances.

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

Our expense levels are based in part on expectations of future sales and, if sales levels do not meet expectations, our operating results could be harmed. In addition, because sales of business communications systems through our dealers, including dealers from our Lake operations, typically produce lower gross margins than sales through our direct sales organization, operating results have varied, and will continue to vary based upon the mix of sales through direct and indirect channels. In addition, in the recent past we have derived a significant part of our revenue from recurring revenue streams, which typically produce higher gross margins. If we do not maintain recurring revenue streams at current or historic levels, our operating results would suffer unless we significantly

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increased sales to new customers. Moreover, particularly in an environment of fluctuating interest rates, the timing, volume and profitability of lease resales from quarter to quarter could impact operating results. Management has historically sold these rental streams at least once per quarter. Furthermore, when the initial term of the lease is concluded, customers have the option to renew the lease at a payment and term less than the original lease. Management has typically held these customer lease renewals on the balance sheet, although the Company could elect to sell these renewals to a third-party financial institution.

In addition, while introducing new systems and software designed for larger customers, demand for these systems and our ability to sell to larger customers may vary based on the success of the product roll-out, our ability to successfully market and sell the products to larger customers, and the extended sales process typically experienced for sales to larger customers. Long distance, DataNet, national, government and education accounts, and our third-party product sales, which typically carry lower gross margins than our core business, have grown in recent periods at a faster rate than our overall net sales, although sales growth and gross margins may fluctuate in these divisions from period to period. In addition, regulatory and other filing requirements can and have caused additional costs associated with local, long distance and network operations business. Consolidated gross margins could be harmed if long distance calling services continue to increase as a percentage of net sales or if gross margins from this division decline. We also experience seasonal fluctuations in our operating results, as net sales for the first quarter is frequently less than the fourth quarter, and net sales for the third quarter is frequently less than the second quarter. As a result of these and other factors, we have historically experienced, and could continue to experience in the future, fluctuations in net sales and operating results on a quarterly basis.

Mitel Merger Announcement. The announcement of, and/or the failure to complete, the proposed merger with Mitel could negatively affect the market price of Inter-Tel securities, as well as adversely affect its business.

On April 26, 2007, the Company and Mitel announced that they had entered into an agreement and plan of merger (the Merger Agreement) pursuant to which a wholly owned subsidiary of Mitel will be merged with Inter-Tel (the Merger) and Inter-Tel will become a wholly owned subsidiary of Mitel. At the effective time of the Merger, each share of Inter-Tel common stock will be converted into the right to receive $25.60 per share in cash. The boards of directors of both companies have approved the transaction and Inter-Tel stockholders approved the transaction at a Special Stockholder meeting on August 2, 2007, which was one of the required closing conditions. The Merger is subject to the satisfaction or waiver of a number of closing conditions, including:

- the receipt of antitrust, other governmental and regulatory approvals in a timely manner or at all;
- the results of a hearing scheduled for August 8, 2007 in the Delaware Chancery Court to rule on a request by a third-party plaintiff for an injunction prohibiting the merger;
- the absence of a material adverse effect on the Company; and
- the satisfaction or waiver of other closing conditions as identified in the Merger Agreement.

In addition, Mitel will need to obtain financing to consummate the Merger and such financing may become unavailable, although Mitel did obtain debt and equity financing commitments prior to signing the Merger Agreement. On June 12, 2007, Inter-Tel announced the expiration of the Hart-Scott-Rodino Act statutory antitrust waiting period for the pending Merger. The expiration satisfied a condition to the closing of the Merger, and no further antitrust approvals are required to complete the Merger. The transaction is expected to close in the third quarter of 2007. However, as of the date hereof, the Merger has not been consummated and there is no guarantee the Merger will be consummated in the third quarter of 2007 or otherwise. There is also certain litigation that could prevent the consummation of the merger with Mitel. Please refer to the descriptions of the Arizona Shareholder Actions and the Delaware Stockholder Action in the risk factor entitled We have been involved in legal disputes, which have resulted in a jury verdict, legal settlement and associated legal costs, which may cause further competitive and financial harm to our business for a description of such litigation.

As a result of the announcement of the Merger Agreement and the potential Merger, our business may be adversely impacted due to the disruption of our relationships with customers, suppliers and employees and the diversion of management s attention from the Company s day to day business operations, which may have a material and adverse impact on our business.

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Although the transaction is expected to close in the third quarter of 2007, if the Merger is not consummated for any reason, the Company will be subject to a number of material risks, including:

- The obligation to pay a termination fee to Mitel of $20 million if the Merger Agreement is terminated under certain circumstances (although this risk could be mitigated in the event of payment due to Inter-Tel as a result of acceptance of a transaction that is considered by our board of directors to be more favorable to our stockholders than the proposed Merger);

- The obligation to reimburse Mitel for up to $6 million in transaction expenses under certain circumstances relating to the failure of our stockholders to adopt the Merger Agreement, although the Merger Agreement specifies that the $20 million termination fee discussed above would be reduced for any amounts paid to Mitel in satisfaction of such reimbursement obligation;

- The market price of Inter-Tel common stock may decline to the extent that the current market price reflects a market assumption that the Merger will be completed; and

- The costs relating to the Merger, including legal and accounting fees and a portion of the investment banking fees or expenses, must be paid even if the Merger is not completed.

Other important factors that might affect actual results, performance or achievements include, among other things, timely and successful hiring or retention of employees; the ability to retain existing dealers and customers; market acceptance of new and existing Inter-Tel products, software and services; evolution in customer demand for Inter-Tel s or Mitel s products and services; fluctuations and seasonality in quarterly results; uncertainty of future operating results; availability of inventory from vendors and suppliers in part due to reactions of such vendors or suppliers to the Merger Agreement announcement; industry, competitive and technological changes and reactions by competitors to the Merger Agreement announcement; the composition, product and channel mixes, timing and size of orders from and shipments to major customers; price and product competition; international sales and operations, in particular in foreign markets where Inter-Tel and Mitel compete; protection of intellectual property; dependence on licensed technology and new product development; risk of product defects; product liability claims and issues; expansion or contraction of indirect channels; management of growth or lack thereof; consolidation in Inter-Tel s industry sectors; general market trends or economic changes; and the impact of recently enacted or proposed regulations.

To the extent the Merger is completed, Inter-Tel will become a wholly owned subsidiary of Mitel and will no longer be a stand-alone public company. Refer to Business acquisitions, business ventures, and/or dispositions entail numerous risks and may disrupt our business, dilute stockholder value and distract management attention below for additional related risks.

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

Refer to the Mitel discussion in Note G and the risk factor noted above. However, as part of our business strategy, we consider acquisitions, dispositions and business ventures of, or significant investments in, businesses that offer products, services and technologies, primarily complementary to ours. Such acquisitions, dispositions or business ventures could materially adversely affect our operating results and/or the price of our common stock. Acquisitions, dispositions and business ventures also entail numerous risks, some of which we have experienced and may continue to experience, including, but not limited to those indicated below:

- unanticipated costs and liabilities;

- difficulty of assimilating or transitioning the operations, products and personnel of the acquired business or business ventures;

- difficulties in managing the financial and strategic position of acquired or developed products, services and technologies;

difficulties in maintaining customer relationships;

difficulties in servicing and maintaining acquired products, in particular where a substantial portion of the target s sales were derived from our competitor s products and services;

difficulty of assimilating the vendors and independent contractors of the acquired business or business venture;

the diversion of management s attention from the core business;

inability to maintain uniform standards, controls, policies and procedures;

potential disagreements and impact on the ongoing acquired operations related to the computation of earn-outs associated with post-acquisition results;

impairment of relationships or risk of loss of acquired employees and customers occurring as a result of integration of the acquired business; and

difficulties with each of the above noted items during the period between announcement and closing of a prospective transaction, in particular the Mitel announcement.

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

Finally, as part of our fiduciary responsibilities, we consider dispositions, including divisions and/or subsidiaries, from our core businesses, and announced the Mitel acquisition on April 26, 2007. Such dispositions entail numerous risks including, but not limited to, costs noted above, other unanticipated costs or liabilities, the diversion of management s attention from our business, risk of loss of affected employees and/or customers resulting from the disposition, inadequacy of sales proceeds and any adverse affect of accounting treatment. Any of such factors could cause a material adverse affect on operations.

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

The market for our products and services is characterized by rapid technological change, evolving industry standards and vigorous customer demand for new products, applications and services. To compete successfully, we must continually enhance our existing telecommunications products, related software and customer services, and develop new technologies and applications in a timely and cost-effective manner. If we fail to introduce new products and services that achieve broad market acceptance and on a timely basis, or if we do not adapt our existing products and services to customer demands or evolving industry standards, our business could be significantly harmed. Problems and delays associated with new product development have in the past contributed to lost sales. In particular, we believe that the delayed roll-out of the Inter-Tel 5000 and 7000 Network Communication Platforms contributed to lost sales during the past two years. In addition, current competitors or new market entrants may offer products, applications or services that are better adapted to changing technology or customer demands and that could render our products and services unmarketable or obsolete. This could lead to write-downs of inventory that could be material to our results of operations.

During 2006, Inter-Tel released two new products that were designed to address larger IP PBX applications. The Inter-Tel 5600 was released in June 2006, while the Inter-Tel 7000 was released in November 2006. The Inter-Tel 7000 product was designed to address the mid-market and enterprise communications market. Although Inter-Tel has successfully sold products in the mid-market, we have not traditionally sold a significant number of systems and software into the large enterprise market. There are no assurances that we will be successful in selling and supporting these customers in the large enterprise market.

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

Our future success largely depends on increased commercial acceptance of our Inter-Tel 5000 series and Inter-Tel 7000 Network Communications Solutions, the Lake OfficeLink product (branded Inter-Tel 3000 (formerly the Inter-Tel EncoreCX®) in North America), the Lake Sigma product (branded Embarq Connection Central in North America), speech recognition, Interactive Voice Response, presence management, collaboration, messaging products, Session Initiation Protocol (SIP) applications, multi-protocol SIP endpoints, and related computer-telephony products, as well as continued acceptance of our Axxess® systems and software.

Over the past few years, we have introduced a number of new products and platforms, including: Inter-Tel Audio and Web Conferencing, a SIP-based web and audio conferencing application; Inter-Tel Web Conferencing and Remote support (collaboration) solutions; the Inter-Tel 5000 Network Communications Platform and updates; the Inter-Tel 7000; enhanced convergence features on the Axxess system; the Lake Sigma product; the advanced router module for the Lake OfficeLink product; significant enhancements to our Call and Contact Center Suite of applications; integrated web collaboration and video conferencing capabilities into our

Unified Communicator® application, and several other telephony-related products. In recent history, sales of our Axxess business communications systems and related software have comprised a substantial portion of our net sales. Our future success depends, in large part, upon increased commercial acceptance and adoption of the products or platforms identified above, including the Inter-Tel 5000 series and Inter-Tel 7000 Network Communications products, the Unified Communicator® products, Contact Center Suite ACD products, web and audio conferencing collaboration technology, the Lake converged systems and software, SIP standards-based applications and devices, new speech recognition and Interactive Voice Response products, and future upgrades and enhancements to these products and networking platforms as well as the continued acceptance of the Axxess systems and software. We cannot assure you that these products or platforms will achieve broad commercial acceptance in the future and if they fail to achieve broad commercial acceptance our operating results could be materially adversely affected.

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

The markets for our products and services are extremely competitive and we expect competition to increase in the future, particularly as the networking and telephony industries continue to consolidate and the shift to IP-centric enterprise telephony solutions accelerates. Our current and potential competitors in our primary business segments include:

- PABX, converged systems and IP-PBX providers, distributors, or resellers such as Aastra, Adtran, Alcatel, Altigen, Avaya, Cisco Systems, 3Com, Iwatsu, Interactive Intelligence/Vonexus, Lucky Goldstar, Mitel, NEC, Nortel, Panasonic, Samsung, ShoreTel, Siemens, Toshiba, Vertical Networks (including acquisitions of the former Comdial and Vodavi organizations).

- large data routing and convergence companies such as 3Com, Adtran and Cisco Systems;

- voice processing applications providers such as ADC, InterVoice-Brite, Active Voice (a subsidiary of NEC America), Avaya, and Captaris (formerly AVT);

- web collaboration product and service providers, such as Centra, Citrix, eDial (a division of Alcatel), IBM, Microsoft, Raindance Communications, and WebEx;

- open-source IP PBX vendors such as Asterisk/Digium, and PingTel;

- hosting service providers such as AT&T (formerly SBC), Layered Technologies, New Global Telecom (NGT), and Vonage using servers to host call processing functions that have traditionally been owned by customers;

- long distance, cell phone and/or PCS services providers such as AT&T, Global Crossing, MCI, Qwest, Sprint and Verizon;

- large computer and software corporations such as Dell, IBM, HP, Intel and Microsoft;

- peer-to-peer softphone services such as Skype/eBay and Grand Central/Google;

- regional Bell operating companies, or RBOCs, competitive local exchange companies, or CLECs; cable television companies, IP Centrex service providers, VoIP trunk replacement providers, and satellite and other wireless and wireline broadband service providers offering IP centrex services such as AccessLine, AT&T (formerly SBC), cBeyond, Covad, Level-3, New Global Telecom, Qwest, Time-Warner Telecom, and Vonage; and

independent leasing companies that provide telecom equipment financing.

These and other companies may also form strategic relationships with each other to compete with us. These relationships may take the form of strategic investments, joint-marketing agreements, licenses or other contractual arrangements. Strategic relationships and business combinations could increase our competitors ability to address customer needs with their product and service offerings that are broader than the product and service offerings we provide. In this regard, Microsoft and Nortel have announced an alliance presumably designed to offer business communications linked with business applications. Furthermore, sales of the Inter-Tel 5600 system (an offering of the Inter-Tel 5000 platform) and the Inter-Tel 7000 platform, which are designed to address the needs of larger customers than Inter-Tel has traditionally sold VoIP systems to, could lead to additional price and margin pressures from larger and better known competitors such as Cisco Systems, Avaya and Nortel. In addition, sales of larger VoIP systems may require higher levels of support, particularly during the introduction of these products to general availability, which could also impact gross margins and net income.

Many of our competitors and potential competitors have substantially greater financial, customer support, technical and marketing resources, larger customer bases, longer operating histories, greater name recognition and more established relationships in

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the industry than we do. We cannot assure you that we will have the resources or expertise to compete successfully, particularly as the market for IP network voice communications evolves and competitors like Cisco become more prominent in our industry. Compared to us, our competitors may be able to:

- offer broader product and service offerings;
- develop and expand their product and service offerings more quickly;
- offer greater price discounts or make substantial product promotions;
- adapt to new or emerging technologies and changing customer needs faster;
- take advantage of acquisitions and other opportunities more readily;
- negotiate more favorable licensing agreements with vendors;
- devote greater resources to the marketing and sale of their products; and
- address customers service-related issues more adequately.

Some of our competitors may also be able to provide customers with additional benefits at lower overall costs or to reduce their gross margins aggressively in an effort to increase market share. We cannot assure you that we will be able to match cost reductions by our competitors. In recent periods, due to competitive pressures, we have discounted pricing on our telephone systems and offered promotions and these actions have negatively impacted our revenues, gross margins and operating results. Several of our competitors have more experience in the mid-market and enterprise market and may be more successful than Inter-Tel in these new markets. In addition, we believe there is likely to be further consolidation in our markets, which could lead to having even larger and more formidable competition and other forms of competition that could cause our business to suffer.

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

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

- costs associated with the remediation of any problems;

costs associated with design modifications;

loss of or delay in revenues;

loss of customers;

damage to our reputation;

failure to achieve market acceptance or loss of market share;

increased service and warranty costs;

liabilities to our customers; and

increased insurance costs.

The complexity of our products has caused delays and could cause future delays in the development and release of new products and services. As a result, customer demand for our products could decline, which could harm our business. Additionally, changes in technology could render current inventories obsolete.

Due to the complexity of our products and software, we have in the past experienced and expect in the future to experience delays in the development and release of new products or product enhancements. If we fail to introduce new software, products or services in a timely manner, or fail to release upgrades to our existing systems or products and software on a regular and timely basis, customer demand for our products and software could decline, which would harm our business. For instance, we believe that a delay in connection with our release of the Inter-Tel 7000 series Network Communications Platforms may have unfavorably impacted our sales efforts in 2006 and 2007. Additionally, as technology changes and as we or our competitors release new products, there is a risk that our current products and inventories could become obsolete or excessive leading to write-downs of our inventory balances in amounts that could be material to our results of operations. If new products or software releases are not commercially accepted, then Inter-Tel financial results would be negatively impacted.

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Our founder and former Chief Executive Officer controls approximately 19.0% of the outstanding shares of our Common Stock, may be able to exert significant influence over the Company and has signaled his willingness to engage with the Company with respect to significant matters.

As of June 30, 2007, Steven G. Mihaylo, a stockholder and member of Inter-Tel s Board of Directors, beneficially owned approximately 19.0% of the existing outstanding shares of the Common Stock of Inter-Tel. As a result, he has the ability to exercise significant influence over all matters requiring stockholder approval. In addition, the concentration of ownership could have the effect of accelerating, delaying or preventing a change in control of Inter-Tel. As previously reported, Mr. Mihaylo took various business and legal actions against Inter-Tel during 2006 and 2007. In March 2007, Mr. Mihaylo submitted a notice to the Company and filed a Form 13D with the SEC disclosing his intention to nominate up to five (5) individuals for election to Inter-Tel s Board of Directors, including incumbent directors Mr. Mihaylo, Dr. Puri and Mr. Urish, at the Company s 2007 Annual Meeting of stockholders, and his intention to submit seven (7) proposals to a vote of the Company s shareholders at the Company s 2007 Annual Meeting. Mr. Mihaylo subsequently notified the Company that he intends to nominate seven individuals (including himself) for election at the upcoming Annual Meeting, but remove the prior proposals from consideration by the stockholders. In addition, during 2007 Mr. Mihaylo recently sent a letter to the Board demanding:

- the Board immediately give Mr. Mihaylo half the seats on a 6 person board (and therefore a veto right on all Board decisions),
- the Board immediately appoint Mr. Mihaylo as the Chairman of the Board,
- the Board immediately appoint Mr. Mihaylo as an interim CEO until a qualified candidate can be found,
- the Board hire an executive search firm to find a CEO suitable to a majority of the newly-constituted Board, and
- the Board disband the Special Committee and form a new Special Committee of the Board, consisting of a majority of Mr. Mihaylo s director nominees. Mr. Mihaylo also publicly advocated a front-end loaded leveraged recapitalization plan for the Company, although he subsequently publicly withdrew that plan.

Mr. Mihaylo s 2006 and 2007 actions as described above are factors in part having caused the Company to incur significant legal and other advisory expenses, and the actions and Company responses to such actions have subjected the Company and its Board of Directors to stockholder class action litigation. Such actions, or any other future actions that Mr. Mihaylo may take or that the Company may take in response to Mr. Mihaylo s actions may:

- further divert the attention of our Board of Directors and management from the conduct of the Company s business and enhancing stockholder value,
- force the Company into another costly and divisive proxy contest that could be highly disruptive,
- cause competitors to negatively use his filings against us in sales proposals,
- cause employees to seek other employment outside the Company,
- cause current customers to look for alternative vendors,

disrupt any strategic initiatives or transactions in which the Company is involved,

expose the Company to additional litigation, and

cause us to incur additional significant legal, advisory and other expenses.

Accordingly, the continuation of Mr. Mihaylo s activities could cause a material adverse affect on the operations of the core business.

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

Our success depends upon the protection of our proprietary technology. As of June 30, 2007, we held 45 U.S. issued patents and issued patents in several foreign countries for telecommunication and messaging products, systems and processes. We also have 27 pending U.S. patent applications and several pending foreign patent applications. We further rely on copyright, trademark and trade secret laws as well as contractual provisions to protect our intellectual property. Despite these precautions, third parties could copy or otherwise obtain and use our technology without authorization, or independently develop similar technology.

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

Many of our competitors have large patent portfolios, and we are or could become subject to third-party claims that our current or future products or services infringe upon the rights of others. For example, we are subject to claims initiated by our primary competitors, including Alcatel-Lucent, alleging that certain of our key products infringe upon their intellectual property rights, including patents, trademarks, copyrights, or other intellectual property rights. We have viewed presentations from Lucent (now Alcatel-Lucent) and others alleging that our Axxess® business communications system, associated applications and related 3rd party products that we distribute utilize inventions covered by certain of their patents. We are continuing the process of investigating these matters. The ultimate outcomes by their nature are uncertain, and we cannot ensure that these matters, individually or collectively, would not have a material adverse impact on our financial position, liquidity and future results of operations.

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

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

We currently obtain certain key components for our communication platforms, including certain microprocessors, integrated circuits, power supplies, voice processing interface cards, servers and IP telephony cards, from a limited number of suppliers and manufacturers. Our reliance on these limited suppliers and contract manufacturers involves risks and uncertainties, including the possibility of a shortage or delivery delay for some key components, quality assurance and costs. We currently manufacture our products, including products manufactured for Lake, through third-party subcontractors located in the United States, Mexico, Malaysia, the People s Republic of China and the United Kingdom. Jabil Circuit, Inc. currently manufactures a significant portion of our products at its Tempe, Arizona and Chihuahua, Mexico facilities, including substantially all of the printed circuit boards used in the Axxess systems and Inter-Tel 5000 series systems. The 7000 Network Communications Product uses commercial grade server platforms specifically branded for Inter-Tel and sourced in Phoenix, Arizona. Foreign manufacturing facilities are subject to changes in governmental policies, imposition of tariffs and import restrictions and other factors beyond our control. We have experienced occasional delays in the supply of components and finished goods that have harmed our business. If inventory levels are not adequately maintained and managed we are at risk of not having the appropriate inventory quantities on hand to meet sales demand. We may experience similar delays in the future.

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

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

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

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

On January 5, 2005, the Company received court approval of a civil settlement agreement (the Civil Settlement) and a criminal plea agreement (the Plea Agreement) with the United States of America, each dated as of December 8, 2004 and disclosed on that same date. The court approval of the Civil Settlement and Plea Agreement resolves the investigation of the Department of Justice into the participation of Inter-Tel Technologies, Inc., the Company s wholly-owned subsidiary (Technologies) in a federally administered E-Rate program to connect schools and libraries to the Internet. In connection with the Civil Settlement, Technologies paid a penalty of $6.7 million and forgave the collection of certain accounts receivable of $0.3 million related to Technologies participation in the E-Rate program. In connection with the Plea Agreement, Technologies entered guilty pleas to charges of mail fraud and an antitrust violation. Under the Plea Agreement, Technologies paid a fine of $1.7 million and is observing a three-year probationary period, which has, among other things, required Technologies to implement a comprehensive corporate compliance program. On December 20, 2005, in connection with the Civil Settlement, Technologies paid outside counsel for the plaintiffs in that action $0.1 million in settlement of their demand for attorney s fees and costs. On March 10, 2006, Technologies agreed to pay an additional $0.4 million to plaintiffs inside counsel in settlement of their separate demand for fees and costs. Inter-Tel has incurred additional costs and suffered revenue losses, including uncompensated E-Rate work, accounts receivable forgiveness, and related attorneys fees and other expenses. The payments constituting the primary components of the settlement and fines were not tax deductible.

In addition, on January 21, 2005, Technologies received notification from the Federal Communications Commission (the FCC) that the Technologies subsidiary was temporarily suspended from participation in the E-Rate program pending a final hearing to determine a possible debarment of three (3) years or more. Technologies contested the scope and length of the proposed debarment from the E-Rate program. The Company was notified on June 30, 2006 that on or about June 21, 2006, the FCC issued its final decision on the matter and imposed upon the Technologies subsidiary a debarment from the E-Rate program of one (1) year from June 30, 2006, and which terminated on or about June 30, 2007. Reasons for the shorter period were, among other factors, that Technologies had instituted a compliance program and been cooperative in the investigation and ongoing hearings with the Department of Justice. The FCC order further clarified that the parent and other subsidiaries were not debarred. The Company recorded no revenues since January 21, 2005 relating to Inter-Tel Technologies participation in the E-Rate program. The existence and disclosure of the Civil Settlement, Plea Agreement and FCC Notice may have already caused competitive harm to Inter-Tel, and these matters may further harm Inter-Tel s business.

During the second quarter of 2005, we identified variances in our sales processes as they relate to certain terms included in the U.S. General Services Administration (GSA) pricing and trade agreement requirements applicable to our business. As a result of this identification, Inter-Tel made voluntary self-disclosure of the matter to the Inspector General of the GSA. We took appropriate corrective measures with respect to these potential variances at the time and continue to review our compliance. In the second quarter of 2005, we accrued $1.8 million in estimated pre-tax adjustments, including reductions in net sales and increases to costs, fines and penalties that may be incurred to correct this issue, of which we have paid $1.2 million through June 30, 2007. Our estimate at June 30, 2007 remains the same as the total identified as of the end of the second quarter of 2005. Our current contract with the GSA expires in September 2007, and we have requested and expect to receive a new contract prior to expiration. However, there can be no assurance that the GSA will issue such contract.

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Our NetSolutions subsidiary pays various federal, state and local taxes and regulatory fees in numerous jurisdictions throughout the United States. There is often uncertainty and complexity regarding the tax and regulatory treatment of NetSolutions services and, consequently, uncertainty about what fees and taxes are due from NetSolutions or its customers and what amounts may ultimately be payable to the various jurisdictions. The Company accrues estimates for these potential regulatory fees and taxes in the normal course of business. In the first quarter of 2007, NetSolutions changed billing platforms and determined that additional potential regulatory fees and taxes were probable of being paid in excess of prior accruals. As a result, the Company increased its accrued liabilities for such regulatory fees and taxes by $1.8 million as of June 30, 2007.

We have been involved in legal disputes, which have resulted in a jury verdict, legal settlement and associated legal costs, which may cause further competitive and financial harm to our business.

In March 2006, certain prior Executone dealers filed a complaint in Columbus, Ohio similar to the complaint in the Florida trial resolved in 2006. While Inter-Tel is in the process of conducting discovery and evaluating the complaint, Inter-Tel believes that the claims are without merit and Inter-Tel intends to vigorously defend against the complaint.

In the first quarter of 2006, the Company settled a legal matter in connection with a longstanding dispute with a former international dealer that existed as of December 31, 2005. The Company recorded an accrual for the settlement amount and related fourth quarter legal fees as of December 31, 2005. The settlement plus related fourth quarter legal fees totaled $1.6 million. Additional legal fees totaling approximately $1.3 million were recorded as period costs during the first quarter of 2006 relating to this matter.

On April 30, 2007, two shareholder class action lawsuits were filed in the Superior Court of the State of Arizona, County of Maricopa, against Inter-Tel and the Board of Directors: *Joel Gerber v. Inter-Tel Incorporated, et al.*, Case No. CV2007-007444 (the *Gerber* Action), and *Farr v. Inter-Tel, Inc., et al.*, Case No. CV2007-007655 (the *Farr* Action) and another was filed on May 22, 2007, *Suan Investments, Inc. v. Stout, et al.*, Case No. CV2007-009603 (the *Suan* Action) (collectively the Arizona Shareholder Actions.) The actions combined allege that the Board of Directors breached their fiduciary duties of loyalty and due care in connection with the proposed merger with Mitel Networks Corporation by purportedly standing on both sides of the transaction, engaging in self-dealing, obtaining unspecified personal benefits, approving the merger without regard to the fairness of the transaction to Inter-Tel stockholders, failing to exercise independent business judgment, and imprudently accepting and relying upon advice as to the fairness of the consideration for the proposed merger with Mitel from a financial advisor with allegedly conflicted interests. The actions further allege that the proposed merger is a product of a flawed process that was not designed to ensure the sale of Inter-Tel for the highest value. The *Gerber* action requests an injunction prohibiting Inter-Tel from consummating the proposed merger, as well as attorneys fees and costs. The *Farr* action seeks an injunction prohibiting Inter-Tel from consummating the proposed merger with Mitel and, to the extent consummated, rescission of the proposed merger with Mitel and any of the terms of the Mitel merger agreement, as well as the imposition of a constructive trust for improper benefits allegedly received by defendants. The complaint also requests attorneys fees and costs. The *Suan* action seeks an injunction prohibiting Inter-Tel from consummating the merger, rights of rescission against the merger agreement entered into with Mitel, an accounting for plaintiff s alleged damages, and attorneys fees and costs. On June 15, 2007, the Court granted the Company s motion to stay the Arizona Shareholder Actions pending resolution of the Delaware Stockholder Action (described below), and ruled that the plaintiffs motions to expedite the proceedings were, accordingly, moot. The plaintiffs then sought to intervene in the Delaware Stockholder Action and on June 22, 2007, the Delaware Court of Chancery granted the plaintiffs motion to intervene. Inter-Tel believes that the claims are without merit and Inter-Tel intends to vigorously defend against all claims brought in the Arizona Shareholder Actions.

Inter-Tel and certain members of the Board of Directors are defendants in a stockholder class action suit filed on June 15, 2006, entitled *Mercier v. Inter-Tel (Delaware), Inc., et al.*, No. 2226-VCS, in the Court of Chancery of the State of Delaware (Delaware Stockholder Action). On March 27, 2007, the plaintiff filed a Second Amended Complaint (SAC) and on May 25, 2007, the plaintiff filed supplement to the SAC alleging that the defendants breached their fiduciary duties because they failed to properly pursue a higher bid for sale of Inter-Tel. The proposed supplement to the SAC sought an injunction prohibiting Inter-Tel from consummating the proposed merger with Mitel and sought an order requiring the defendants to conduct an auction of Inter-Tel open to Steven G. Mihaylo, Vector Capital Corporation, and all other potentially interested bidders. It further sought an injunction against enforcement of Inter-Tel s business combination charter amendment approved by stockholders on May 31, 2006 (the BCCA) or,

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alternatively, a declaration that Mitel is an interested stockholder under the BCCA and that the proposed merger with Mitel cannot be consummated because the required vote cannot be obtained. Finally, it sought a declaration that representations and covenants in the merger agreement with Mitel are invalid, and damages in an unspecified amount. On May 24, 2007, the plaintiff filed motions seeking a preliminary injunction and summary judgment on the claims in the SAC. On June 4, 2007, the Court denied the plaintiff s Motion For Expedited Proceedings, which sought to set a briefing schedule for a preliminary injunction and allow discovery on an expedited basis regarding alleged failure of Inter-Tel s Board of Directors to maximize stockholder value, among other claims. On July 12, 2007, the plaintiffs (now including the Arizona Shareholder Action plaintiffs) filed a Second Supplement to the Second Amended Complaint alleging, in addition to their prior claims, that it was improper for the stockholder meeting scheduled for June 29, 2007, to be rescheduled for August 2, 2007. On July 19, 2007, the plaintiffs filed a motion for preliminary injunction, and the parties have conducted expedited discovery. The motion seeks to enjoin the consummation of the merger on the grounds that Inter-Tel improperly rescheduled the stockholder vote. The motion is set to be heard on August 8, 2007. Inter-Tel believes that all of the plaintiffs claims in the Delaware Stockholder Action are without merit, and intends to vigorously defend against them.

Inter-Tel is also subject to litigation in the ordinary course of business. We cannot assure you that any adverse outcome in connection with the litigation described above or ordinary course litigation would not materially impair our business, results of operations, liquidity or financial condition. In addition, litigation in connection with the Mitel merger could prevent the consummation of the proposed merger. For risks related to the failure to consummate the Mitel merger, please refer to Mitel Merger Announcement. The announcement of, and/or the failure to complete, the proposed merger with Mitel could negatively affect the market price of Inter-Tel securities, as well as adversely affect its business above.

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

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

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

We depend on the continued service of, and our ability to attract and retain, qualified technical, marketing, sales and managerial personnel, many of whom would be difficult to replace. Competition for qualified personnel is intense, and we have historically had difficulty in hiring employees in the timeframe we desire, particularly skilled engineers or sales personnel. The loss of any of our key personnel or our failure to effectively recruit additional key personnel could make it difficult for us to manage our business, complete timely product introductions or meet other critical business objectives. Acquiring or maintaining the continued service of key personnel may be particularly difficult due to the uncertainty created by Mr. Mihaylo s proxy initiatives. Moreover, our operating results could be impaired if we lose a substantial number of key employees in response to the Mitel merger announcement or the proxy contest and related costs. We cannot assure you we will be able to continue to attract and retain the qualified personnel necessary for the development of our business.

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

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

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

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

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

In the past few years, we introduced the Inter-Tel 5000 series and 7000 platforms, IP telephony enhancements to the Axxess® system as well as presence management and collaboration applications, which are typically sold to larger customers at a higher average selling price and often represent a significant expenditure in communications infrastructure by the prospective enterprise customer. Sales of the new Inter-Tel 5600 and 7000 platforms, which are designed to address the needs of larger customers, could lead to additional price and margin pressures from larger and better known competitors such as Cisco Systems, Avaya and Nortel. In addition, sales of larger VoIP systems may require higher levels of support, in particular during the introduction of these products to general availability, which could also impact gross margins and net income. The purchase of our products typically involves numerous internal approvals relating to the evaluation, testing, implementation and acceptance of new technologies. This evaluation process frequently results in a lengthy sales process, which can range from a few months to more than 12 months, thereby subjecting our sales cycle to a number of significant uncertainties concerning budgetary constraints and internal acceptance reviews. The length of our sales cycle also may vary substantially from customer to customer and along product lines. While our customers are evaluating our products before placing an order with us, we may incur substantial sales and marketing expenses and expend significant management effort. In addition, installation of multiple systems for large, multi-site customers may occur over an extended period of time, and depending on the contract terms with these customers, revenues may be recognized over more than one quarter, as systems are completed in separate phases and accepted by the customers. Consequently, if sales forecasted from such customers for a particular quarter are not realized in that quarter, our operating results could be materially adversely affected.

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

We currently run third-party applications for data processing in our distribution center operations, shipping, materials movement, customer service, invoicing, sales functions, financial record keeping and reporting, and for other operations and administrative functions. The nature of the software industry is to upgrade software systems to make architectural changes, increase functionality, improve controls and address software bugs. Over time, older versions of the software become less supported or unsupported by our vendors for financial and other reasons and eventually become obsolete. The primary supplier of our third-party

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

We also use a third party application service provider to generate invoicing, manage provisioning and reporting in our local, long distance and network services division. This hosted third party service is off-premise, we do not own or manage the systems or software, and we have no control over the actions of the third party company. Disruptions in their software, servers, or network connectivity, including any loss of this invoicing service could severely affect our ability to generate invoices to our customers and could thus have a significant impact on our net sales. Accordingly, such disruptions could adversely affect our business.

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

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

- reactions of investors, competitors, customers or suppliers to the Mitel merger announcement;
- reactions of investors, competitors, customers or suppliers to the 2007 proxy contest initiated by Mr. Mihaylo, including the non-binding proposals submitted by Mr. Mihaylo;
- announcements of developments relating to our business;
- investors reactions to actions of large stockholders;
- fluctuations in our operating results;
- the impact of our dividend announcements, repurchase program or stock transactions by officers and directors;
- shortfalls in revenue or earnings relative to securities analysts expectations or alternatively, results that exceed such expectations;
- announcements of technological innovations or new products or enhancements by us or our competitors, including product delays;

announcements of acquisitions or planned acquisitions of other companies or businesses;

investors reactions to acquisition or disposition announcements or any forecasts of our future results;

general economic conditions in the telecommunications industry;

the market for Internet-related voice and data products and services;

changes in the national or worldwide economy;

changes in legislation or regulation affecting the telecommunications industry;

developments relating to our intellectual property rights and the intellectual property rights of third parties;

litigation or governmental investigations of our business practices;

the impact of expected fines and penalties associated with the GSA variances and noncompliance which could affect both our government business and our commercial business;

the impact on our business of settlements, continuing litigations, proceedings and other contingencies, which could affect our business;

changes in our relationships with our customers and suppliers, including shipping and manufacturing problems associated with subcontracted vendors;

national and regional weather patterns; and

threats of or outbreaks of war, hostilities, terrorist acts or other civil disturbances.

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

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

Technology companies like ours have a history of using broad-based employee stock option and equity award programs to hire, provide incentives for and retain our workforce in a competitive marketplace. Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS 123) requires all share-based payments to employees, including grants of employee stock options, performance shares, and employee stock purchase plan shares, to be recognized in the financial statements over the period during which employees are required to provide services based on their grant-date fair values. The pro forma disclosures previously permitted under SFAS 123 are no longer an alternative to financial statement recognition. We adopted SFAS No. 123R using the modified prospective application method as defined by SFAS No. 123R and accordingly began recognizing compensation expense for all unvested and partially vested stock options, employee stock purchase plan shares in the first quarter of 2006. SFAS 123R has had a material impact on our consolidated results of operations and earnings per share. This new statement could impact our ability to utilize broad-based employee stock plans to reward employees and could result in a competitive disadvantage to us in the employee marketplace.

Risks Related to Our Industry

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

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

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

Although the IP network voice communication market is reaching mainstream, it is still developing, is evolving rapidly and is characterized by an increasing number of market entrants who have introduced or developed products and services for Internet or other IP network voice communications. As is typical of a new and rapidly evolving industry, the demand for and market acceptance of recently introduced IP network products and services are highly uncertain. We cannot assure you that IP voice networks will not change and shift as the market develops, or that the nature of the delivery mechanisms or competitive landscape will not change. Even if IP voice markets fully develop, we cannot assure that our products, including the IP telephony features of the *Axxess* systems, the Lake communications products, the Inter-Tel 5000 Network Communication Solutions, the newly released Inter-Tel 7000 Network Communication Solutions, our SIP/IP endpoints and IP applications will successfully compete against other market players and attain broad market acceptance.

Moreover, the adoption of IP voice networks and importance of development of products using industry standards such as SIP, generally require the acceptance of a new way of exchanging information. In particular, enterprises that have already invested substantial resources in other means of communicating information may be reluctant or slow to adopt a new approach to communications. If the market for SIP network voice communications fails to develop or develops more slowly than we anticipate, our SIP network telephony products such as the Inter-Tel 7000 could fail to achieve market acceptance, which in turn could significantly harm our business, financial condition and operating results. This growth may be inhibited by a number of factors, such

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as quality of infrastructure; security concerns; equipment, software or other technology failures; regulatory encroachments; inconsistent quality of service; poor voice quality over IP networks as compared to circuit-switched networks; and lack of availability of cost-effective, high-speed network capacity. Moreover, as IP-based data communications and telephony usage grow, the infrastructure used to support these IP networks, whether public or private, may not be able to support the demands placed on them and their performance or reliability may decline. The technology that allows voice and facsimile communications over the Internet and other data networks, and the delivery of other value-added services, is at the beginning of its development cycle.

Government regulation, including regulation of our Inter-Tel NetSolutions and Network Services Agency subsidiaries, as well as third party long distance and network service entities on which we rely, may harm our business.

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

Our NetSolutions subsidiary pays various federal, state and local taxes and regulatory fees in numerous jurisdictions throughout the United States. There is often uncertainty and complexity regarding the tax and regulatory treatment of NetSolutions services and, consequently, uncertainty about what fees and taxes are due from NetSolutions or its customers and what amounts may ultimately be payable to the various jurisdictions. The Company accrues estimates for these potential regulatory fees and taxes in the normal course of business. In the first quarter of 2007, NetSolutions changed billing platforms and determined that additional potential regulatory fees and taxes were probable of being paid in excess of prior accruals. As a result, the Company increased its accrued liabilities for such regulatory fees and taxes by $1.8 million as of March 31, 2007.

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

There has been a trend in the telecommunications industry toward consolidation and we expect this trend to continue as the industry evolves. As a result of this consolidation trend, new stronger companies may emerge that have improved financial resources, enhanced research and development capabilities and a larger and more diverse customer base. Refer to the risk factor entitled Mitel Merger Announcement. The announcement of, and/or the failure to complete, the proposed merger with Mitel could negatively affect the market price of Inter-Tel securities, as well as adversely affect its business for additional information about a pending prospective merger transaction. The changes within the telecommunications industry may adversely affect our business, operating results and financial condition.

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

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

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

We continue to spend a substantial amount of management time and external resources to comply with existing and changing laws, regulations and standards in general, and specifically relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new SEC regulations, PCAOB and Nasdaq Stock Market rules, as well as commercial dealings with other government entities. In particular, Section 404 of the Sarbanes-Oxley Act of 2002 requires management s annual review and evaluation of our internal control systems, and attestations of the effectiveness of these systems by our management and by our independent auditors. We completed our documentation and testing of our internal control systems and procedures as required for 2006, 2005, and 2004. This process has required us to hire additional personnel and use outside advisory services and resulted in additional accounting and legal expenses. The results of the documentation and testing for these periods indicated that we had adequate internal controls over financial reporting. However, if in the future our chief executive officer, chief financial officer or independent auditors determine that our controls over financial reporting are not effective as defined under Section 404, investor perceptions of Inter-Tel may be adversely affected and could cause a decline in the market price of our stock. Failure to comply with other existing and changing laws, regulations and standards could also adversely affect the Company.

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

Board Authorization to Repurchase up to $75 Million of Inter-Tel Stock. On February 15, 2005, Inter-Tel announced that its Board of Directors approved a stock repurchase program, with no stated expiration date, in which Inter-Tel may purchase up to $75 million of its Common Stock in the open market from time to time, depending upon general market conditions, the Company s share price, the level of employee stock option exercises, the level of employee stock purchase plan purchases, the availability of funds and other factors. The Company repurchased 716,500 shares of its Common Stock pursuant to the Plan during the year ended December 31, 2005, but the Company did not repurchase shares of its Common Stock during the year ended December 31, 2006 or during the first two fiscal quarters of 2007.

ISSUER PURCHASES OF EQUITY SECURITIES

Period	(a) Total Number of Shares (or Units) Purchased	(b) Average Price Paid per Share (or Unit)	(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
4/1/05 to 4/30/05	None	N/A	None	
5/1/05 to 5/31/05	716,500	$ 19.228	716,500	
6/1/05 to 6/30/07	None	N/A	None	
Total	716,500	$ 19.228	716,500	$ 61,223,240(1)

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

ITEM 3. DEFAULTS UPON SENIOR SECURITIES Not Applicable

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS Not Applicable

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ITEM 5. OTHER INFORMATION Not Applicable

ITEM 6. EXHIBITS:

Exhibit 31.1:	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
Exhibit 31.2:	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
Exhibit 32.1:	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURES

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

INTER-TEL, INCORPORATED

August 8, 2007

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

August 8, 2007

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