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

FORM 10-K
ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2004

Commission File Number: 0-10211

INTER-TEL, INCORPORATED

Incorporated in the State of Arizona

I.R.S. No. 86-0220994

1615 S. 52nd Street
Tempe, Arizona 85281
(480) 449-8900

Securities registered pursuant to Section 12(g) of the Act:

Common Stock
(26,681,045 shares outstanding as of March 4, 2005)

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (S 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K - [__]

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

The aggregate market value of the voting stock held by non-affiliates of the registrant, based upon the last reported sales price of Inter-Tel's Common Stock reported on the Nasdaq National Market System on June 30, 2004 was approximately $643.5 million. Shares of Common Stock held by each executive officer and director have been excluded in that such persons may be deemed to be affiliates.

Selected portions of Item 10, and Items 11, 12, 13 and 14 of Part III incorporate by reference information from the Registrant's Proxy Statement relating to its 2005 Annual Meeting of Shareholders. The Proxy Statement relating to the Registrant's 2004 Annual Meeting of Shareholders will be filed within 120 days of the Registrant's fiscal year ended December 31, 2004.

INTER-TEL, INCORPORATED
2004 FORM 10-K ANNUAL REPORT

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PART I

ITEM 1. BUSINESS

The Company

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

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

On October 14, 2004, Inter-Tel announced the purchase by an operating subsidiary of selected assets and assumption of certain liabilities of Converging Technologies, Inc. and Linktivity, Inc. The acquired assets primarily include Web-based conferencing solutions, notably Linktivity® software. These solutions provide real-time communications and remote control software to enable instantaneous, browser-to-browser Web conferencing and help desk support solutions. The acquisition of these selected assets enables Inter-Tel to continue to expand its Presence Management and Collaboration tools. Linktivity offers its products and services through its international distributors and certified North American resellers.

On October 14, 2004, Inter-Tel also announced the license of intellectual property from eDial, a division of Alcatel USA Marketing, Inc., and provider of Session Initiation Protocol (SIP) audio conferencing and collaboration solutions for enterprises and service providers. The eDial and Linktivity technologies were selected to complement Inter-Tel's Converged Business Communication systems and to allow Inter-Tel to further enhance its presence management, conferencing and collaboration products.

On February 28, 2005, Inter-Tel Lake Ltd, a wholly owned Irish subsidiary of Inter-Tel executed an agreement for the purchase of 100% of the issued share capital of Lake Communications Limited and certain affiliated entities (collectively, "Lake") for $28.0 million, plus an earn-out of up to $17.6 million based upon certain targets relating to operating results for Lake through the first eighteen months following the closing date of the transaction. The transaction closed out of escrow on March 4, 2005 upon the release from escrow of closing documentation. Lake, based in Dublin, Ireland, is a provider of converged communications products in the under 40 user market, including EncoreCX® products currently being distributed by Inter-Tel in the United States. Lake designs and develops its products for sale through a distribution network of telecom operators and distributors, including Inter-Tel in the United States. Lake outsources its manufacturing to third-party suppliers. For more than a year, Lake has sold certain communications products to the Company in the ordinary course of its business. See Note R of the Notes to our Consolidated Financial Statements for additional information on the Lake Acquisition.

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 March 4, 2005, we had fifty-nine (59) direct sales offices in the United States and a network of hundreds of dealers and VARs primarily in the United States, that purchase directly from us. Included in our sales office in Phoenix is the primary location for our national and government accounts division, as well as our local, long distance and network services divisions. Our wholesale distribution center is located in Tempe, Arizona, which is the primary location from which we distribute products to our network of direct sales offices, dealers and VARs in North America. In addition, we maintain a wholesale distribution office in the United Kingdom that supplies Inter-Tel's dealers and distributors throughout the UK and other parts of Europe, and we have dealers in South Africa and Japan. We also maintain research and development and software sales offices in Tucson, Arizona and in the United Kingdom. In March 2005, as a result of the closing of the Lake acquisition identified above, we will also maintain a wholesale distribution office in Dublin, Ireland that supplies Inter-Tel's dealers and distributors in the UK, Ireland, other parts of Europe and Australia.

PRODUCTS AND SERVICES OFFERED TO INTER-TEL'S DISTRIBUTION NETWORK

Inter-Tel is focused on the enterprise communications market and has an established record of technological innovation and leadership. Inter-Tel serves business enterprise customers, such as manufacturers, healthcare providers, the automotive industry, financial institutions, government agencies, non-profit organizations and other service organizations with value-driven solutions. Our core products include include converged and IP-centric communications platforms, IP telephony products and services, audio, video and Web conferencing solutions, computer telephony applications, unified messaging and voice processing software.

Inter-Tel addresses current industry-standard terminology by categorizing its software and endpoints under the following four technology categories: **Communication Systems and Software, as well as Presence, Collaboration, and Messaging Applications**. We also offer a complete line of managed services, including custom development, local and long distance calling services, network design and implementation services, maintenance services, leasing and support services. In addition, we resell peripheral data and telecommunications products.

Communication Systems and Software

Inter-Tel 5000 Network Communications Solutions

Designed for small-or medium-sized businesses with single or multiple sites, the Inter-Tel 5000 Network Communication System is designed to enable businesses to combine voice communications with enterprise data networks and applications for cost savings and infrastructure improvements. The platform delivers an integrated solution consisting of: Call Processing; IP, digital and analog endpoints; digital and analog trunks; auto attendant, and voice mail.

The Inter-Tel 5000 family of network communication solutions, which is scheduled to be released for general availability in the first half of 2005, include the Inter-Tel CS-5200 Communication Server, which supports 25 IP endpoints and 4 ports of built-in voice mail, and the Inter-Tel CS-5400, which supports 110 IP endpoints and 4 ports of built-in voice mail. Also scheduled for release in mid-2005 is the Inter-Tel DE-5200 Digital Expansion Interface, which is also being designed to allow our digital endpoints to connect to these systems. For larger applications, customers may also add an external voice mail server in lieu of using the built-in voice mail.

The design of the Inter-Tel 5000 provides for up to 63 servers to be transparently networked together. The Inter-Tel 5000 servers are designed to come equipped and licensed for networking right out of the box. If a customer wishes to network an Inter-Tel 5000 server over traditional phone circuits, the customer can purchase a T1/E1/PRI Module and place it one of the modular bays. Inter-Tel 5000 servers can also be networked with Inter-Tel Axxess® v7.0 or later converged platforms over T-1/PRI or the Inter-Tel 5000 servers can be networked over IP with any Axxess® v8.231 or later. The Inter-Tel 5000 also integrates with a wide range of Inter-Tel's flexible IP, digital and wireless endpoints.

Axxess® Converged Communications Platform

Designed for business enterprises, the Axxess converged communications platform provides tightly integrated voice processing, IP telephony functionality and transparent networking throughout an organization. With an Inter-Tel converged system, our customers can network up to 63 systems together with full-feature transparency, allowing customers to choose between traditional T-1 lines, frame relay, managed bandwidth or the Internet to network sites. Our commercially available systems support up to 40,000 ports, which enables flexible growth options up to this level.

The Axxess platform incorporates open interfaces, employs the standard programming languages C++ and JAVA, and is built on a computer telephony interface, which enables the seamless integration of Computer Telephony (CT) applications, development and customization. The modular platform can be tailored around the way an organization does business with the flexibility to modify the solution with growth or change.

Our converged system combines Internet Protocol (IP), digital, analog and wireless into a single platform—giving our customers a choice of technologies based on their organizations' needs. Whether our customers want to blend traditional and IP solutions or deploy full IP solutions, Inter-Tel offers a collection of applications and endpoints that enable them to benefit from IP telephony. The distributed architecture enables the connectivity of several phones in an office, of hundreds of phones in a building or on a campus, for remote and telecommuting associates, or even for geographically dispersed offices. All advanced features of the Axxess system, such as Automated Call Distribution (ACD) hunt groups, call center applications, paging zones, centralized attendants and tightly integrated voice mail, remain in place even when an organization is networking over IP.

By using IP-based endpoints and data networks, our customers can connect their local employees, remote staff and satellite offices as if they were all located in a single site. Our IP phones enable remote users to have access to advanced features, such as transferring calls, conferencing, accessing voice mail, record-a-call and more. Even call center agents working off-site do not sacrifice functionality. They can be members of ACD hunt groups or call routing patterns, and supervisors can monitor their calls as if they were in the same office. Additionally, our IP phones eliminate the need for a separate phone system in geographically dispersed locations.

Inter-Tel's IP Resource Card (IPRC) allows our customers to transparently network their locations over IP or Frame Relay networks. The IPRC is a multipurpose card for IP-based communications. Controlled through software, the IPRC can be used to network multiple locations without the need for a separate gateway to connect IP endpoints or to connect remote IP gateways. In December 2004, Inter-Tel enhanced the IPRC software to support both IP devices and IP transparent networking on a single IPRC card. The IPRC now supports up to 32 IP devices, effectively doubling the capacity of each modular slot within the chassis.

As businesses move toward the converged communications model, a common concern remains how best to leverage existing hardware and software. Connectivity protocols—SIP (Session Initiation Protocol) in particular—provide the architecture of how infrastructure and applications connect. SIP's primary role is that of a communications path, connecting diverse communication tools together so that they can "speak" to one another. SIP enables simple, flexible connectivity that allows infrastructures, applications and endpoints to interact in a standard manner.

Standards-based convergence solutions enable businesses to maintain their current communications investments during transition to the converged model. The open nature of SIP presents interoperability opportunities that make transport and connectivity transparent. SIP provides immediate impact and enhancement to existing communications platforms, leveraging the benefits of today's integrated applications.

Inter-Tel's convergence approach to communications enables us to deliver dynamic, blended, custom-tailored communications solutions that address unique enterprise needs.

In December 2004, Inter-Tel announced the general availability of Axxess v9.0 software. Axxess Version 9.0 software enhancements offer Private Networking and IP endpoints on the same Inter-Tel

Internet Protocol Resource Card (IPRC). Axxess v9.0 also offers Virtual Local Area Network (VLAN) Tagging support for Inter-Tel Model 8600, Model 8622, Model 8662 and Model 8690 IP endpoints. VLAN Tagging is designed to enable administrators to segment a single physical network into multiple virtual networks for simpler management, increased performance, improved voice quality and enhanced network security. Additionally, this release included support for Phantom Stations, which enables traveling associates to create virtual stations that do not require a physical endpoint, since these users are not typically in the office.

Axxess Version 9.0 software also added "Barge In" capabilities and enhanced the "Silent Monitor" feature to allow our customers to monitor and participate in agent calls for quality assurance and training efforts when those agents are located on a network node that is different from the supervisor's node. A number of diagnostic enhancements and new administration and development tools were also included in this release, designed to streamline system management and increase the productivity of network administrators.

Standards-based Architecture

Inter-Tel's CT Enablers, Open Architecture Interface (OAI), TAPI Service Provider, Intel/Dialogic CT-Connect interface and Computer Supported Telephony Application (CSTA) Service Provider, allow for smooth integrations with "off-the-shelf", shrink-wrapped applications or custom developed software packages that help organizations increase customer satisfaction and employee productivity.

Open Architecture Interfaces allow our converged systems to easily integrate with off-the-shelf or custom software applications. There are two types of Open Architecture Interfaces – Desktop OAI and System OAI. The flexibility of our open platform allows for seamless integration of CT applications, customization and development, which protect our customers' investments as technology evolves and their needs change.

Inter-Tel's support for industry standards, such as CSTA, TAPI and Intel/Dialogic CT-Connect, allow our Converged Communications Systems to integrate with Customer Relationship Management (CRM) database software applications in order to enhance telephony features such as screen pops, outbound dialing, etc.

Inter-Tel is committed to developing standards-based IP telephony solutions. Inter-Tel supports Media Gateway Control Protocol (MGCP) and Session Initiation Protocol (SIP) in our Axxess communications platform. SIP and MGCP are industry-standard protocols for transmitting voice over IP networks. Through our support of these two standard protocols, Axxess can interoperate with other industry-standard devices such as SIP and MGCP gateways for converting IP voice calls to standard telephone lines, and for using standard SIP telephones as extension numbers on the system.

Inter-Tel also supports IEEE standards 802.11b, and 802.3af. Inter-Tel's adoption of 802.11b enables our customers to access system features from devices, such as the Inter-Tel Model 8601 SIP SoftPhone for Pocket PC or Models 8664 and 8665 wireless endpoints, while they're mobile within their enterprise's 802.11b network. The IEEE standard 802.3af enables customers to implement power over Ethernet, eliminating the need for customers to supply power to their IP phones at their desktops. Inter-Tel's multi-protocol endpoints support G.711 a-law, G.711 u-law, and G.729a/b vocoders.

To support quality of service on our multi-protocol IP endpoints, Inter-Tel supports DiffServ, ToS, IEEE 802.1p packet prioritization and 802.1Q VLAN identification. These standard protocols are used to help Inter-Tel provide improved voice quality on its IP endpoints.

Enabling technologies incorporated into Inter-Tel's applications include Wireless Application Protocol (WAP) and ActiveX, which format the Web experience for various end-user tools. Additionally, Inter-Tel continued to develop products that leverage LDAP, a protocol for accessing database information in a standard format, as well as adopted .NET, Microsoft's development framework.

With the launch of the Inter-Tel 5000 Network Communications Solutions in the first half of 2005, Inter-Tel is planning to offer support of T.38, a standard Fax over IP protocol.

Standards-based convergence solutions enable businesses to maintain their current communications investments during their transition to the converged model. Our future product strategy is focused on continuing to provide support for these and other industry-standard interfaces.

Endpoints

Tightly integrated with the Inter-Tel 5000 Network Communications Solutions and the Inter-Tel Axxess converged platform, our suite of endpoints deliver exceptional voice quality, powerful features and intuitive interfaces. Whether our customers have associates onsite, mobile, or working from remote locations, our endpoints help customers to perform their functions with continuity.

Inter-Tel's suite of powerful, IP endpoints connect local employees, remote staff and satellite offices as if they were all in the same location. Inter-Tel's IP endpoints are available in two modes – Inter-Tel Protocol or SIP mode. Inter-Tel Protocol enables an IP endpoint access to the features and functionality of a traditional Inter-Tel endpoint. Implementing SIP mode allows an enterprise to access the shared extension feature, which allows multiple endpoints to use the same extension number on an Inter-Tel advanced communications platform. Incoming calls to a shared extension are sent to SIP endpoints simultaneously; offering customers dynamic mobility when away from their main desks. Additionally, SIP mode enables IP endpoints to interoperate with third-party SIP solutions. Inter-Tel's diverse suite of IP endpoints includes advanced functionality and one-touch access to frequently used features.

In November 2004, Inter-Tel released the Model 8622 two-port IP endpoint, which added a second LAN port for peripheral devices such as a computer or IP printer. In mid 2004, Inter-Tel also released the Model 8524 and Model 8525 to its customers. These digital wireless solutions are 900 MHz phones that enable customers to access system features and voice mail while mobile.

Inter-Tel offers wireless solutions, including the Model 8664, Model 8665 and Inter-Tel's Model 8601 SIP SoftPhone for Pocket PC. Users can receive and initiate calls and access features and messages from these handheld devices, while mobile within an 802.11b wireless network.

Additionally, Inter-Tel's Model 8690 multi-protocol, multimedia endpoint released in March 2004 is designed to enable users to access systems features and integrated Unified Communicator® software, as well as manage messages via a touch-screen. Model 8690 is designed to allow users to initiate, hold, transfer and conference calls with the soft phone interface. The Integrated Unified Communicator software is designed to enable users to control their presence and availability status, monitor the status of coworkers, speed-dial contacts, conference associates and clients, and view call history and messages.

To complement our Inter-Tel 5000 Network Communications Solutions and Axxess converged system, Inter-Tel offers a variety of full-featured digital endpoints. Our digital phones deliver exceptional voice quality, advanced digital features and a range of programmable keys for high-speed, high-quality call processing. The user-friendly, liquid crystal displays (LCDs), with up to 6 line by 16 characters (6x16), lead users through system features and capabilities—serving as built-in user guides. Menu-driven, one-touch "soft keys" allow users to reduce the time it takes to initiate and receive calls, retrieve messages, leave messages and access features.

Presence Tools

Inter-Tel's Presence tools enable our customers to control how, when and where they communicate. Since many enterprises have multiple locations or campuses, and require their employees to be connected while mobile, the ability to control and view information about individuals' availability is important. Inter-Tel's Presence tools, such as Unified Communicator® software, Connection Assistant®, Enterprise® Instant Messaging and Telephony Manager, facilitate communications among individuals and groups and can convey the individual's availability, location and the tools currently available to him or her. These tools also allow employees to have communications controlled or enhanced on his or her behalf—streamlining the communication process. Businesses can use presence tools most appropriate to enterprise goals. Users can stay connected to geographically separated associates, customers, partners and vendors, creating a virtual enterprise.

Collaboration Tools

Inter-Tel's Collaboration tools enable real-time interaction among two or more people. A business and its resources face many challenges in the pursuit to share ideas, exchange pertinent information, make critical business decisions and respond to customer needs. Connectivity offers our customers' enterprises better collaboration with their distributed work forces, partners, suppliers and customers. Inter-Tel provides many tools that enable businesses to collaborate cost-effectively and easily, such as Enterprise Conferencing, Enterprise Instant Messaging, Call Center Suite and Connection Assistant and Telephony Manager.

Messaging Tools

Messaging Tools facilitate the exchange of information between people and locations. Enterprises need to be able to respond uniquely to employees, suppliers, partners and customers, as well as offer 24/7 coverage to capture incoming requests from external sources. Inter-Tel's Messaging tools, such as Enterprise Messaging, Enterprise Instant Messaging, Unified Messaging and Voice Processing, can address the challenges faced by enterprises with distributed resources and customers across state, national and international boundaries. Inter-Tel offers flexible choices to provide channels of communication no matter the time of day or geographic location.

Inter-Tel's Suite of Presence, Collaboration & Messaging Tools (Business Applications for the Enterprise)

As an integral part of our Managed Services offerings, Inter-Tel provides a variety of applications designed for business use, enhanced productivity and operational performance. Inter-Tel's applications can facilitate audio conferencing and real-time document sharing, automate repetitive tasks, enable call handling tasks from a personal computer (PC), generate historical and real time call statistics, enable intelligent call routing, manage communications using a Web browser or Wireless Application Protocol (WAP) device and more. Specific applications are highlighted in additional detail below.

Attendant Console

Inter-Tel's Attendant Console provides attendants and employees with knowledge of station and hunt group status, such as Do-Not-Disturb messages, forwarding information and busy or available status. The unique user-friendly interface allows users to view the real-time status of employees, enabling them to process calls quickly via touch screen, mouse or keyboard.

Applications Platform: IVR

Inter-Tel's Applications Platform is a scaleable, flexible platform that enables the customization of applications according to the specific needs of an organization. It includes a signaling and services engine, plus a graphical service creation environment. Inter-Tel's Interactive Voice Response (IVR) integrates computer, telephony, Automatic Speech Recognition (ASR) and Text-To-Speech (TTS) capabilities, and allows for customization for different environments. Inter-Tel's IVR platform includes a starter pack with two IVR applications for general business purposes, and can be expanded or customized. Our customers have the choice of having their custom applications developed by an authorized Inter-Tel reseller or engaging Inter-Tel's Custom Solutions group.

Interactive Voice Response can be deployed as a front-end to Automatic Call Distribution (ACD) systems, which can ask questions that help routing and enable more intelligent and informed call processing. By using IVRs as front-ends, recordings can be used for repetitive messages, and transactions can be performed without involving customer service personnel.

Call Center Suite

Call Center Suite is a collection of modular computer telephony software applications that help organizations optimize call center and workgroup performance. Whether an organization has a department workgroup environment with extensions or a call center with agents at a single or multiple locations, Call Center Suite offers a variety of solutions. Combined with a flexible infrastructure, the suite of applications encompasses Management Tools for reporting and activity monitoring, plus Agent and Workgroup Tools to aid in increasing productivity and delivering consistent customer service.

In April 2004, Inter-Tel released Call Center Suite v3.3, which enabled customers to integrate with Audiolog™ from Mercom Systems, Inc., a call logging/recording solution. With the integration, the Call Center Suite Reporter module can provide call recording retrieval from the Audiolog system. A supervisor can use one interface, Call Center Suite, to research unusual call statistics and uncover the underlying cause by listening to caller and agent dialog.

Connection Assistant®

Connection Assistant enables work group members to receive screen pops of key client or customer information, applications, and Web applications, and is designed to enable individuals to provide personalized service and enhance productivity levels. Work group members can receive call notes from their group members, automatically displaying pertinent customer and account information. Connection Assistant also provides group members with the ability to view the programmed status of any colleague. Call control buttons allow users to quickly call colleagues, pickup inbound calls and perform blind or screened transfers. Additionally, Connection Assistant provides users with flexible control of their extensions to better manage communications. Using a rules-based system, users can assign actions to specific events occurring at their extensions. Associates can divert unidentified calls at a particular time or from a specific number to another extension or to voice mail.

Enterprise® Conferencing

Enterprise Conferencing is a SIP-based audio conferencing and Web presentation solution. This collaboration tool features an intuitive, browser-based control interface, which allows users to create and manage conferences, meetings, training sessions and more. Call leaders can navigate the interface to perform various tasks using drop-down menus, type-in text fields and check boxes. Users can initiate and set-up a variety of conference calls such as ad hoc, reoccurring or one-time only. Once a conference is set up, call leaders can e-mail an invitation to conference participants, containing all of the necessary information for a hassle-free conference. When a conference is in progress, the leader has control over each call participant. Call control buttons allow the call leader to mute, hold and drop each participant or the collective group of participants.

Enterprise Conferencing also allows users to instantly set-up presentations, Web-based seminars or training sessions that require little coordination. Call leaders can present information to fellow co-workers, customers or vendors, allowing customers to reduce travel expenses.

Enterprise® Instant Messaging

This browser-based instant messaging (IM) tool for the business environment seamlessly integrates with Inter-Tel's Enterprise Conferencing, creating a powerful solution. The intuitive user interface enables users to create a list of contacts or groups to communicate more efficiently. From the same interface, users can send e-mails or conduct business chat sessions, as well as send documents to quickly address changing business situations. This solution enables busy employees to better manage their work flows and respond to imperative business matters. When integrated with Enterprise Conferencing, users can quickly escalate IM sessions into conference calls and Web presentation sessions.

System Manager

In January 2004, Inter-Tel announced the release of System Manager software, a network management system for the Inter-Tel Axxess platform. Inter-Tel's System Manager unites Inter-Tel's diverse product line into a family of products that can be viewed, programmed, managed and diagnosed through a single interface. System Manager is designed to help reduce the cost and overall complexity of operating the system. When the Inter-Tel 5000 Network Communication product is released for general availability, an updated version of the System Manager is scheduled to be released with support for the Inter-Tel 5000.

Telephony Manager

Many businesses use Microsoft® Customer Relationship Management (CRM) software to manage customer account information and make informed business decisions. An Inter-Tel Presence tool,

Telephony Manager (released in May 2004) links an Inter-Tel communications platform to Microsoft CRM so businesses can build customer loyalty, collaborate effectively with team members and make informed business decisions.

Telephony Manager automatically links incoming customer calls to a company's MSCRM database, via Automatic Number Identification (ANI)—screen-popping customer information to sales and support personnel. Employees immediately have the customer information they need to provide superior customer service. Telephony Manager also enables users to convey their current availability to fellow colleagues—for better collaboration and workflow. Additionally, the integration allows employees to transfer, conference or record the call from the MSCRM interface.

Telephony manger was developed with the assistance of ePartners, a national reseller of Microsoft CRM software. Inter-Tel's contractual relationship is structured around a referral program for sales of both the Telephony Manager and Microsoft CRM software.

Unified Communicator® v2.1 Software/SIP Server v1.1

Inter-Tel currently offers Unified Communicator v2.1 software, which provides our customers with control of their endpoints through multiple user interfaces including speech recognition, touch-tone, PC Web browser and WAP devices. Unified Communicator provides users with a powerful set of tools designed to enhance the control and flexibility of the desktop environment. Users can manage their presence by controlling how and where they can be reached—routing calls to their current location, or by forwarding calls to a specified number. They can access their personal address book and the System Directory, control availability and location, check availability of colleagues and initiate calls from a Web browser or WAP-enabled device. Our mobile customers can manage communications through speech recognition or with a touch-tone phone if a Web browser is unavailable. The Unified Communicator and the SIP Server are bundled to provide an integrated SIP and presence management platform.

In the second quarter of 2005, Inter-Tel expects to release Unified Communicator v3.0 software, which is being designed to incorporate a number of collaboration enhancements to the Web client interface. Unified Communicator v3.0 is being designed to enable users to initiate ad hoc Web collaboration meetings with colleagues and clients; share their desktops and applications to discuss business matters, training or customer support; and illustrate or "white board" ideas or concepts with customers and coworkers.

Unified Messaging

Designed to run in a Microsoft® Windows® environment, our Unified Messaging software combines e-mail, voice mail and fax into a single, mail management program. Depending on the level of integration our customers choose, messages are either converted to standard file formats, or seamlessly integrated so that users can view, access and process messages through a variety of devices, including Microsoft's Exchange messaging application, Lotus Notes® and cc:Mail™ and Novell's GroupWise®, as well as other Internet mail applications.

Voice Processing

Designed to integrate with the Inter-Tel 5000 Network Communications Solutions and the Axxess platform, our Voice Processing system provides an automated attendant to guide callers to the person or information they need. This automated attendant answers incoming calls, transfers calls, records messages, screens calls and returns calls using caller identification software. The Voice Processing systems provides Call Routing Announcements, voice mail, the ability to record a call and various call handling functions. Additionally, voice mail messages can be retrieved using the Voice Processing system from any location using a touch-tone phone. Inter-Tel offers Voice Processing in two varieties—embedded in the chassis and in an external server.

Small Business Communications Systems

EncoreCX®

EncoreCX® is a converged voice and data telephone system designed for businesses with up to 40 employees, or large residences. The EncoreCX includes feature-rich telephones that have a large intuitive display. The flexible EncoreCX system allows our customers to integrate a mix of standard analog devices, such as cordless telephones and fax machines. In addition, EncoreCX can be programmed and maintained remotely, minimizing the costs associated with on-site technician visits. The EncoreCX is targeted for retail or small business, multi-branch businesses, or even home-based businesses.

In the first half of 2005, Inter-Tel expects to release EncoreCX v3.0, which is being designed to support T-1/Primary Rate Interface (PRI) services. This release is being developed to give our small business and large residential customers a choice to deploy a digital trunk connection (T-1 or PRI) instead of an analog trunk connection. This new version of software is also being designed to offer customers additional bandwidth on network connections and Direct Inward Dial (DID) functionality—connecting callers directly with employees within the Inter-Tel EncoreCX system. By combining voice and/or data capability on the Inter-Tel EncoreCX system, the T-1/PRI Module is expected to provide reduced equipment and administrative costs, and to streamline resource management.

PRODUCTS & SERVICES OFFERED THROUGH OUR LINKTIVITY® DISTRIBUTION NETWORK

Collaboration & Web Conferencing Solutions

Linktivity WebDemo® 4.0

In December 2004, Inter-Tel released Linktivity WebDemo® 4.0, which offers our customers a web-based, real-time conferencing and collaboration solution. This software is available in three versions: WebDemo Express, WebDemo Professional and WebDemo Enterprise, which are designed to support a broad range of businesses and enterprises at an affordable price. WebDemo 4.0 provides our customers with an enhanced software tool to facilitate virtual meetings, collaboration sessions with remote associates, and sales presentations with remote customers. WebDemo 4.0 enhancements, such as new launch icons, multilingual support and HTML collaboration client are designed to offer existing and new customers improved connectivity rates and easy-to-initiate virtual meetings, e-training and Internet collaboration.

Linktivity WebInteractive® 4.0

Announced in December 2004, the release of Linktivity WebInteractive® 4.0 offers real-time communications software that provides server-based collaboration and control products. The software is designed to help our customers to improve their support and online sales environments. By connecting to the Internet or via intranets and extranets, associates can chat in real-time with their customers or prospects and quickly escalate chats to desktop sharing, virtual product demonstrations, training or live customer service to help reduce operating costs and increase sales.

Other Services and Products

Inter-Tel offers a broad range of products and a complete and comprehensive Managed Services program that incorporates advanced technologies while providing customers a single source provider and designed to cost-effectively fulfill their business communications needs. The Inter-Tel Managed Services program offers business solutions for professional services, provisioning and facilities management, and custom development services.

We couple this solution-oriented approach with a high level of customer service and support and a commitment to quality throughout our operations. Our business communications systems are integrated with our integrated computer-telephone applications and include voice mail, auto attendant, unified messaging, call center applications, Interactive Voice Response (IVR), wireless applications, Automatic Call Distribution (ACD), long distance and networking services, together with a variety of other communications applications.

Because of the modular design of our systems and the high level of software content in our products, customers can readily increase the size and functionality of their systems as their needs change by adding new services, software and hardware applications, or by upgrading to new systems or advanced versions of their existing systems.

We believe our customers prefer to purchase business communications systems and services from a single-source because of the convenience, consistency of service, ease of upgrade, availability of financing alternatives and confidence in the performance of integrated systems and services all incorporated into a total managed services solution package.

Network, Local and Long Distance Services

Through our subsidiary, Inter-Tel NetSolutions®, we resell a variety of telecommunications services, including local communications services, domestic and international long distance services, calling card services, 800 services, dedicated data services, Internet, frame-relay and voice and video conferencing, disaster recovery solutions, and network monitoring and management. We resell these services through our agreements with major U.S. long distance carriers. These services are then billed to the end-user customer by Inter-Tel NetSolutions.

Through our division Inter-Tel Network Services Agency (INSA), we sell services as an Agent of various Regional Bell Operating Companies (RBOCs) and Competitive Local Exchange Carriers (CLECs). These services include primarily local communications services, data services and Internet access. The Local Exchange Carrier (LEC) or CLEC bills these services to the end user, providing they and INSA receive compensation from the provider for marketing these services.

We support telecommunications applications such as T-1 access for incoming toll-free traffic at call centers, switched long distance and frame relay networks linking together multiple offices of an enterprise. Customers who desire the convenience of acquiring long distance and other related calling services through the same vendor they use to purchase separate telephony equipment and services can do so with Inter-Tel.

Networking Technologies Integration

Our division Inter-Tel DataNet designs, installs and supports an integrated, comprehensive solution for our customers' complex data and telecommunications networks, from local area networks, or LANs, to geographically dispersed wide area networks, or WANs.

By forming relationships with major manufacturers of hardware and software technologies, Inter-Tel provides the routers, ATM, LAN and WAN switches, wire-less WAN connections, file servers, intelligent hubs and other devices required for the customer's intranet or for access to the Internet. We offer pre-sale design support, project coordination for implementation, and installation support on our full line of server-based telephony products and IP telephony products and services.

Custom Professional Services and Solutions

Inter-Tel Custom Solutions (ICS) is an Inter-Tel division that delivers professional services to our customers a variety of custom IVR and computer telephony solutions built with our industry-leading software and hardware products. ICS can also customize computer telephony applications and extend the capabilities of existing Inter-Tel converged platforms and Call Center Suite installations, as well as assist in the integration of third-party hardware and software that may be required to deliver complete call center telephony solutions.

ICS is also a resource for pre-sales help, specifying and selling the Inter-Tel Applications Platform, or IVR product line, the foundation on which both ICS and our channel partners can deploy flexible and customized speech-enabled IVR solutions for market sectors and business applications. Additionally, the ICS team provides support and coordination of on-site installations and/or remote installation support, as well as comprehensive sales engineering and sales support services for all of the above, including customer calls, visits and videoconferences, product demonstrations, request for proposal and requirements analysis, functional specification development, quotations and full sales cycle support.

Leasing Services

Inter-Tel offers its Total Solutions (formerly TotaLease®) program through our subsidiary, Inter-Tel Leasing, Inc. The Total Solutions program enables end users to acquire a full range of business communications systems and applications designed and manufactured by Inter-Tel, as well as maintenance and support services. This program provides a total system financing package to the customer at a set

monthly cost, with system expansion available for an additional fee. The typical Total Solutions contract has a term of 60 months, and allows the customer to renew the contract at a specified price for up to an additional 36 months.

Inter-Tel also offers a line of low-cost lease purchase financing. Lease terms range from 24 to 84 months with $1.00, fixed and fair market value purchase options. Inter-Tel can also customize financing packages to suit customers with special financial needs. By offering this type of financing to acquire our products and services, our customers are able to lease directly from Inter-Tel or an authorized third-party leasing company supporting an Inter-Tel dealer, thereby allowing us, or one of our dealers to maintain a direct relationship with our customers. This direct relationship allows Inter-Tel to provide maintenance and support services and information regarding other Inter-Tel products and services.

Peripheral Products

Through our CommSource® division, Inter-Tel distributes peripheral telecommunications products, applications and services developed by third parties to our direct sales offices, dealers and VARs. We offer a selection of products including the following: analog and cordless telephones; audio-conferencing, bridges and accessories; call accounting; call logging/recording; computer telephony products; data equipment; headsets; installation equipment; message-on-hold; paging equipment; power protection and backup; premise wireless and videoconferencing systems and other accessories. Our CommSource division sells and distributes products we have endorsed as leading communications peripherals widely deployed within organizations. Many of these products and services interface with our telephone systems.

SALES AND DISTRIBUTION

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 March 4, 2005, we had fifty-nine (59) direct sales offices in the United States and a network of hundreds of dealers and VARs primarily in the United States, that purchase directly from us. Included in our sales office in Phoenix is the primary location for our national and government accounts division, as well as our local, long distance and network services divisions. Our wholesale distribution center is located in Tempe, Arizona, which is the primary location from which we distribute products to our network of direct sales offices, dealers and VARs in North America. In addition, we maintain a wholesale distribution office in the United Kingdom that supplies Inter-Tel's dealers and distributors throughout the UK and other parts of Europe, and we have dealers in South Africa and Japan. We also maintain research and development and software sales offices in Tucson, Arizona and in the United Kingdom. In March 2005, as a result of the closing of the Lake acquisition, we will also maintain a wholesale distribution office in Dublin, Ireland that supplies Inter-Tel's dealers and distributors in the UK, Ireland, other parts of Europe and Australia.

Distribution Channels

Our success depends in part upon the strength of our distribution channels and our ability to maintain close access to our end user customers through our distribution channels. In recent periods, we have sought to improve our access to end users through strategic acquisitions of resellers of telephony products and services, some of which are located in markets in which we have existing direct sales offices. As of December 31, 2004, Inter-Tel's direct sales office personnel and national and government accounts personnel consisted of 1,144 and 52 persons, respectively.

Direct dealers and VARs enter into reseller agreements with us for a term of one or more years. These agreements often include requirements that the reseller meet, or use their best efforts to meet, minimum annual purchase quotas. We generally provide support and other services to our resellers under the terms of the agreements. We face intense competition from other telephone system and voice processing system manufacturers, as many of our dealers carry other products that compete with our products.

We offer additional incentives, programs and support resources to dealers that agree to sell Inter-Tel systems and solutions on an exclusive basis. We launched an exclusive business partner program during 2001. This program was designed to reward dealers who sell only Inter-Tel products to all new prospects and aggressively seek to upgrade their non-Inter-Tel customer base. For this commitment from the dealers, we have offered our expertise to help them manage their business. This includes operational business

reviews, shared human resource forms and policies, additional sales, marketing and training support, enhanced co-op benefits as well as special sales promotions and awards. In addition, we allow exclusive dealers to use our branch sales offices and demonstration rooms to help them in the sales process. We believe this program offers us an opportunity to expand our wholesale channel of distribution.

National, Government and Education Accounts

Inter-Tel's National, Government and Education Accounts Division (NGEA) services large commercial companies; the Federal Government and its agencies; state, municipal and local governments; and educational institutions throughout the United States. NGEA offers the full line of Inter-Tel converged communications solutions to its customers, as well as consulting, financial planning and related assistance.

NGEA support programs and Managed Services Rental Program, are comprehensive and flexible, providing companies, government agencies, and educational organizations technical solutions, with a level of support provided to allow them to concentrate on building future infrastructure needs, with support for previously installed products.

Inter-Tel has been the subject of government investigations relating to its e-Rate program, which have resulted in convictions and civil penalties. Please refer to "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" in the "Factors That May Affect Future Operating Results" section of this document and Note A of Notes to Consolidated Financial Statements for additional information.

Lease Financing Services

Inter-Tel offers lease financing options, including its Total Solutions (formerly TotaLease) program through our subsidiary, Inter-Tel Leasing, Inc. and a line of low-cost lease purchase financing from Inter-Tel or an authorized third-party leasing company supporting Inter-Tel dealers. These programs enable end users to acquire a full range of telephony systems and applications designed and manufactured by Inter-Tel, as well as maintenance and support services. Please refer to "Leasing Services" in "PRODUCTS AND SERVICES" above for additional information regarding these programs.

International Sales

We currently have dealers in North America, the UK, parts of Europe, Japan and South Africa**,** and we are currently working to expand our international dealer network. In addition, as a result of the Lake acquisition closed in March 2005, Inter-Tel expects to have dealers in Ireland, other parts of Europe and Australia. International sales, which include business communications systems and IP telephony and peripheral products, accounted for approximately 3.2% and 3.0% of our net sales in 2004 and 2003, respectively. In order to sell our products to customers in other countries, Inter-Tel must comply with local telecommunications standards. Our Inter-Tel 5000 Family of Network Communications Solutions, *Axxess* system and IP telephony products can be modified using our software to facilitate compliance with these local regulations. In addition, the Inter-Tel *Axxess* and the Inter-Tel 5000 platforms have been designed to support multi-lingual functionality, and both platforms currently support American English, British English, Japanese and Spanish languages.

Customer Service and Support

Customer service and support are critical components of customer satisfaction and the success of our business. We operate a technical support group that provides a range of support services to our distributors, dealers and end user customers through the Internet and through a toll-free telephone number. Inter-Tel provides on-site customer support through our direct sales offices and dealers and, using remote diagnostic procedures, we have the ability to detect and correct system problems from our technical support facilities. In the past several years, we greatly enhanced our Internet, intranet and extranet capabilities. Inter-Tel's Web site is designed to offer our direct sales offices and dealer channel support for sales and technical support activities. Our Web site also offers a wide array of sales and technical information, including an on-line product and service catalog, efficient order processing, portable-document-format sales brochures, competitive information, on-line technical manuals and frequently-asked-questions on important topics. The Inter-Tel website also supports the ability to initiate and track the status of technical support tickets from our web site to help improve communication concerning the status of submitted tickets, and we have continued to develop and enhance our sales proposal platform. In 2004 we implemented a centralized customer care center. The customer care center takes service calls from customers that have purchased phone systems from our direct sales offices and government and national accounts division. Personnel at the customer care center manage the scheduling and dispatching of technicians and quality of service to the customer. We intend to further develop our Web site to add additional information and services. During 2005, we plan on

migrating all primary service call and dispatch functions currently being performed at our branch locations to the centralized customer care center.

We analyze feedback from our customer service call records to provide direction for product and service enhancements. Our direct sales offices and resellers can receive service activity reports summarizing the reasons that technicians are asking for assistance and common issues that give rise to technical inquiries. This allows our direct sales offices and resellers to track trends in their service operations and to thereby provide better customer service.

We believe we can best serve our customers by continually improving the quality of our systems, customer service and support, and other aspects of our organization. Through our continuous improvement process, Inter-Tel implements quality processes throughout its business operations. We have established formal procedures to provide responsiveness to customer requests, monitor response times and measure customer satisfaction. We have also established means by which all end users, including customers of our resellers, can request product enhancements directly from us. Inter-Tel supports its dealers and VARs through extensive training programs offered at Inter-Tel's facilities and through virtual remote training courses tied into Inter-Tel University. Inter-Tel also provides a toll-free telephone number for sales and technical support, an extranet site offering up-to-date sales and support information, and end-user marketing materials. We typically provide a one-year warranty on our systems to end users. Inter-Tel receives manufacturing warranties for periods of up to two years from the date of manufacture from its third-party manufacturers. We offer to pass through the warranties on our systems to our dealers for a period of up to two years from the date of manufacture, and the dealers are then responsible for providing a warranty to their end users.

RESEARCH AND DEVELOPMENT

We believe that our ability to enhance our current products, develop and introduce new products on a timely basis, maintain technological competitiveness and meet customer requirements is essential to our success. Inter-Tel's research and development efforts over the last several years have been focused primarily on the development of, and enhancements to, our Axxess® system, including adding new applications, enhancing and developing new IP convergence applications and IP endpoints, developing Unified Communications applications, developing presence management applications, and developing speech-recognition and text-to-speech applications. More recently, Inter-Tel's research and development efforts have been focused on the development of the new Inter-Tel 5000 Network Communications family of products, next generation LAN-enabled telephony platforms, cost reductions of our multi-protocol IP endpoints, and the integration of the Linktivity web collaboration technology into many of our applications.

As of December 31, 2004, we had a total of 308 personnel engaged in research and development and related technical service and support functions. Research and development expenses were $28,815,000; $21,978,000; and $19,340,000 in 2004, 2003, and 2002, respectively.

MANUFACTURING

Inter-Tel manufactures substantially all of its systems through third party subcontractors located in the United States, Mexico, the People's Republic of China and the United Kingdom. These subcontractors use both standard and proprietary integrated circuits and other electronic devices and components to produce our communications systems, physical endpoints and printed circuit boards to our engineering specifications and designs. In some cases, our suppliers perform systems integration, software loads, perform functional tests and make final shipment. Varian, Inc., a multinational electronics company, currently manufactures a significant portion of our products, including substantially all of the printed circuit boards used in the Inter-Tel 5000 Network Communications Solutions and the *Axxess* platform, at Varian's Tempe, Arizona facility. We provide our manufacturing contractors with forecasted schedules of our manufacturing needs and revise the forecasts on a periodic basis. We continuously monitor the quality of the products produced on our behalf by our manufacturing subcontractors.

COMPETITION

The market for our products is highly competitive and has in recent periods been characterized by rapid technological change, business consolidations and decreasing prices. Competitors for our converged communication products geared toward the enterprise market include Avaya, Nortel Networks, 3Com, Altigen, Cisco Systems, Comdial, Iwatsu America, Inc., Mitel Networks, NEC Corporation, Panasonic, Shoreline, Siemens, Toshiba and Vodavi, among numerous other resellers of these and similar products. Several of these competitors have been active in developing and marketing IP networking products and have established relationships with customers within their markets. Microsoft offers the Microsoft Live Communications Server, which is proprietary software that facilitates voice communication and collaboration over IP networks. This platform could be further enhanced in the future to compete with our IP convergence products. We also compete against the RBOCs, which typically offer systems produced by one or more of our competitors listed above and also typically offer Centrex systems in which automatic calling facilities are provided through equipment located in the telephone company's central office. We also compete with RBOC's and next-generation service providers, such as DSL providers and cable companies, that offer IP Centrex services as well as bundled telephony and data services in an application service provider telephony model.

In the market for voice processing applications, including voice mail, we compete against Captaris, Active Voice (subsidiary of NEC America), InterVoice-Brite, Avaya, Nortel Networks, Comdial and other competitors. In the market for long distance services, we compete against AT&T, Sprint, Qwest and others. We also expect to compete with RBOCs, cable television companies, satellite and other wireless broadband service providers for long distance business. Key competitive factors in the sale of converged communications systems and related applications include price, performance, features, reliability, service and support, brand recognition and distribution capability. We believe that we compete favorably in our markets with respect to the price, performance and features of our systems, as well as the level of service and support that we provide to our customers. However, certain of our competitors have significantly greater resources, brand recognition and distribution capabilities than we do.

As we compete for local telephone service, long distance service and IP network access, we face additional competition from established foreign and domestic long distance carriers, RBOCs and other providers. Many of these competitors have larger marketing and sales organizations, significantly greater financial and technical resources and a larger and more established customer base than we do. In addition, RBOCs and other providers have greater name recognition, more established positions in the market and long standing relationships with customers.

INTELLECTUAL PROPERTY RIGHTS

As of December 31, 2004, we held patents for 27 telecommunications and unified messaging products. The remaining life of these patents ranges from six months to eighteen years. We have also applied to the U.S. Patent and Trademark Office for fourteen additional patents. We also rely on copyright, trademark, trade secret law and contractual provisions to protect our intellectual property.

EMPLOYEES

As of December 31, 2004, we had a total of 2,022 employees, of whom 747 were engaged in sales, marketing, e-business and customer support; 268 in direct sales office administrative, wholesale administrative and other management personnel; 582 in manufacturing, quality and related operations, including direct sales office operations personnel; 308 in research and development and related technical service and support functions; and 117 in finance, information systems, administration and executive management. We believe our relations with our employees are good.

ACCESS TO INFORMATION

Our Internet address is *www.inter-tel.com*. We make available at this address, free of charge, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. We will also provide paper copies of this annual report on Form 10-K, available upon written request to Shareholder Relations, 1615 S. 52nd Street, Tempe, Arizona 85281.

FACTORS THAT MAY AFFECT FUTURE OPERATING RESULTS

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

Risks Related to Our Business

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

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

- volume and timing of orders received during the quarter;
- gross margin fluctuations associated with the mix of products sold;
- the mix of distribution channels;
- general economic conditions and the condition of the markets our business addresses;
- patterns of capital spending by customers;
- the timing of new product announcements and releases by us and our competitors and other competitive factors;
- pricing pressures;
- the cost and effect of acquisitions;
- the availability and cost of products and components from our suppliers, including shipping and manufacturing problems associated with subcontracted vendors;
- the potential impact of new accounting pronouncements such as FAS 123R;
- national and regional weather patterns;
- threats of or outbreaks of war, hostilities, terrorist acts or other civil disturbances; and
- the impact of the E-Rate settlement and possible FCC debarment, which could effect both our government business and our commercial business.

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

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

quarter is frequently less than the fourth quarter, and net sales for the third quarter is frequently less than the second quarter. As a result of these and other factors, we have historically experienced, and could continue to experience in the future, fluctuations in net sales and operating results on a quarterly basis.

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

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

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

Our future success largely depends on increased commercial acceptance of our Inter-Tel 5000 Network Communications Solutions, Axxess® system, EncoreCX®, speech recognition, Interactive Voice Response, presence management, collaboration, messaging products, Session Initiation Protocol (SIP) applications, and related computer-telephony products.

Over the past 18 to 24 months, we have introduced a number of new products and platforms, including: Unified Communicator® software, a web-based, speech-recognition, wireless PDA, and Wireless Application Protocol (WAP) software application for controlling and managing calls, contacts and presence status; Enterprise® Conferencing and Enterprise® Instant Messaging software, a SIP-based web and audio conferencing application; Model 8500 series digital endpoints; Model 8600 series Multi-protocol SIP endpoints; Inter-Tel Application Platform, a highly flexible speech-recognition, text-to-speech and CTI application generation platform; enhanced convergence features on the Axxess system, including support of standard Session Initiation Protocol (SIP) endpoints and trunk gateways; 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, as well as the Axxess system, the Inter-Tel 5000 Network Communications products, the Application Platform, the Unified Communicator and related computer-telephony products, the Linktivity collaboration technology, EncoreCX products, converged systems and software, SIP standards-based applications and devices, new speech recognition and Interactive Voice Response products, and future upgrades and enhancements to these products and networking platforms. We cannot assure you that these products or platforms will achieve commercial acceptance in the future.

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

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

- costs associated with the remediation of any problems;

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

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

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

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

As part of our business strategy, we consider acquisitions of, or significant investments in, businesses that offer products, services and technologies complementary to ours. Such acquisitions could materially adversely affect our operating results and/or the price of our common stock. Acquisitions also entail numerous risks, some of which we have experienced and may continue to experience, including:

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

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

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

Finally, to the extent that shares of our stock or the rights to purchase stock are issued in connection with any future acquisitions, dilution to our existing shareholders will result and our earnings per share may

suffer. Any future acquisitions may not generate additional revenue or provide any benefit to our business, and we may not achieve a satisfactory return on our investment in any acquired businesses.

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

Our success depends in part upon protecting our proprietary technology. As of December 31, 2004, we held twenty-seven (27) U.S. patents for telecommunication and messaging products, systems and processes and have applied to the U.S. Patent and Trademark Office for fourteen (14) additional patents. We also rely on copyright and trade secret law and contractual provisions to protect our intellectual property. Despite these precautions, third parties could copy or otherwise obtain and use our technology without authorization, or develop similar technology independently.

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

Many of our competitors have large patent portfolios and we are subject to or could become subject to third party claims that our current or future products or services infringe upon the rights of others. For example, we are subject to claims initiated by Avaya, one of our primary competitors, 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 Avaya alleging that our Axxess business communications system and associated applications utilize inventions covered by certain of their patents. We are continuing the process of investigating this matter and we have made claims against Avaya for infringement of our patents. The ultimate outcomes by their nature are uncertain and we cannot assure you that these matters, individually or collectively, would not have a material adverse impact on our financial position and future results of operations.

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

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

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

- PABX and converged systems providers, distributors, or resellers such as Alcatel, Altigen, Avaya, Cisco Systems, Comdial, 3Com, Iwatsu, Lucky Goldstar, Mitel, NEC, Nortel, Panasonic, Samsung, ShoreTel, Siemens, Toshiba, Vertical Networks/ArtiSoft and Vodavi;
- large data routing and convergence companies such as 3Com and Cisco Systems;
- voice processing applications providers such as ADC, InterVoice-Brite, Active Voice (a subsidiary of NEC America), Avaya, and Captaris (formerly AVT);
- web collaboration product and service providers, such as Centra, eDial (a division of Alcatel), IBM, Microsoft, Raindance Communications, and WebEx;
- long distance services providers such as AT&T, MCI, Qwest and Sprint;

- large computer and software corporations such as IBM, HP, Intel and Microsoft;
- regional Bell operating companies, or RBOCs, cable television companies, IP Centrex service providers, and satellite and other wireless broadband service providers; and
- independent leasing companies that provide telecom equipment financing.

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

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

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

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

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

We currently obtain certain key components for our digital communication platforms, including certain microprocessors, integrated circuits, power supplies, voice processing interface cards and IP telephony cards, from a limited number of suppliers and manufacturers. Our reliance on these limited suppliers and contract manufacturers involves risks and uncertainties, including the possibility of a shortage or delivery delay for some key components. We currently manufacture our products through third-party subcontractors located in the United States, Mexico, the People's Republic of China and the United Kingdom. Varian, Inc. currently manufactures a significant portion of our products at Varian's Tempe, Arizona facility, including substantially all of the printed circuit boards used in the Axxess systems and Inter-Tel 5000 Network Communications Systems. 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. Our business may also be harmed if we are unable to develop alternative or additional supply sources as necessary. To date, we have been able to obtain supplies of components and products in a timely manner even though we do not have long-term supply contracts with any of our contract manufacturers. However, we cannot assure you we will be able to continue to obtain components or finished goods in sufficient quantities or quality or on favorable pricing or delivery terms in the future.

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

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

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

On January 5, 2005, the Company received court approval of a civil settlement agreement (the "Civil Settlement") and a criminal plea agreement (the "Plea Agreement") with the United States of America, each dated as of December 8, 2004 and disclosed on that same date. The court approval of the Civil Settlement and Plea Agreement resolves the investigation of the Department of Justice into the participation of Inter-Tel Technologies, Inc., the Company's wholly-owned subsidiary ("Technologies") in a federally administered "E-Rate program" to connect schools and libraries to the Internet. In connection with the Civil Settlement, Technologies agreed to pay a penalty of $6,740,450 and forego the collection of certain accounts receivable of $259,540 related to Technologies' participation in the E-Rate program. In connection with the Plea Agreement, Technologies entered guilty pleas to charges of mail fraud and an antitrust violation. Under the Plea Agreement, Technologies agreed to pay a fine of $1,721,000 and observe a three-year probationary period, which will, among other things, require Technologies to implement a comprehensive corporate compliance program. The resolution is currently expected to cost Inter-Tel approximately $9.5 million in total, including criminal fines, civil settlement and restitution, uncompensated E-Rate work, accounts receivable forgiveness, and related remaining attorneys' fees and other expenses. The payments constituting the primary components of the settlement are not tax deductible. The effect of the resolution on fourth quarter results of operations was a reduction to net income by approximately $9.0 million, after considering (1) accounts receivable reserves previously accrued and (2) an income tax benefit of approximately $0.3 million related to attorneys' fees and other expenses.

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

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

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

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

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

customers in a particular country, leading to a reduction in sales or profitability in that country. In addition, the costs associated with developing international sales or an international dealer network may not be offset by increased sales in the short term, or at all. Any of these risks could cause our products to become relatively more expensive to customers in a particular country, leading to reduced sales or profitability in that country.

During the past year, Inter-Tel has been in the process of establishing a new dealer relationship in South Africa and expects to start receiving revenues from these efforts in the first half of 2005. It is possible that this business many not materialize as soon as expected and may require additional expenses to complete the approval process and to launch the product in South Africa.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Our Chairman of the Board of Directors, CEO and President controls 19.8% of our Common Stock and is able to significantly influence matters requiring shareholder approval.

As of December 31, 2004, Steven G. Mihaylo, Inter-Tel's Chairman of the Board of Directors, Chief Executive Officer and President, beneficially owned approximately 19.8% 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 shareholder approval. In addition, the concentration of ownership could have the effect of delaying or preventing a change in control of Inter-Tel.

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

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

In December 2004, the FASB issued Statement No. 123 (revised 2004), Share-Based Payment ("SFAS 123R"), which replaces SFAS No. 123, Accounting for Stack-Based Compensation, (SFAS 123) and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees. SFAS 123R requires all share-based payments to employees, including grants of employee stock options and employee stock purchase plan shares, to be recognized in the financial statements based on their fair values beginning with the first interim or annual period after June 15, 2005. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. We are required to adopt SFAS 123R in the third quarter of fiscal 2005, beginning July 2, 2005.

Under SFAS 123R, we must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at date of adoption. The transition methods include prospective and retroactive adoption options. Under the retroactive option, prior periods may be restated either as of the beginning of the year of adoption or for all periods presented. The prospective method requires that compensation expense be recorded for all unvested stock options and restricted stock at the beginning of the first quarter of adoption of SFAS 123R, while the retroactive methods would record compensation expense for all unvested stock options and restricted stock beginning with the first period restated. We are evaluating the requirements of SFAS 123R and expect that the adoption of SFAS 123R will have a material impact on our consolidated results of operations and earnings per share.

We have not yet determined the method of adoption or the effect of adopting SFAS 123R, and we have not determined whether the adoption will result in amounts that are similar to the current pro forma disclosures under SFAS 123. In addition, this new statement could impact our ability to utilize broad-based employee stock plans to reward employees and could result in a competitive disadvantage to us in the employee marketplace.

Risks Related to Our Industry

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

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

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

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

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

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

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

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

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

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

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

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

We Are Exposed To Increased Costs And Risks Associated With Complying With Increasing And New Regulation Of Corporate Governance And Disclosure Standards.

We are spending an increased amount of management time and external resources to comply with changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new SEC regulations, PCAOB and Nasdaq Stock Market rules. 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 have completed our documentation and testing of our internal control systems and procedures for 2004. This process required us to hire additional personnel and use outside advisory services and resulted in additional accounting and legal expenses. The results of the documentation and testing for 2004 indicate that we currently have 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 or our stock.

ITEM 2. PROPERTIES

Our corporate headquarters in Tempe, Arizona is located in a 22,600 square foot building pursuant to a lease that expires in May 2008. Our 68,000 square foot operations and distribution center is also located in Tempe, Arizona pursuant to a lease that expires in March 2006. The principal product development and support operations remain in a 96,000 square foot building located in Chandler, Arizona pursuant to a lease that expires in May 2008. We also own a 74,000 square foot facility located in Reno, Nevada, which includes portions of our credit and lease finance facilities, executive and administrative functions, a business development center, a customer care center and a sales office. We also lease sales and support offices and warehouses in a total of 66 lease locations in the United States and two in the United Kingdom. The number of lease locations does not include office space in Milford, Connecticut that we leased in connection with the Executone acquisition, since the lease expired January 14, 2005 and we did not renew the lease. In February 2003, we consolidated three Phoenix, Arizona area offices with an aggregate of 31,300 square feet into a single Phoenix location of 35,000 square feet pursuant to a lease, which expires in July 2008. Our aggregate monthly payments under these leases were approximately $673,000 at December 31, 2004. We believe our facilities will be adequate to meet our current needs and that additional or alternative space will be available as necessary in the future on commercially reasonable terms.

ITEM 3. LEGAL PROCEEDINGS

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

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

None.

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON STOCK AND RELATED SHAREHOLDER MATTERS

Inter-Tel Common Stock is traded over-the-counter (Nasdaq symbol: INTL) and since February 1983 has been included in the Nasdaq National Market System. As of March 4, 2005 there were of record approximately 1,069 registered shareholders of our Common Stock. The following table sets forth high and low sales prices reported by Nasdaq for each quarter in the last two years.

2004	High	Low	2003	High	Low
First Quarter	$ 34.500	$ 24.400	First Quarter	$ 26.590	$ 14.255
Second Quarter	33.000	20.800	Second Quarter	22.240	12.850
Third Quarter	24.930	18.740	Third Quarter	28.350	20.790
Fourth Quarter	30.780	21.830	Fourth Quarter	29.560	21.950

Dividends. Since December 31, 1997, we have paid quarterly cash dividends (the "cash dividend") for every share of Common Stock to shareholders of record. Dividend payments commence on or about 15 days after the end of each fiscal quarter. Our Board of Directors has periodically increased the cash dividend and attached below is a summary of our dividends accrued and paid since December 31, 1997, the date we first declared cash dividends on our Common Stock. The Company currently anticipates paying cash dividends in the foreseeable future on its common stock.

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

Increase to Quarterly Dividend and One-Time Special Dividend. Inter-Tel's board of directors also made two dividend announcements in February 2005 affecting dividends:

- Increase of Inter-Tel's quarterly dividend by 14.3% from $0.07 per share per quarter (total of $0.28 per share per year) to $0.08 per share per quarter (total of $0.32 per share per year). The increase will be effective beginning the first dividend payment made in April 2005 for shareholders of record at March 31, 2005, and will continue in effect unless canceled or revised by the board of directors.
- One-time special dividend of $1.00 per share effective for shareholders of record at March 31, 2005 and paid on or about April 15, 2005.

No Sales of Unregistered Securities

We have not made any sales of unregistered securities during the past three years, except for sales of our common stock to employees exercising their stock options during the period prior to the effectiveness of a registration statement on Form S-8 relating to such sales.

Equity Compensation Plan Information

Information regarding Inter-Tel's equity compensation plans, including both shareholder approved plans and non-shareholder approved plan, is set forth in the section entitled "Equity Compensation Plan Information" in Inter-Tel's Notice of Annual Meeting of Shareholders and Proxy Statement, to be filed within 120 days after Registrant's fiscal year end of December 31, 2004. The table required by Item 201(d) of Regulation S-K referred to under Item 12 herein is incorporated by reference to the proxy statement.

ITEM 6. SELECTED FINANCIAL DATA
Financial Summary

The following selected consolidated financial data should be read in conjunction with Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" and Item 8, "Financial Statements and Supplementary Data." The table contains selected consolidated financial data for the years ended December 31, 2000, 2001, 2002, 2003 and 2004 derived from our audited consolidated financial statements.

(In thousands, except
per share amounts and ratios)

	For the years ended December 31,				
	2004	**2003**	**2002**	**2001**	**2000**
Net Sales	$ 416,893	$ 373,836	$ 381,456	$ 385,655	$ 402,723
Cost of sales	195,318	176,763	186,983	211,161	243,685 (4)
Research and development	28,815	21,978	19,340	17,556	19,489
Selling, general and administrative	139,917	128,964	128,284	128,604	124,664
Amortization of goodwill	--	--	--	1,876	2,228
Amortization of purchased intangible assets	1,867	1,803	1,122	677	576
In-process research and development	--	--	--	--	5,433 (4)
Other charges	9,261 (1)	--	--	5,357 (3)	45,245 (4)
Operating (loss) income	41,715	44,328	45,727	20,424 (3)	(38,597) (4)
Litigation settlement (net of costs except for taxes)	--	--	15,516 (2)	--	--
Write-down/recovery of investment in Inter-Tel.NET/Vianet	--	124	(1,200)	--	--
Equity share of Cirilium Corp.'s net losses	--	--	--	--	(5,938) (4)
Write-off of Cirilium Corp. investment	--	--	--	--	(2,045) (4)
Interest and other income	2,654	1,683	1,936	1,081	1,474
Foreign currency transaction gains (losses)	(399)	18	330	(337)	(421)
Interest expense	(118)	(155)	(156)	(468)	(213)
Income (loss) before income taxes (benefit)	43,852 (1)	45,998	62,153 (2)	20,700 (3)	(45,740) (4)
Income taxes (benefit)	16,798	17,480	23,516	7,659	(16,817)
Net income (loss)	$ 27,054 (1)	$ 28,518	$ 38,637 (2)	$ 13,041 (3)	$ (28,923) (4)
Net income (loss) per share					
Basic	$ 1.05 (1)	$ 1.14	$ 1.58 (2)	$ 0.53 (3)	$ (1.10) (4)
Diluted	$ 0.99 (1)	$ 1.08	$ 1.49 (2)	$ 0.52 (3)	$ (1.10) (4)
Weighted average basic common shares	25,767	25,078	24,444	24,488	26,273
Weighted average diluted common shares	27,266	26,473	25,864	25,240	26,273
BALANCE SHEET DATA					
Total assets	$ 406,966	$ 359,876	$ 282,062	$ 227,462	$ 243,126
Working capital	221,475	200,561	131,624	93,156	86,008
Shareholders' equity	239,431	207,305	173,903	126,837	136,436
OTHER INFORMATION					
Current ratio (current assets divided by current liabilities)	3.67	3.64	2.80	2.41	2.05
Dividends declared per share	$ 0.26	$ 0.18	$ 0.10	$ 0.05	$ 0.04
Net cash provided by operating activities	$ 54,550	$ 54,060	$ 77,151	$ 75,006	$ 17,339

Notes to Financial Summary:

The following notes to the above summary schedule include non-GAAP financial information. In each note the non-GAAP information is reconciled to the GAAP financial information above. The Company

uses such information in evaluating the core operating results of the Company and believes that such information may be useful to investors in evaluating our performance.

(1) 2004 operating income included a pre-tax charge of $9.3 million, which reduced net income by $9.0 million, or $0.33 per diluted share after tax. These pre-tax charges reflected the penalties, fines and legal costs associated with the E-Rate settlement announced in the fourth quarter. Without this charge, we would have reported net income of $36.0 million ($1.32 per diluted share) for the year ended December 31, 2004.

(2) 2002 income before taxes included $15.5 million of proceeds, net of related expenses from a binding arbitration settlement, which increased net income by $9.5 million, or $0.37 per share after tax. Without this settlement, we would have reported net income of $29.1 million ($1.13 per diluted share) for the year ended December 31, 2002.

(3) 2001 operating income included a pre-tax charge of $5.4 million, which reduced net income by $3.4 million, or $0.13 per share after tax. This pre-tax charge reflects the write-down of our investment in Inter-Tel.NET to net realizable value.

(4) 2000 operating income included pre-tax charges of $66.8 million, which reduced net income by $42.0 million, or $1.60 per share after tax. These pre-tax charges reflected the write-off of the Executone acquisition of $50.9 million ($7.6 million of which is included in cost of sales) in the second quarter, the write-off of IPRD in connection with the Executone purchase of $5.4 million during the first quarter, the write-down to net realizable value of Inter-Tel.NET assets of $2.0 million during the second quarter, the equity share of the losses from an investment in a joint venture of $5.9 million for the year, and the write-off of our investment in such joint venture of $2.6 million (including reserve adjustments) during the third quarter. Without these charges, we would have reported net income of $13.1 million ($0.50 per diluted share) for the year ended December 31, 2000.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This Management's Discussion and Analysis of Financial Condition and Results of Operations and other parts of this Annual Report on Form 10-K contain forward-looking statements that involve risks and uncertainties. The words "expects," "anticipates," "believes," "intends," "will" and similar expressions identify forward-looking statements, which are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including those set forth in "Factors That May Affect Future Operating Results" and elsewhere in this Form 10-K.

Overview

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

- *Axxess* by Inter-Tel and EncoreCX by Inter-Tel converged voice and data business communication systems,
- Inter-Tel 5000 Network Communications Solutions,
- integrated voice mail, voice processing and unified messaging systems,
- IP telephony voice and data routers, and e-commerce software,
- managed services, including voice and data network design and traffic provisioning, custom application development, and financial solutions packages (leasing),
- networking applications,
- local and long distance calling services and other communications services and peripheral products,
- call accounting software, computer-telephone integration (CTI) applications, and

- maintenance and support services for our products.

We have developed a distribution network of direct sales offices, dealers and value added resellers (VARs), which sell our products to organizations throughout the United States and internationally, primarily targeting small-to-medium enterprises, service organizations and governmental agencies. As of March 4, 2005, we had fifty-nine (59) direct sales offices in the United States and a network of hundreds of dealers and VARs primarily in the United States, that purchase directly from us. Included in our sales office in Phoenix is the primary location for our national and government accounts division, as well as our local, long distance and network services divisions. Our wholesale distribution center is located in Tempe, Arizona, which is the primary location from which we distribute products to our network of direct sales offices, dealers and VARs in North America. In addition, we maintain a wholesale distribution office in the United Kingdom that supplies Inter-Tel's dealers and distributors throughout the UK and other parts of Europe, and we have dealers in South Africa and Japan. We also maintain research and development and software sales offices in Tucson, Arizona and in the United Kingdom. In March 2005, as a result of the closing of the Lake acquisition identified below, we will also maintain a wholesale distribution office in Dublin, Ireland that supplies Inter-Tel's dealers and distributors in the UK, Ireland, other parts of Europe and Australia.

On October 14, 2004, Inter-Tel announced the purchase by an operating subsidiary of selected assets and assumption of certain liabilities of Converging Technologies, Inc. and Linktivity, Inc. The acquired assets primarily include Web-based conferencing solutions, notably Linktivity® software. These solutions provide real-time communications and remote control software to enable instantaneous, browser-to-browser Web conferencing and help desk support solutions. The acquisition of these selected assets enables Inter-Tel to continue to expand its Presence Management and Collaboration tools. Linktivity offers its products and services through its international distributors and certified North American resellers.

On October 14, 2004, Inter-Tel also announced the license of intellectual property from eDial, a division of Alcatel USA Marketing, Inc., and provider of Session Initiation Protocol (SIP) audio conferencing and collaboration solutions for enterprises and service providers. The eDial and Linktivity technologies were selected to complement Inter-Tel's Converged Business Communication systems and to allow Inter-Tel to further enhance its presence management, conferencing and collaboration products.

On February 28, 2005, Inter-Tel Lake Ltd, a wholly owned Irish subsidiary of Inter-Tel Incorporated ("Inter-Tel") executed an agreement for the purchase of 100% of the issued share capital of Lake Communications Limited and certain affiliated entities (collectively, "Lake") for $28.0 million, plus an earn-out of up to $17.6 million based upon certain targets relating to operating results for Lake through the first eighteen months following the closing date of the transaction. The transaction closed out of escrow on March 4, 2005 upon the release from escrow of closing documentation. Lake, based in Dublin, Ireland, is a provider of converged communications products in the under 40 user market, including EncoreCX® products currently being distributed by Inter-Tel in the United States. Lake designs and develops its products for sale through a distribution network of telecom operators and distributors, including Inter-Tel in the United States. Lake outsources its manufacturing to third-party suppliers. For more than a year, Lake has sold certain communications products to the Company in the ordinary course of its business.

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 government and national accounts division*. We recognize revenue from sales of systems and services to end-user customers upon installation of the systems and performance of the services, respectively, allowing for use by our customers of these systems. We defer pre-payments for communications services and recognize these pre-payments as revenue as the communications services are provided. For our sales-type lease accounting, we record the discounted present values of minimum rental payments under sales-type leases as sales, net of provisions for continuing administration and other expenses over the lease period. We record the lease sales at the time of system sale and installation as discussed above for sales to end user customers, and upon receipt of the executed lease documents. The net rental streams are sold to funding sources on a regular basis with the

income streams discounted by prevailing like-term rates at the time of sale. Gains or losses resulting from the sale of net rental payments from such leases are also recorded as net sales.

- *Dealer and VAR sales*. For shipments to dealers and other distributors, our revenue is recognized as products are shipped and services are rendered, because the sales process is complete. Title to these products passes when goods are shipped (free-on-board shipping point).
- *Resale of long distance*. We recognize revenue from long distance resale services as services are provided.
- *Software Sales*. We recognize revenues from sales of software, such as our new Linktivity products discussed above upon shipment to dealers or end-users.
- *Maintenance and software support*. Maintenance and software support revenue is recognized ratably over the term of the maintenance or support agreement.

Costs and gross margins. Our costs of products sold primarily consist of materials, labor and overhead. Our costs of services performed consist primarily of labor, parts and service overhead. Total costs of goods and services sold increased 10.5%, or $18.5 million, to $195.3 million for the year ended December 31, 2004, compared to $176.8 million for the same period in 2003. Our consolidated gross margin percentage increased to 53.1% in 2004 compared to 52.7% in 2003. This margin improvement was attributable to several factors, including a higher proportion of recurring revenues from existing customers in our direct sales offices and government and national accounts division, increased maintenance and services revenues as a percentage of total sales, higher software content in our products, cost containment efforts, product design improvements, and efficiencies achieved with our manufacturing vendors.

Sales of systems through our direct sales organization typically generate higher gross margins than sales through our dealers and VARs, primarily because we recognize both the wholesale and retail margins on these sales. Conversely, sales of systems through our dealers and VARs typically generate lower gross margins than sales through our direct sales organization, although direct sales typically require higher levels of selling, general and administrative expenses. In addition, our long distance services and Datanet products typically generate lower gross margins than sales of software and system products. For revenues recognized under sales-leases, we record the costs of systems installed as costs of sales. Our margins may vary from period to period depending upon distribution channel, product and software mix. 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.

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

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

In addition, we are subject to seasonal variations in our operating results, as net sales for the first and third quarters are frequently lower than those experienced during the fourth and second quarters, respectively. 2004 followed this historical pattern and we do not anticipate a significant change in this trend.

Cash Flows. At December 31, 2004, Inter-Tel's cash and short-term investments totaled $205.0 million. We also maintain a $10 million unsecured, revolving line of credit with BankOne, NA, which is available through June 1, 2006 and ordinarily used to support international letters of credit to suppliers, if necessary. Historically, our primary source of cash has come from net income plus non-cash charges for depreciation and amortization expenses. We have generated cash from continuing operations in every year since 1986. In 1993, 1995 and 1997, the Company received net proceeds from stock offerings, offset in part by cash expended to repurchase the Company's common stock. In addition, Inter-Tel historically has paid cash for capital expenditures of property and equipment or acquisitions. Inter-Tel has also received cash proceeds from the exercise of stock options and our Employee Stock Purchase Plan. We believe our working capital and credit facilities, together with cash generated from operations, will be sufficient to develop and expand our business operations, to finance acquisitions of additional resellers of telephony products and other strategic acquisitions or corporate alliances, to fund the special dividend of $1.00 per share to shareholders of record on March 31, 2005, to repurchase shares of the Company's common stock pursuant to a Board approved repurchase program of up to $75 million announced in February 2005, and to provide adequate working capital for the foreseeable future.

Our consolidated revenues from all sources had declined slightly from 2001 to 2003, but at a lower rate than the decline in revenues of some of our primary competitors in the business communications systems market. However, during 2004, net sales increased by $43.1 million, or 11.5% compared to 2003. Net sales for the years ended December 31, 2003 were $373.8 million. The 2.0% decline in net sales in 2003 resulted from the effect of general economic conditions and our customers appeared less willing to spend significantly on business communications systems. The increase in net sales in 2004 can be attributed in part to new sales offices acquired during the year, new product releases and improved sales in our long distance resale division. However, we can provide no assurance that net sales will continue to increase in the future, as we believe businesses may continue to be reluctant to significantly increase spending on enterprise communications systems in the near future.

We believe that enterprises 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.

The markets we serve have been characterized by rapid technological changes and increasing customer requirements. We have sought to address these requirements through the development of software enhancements and improvements to existing systems and the introduction of new systems, products, and applications. Research and development expenses increased 31.1% to $28.8 million, or 6.9% of net sales in 2004, compared to $22.0 million, or 5.9% of net sales in 2003. The increases in research and development expenses during 2004 were primarily attributable to the planned increases in engineering headcount and third-party outsourcing of selected development costs in connection with our efforts to accelerate development of new products and software. We expect that research and development expenses will increase in absolute dollars relative to the prior year as we continue to develop and enhance existing and new technologies and products; however, these expenses may vary as a percentage of net sales. Inter-Tel's research and development efforts over the last several years have been focused primarily on the development of, and enhancements to, our *Axxess* system, including adding new applications, enhancing and developing new IP convergence applications and new SIP and IP endpoint technology, developing Unified Communications applications, developing presence management applications, and developing speech-recognition and text-to-speech applications. More recently, Inter-Tel's research and development efforts have been focused on the development of the new Inter-Tel 5000 Network Communications family of products, next generation LAN-enabled telephony platforms, cost reductions of our multi-protocol IP endpoints, and the integration of the Linktivity web collaboration technology into many of our applications.

We offer our customers a package of lease financing and other services under the name Total Solution (formerly, Totalease). Total Solution provides our customers lease financing, maintenance and support services, fixed price upgrades and other benefits. We finance this program through the periodic resale of

lease rental streams to financial institutions. Refer to Note D of Notes to Consolidated Financial Statements for additional information regarding our program.

Results of Operations

The following table sets forth certain statement of income data expressed as a percentage of net sales for the periods indicated (amounts do not add due to rounding):

	Year Ended December 31		
	2004	2003	2002
NET SALES			
Telecommunications systems, software and related	88.3 %	89.8 %	92.1 %
Resale of local, long distance and network services	11.7	10.2	7.9
TOTAL NET SALES	100.0	100.0	100.0
COST OF SALES			
Telecommunications systems, software and related	39.7	40.2	43.2
Resale of local, long distance and network services	7.2	7.1	5.8
TOTAL COST OF SALES	46.9	47.3	49.0
GROSS PROFIT	53.1	52.7	51.0
Research and development	6.9	5.9	5.1
Selling, general and administrative	33.6	34.5	33.6
Amortization of intangibles	0.4	0.5	0.3
E-Rate Settlement	2.2	--	--
OPERATING INCOME	10.0	11.9	12.0
Litigation settlement and write-down/recovery of investment	--	0.0	3.8
Interest and other income	0.6	0.5	0.5
Foreign currency transaction gains (losses)	(0.1)	0.0	0.1
Interest expense	(0.0)	(0.0)	(0.0)
INCOME BEFORE INCOME TAXES	10.5	12.3	16.3
INCOME TAXES	(4.0)	(4.7)	(6.2)
NET INCOME	6.5 %	7.6 %	10.1 %

Year Ended December 31, 2004 Versus Year Ended December 31, 2003

Net Sales. Net sales increased 11.5% to $416.9 million in 2004 from $373.8 million in 2003, representing an increase of $43.1 million. The increase in net sales was primarily attributable to an increase in sales through our direct sales offices (including leasing revenues), dealer network, international, DataNet and local and long distance divisions, offset in part by a decrease in sales from our National and Government Accounts division. Sales from our direct sales offices (including leasing revenues) increased $25.5 million or 12.6% in 2004 compared to 2003. Sales to our dealer network increased by $7.6 million or 8.9% in 2004 compared to 2003. International revenues increased by $2.1 million or 19.0% in 2004 compared to 2003. Sales from our DataNet division, which sells networking products through our direct sales offices, government and national accounts division and dealer channel, increased $3.0 million, or 29.0% in 2004 compared to 2003. Sales from our government and national accounts division decreased slightly by 1.5% or $0.3 million, in 2004 compared to 2003.

Sales from our local and long distance resale and network services division, increased 11.6%, or $5.1 million in 2004 to $48.9 million compared to $43.8 million in 2003. Sales increased in our local, long distance resale and network services division despite downward price pressure and significant competition. Increased sales volume has allowed NetSolutions, our long distance reseller, to offer more competitive pricing, which improved sales to our existing customer base. Sales from Network Services Agency, a commission-based sales unit within the local, long distance resale and network services division acting as

an agent to sell services for selected RBOC's and CLEC's, decreased in 2004. Please refer to Note N of Notes to Consolidated Financial Statements for additional segment reporting information.

Gross Profit. Gross profit increased 12.4% to $221.6 million, or 53.1% of net sales in 2004, compared to $197.1 million, or 52.7% of net sales, in 2003. Gross profit and gross margin increased in 2004 compared to 2003 as a result of several factors, including higher software content in our products, cost containment efforts, product design improvements, and efficiencies achieved with our manufacturing vendors. In addition, during 2004, recurring revenues increased $9.7 million, or 8.8%, and our gross margins are generally higher with recurring revenues because we incur lower materials costs compared to new installations. Recurring revenues from existing customers include net sales from maintenance and other services, software additions and/or upgrades, support, training and hardware products such as video conferencing, headsets (wired and wireless), networking products and speakerphones. Our business communications platforms allow for system migration without the complete change-out of hardware, which enables us to offer enhancements and new solutions through software-only upgrades to our existing customers.

Sales from local and long distance and network services (NSG), which includes Inter-Tel NetSolutions (NetSolutions) and Network Services Agency (NSA), increased by 11.6%, or $5.1 million, in 2004 compared to 2003. Although gross margin is generally lower in our long distance division compared to our consolidated gross margin, our gross margin on commissions on network services through NSA generally exceed consolidated gross margin. The gross margins in NSG decreased to 37.8% in 2004 compared to 38.5% in 2003, primarily due to lower volume of higher margin NSA revenues, offset in part by improved gross margins in our long distance resale operations due to more favorable pricing with vendors on higher resale volumes. Sales from long distance and network services increased by 18.8%, or $7.2 million, in 2004 compared to 2003. However, sales from NSA decreased 37.7%, or $2.1 million, in 2004 compared to 2003, which partially offset our overall increase in consolidated gross margin. The decease in sales from NSA is largely due to changes in 2003 to our commission compensation structure from one of our RBOCs. This division generally receives commissions on network services we sell as an agent for RBOCs and these sales carry little to no equipment costs and generated margins of approximately 86.0% in 2004 compared to 89.3% in 2003. The decrease in sales from this division therefore partially offset our overall increase in consolidated gross profit and margins.

The overall increases in consolidated gross margin noted above were also offset in part by continued competitive pricing pressures in our direct sales offices, government and national accounts and dealer channels in 2004, including pricing discounts or special competitor promotions on telephone system and software sales and related equipment. Our margins may vary from period to period depending upon distribution channel, product and software mix. 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. Sales of scrap were not significant during the year ended December 31, 2004 and had no effect on gross margin.

Research and Development. Research and development expenses increased 31.1% to $28.8 million, or 6.9% of net sales in 2004, compared to $22.0 million, or 5.9% of net sales in 2003. Included in research and development expenses in 2004 and 2003 was amortization of patents totaling $222,000 in each period. The increases in research and development expenses during 2004 were primarily attributable to the increased engineering headcount and third-party outsourcing of selected development costs in connection with our efforts to accelerate development of new products and software. To a lesser extent, the increases were also attributable to increased research and development spending related to our development of convergence applications and new SIP and IP endpoint technology. In 2004, research and development expenses were directed principally toward the continued development of converged features on the Axxess system, development of the new Inter-Tel 5000 converged systems and software, unified messaging and voice processing software, speech recognition and text-to-speech applications, call center applications, unified communications applications, IP endpoint development, and certain CTI and IVR applications and SIP applications. We expect that research and development expenses will increase in absolute dollars relative to the prior year as we continue to develop and enhance existing and new technologies and products. These expenses may vary, however, as a percentage of net sales.

Selling, General and Administrative. Selling, general and administrative expenses increased in absolute dollars to $139.9 million in 2004, an increase of 8.5% compared to $129.0 million in 2003. However, these expenses decreased as a percentage of net sales to 33.6% in 2004 compared to 34.5% in 2003.

The increases in absolute dollars were primarily due to increased expenses associated with the increases in consolidated net sales in 2004 compared to 2003, compensation and benefits cost increases of $7.3 million due to increased headcount and higher costs of health benefits, and additional costs related to the opening and operation of new sales offices in Philadelphia, Tennessee, South Carolina, Pittsburgh and Las Vegas totaling $3.0 million. Higher net sales in our direct sales offices (including acquisitions) and long distance resale division led to increased selling expenses and commission costs in 2004 relative to such costs in 2003. In 2004, selling, general and administrative expenses decreased as a percentage of net sales, primarily due to the greater leverage of fixed expenses on the higher volume of sales, relative to 2003. Our consolidated bad debt costs decreased in 2004 compared to 2003 and also decreased as a percentage of total net sales, based on improved credit and collections on existing accounts receivable. We expect for the foreseeable future selling, general and administrative expenses will increase sequentially in absolute dollars assuming we increase sales and continue to enhance existing and develop new technologies and products. These expenses may vary, however, as a percentage of net sales.

Amortization of Purchased Intangible Assets. We adopted Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" ("SFAS 142") effective in the beginning of fiscal 2002. In accordance with SFAS 142, we ceased amortizing goodwill. We are required to perform goodwill impairment tests on an annual basis and between annual tests in certain circumstances. As of December 31, 2004, no impairment of goodwill has been recognized. We face the risk that future goodwill impairment tests may result in charges to earnings. For additional information regarding SFAS 142, see "Goodwill and Other Intangible Assets" in Note A and Note F of Notes to Consolidated Financial Statements.

Amortization of purchased intangible assets included in operating expenses was $1.9 million in 2004, compared to $1.8 million in 2003. In addition, $222,000 of amortization was included in research and development expenses for 2004 and 2003. The increase in the amortization of purchased intangible assets for 2004 compared to 2003 was primarily related to additional amortization from recent acquisitions, offset in part by full amortization of certain previously purchased intangibles. For additional information regarding purchased intangible assets, see Note A—Significant Accounting Policies “Goodwill and Other Intangible Assets” and Note B “Acquisitions, Dispositions and Restructuring Charges " to Consolidated Financial Statements.

Other Charge -- E-Rate Settlement. 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 in a federally administered “e-Rate program” to connect schools and libraries to the Internet. In connection with the Civil Settlement, Inter-Tel agreed to pay a penalty of approximately $6,740,450 and forego the collection of certain accounts receivable of approximately $259,540 related to Inter-Tel Technologies’ participation in the e-Rate program. In connection with the Plea Agreement, Inter-Tel Technologies entered guilty pleas to charges of mail fraud and an antitrust violation. Under the Plea Agreement, Inter-Tel agreed to pay a fine of $1,721,000 and observe a three-year probationary period, which will, among other things, require Inter-Tel to implement a comprehensive corporate compliance program.

The resolution is expected to cost Inter-Tel approximately $9.5 million in total, including criminal fines, civil settlement and restitution, uncompensated e-rate work, accounts receivable forgiveness, and related remaining attorneys’ fees and other expenses. The payments constituting the primary components of the settlement are not tax deductible. The Company recorded a charge of $9.3 million in the fourth quarter of 2004 in connection with the settlement, which reduced net income by approximately $9.0 million, or $0.33 per diluted share, after considering (1) accounts receivable reserves previously accrued and (2) an income tax benefit of approximately $0.3 million related to attorneys’ fees and other expenses.

Interest and Other Income. In 2004, interest and other income totaling $2.3 million consisted primarily of interest income, offset by foreign currency transaction losses. Interest and other income in 2003 totaling

$1.8 million consisted primarily of interest income and foreign currency transaction gains. Interest and other income (including the recovery of the investment in Inter-Tel.NET/Vianet of $124,000 in 2003) increased approximately $847,000 to $2.7 million in 2004 compared to $1.8 million 2003 based on higher interest rates and a higher level of invested funds. During 2004, we recognized foreign currency transaction losses of $399,000, compared to gains of $18,000 in 2003, representing a difference of $417,000.

Interest expense. Interest expense decreased $37,000 to $118,000 in 2004 compared to $155,000 in 2003.

Income taxes. The Company's effective tax rate increased slightly to 38.3% in 2004 compared to 38.0% in 2003. The effective tax rate was adversely impacted by the nondeductibility of the E-Rate settlement and favorably impacted by tax benefits relating to the write off of Japanese operations.

The E-Rate settlement totaling $9.5 million included $8.5 million of penalties and fines, which are not deductible for tax purposes. This effectively increased income tax expense by approximately $3 million and the effective tax rate by 6.8%. In the fourth quarter of 2004, the Company's management decided to shut down the operations in Japan. The write off of Japan consisted of the recognition of the valuation allowance and 2004 Japanese loss, as well as a tax benefit for the write off of the investment. The company will write off an estimated $2.8 million of intercompany receivables for which the Japanese subsidiary will have corresponding income for the forgiveness of debt. This income will be offset by net operating loss carryforwards. The tax benefit is 3.4% or approximately $1.5 million. In prior years the tax benefit of the Japanese operations were offset by a valuation allowance due to historical losses and an inability to project future income by management.

Net deferred tax liabilities increased in 2004 primarily due to accelerated depreciation of fixed assets, temporary differences relating to leases in our Total Solution program and utilization of taxable losses which decreased the net operating loss carryforward deferred asset. The accelerated depreciation of fixed assets is due to the bonus depreciation of 50% enacted in the 2003 Jobs Creation Act. This acceleration of depreciation expenses ceases for new purchases after December 31, 2004.

The combination of accelerated depreciation and leasing transactions gave rise to a net operating loss in 2002. These losses were carried back to 2001 and carried forward to 2003 and 2004. The remaining $2.9 million of deferred tax asset is expected to be fully utilized in 2005.

The 2005 effective tax rate is estimated to be approximately 36%, without taking into consideration the effect of the 2005 Lake acquisition. The 2005 rate is expected to be lower than the 2004 effective tax rate primarily due to the removal of the 2004 effect on taxes of the E-Rate settlement and write off of Japan operations.

Net Income. Net income for 2004 decreased to $27.1 million, or $0.99 per diluted share including the E-Rate settlement in 2004, compared to net income of $28.5 million, or $1.08 per diluted share, in 2003. The decrease was primarily attributable to the E-Rate settlement in 2004. The reduction to net income from this E-Rate settlement was approximately $9.0 million after taxes, or $0.33 per diluted share, for the year ended December 31, 2004.

Excluding the 2004 E-Rate settlement, we would have reported net income of $36.0 million, or $1.32 per diluted share, in 2004. The increase in net income of 26.3% in 2004, excluding the settlement, was primarily the result of higher operating profits on a higher volume of sales, offset in part by higher research and development expenses.

Year Ended December 31, 2003 Versus Year Ended December 31, 2002

Net Sales. Net sales decreased 2.0% to $373.8 million in 2003 from $381.5 million in 2002, representing a decrease of $7.6 million. The decrease in net sales was primarily attributable to a reduction in sales through our direct sales offices and DataNet division, offset in part by sales increases from Inter-Tel NetSolutions, dealer and international sales. Sales from our direct sales offices decreased 6.9% in 2003 compared to 2002, due primarily to a revenue shortfall in the first quarter of 2003 relative to the comparable period in 2002. The first quarter of 2003 represented our worst quarter of the year, due primarily to relatively weak economic conditions, uncertainties associated with the war in Iraq and threatened terrorist attacks, and

the impact of adverse weather conditions in the eastern United States and Colorado. Sales from our government and national accounts division decreased slightly by 2.0%, in 2003 compared to 2002. Sales from our DataNet division, which sells networking products through our direct sales offices, government and national accounts division and dealer channel, decreased $3.0 million, or 22.2% in 2003 compared to 2002 as a result of selling less third-party lower margin products. Sales to our dealer network increased 1.2% in 2003.

The 2003 decrease in net sales from our direct sales offices, government and national accounts division and DataNet division was also attributable to delayed customer buying decisions related to a continued deterioration in industry and macroeconomic conditions, as well as increased competitive pressures, among other factors identified above and further noted above. Inter-Tel recognized lower revenues due to lower sales volumes of new system installations collectively through the direct sales offices and government and national accounts group, offset in part by sales increases in our NetSolutions division, and to a lesser extent, dealer sales and international operations. In some instances, prices of various telecommunications systems decreased, and discounts or other highly competitive promotions that were offered to customers to generate sales resulted in lower revenue through both our direct and indirect channels. Although sales to new customers declined during 2003, recurring revenues to existing customers increased in total dollars and as a percentage of total sales.

Sales from NetSolutions, our long distance resale division, increased 27.4%, or $8.2 million in 2003 to $38.3 million compared to $30.0 million in 2002 and represented the division with our largest percentage sales increase. Sales increased in our long distance division despite downward price pressure and significant competition. Increased sales volume has allowed NetSolutions, our long distance resale division, to offer more competitive pricing, which improved sales to our existing customer base. Sales from Network Services Agency, a commission-based sales division acting as an agent to sell services for selected RBOC's and CLEC's, decreased 15.0% to $5.6 million, largely due to changes in our commission compensation structure from one of the RBOC's. The change in the RBOC's pricing structure resulted in a more deferred sales commission structure on local and network services such as T-1 access, frame relay and other voice and data circuit services. Net sales from lease financing were flat in 2003 compared to 2002, an increase of 0.2%, and international revenues increased $0.9 million, or 9.1% in 2003 compared to 2002, primarily as a result of a full year of revenues from Swan, which was acquired in December 2002 and represented $0.6 million of the increase.

Please refer to Note N of Notes to Consolidated Financial Statements for additional segment reporting information.

Gross Profit. Gross profit increased 1.3% to $197.1 million, or 52.7% of net sales in 2003, from $194.5 million, or 51.0% of net sales, in 2002. Gross profit and gross margin increased in 2003 compared to 2002 as a result of several factors, including a higher proportion of recurring revenues from existing customers in our direct sales offices and government and national accounts division, increased maintenance and services revenues as a percentage of total sales, higher software content in our products, cost containment efforts, product design improvements, and efficiencies achieved with our manufacturing vendors.

During 2003, recurring revenues from existing customers in our direct sales and national and government accounts channels increased as a percentage of total sales from these same channels from approximately 46% in 2002 to approximately 51% in 2003. Existing customers accounted for a significant portion of our 2003 net sales from maintenance and other services, software additions and/or upgrades, support, training and hardware products such as video conferencing, headsets (wired and wireless), networking products and speakerphones. Our business communications platforms allow for system migration without the complete change-out of hardware, which enables us to offer enhancements and new solutions through software-only upgrades to our existing customers. Our gross margin is generally higher with recurring revenues because we incur less materials costs compared to new installations. Accordingly, our gross profit and gross margins improved in 2003 as a result of this recurring revenue percentage increase.

Sales from NetSolutions increased by 27.4%, or $8.2 million, in 2003 compared to 2002. Although gross margin is generally lower in this division than our consolidated gross margin, the gross margin improved to 32.2% in 2003 compared to 28.7% in 2002, based in part on our ability to negotiate more favorable pricing with vendors on higher resale volumes. In addition, sales from our Network Services

Agency decreased 15.0%, or $1.0 million, in 2003 compared to 2002, which partially offset our overall increase in gross margin. This division generally receives commissions on network services we sell as an agent for RBOCs. These sales carry little to no equipment costs and generated margins of approximately 89% in 2003 compared to 91% in 2002. The decrease in sales from this division therefore partially offset our overall increase in consolidated gross profit and margins.

The overall increases in gross margin noted above were also offset in part by continued competitive pricing pressures in our direct sales offices, government and national accounts and dealer channels in 2003, including pricing discounts or special competitor promotions on telephone system and software sales and related equipment.

Research and Development. Research and development expenses increased 13.6% to $22.0 million, or 5.9% of net sales in 2003, compared to $19.3 million, or 5.1% of net sales in 2002. The increase is attributable in large part to the acquisition of Swan Solutions Limited (Swan) in December 2002. The increase is also attributable, to a lesser extent, to increased research and development spending related to convergence applications and new IP endpoint development. In 2003, research and development expenses were directed principally toward the continued development of the *AXXESS* software and systems, SIP applications, presence management applications, unified messaging and voice processing software, speech recognition and text-to-speech applications, call center applications, unified communications applications, IP endpoint development, and certain CTI and IVR applications.

Selling, General and Administrative. Selling, general and administrative expenses increased slightly in absolute dollars to $129.0 million in 2003, compared to $128.3 million in 2002. These expenses also increased as a percentage of net sales to 34.5% in 2003 compared to 33.6% in 2002. These increases in absolute dollars and as a percentage of net sales were primarily due to higher selling expenses relative to total sales.

Selling, general and administrative expenses increased as a percentage of net sales in part due to the decrease in consolidated net sales by $7.6 million in 2003 compared to 2002. We incurred higher relative selling expenses through our combined direct sales offices and government and national accounts divisions, as we had increased sales personnel and sales training and support in anticipation of higher sales volumes and activity than actually materialized, particularly in the early part of 2003. We also incurred higher relative sales expenses in our long distance calling services division in 2003 relative to 2002 as a result of an increased number of sales personnel working directly for this division. Selling, general and administrative expenses also increased as a percentage of net sales due to higher costs of benefits, including higher health insurance for our associates. Our consolidated bad debt costs decreased in 2003 compared to 2002 and also decreased as a percentage of total net sales, based on improved credit and collections on existing accounts receivable. Depreciation expense was relatively flat in 2003 compared to 2002.

Amortization of Goodwill and Purchased Intangible Assets. We adopted SFAS No. 142 effective the beginning of fiscal 2002. In accordance with SFAS 142, we ceased amortizing goodwill. We are required to perform goodwill impairment tests on an annual basis and between annual tests in certain circumstances. As of December 31, 2003, no impairment of goodwill has been recognized. There can be no assurance that future goodwill impairment tests will not result in a charge to earnings. For additional information regarding SFAS 142, see "Goodwill and Other Intangible Assets" in Note A and Note F of Notes to Consolidated Financial Statements.

Amortization of purchased intangible assets included in operating expenses was $1.8 million in 2003 compared to $1.1 million in 2002. The increases in the amortization of purchased intangible assets for 2003 compared to 2002 was primarily related to the additional amortization from recent acquisitions. For additional information regarding purchased intangible assets, see Note A—Significant Accounting Policies “Goodwill and Other Intangible Assets” and Note B “Acquisitions, Dispositions and Restructuring Charges " to Consolidated Financial Statements.

Litigation Settlement, Net of Costs Except for Taxes. In May 2001, Inter-Tel entered into an agreement to submit to binding arbitration a lawsuit we filed in 1996. The arbitration was completed in January 2002 and, as a result of the arbitration, Inter-Tel received a one-time gross cash award of $20 million in February 2002. Direct costs for attorney’s fees, expert witness costs, arbitration costs and additional payments and expenses, totaled approximately $4.5 million in 2002, excluding income taxes, for a

net award of approximately $15.5 million. The net proceeds from this arbitration settlement were approximately $9.5 million after taxes, or $0.37 per diluted share for the year ended December 31, 2002.

Interest and Other Income. In 2003, interest and other income totaling $1.7 million consisted primarily of interest income and foreign currency transaction gains. Other income in 2002 totaling $1.9 million also consisted primarily of interest income and foreign currency transaction gains. Interest and other income decreased approximately $253,000 in 2003 compared to 2002 based on lower interest rates, despite a higher level of invested funds in part due to cash received from the litigation settlement noted above. During 2003, we recognized foreign currency transaction gains of $18,000, a decrease of $312,000 compared to gains of $330,000 in 2002.

Interest expense. Interest expense was flat at $155,000 in 2003 compared to $156,000 in 2002.

Other. Since July 24, 2001, the date of the sale of 83% of Inter-Tel.NET to Comm-Services/Vianet, we have used the cost method of accounting for our remaining investment in Inter-Tel.NET/Vianet. Accordingly, we have not recorded revenues or operating expenses of that entity since the date of sale. In 2002, the other component of this caption included an expense of approximately $1.2 million related to the write-down of Inter-Tel's investment in Inter-Tel.NET/Vianet. In 2003, other income included $124,000 related to a recovery of our investment and adjustment of projected costs to actual costs associated with the 2002 write-down in the Vianet investment. At December 31, 2003, our net investment in Vianet was recorded at no value.

Income Taxes. Our effective income tax rate for 2003 was relatively flat at 38.0% compared to 37.8% for 2002. The net deferred tax liabilities increased significantly in 2003 due primarily to accelerated depreciation of fixed assets, and temporary differences relating to leases in our Total Solution program. Most of the increase arose from deductions taken in the company's 2002 federal income tax return wherein the company decided in 2003 to elect to take bonus depreciation and accelerated depreciation of fixed assets and certain leased equipment when filing its 2002 return in 2003. The company filed a change in accounting method with the Internal Revenue Service to utilize accelerated depreciation for the 2002 tax year. Effective May 6, 2003, the bonus depreciation increased from a 30% to a 50% depreciation deduction, which favorably impacted the 2003 tax deduction and increased the deferred liabilities for 2003.

The depreciation deductions identified above generated a net operating loss that was not fully utilized in a carryback claim to 2001; accordingly, the loss was carried forward. This net operating loss created deferred assets for net operating loss carryforwards and certain tax credit carryforwards, each of which is separately identified in the components of deferred tax assets and liabilities schedule included in Note J to the Consolidated Financial Statements. We expect these carryforwards to be fully utilized by 2004. Our effective income tax rate for 2003 was not significantly impacted by these carryforwards.

Net Income. Net income for 2003 decreased to $28.5 million, or $1.08 per diluted share, compared to net income of $38.6 million, or $1.49 per diluted share, including the litigation settlement in 2002. The decrease was primarily attributable to income from net proceeds of an arbitration settlement in 2002. The net proceeds from this arbitration settlement were approximately $9.5 million after taxes, or $0.37 per diluted share for the year ended December 31, 2002.

Excluding the 2002 litigation settlement, we would have reported net income of $29.1 million, or $1.13 per diluted share in 2002. The decrease in net income of 2.2% in 2003, excluding the settlement, was primarily the result of lower profits on a lower volume of sales, higher research and development expenses and higher amortization costs, offset by higher gross profit margins described in further detail above.

Other Charges.

Set forth herein is a further description of the items reflected in other charges during the years ended December 31, 2001 and 2000, as well as subsequent events and activity occurring through 2004.

Inter-Tel.NET/Comm-Services/Vianet. During the second quarter of 2000, Inter-Tel recorded a pre-tax charge associated with Inter-Tel.NET operations of $2.0 million ($1.2 million after-tax), related to the write-down to net realizable value of network equipment and lease termination costs of certain redundant

facilities. The reserves established at the time of the write-down have been fully utilized as of December 31, 2001.

On July 24, 2001, Inter-Tel sold 83% of the stock of Inter-Tel.NET, Inc. to Comm-Services Corporation for a note of $4.95 million, collateralized by Comm-Services stock, other marketable securities of the shareholders of Comm-Services and 100% of the net assets of Inter-Tel.NET. In connection with the sale of 83% of Inter-Tel.NET, we assessed the fair value of the remaining 17% investment in Inter-Tel.NET. Pursuant to SFAS 121, we recorded a charge as of the close of the second quarter of 2001 of $5.4 million ($3.4 million after tax) associated with the impairment of our investment in Inter-Tel.NET. After the impairment charge, the carrying value of our investment (the note receivable from Comm-Services plus the 17% ownership interest in Comm-Services) totaled $3.7 million as of December 31, 2001. The charge was primarily non-cash.

Inter-Tel's management has not participated in the management of Inter-Tel.NET since its partial sale in July 2001. As a result, since July 24, 2001, we have accounted for the remaining Inter-Tel.NET/Comm-Services investment using the cost method of accounting. On December 30, 2001, Comm-Services entered into a merger agreement with Vianet. Inter-Tel's 17% investment in Comm-Services was converted to approximately 10% of Vianet stock and as a result, Vianet assumed the loan for the purchase and Inter-Tel continued to hold collateral from the former shareholders of Comm-Services until March 2003. During 2002, the net investment in the notes receivable and 10% interest in Vianet (formerly Comm-Services) was written down by $1.2 million and was recorded in other assets at a carrying value of approximately $2.5 million as of December 31, 2002, which approximated management's estimate of the related collateral value at that time.

During 1999, 2000 and 2001, Inter-Tel.NET entered into operating lease agreements totaling approximately $6.5 million from an equipment vendor for network equipment and software. The lease agreements required Inter-Tel.NET to purchase vendor maintenance on their products. Inter-Tel originally guaranteed the indebtedness. In February 2003, we executed an agreement with Vianet and this vendor releasing Inter-Tel from its guarantee of any and all of these obligations, and Inter-Tel and Vianet released the vendor from claims arising from the failure of the network equipment and software previously leased. As part of this agreement, Inter-Tel also received payment from the Vianet shareholders of $1.45 million, in exchange for the release of the remaining collateral and as payment of the loan. Inter-Tel had also retained a collateral interest in a Vianet shareholder's variable forward option contract that matured in April and May of 2003, and for which we received no value for the collateral interest. After an adjustment of $124,000 in 2003 related to a recovery of our investment and adjustment of projected costs to actual costs associated with the 2002 write-down in the Vianet investment, the estimated value received in this transaction was equivalent to our remaining investment value, less accruals for potential obligations to the vendor discussed above.

Inter-Tel retains its ownership interest in Vianet and will account for the remaining investment interest of approximately 10% in Vianet using the cost method of accounting. At December 31, 2004 and 2003, our net investment in Vianet was recorded at no value.

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

During the second quarter of 2000, we decided to close the primary Executone facility in Milford, Connecticut and to recognize a restructuring charge related to our exit plan and closure of the Executone operations. We have accounted for the restructuring of the Executone operations, including severance and related costs, the shut down and consolidation of the Milford facility and the impairment of assets associated with the restructuring. We finalized our plan for the exiting of activities and the involuntary termination or relocation of the employees. Accrued costs associated with this plan were estimates, although the original estimates made for the second quarter of 2000 for reserve balances have not changed significantly as of December 31, 2004.

Exit costs associated with the closure of the Milford facility also included liabilities for building, furniture and equipment lease, and other contractual obligations. We are liable for the lease on the Milford buildings through January 14, 2005. Various other furniture, computer and equipment leases terminated on varying dates through September 2002. To date, we have entered into sublease agreements with third parties to sublease portions of the facility. The reserve for lease and other contractual obligations is identified in the table below.

The total restructuring charge from this event totaled $50.9 million. The following table summarizes details of the restructuring charge in connection with the Executone acquisition, including the description of the type and amount of liabilities assumed, and activity in the reserve balances from the date of the charge through December 31, 2004. Activity represents payments made or amounts written off.

(In thousands)

Description	Cash/ Non-Cash	Restructuring Charge	2000 and 2001 Activity	2002 Activity	2003 Activity	2004 Activity	Reserve Balance At 12/31/04
Personnel Costs:							
Severance and termination costs	Cash	$ (1,583)	$ 1,560	$ 20	$ 3	$ --	$ --
Other Plant closure costs	Cash	(230)	230	--	--	--	--
Lease termination and other contractu obligations (net of anticipated recovery):							
Building and equipment leases	Cash	(7,444)	2,837	2,594	767	1,238	(8)
Other contractual obligations	Cash	(1,700)	1,700	--	--	--	--
Impairment of Assets:							
Inventories	Non-Cash	(3,454)	1,585	1,869	--	--	--
Prepaid inventory and other expenses	Non-Cash	(2,485)	2,485	--	--	--	--
Accounts receivable	Non-Cash	(1,685)	766	88	831	--	--
Fixed assets	Non-Cash	(3,151)	2,942	53	14	26	(116)
Net intangible assets	Non-Cash	(29,184)	29,184	--	--	--	--
Total		**$ (50,916)**	**$ 43,289**	**$ 4,624**	**$ 1,615**	**$ 1,264**	**$ (124)**

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

Inflation/Currency Fluctuation

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

Liquidity and Capital Resources

(In thousands)	2004	2003	2002
Net cash provided by operating activities	$ 54,550	$ 54,060	$ 77,151
Net cash used in investing activities	(20,096)	(27,040)	(56,565)
Net cash provided by financing activities	2,780	2,424	5,498
Effect of exchange rate changes	(101)	830	44
Increase in cash and equivalents	37,133	30,274	26,128

Cash and equivalents at beginning of year	115,197	84,923	58,795
Cash and equivalents at end of year	$ 152,330	$ 115,197	$ 84,923

At December 31, 2004, cash and equivalents and short-term investments totaled $205.0 million, which represented an increase of approximately $30.5 million from the $174.5 million total at December 31, 2003. In addition, long-term investments in marketable debt securities totaled $9.9 million at December 31, 2004, compared to no long-term investments in marketable debt securities at December 31, 2003 or in prior years. We maintain a $10 million unsecured, revolving line of credit with BankOne, NA, which is available through June 1, 2006. Under the credit facility, we have the option to borrow at a prime rate or adjusted LIBOR interest rate. Historically, we have used the credit facility primarily to support international letters of credit to suppliers. A portion of our cash balances may be used for, among other things, acquisitions, strategic alliances, working capital and general corporate purposes.

Net cash provided by operating activities totaled $54.6 million for the year ended December 31, 2004, compared to $54.1 million for the same period in 2003. Cash provided by operating activities in 2004 primarily resulted from net income plus non-cash charges for depreciation and amortization expenses, provision for losses on receivables and leases, increased deferred income taxes and the change in operating assets and liabilities. Cash generated by the increase in deferred income taxes in 2004 totaled $11.1 million compared to $30.3 million in 2003. Cash provided by the change in operating assets and liabilities was $2.0 million in 2004, compared to $19.0 million used in operating assets and liabilities in 2003. The primary factors for cash provided by operating accounts in 2004 was a decrease in the income tax receivable, an increase in accounts payable and other accrued liabilities, offset in part by an increase in inventories, increased accounts receivable and increased net investment in sales-leases. We expect to expand sales through our direct sales office and dealer networks, which is expected to require the expenditure of working capital for increased accounts receivable, inventories and net investment in sales-leases.

Net cash used in investing activities totaled $20.1 million for the year ended December 31, 2004, primarily in the form of $11.9 million used to purchase held-to-maturity investments, $10.7 million used in capital expenditures and $6.2 million used in acquisitions and other investments, which was partially offset by the net reduction in short-term investments of $8.7 million. Cash used in capital expenditures and in acquisitions and other investments totaled $7.0 million and $3.1 million, respectively in 2003. Cash was provided by sales of short-term investments net of purchases of $8.7 million in 2004 as compared to $18.4 million used in purchasing short-term investments net of sales and maturities in 2003. We anticipate continued capital expenditures during 2005, principally relating to expenditures for equipment, personal computers and management information systems used in operations, facilities expansion and acquisition activities.

Net cash provided by financing activities totaled $2.8 million during 2004 compared to $2.4 million in 2003. Net cash used for cash dividends totaled $6.4 million in 2004 and $3.8 million during 2003. Cash provided by the exercise of stock options and stock issuances pursuant to our Employee Stock Purchase Plan totaled $9.3 million in 2004 and $6.5 million in 2003. Although we did not expend cash for stock repurchases in 2004, we expended approximately $207,000 for stock repurchases during 2003 funded by existing cash balances. Repayment of our long-term debt for the year 2004 was $59,000 compared to $102,000 in 2003. During 2004, we reissued treasury shares through stock option exercises and issuances, with the proceeds received totaling more than the cost basis of the treasury stock reissued. Accordingly, the difference was recorded as an increase to retained earnings. During 2003, we reissued treasury shares through stock option exercises and issuances, with the proceeds received totaling less than the cost basis of the treasury stock reissued. Accordingly, the difference was recorded as a reduction to retained earnings.

We offer to our customers lease financing and other services, including our TotalSolution (formerly Totalease) program, through our Inter-Tel Leasing, Inc. subsidiary. We fund our Total Solution program in part through the sale to financial institutions of rental payment streams under the leases. Sold lease rentals totaling $241.4 and $210.1 million remained unbilled at December 31, 2004 and December 31, 2003, respectively. 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. Although we to date 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.

On January 5, 2005, the Company received court approval of a civil settlement agreement (the "Civil Settlement") and a criminal plea agreement (the "Plea Agreement") with the United States of America, each dated as of December 8, 2004 and disclosed on that same date. The court approval of the Civil Settlement and Plea Agreement resolves the investigation of the Department of Justice into the participation of Inter-Tel Technologies, Inc., the Company's wholly-owned subsidiary ("Technologies") in a federally administered "E-Rate program" to connect schools and libraries to the Internet. In connection with the Civil Settlement, Technologies agreed to pay a penalty of $6,740,450 and forego the collection of certain accounts receivable of $259,540 related to Technologies' participation in the E-Rate program. In connection with the Plea Agreement, Technologies entered guilty pleas to charges of mail fraud and an antitrust violation. Under the Plea Agreement, Technologies agreed to pay a fine of $1,721,000 and observe a three-year probationary period, which will, among other things, require Technologies to implement a comprehensive corporate compliance program. The resolution is currently expected to cost Inter-Tel approximately $9.5 million in total, including criminal fines, civil settlement and restitution, uncompensated E-Rate work, accounts receivable forgiveness, and related remaining attorneys' fees and other expenses. The payments constituting the primary components of the settlement are not tax deductible. The effect of the resolution on fourth quarter results of operations was a reduction to net income by approximately $9.0 million, after considering (1) accounts receivable reserves previously accrued and (2) an income tax benefit of approximately $0.3 million related to attorneys' fees and other expenses.

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

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

We believe our working capital and credit facilities, together with cash generated from operations, will be sufficient to develop and expand our business operations, to finance acquisitions of additional resellers of telephony products and other strategic acquisitions or corporate alliances, to fund the special dividend of $1.00 per share to shareholders of record on March 31, 2005, to repurchase shares of the Company's common stock pursuant to a Board approved repurchase program, and to provide adequate working capital for the foreseeable future. However, to the extent additional funds are required in the future to address working capital needs and to provide funding for capital expenditures, expansion of the business or additional acquisitions, we will seek additional financing. There can be no assurance additional financing will be available when required or on acceptable terms.

Contractual Obligations

We had the following contractual obligations outstanding:

	Amount of Commitment Expiration Per Period (in thousands)				
	Total	Less Than 1 Year	1-3 Years	4-5 Years	After 5 Years
December 31, 2004					
Operating lease obligations, primarily for building and equipment leases	$20,178	$7,584	$9,881	$2,447	$266
Totals at December 31, 2004 (1)	$20,178	$7,584	$9,881	$2,447	$266

(1) Total contractual obligations do not include contractual obligations recorded on the balance sheet as current liabilities, or certain purchase obligations as discussed below.

Noncancellable operating leases are primarily for buildings. Certain of the operating leases contain provisions for renewal options and scheduled rent increases. At December 31, 2004, future minimum commitments under noncancellable leases, including our headquarters facility and a 15 year lease for our research and development facility and 63 month lease for our distribution and support facility, are as follows: 2005 -- $7,584,000; 2006 -- $5,811,000; 2007 – $4,070,000; 2008 -- $1,782,000; 2009 -- $665,000; thereafter -- 266,000.

Beginning in 2000, we leased a Milford, Connecticut building in connection with the Executone acquisition. The lease expired on January 14, 2005, and we did not renew that lease. The costs included in the Milford operating lease are $121,000 in 2005 and are reflected in the operating lease obligation totals noted above. In connection with the Executone charge taken in 2000, we included in the charge the anticipated lease costs through the lease termination date, offset by expected sublease receipts. The total costs included in operating lease obligations referred to above, which are associated with the Milford lease, total $2.9 million in 2004 and $121,000 in 2005.

Purchase orders or contracts for the purchase of raw materials and other goods and services are not included in the table above. We are not able to determine the aggregate amount of such purchase orders that represent contractual obligations, as purchase orders may represent authorizations to purchase rather than binding agreements. For the purpose of this table, contractual obligations for purchase of goods or services are defined as agreements that are enforceable and legally binding on Inter-Tel and that specify all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction. Our purchase orders are based on our current manufacturing needs and are fulfilled by our vendors with short time horizons. We do not have significant agreements for the purchase of goods specifying minimum quantities or set prices that exceed our expected requirements for three months. We also enter into contracts for outsourced services; however, the obligations under these contracts were not significant and the contracts generally contain clauses allowing for cancellation without significant penalty.

The expected timing of payment of the obligations discussed above is estimated based on current information. Timing of payments and actual amounts paid may be different depending on the time of receipt of goods or services or changes to agreed-upon amounts for some obligations.

In connection with the acquisition of the rights to certain developed technology for a capitalized purchase price of $2.25 million (included in purchased intangible assets) during the year ended December 31, 2003, the Company entered into an arrangement with the selling entity under which the selling entity would perform additional development activities on a cost reimbursement basis. Under the terms of the arrangement, the selling entity could also earn bonus payments totaling up to $1,000,000 for meeting certain development milestones. Milestone bonuses totaling $750,000 for the year ended December 31, 2004 were achieved and expensed as research and development costs. Technological feasibility of the underlying technology has not yet been achieved to provide for viable product sales. As of December 31, 2004, the remaining milestone bonus of $250,000 is dependent on future events and is not considered to be probable or reasonably estimable. The following table summarizes details of the expenses in connection with this technology investment recorded during the respective periods:

(In thousands)	**2004**	**2003**	**2002**
Milestone bonus payments	$ 750	$ --	$ --
Development activities on a cost reimbursement basis	665	525	--
Totals	$ 1,415	$ 525	$ --

Off-Balance Sheet Arrangements

As part of our ongoing business, we do not participate in transactions that involve unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose

entities, which have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. However, we offer to our customers lease financing and other services through our Inter-Tel Leasing, Inc. subsidiary. We fund our Total Solution program in part through the sale to financial institutions of rental payment streams under the leases. Such financial institutions have the option to require us to repurchase such income streams, subject to limitations, in the event of defaults by lease customers and, accordingly, we maintain reserves based on loss experience and past due accounts. For more information regarding our lease portfolio and financing, please see "Liquidity and Capital Resources" above and Notes A and D of Notes to 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. SAB 104 supercedes SAB 101, "Revenue Recognition in Financial Statements." The primary purpose of SAB 104 is to rescind accounting guidance contained in SAB 101 related to multiple element revenue arrangements, superceded as a result of the issuance of EITF 00-21. Additionally, SAB 104 rescinds the SEC's Revenue Recognition in Financial Statements Frequently Asked Questions and Answers ("the FAQ") issued with SAB 101 that had been codified in SEC Topic 13, Revenue Recognition. Selected portions of the FAQ have been incorporated into SAB 104. While the wording of SAB 104 has changed to reflect the issuance of EITF 00-21, the revenue recognition principles of SAB 101 remain largely unchanged by the issuance of SAB 104. The issuance of SAB 104 did not have a material impact on the Company's financial position, results of operations or cash flows.

Accordingly, 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.

For shipments to dealers and other distributors, our revenues are recorded as products are shipped and services are rendered, because 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). Long distance services revenues are recognized as service is provided. 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).

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

Sales-Leases. For our sales-type lease accounting, we follow the guidance provided by FASB Statement No. 13, Accounting for Leases and FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities – A Replacement of FASB Statement No. 125. We record the discounted present values of minimum rental payments under sales-type leases as sales, net of provisions for continuing administration and other expenses over the lease period. We record

the lease sales at the time of system sale and installation pursuant to Staff Accounting Bulletin No. 104, as discussed above for sales to end user customers, and upon receipt of the executed lease documents. The costs of systems installed under these sales-leases are recorded as costs of sales. The net rental streams are sold to funding sources on a regular basis with the income streams discounted by prevailing like-term rates at the time of sale. Gains or losses resulting from the sale of net rental payments from such leases are recorded as net sales. We establish and maintain reserves against potential recourse following the resales based upon historical loss experience, past due accounts and specific account analysis. The allowance for uncollectible minimum lease payments and recourse liability at the end of the year represents reserves against the entire lease portfolio. Management reviews the adequacy of the allowance on a regular basis and adjusts the allowance as required. These reserves are either netted in the accounts receivable, current and long-term components of "Net investments in Sales-Leases" on the balance sheet, or included in long-term liabilities on our balance sheet for off-balance sheet leases.

Historically, our reserves have been adequate to cover write-offs. During the year ended December 31, 2004, our total reserve for losses related to the lease portfolio declined from 6.1% to 5.3%, primarily as a result of improved write-off experience and accounts receivable agings. Should the financial condition of our customers deteriorate in the future, additional reserves in amounts that could be material to the financial statements could be required.

Goodwill and Other Intangible Assets. Inter-Tel follows SFAS No. 141, *Business Combinations*, and SFAS No. 142, *Goodwill and Other Intangible Assets* in accounting for 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.

On January 1, 2002, Inter-Tel began accounting for goodwill under the provisions of SFAS Nos. 141 and 142 and discontinued the amortization of goodwill. As of December 31, 2004, Inter-Tel had gross goodwill of $24.9 million and accumulated amortization of $5.0 million. Inter-Tel completed five acquisitions in 2004 and one in 2003 and has not recorded any amortization for these acquisitions on amounts allocated to goodwill in accordance with SFAS No. 141.

The Company performs an annual impairment test on Goodwill using the two-step process prescribed in SFAS No. 142. The first step is a screen for potential impairment, while the second step measures the amount of the impairment, if any. In addition, the Company will perform impairment tests during any reporting period in which events or changes in circumstances indicate that an impairment may have incurred. Inter-Tel performed the first step of the required impairment tests for goodwill as of December 31, 2004 and determined that goodwill is not impaired and it is not necessary to record any impairment losses related to goodwill. In 2004, $17.8 million of the Company's goodwill, net of amortization, relates to the Company's principal segment and $2.1 million relates to the Network Services segment. There is only one reporting unit (i.e., one component) as defined in paragraph 30 of SFAS 142 within each of the Company's two operating segments as defined in paragraph 10 of SFAS 131. Therefore, the reporting units are identical to the segments. Fair value has been determined for each segment in order to determine the recoverability of the recorded goodwill. At December 31, 2004, the Company primarily considered an allocated portion of the market capitalization for the entire Company using average common stock prices in determining that no impairment has occurred. This allocated market capitalization value far exceeded the net carrying value of the goodwill included in the financial statements. Therefore, the second step for potential impairment was unnecessary.

The Company evaluates the remaining useful lives of its purchased intangible assets, all of which are subject to amortization, each reporting period. Any changes to estimated remaining lives prospectively effect the remaining period of amortization. In addition, the purchased intangible assets are reviewed for possible impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. A loss would be recognized for any excess of the carrying amount over the estimated fair value. As of December 31, 2004, Inter-Tel had gross purchased intangible assets of $19.1 million and accumulated amortization of $8.1 million.

At December 31, 2004 and December 31, 2003, goodwill, net of accumulated amortization, totaled $19.9 million and $18.0 million, respectively. Other acquisition-related intangibles, net of accumulated

amortization, totaled $11.0 million at December 31, 2004 and $8.2 million at December 31, 2003. Accumulated amortization through December 2004 was $13.1 million, including $5.0 million of accumulated amortization attributable to goodwill and $8.1 million of accumulated amortization of other acquisition-related intangibles. Accumulated amortization through December 31, 2003 was $11.0 million, including $5.0 million of accumulated amortization attributable to goodwill and $6.0 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 year lives) and non-competition agreements (2-5 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. 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.

Inventories. We value our inventories at the lower of cost (principally on a standard cost basis, which approximates the first-in, first-out (FIFO) method) or market. Significant management judgment is required to determine the reserve for obsolete or excess inventory and we make our assessment primarily on a significant product-by-product basis and 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 our reserves for obsolescence, we primarily evaluate estimates of demand over a 12-month period and provide reserves for inventory on hand in excess of the estimated 12-month demand, as well as evaluating reserves for specific classifications of inventory, including new, used and staged inventory for specific customers. 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.

Income Taxes. As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income within the relevant jurisdiction and to the extent we believe that recovery is not likely, we must establish a valuation allowance. We have not provided for a valuation allowance because we believe that it is "more likely than not" that our deferred tax assets will be recovered from future taxable income. Should we determine that we would not be able to realize all or part of our net deferred tax asset in the future, an adjustment to the deferred tax asset would be charged to income in the period such determination was made. At December 31, 2004, our gross deferred tax asset was $33.2 million.

Numerous taxing authorities in the jurisdictions in which we do business are increasing their scrutiny of various tax positions taken by businesses. We believe that we maintain adequate tax reserves to offset the potential tax liabilities that may arise upon audit in these jurisdictions. If such amounts ultimately prove to be unnecessary, the resulting reversal of such reserves would result in tax benefits being recorded in the period the reserves are no longer deemed necessary. If such amounts ultimately prove to be less than the ultimate assessment, a future charge to expense would result.

Contingencies. We are a party to various claims and litigation in the normal course of business. Management's current estimated range of liability related to various claims and pending litigation is based on claims for which our management can estimate the amount and range of loss, or can estimate a minimum amount of a loss. Because of the uncertainties related to both the amount and range of loss on the remaining pending claims and litigation, management is unable to make a reasonable estimate of the liability that could result from an unfavorable outcome. As additional information becomes available, we will assess the potential liability related to our claims and pending litigation, revise our estimates and accrue for any losses to the extent that they are probable and the amount is estimable. Such revisions in our estimates of the potential liability could materially impact our results of operations and financial position. However, at December 31, 2004, management did not believe that the ultimate impact of various claims and pending litigation would have a materially adverse impact on the Company.

Recent Accounting Pronouncements

In December 2004, the FASB issued SFAS No. 123R *"Share Based Payment."* This statement is a revision to SFAS No. 123, supersedes APB No. 25, *"Accounting for Stock Issued to Employees,"* and amends SFAS No. 95, *"Statement of Cash Flows."* This statement will require us to expense the cost of employee services received in exchange for an award of equity instruments. This statement also provides guidance on valuing and expensing these awards, as well as disclosure requirements, and is effective for the first interim reporting period that begins after June 15, 2005. SFAS No. 123R permits public companies to choose between the following two adoption methods:

1. A "modified prospective" method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of SFAS No. 123R for all share-based payments granted after the effective date and (b) based on the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of SFAS No. 123R that remain unvested on the effective date, or

2. A "modified retrospective" method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS No. 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

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

ITEM 7A. 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 typically maturing in

three months or less as of the date of purchase. Inter-Tel makes investments in instruments that meet high credit quality standards, as specified in our investment policy guidelines.

The Company also maintains short-term and long-term investments. Those investments that are classified as available-for-sale have been recorded at fair value, which approximates cost. Those investments that are classified as held-to-maturity have been recorded at cost and amortized to face value. Short-term investments include certificates of deposit, auction rate certificates, auction rate preferred securities, municipal preferred securities, federal agency issues and mutual funds. The auction rate securities are adjustable-rate securities with dividend rates that are reset periodically by bidders through periodic "Dutch auctions" generally conducted every 7 to 49 days by a trust company or broker/dealer on behalf of the issuer. The Company believes these securities are highly liquid investments through the related auctions; however, the collateralizing securities have stated terms of up to thirty-one (31) years. The long-term investments consist of federal agency issues. Both the short-term and the long-term instruments are rated A or higher by Standard & Poor's Ratings Group, or equivalent. The Company's short-term investments are intended to establish a high-quality portfolio that preserves principal, meets liquidity needs, avoids inappropriate concentrations and delivers an appropriate yield in relationship to the Company's investment guidelines and market conditions. Given the short-term nature of the majority of these investments, and that we have no borrowings outstanding, we are not subject to significant interest rate risk.

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

IMPACT OF FOREIGN CURRENCY RATE CHANGES. We invoice the customers of our international subsidiaries primarily in the local currencies of our subsidiaries for product and service revenues. Inter-Tel is exposed to foreign exchange rate fluctuations as the financial results of foreign subsidiaries are translated into U.S. dollars in consolidation. The impact of foreign currency rate changes have not historically been significant. The March 2005 acquisition of entities in Ireland could increase our exposure to foreign currency rate changes.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The information required by this Item is incorporated herein by reference to Exhibit 13.0.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act). Based on this evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this annual report.

Management's Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f). Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under the framework in *Internal Control – Integrated Framework*, our management concluded that our internal control over financial reporting was effective as of December 31, 2004.

Our management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2004 has been audited by Ernst & Young LLP, an independent registered public accounting firm, as stated in their report which is included herein.

Changes In Internal Control Over Financial Reporting

There were no changes in the company's internal controls over financial reporting that occurred during the year ended December 31, 2004, that have materially affected, or are reasonably likely to materially affect, the company's internal control over financial reporting.

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders of
Inter-Tel, Incorporated

We have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that Inter-Tel, Incorporated maintained effective internal control over financial reporting as of December 31, 2004, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Inter-Tel, Incorporated's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Inter-Tel, Incorporated maintained effective internal control over financial reporting as of December 31, 2004, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Inter-Tel, Incorporated maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets as of December 31, 2004 and 2003 and the related consolidated statements of income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2004 of Inter-Tel, Incorporated and Subsidiaries, and our report dated March 10, 2005 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Phoenix, Arizona
March 10, 2005

ITEM 9B. OTHER INFORMATION

None.

PART III

Certain information required by Part III is omitted from this report in that the Registrant will file a definitive proxy statement pursuant to Regulation 14A (the "Proxy Statement") not later than 120 days after the end of the fiscal year covered by this report, and the information included therein is incorporated herein by reference to the extent the information required by Part III is not provided below.

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The names of the executive officers of Inter-Tel and their ages, titles, and biographies as of the end of the period covered by this report and as updated through February 2005 are set forth below.

Steven G. Mihaylo; age 61; Chairman of the Board of Directors and Chief Executive Officer. Mr. Mihaylo, the founder of Inter-Tel, has served as Chairman of the Board of Directors of Inter-Tel from July 1969 to October 1982 and from September 1983 to the present. He served as President of Inter-Tel from 1969 to 1983, from 1984 to December 1994, and from May 1998 to February 2005. Mr. Mihaylo has served as Inter-Tel's Chief Executive Officer since the Company's formation in July 1969.

Craig W. Rauchle; age 49; President and Chief Operating Officer. Mr. Rauchle was elected President in February 2005. He was elected Chief Operating Officer in August 2001 and served as our Executive Vice President from December 1994 to February 2005. As President and Chief Operating Officer, Mr. Rauchle is responsible for Inter-Tel's sales and support functions, marketing, procurement, distribution and research and development activities. He had been our Senior Vice President and continues as President of Inter-Tel Technologies, Inc., our wholly owned sales subsidiary. Mr. Rauchle joined Inter-Tel in 1979 as Branch General Manager of the Denver Direct Sales Office and in 1983 was appointed the Central Region Vice President and subsequently the Western Regional Vice President. From 1990 to 1992, Mr. Rauchle served as President of Inter-Tel Communications, Inc. Mr. Rauchle holds a Bachelor of Arts degree in Communications from the University of Denver.

Norman Stout; age 47; Executive Vice President, Chief Strategy Officer and Chief Administrative Officer. Mr. Stout was elected Chief Strategy Officer in February 2005. He was elected Executive Vice President, Chief Administrative Officer and President of Inter-Tel Software and Services in June 1998. As Chief Strategy Officer and Chief Administrative Officer, Mr. Stout is responsible for Inter-Tel's strategic planning, mergers and acquisitions, leasing business and centralized corporate support functions including finance, treasury, accounting, human resources, legal, MIS and eCommerce. From October 1994 to June 1998, he served as one of our directors. Prior to joining Inter-Tel, Mr. Stout was Chief Operating Officer of Oldcastle Architectural Products and since 1996, Mr. Stout also had served as President of Oldcastle Architectural West. Mr. Stout was previously President of Superlite Block, a subsidiary of Oldcastle Architectural Products and a manufacturer of concrete products, since February 1993. Prior thereto he was employed by Boorhem-Fields, Inc. of Dallas, Texas, a manufacturer of crushed stone, as Chief Executive Officer from 1990 to 1993 and as Chief Financial Officer from 1986 to 1990. Prior to that, Mr. Stout was a Certified Public Accountant with Coopers & Lybrand. He currently serves on the board of Hypercom Corporation, a public company headquartered in Phoenix, Arizona. Mr. Stout holds a Bachelor of Science degree in Accounting from Texas A&M and an MBA from the University of Texas.

Jeffrey T. Ford; age 43; Senior Vice President and Chief Technology Officer. Mr. Ford was elected Senior Vice President in May 1998 and has served as our Chief Technology Officer since 1997. He was elected President of Inter-Tel Integrated Systems, Inc. (IIS) in May 1998, after serving as Senior Vice President of IIS for one year and Vice President of Software Engineering of Inter-Tel Integrated Systems from 1993 to 1997. He joined Inter-Tel in 1983 as a software design engineer. Mr. Ford holds a Bachelor of Science degree in Computer Systems Engineering from Arizona State University and an SEP certificate from the Stanford Graduate School of Business.

Kurt R. Kneip; age 42; Chief Financial Officer, Senior Vice President and Secretary. Mr. Kneip has served as our Chief Financial Officer since September 1993. He has served as Senior Vice President since February 2003 and as Vice President from September 1993 to February 2003. He was elected Secretary and Treasurer in October 1994. In May 1996 he was elected Assistant Treasurer, as John Abbott was elected Treasurer. He joined Inter-Tel in May 1992 as Director of Corporate Tax, after seven years with the accounting firms of Ernst & Young and KPMG Peat Marwick. Mr. Kneip is a Certified Public Accountant,

and holds a Bachelor of Science degree in Commercial Economics from South Dakota State University and a Masters Degree in Professional Accountancy from the University of South Dakota.

Code of Business Conduct

Inter-Tel has a Code of Business Conduct ("Code") that applies to all of our employees, including our principal executive officer and principal financial and accounting officer. This code is posted on our Internet web site. The Internet address for our web site is http://www.inter-tel.com, and the code may be found as follows:

1. From our main web page at http://www.inter-tel.com, first click on "Company."
2. Then click on "About Inter-Tel".
3. Next, click on "Code of Business Conduct."

We will provide a copy of the Code upon request made by email to financialinfo@inter-tel.com or by writing to us at Inter-Tel, Incorporated, Attention: Investor Relations, 1615 S. 52nd Street, Tempe, Arizona 85281. We intend to satisfy the disclosure requirement under Item 10 of Form 8-K regarding an amendment to, or waiver from, a provision of this Code by posting such information on our web site, at the address and location specified above, and to the extent required, by filing a Current Report on Form 8-K with the SEC disclosing such information.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item is included under the caption "Executive Compensation" in the Company's Proxy Statement incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The information required by this Item is included under the caption "Security Ownership of Management" in the Company's Proxy Statement incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required by this Item is included under the caption "Certain Relationships and Related Party Transactions" in the Company's Proxy Statement incorporated herein by reference.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this Item is included under the caption "Principal Accountant Fees and Services" in the Company's Proxy Statement incorporated herein by reference.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULE

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

1. Financial Statements

The following consolidated financial statements of Inter-Tel, Incorporated, and subsidiaries, are incorporated by reference to Exhibit 13.0:

Report of Independent Registered Public Accounting Firm
Consolidated balance sheets--December 31, 2004 and 2003
Consolidated statements of income--years ended December 31, 2004, 2003 and 2002
Consolidated statements of shareholders' equity--years ended December 31, 2004, 2003 and 2002

Consolidated statements of cash flows--years ended December 31, 2004, 2003 and 2002
Notes to consolidated financial statements

2. Financial Statement Schedules

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

Schedule for the three years ended December 31, 2004:

Schedule II--Valuation and Qualifying Accounts Page No. 59

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

3. Exhibits

Exhibits incorporated herein by reference.

3.1(10)	Articles of Incorporation, as amended.
3.2(16)	By-Laws, as amended.
10.15(1)	Registrant's form of standard Distributor Agreement.
10.16(1)	Registrant's form of standard Service Agreement.
10.35(3)	Agreement between Registrant and Samsung Semiconductor and Telecommunications Company, Ltd. dated October 17, 1984.
10.37(3) *	Tax Deferred Savings Plan.
10.51(11) *	1990 Directors' Stock Option Plan and form of Stock Option Agreement.
10.52(15) *	Inter-Tel, Incorporated Long-Term Incentive Plan and forms of Stock Option Agreements.
10.53(12)	Agreement between Registrant and Maxon Systems, Inc. dated February 27, 1990.
10.54(12)	Agreement between Registrant and Varian Tempe Electronics Center dated February 26, 1991.
10.55(12)	Agreement between Registrant and Jetcrown Industrial Ltd. dated February 18, 1993.
10.56(13) *	Employee Stock Ownership Plan.
10.57(14)	Loan and Security Agreement dated March 4, 1997 between Bank One, Arizona, N.A. and Registrant and Modification Agreement dated July 25, 1997.
10.58 (16)	Development, Supply and License Agreement between Registrant and QUALCOMM dated January 17, 1996.
10.59(17) *	Inter-Tel, Incorporated 1997 Long-Term Incentive Plan.
10.60(18) *	Inter-Tel, Incorporated 1997 Employee Stock Purchase Plan.
10.61(19) *	Inter-Tel, Incorporated Acquisition Stock Option Plan and form of Stock Option Agreement.
10.62(20)	Computer Telephony Asset Purchase Agreement dated as of October 17, 1999 by and between Executone Information Systems, Inc., Inter-Tel, Incorporated and Executone Inter-Tel Business Information Systems, Inc.
10.63(21) *	Form of Key Employee Tier 1 Change of Control Severance Agreement.
10.64(21) *	Form of Key Employee Tier 2 Change of Control Severance Agreement.

(1) Incorporated by reference to Registrant's Registration Statement on Form S-1 (File No. 2-70437).

(2) Incorporated by reference to Registrant's Registration Statement on Form S-8 (File No. 2-94805).

(3) Incorporated by reference to Registrant's Annual Report on Form 10-K for the year ended November 30, 1984 (File No. 0-10211), Registration Statement on Form S-8 (File No. 333-106868) and Registrant's Annual Report on Form 11-K for the year ended December 31, 2002 (File No. 0-10211)

(10) Incorporated by reference to Registrant's Annual Report on Form 10-K for the year ended December 31, 1988 (File No. 0-10211).

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

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

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

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

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

(16) Incorporated by reference to Registrant’s Annual Report on Form 10-K for the year ended December 31, 1995 (File No. 0-10211).

(17) Incorporated by reference to Registrant’s Registration Statements on Forms S-8 (File Nos. 333-41197, 333-85098, 333-104642 and 333-113600).

(18) Incorporated by reference to Registrant’s Registration Statements on Forms S-8 (File Nos. 333-41197 and 333-87474).

(19) Incorporated by reference to Registrant’s Registration Statements on Forms S-8 (File Nos. 333-56872, 333-67261 and 333-85098).

(20) Incorporated by reference to Registrant’s Report on Form 8-K (File No. 333-67261).

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

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

(b) Exhibits filed herewith.

13.0 Excerpts from Annual Report to Security Holders.

21 Subsidiaries of Inter-Tel, Incorporated.

23.0 Consent of Ernst & Young LLP, Independent Registered Public Accounting Firm.

24.1 Power of Attorney (See signature page of this Annual Report on Form 10-K and incorporated herein by reference).

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

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

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

See Item 15(a) 3 also.

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

SIGNATURES

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

INTER-TEL, INCORPORATED

BY: /s/ Steven G. Mihaylo
Steven G. Mihaylo
Chairman and Chief Executive Officer

Dated: March 14, 2005

EXHIBIT 24.1--POWER OF ATTORNEY

KNOW ALL MEN BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Steven G. Mihaylo and Kurt R. Kneip, jointly and severally, his attorneys-in-fact, each with the power of substitution, for him in any and all capacities, to sign any amendments to this Report on Form 10-K, and to file the same, with exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, hereby ratifying and confirming all that each of said attorneys-in-fact, or his substitute or substitutes, may do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this Report has been signed below by the following persons on behalf of the Registrant in the capacities and on the dates indicated.

Signature	Title	Date
/s/ Steven G. Mihaylo Steven G. Mihaylo	Chairman and Chief Executive Officer	March 14, 2005
/s/ Kurt R. Kneip Kurt R. Kneip	Sr. Vice President and Chief Financial Officer	March 14, 2005
/s/ J. Robert Anderson J. Robert Anderson	Director	March 14, 2005
/s/ Jerry W. Chapman Jerry W. Chapman	Director	March 14, 2005
/s/ Gary D. Edens Gary D. Edens	Director	March 14, 2005
/s/ C. Roland Haden C. Roland Haden	Director	March 14, 2005

SCHEDULE II - VALUATION AND QUALIFYING ACCOUNTS

(In thousands)

	COL. A	COL. B	COL. C	COL. D	COL. E
		ADDITIONS			
DESCRIPTION	Balance at Beginning of Period	Charged to Costs & Expenses	Charged to Other Accounts Describe	Charged to Deductions Describe	Balance at End of Period
Year ended December 31, 2004					
Deducted from asset accounts:					
Allowance for doubtful accounts	$ 11,010	$1,525	$ (349) (3)	$ 2,265 (1)	$ 9,921
Allowance for lease accounts	14,754	3,839	--	3,656 (1)	14,937
Inventory allowance	6,952	1,378	(12)	1,606 (2)	6,712
Year ended December 31, 2003					
Deducted from asset accounts:					
Allowance for doubtful accounts	$ 12,159	$ 3,164	$ (770) (3)	$ 3,543 (1)	$ 11,010
Allowance for lease accounts	13,052	4,528	--	2,826 (1)	14,754
Inventory allowance	10,558	991	--	4,597 (2)	6,952
Year ended December 31, 2002					
Deducted from asset accounts:					
Allowance for doubtful accounts	$ 11,858	$ 4,177	$517 (3)	$ 4,393 (1)	$ 12,159
Allowance for lease accounts	10,736	6,356	--	4,040 (1)	13,052
Inventory allowance	13,202	1,526	--	4,170 (2)	10,558

(1) Uncollectible accounts written off, net of recoveries.
(2) Inventory written off or sold.
(3) Acquisition related adjustments.

EXHIBIT 13.0 ANNUAL REPORT TO SECURITY HOLDERS

FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Report of Independent Registered Public Accounting Firm

Shareholders and Board of Directors
Inter-Tel, Incorporated

We have audited the accompanying consolidated balance sheets of Inter-Tel, Incorporated and subsidiaries as of December 31, 2004 and 2003, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2004. Our audits also included the financial statement schedule listed in the Index to consolidated financial statement and schedule. These financial statements and the schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements and schedule based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Inter-Tel, Incorporated and subsidiaries at December 31, 2004 and 2003, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2004, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Inter-Tel, Incorporated's internal control over financial reporting as of December 31, 2004, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 10, 2005 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Phoenix, Arizona
March 10, 2005

INTER-TEL, INCORPORATED AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
December 31, 2004 and 2003

(In thousands, except share amounts)

	2004	2003
ASSETS		
CURRENT ASSETS		
Cash and equivalents	$ 152,330	$ 115,197
Short-term investments	52,644	59,334
TOTAL CASH AND SHORT-TERM INVESTMENTS	204,974	174,531
Accounts receivable, net of allowances of $9,921 in 2004 and $11,010 in 2003	45,176	43,434
Inventories, net of allowances of $6,712 in 2004 and $6,952 in 2003	16,055	14,648
Net investment in sales-leases, net of allowances of $886 in 2004 and $749 in 2003	17,151	15,502
Income taxes receivable	4,017	8,196
Deferred income taxes	9,905	13,789
Prepaid expenses and other assets	7,194	6,432
TOTAL CURRENT ASSETS	304,472	276,532
LONG-TERM INVESTMENTS	9,900	--
PROPERTY, PLANT & EQUIPMENT	27,840	24,657
GOODWILL	19,890	17,967
PURCHASED INTANGIBLE ASSETS	10,987	8,191
NET INVESTMENT IN SALES-LEASES, net of allowances of $1,810 in 2004 and $1,985 in 2003	33,877	32,529
TOTAL ASSETS	$ 406,966	$ 359,876
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	$ 30,801	$ 28,386
Other current liabilities	52,196	47,585
TOTAL CURRENT LIABILITIES	82,997	75,971
DEFERRED TAX LIABILITY	65,234	57,996
LEASE RECOURSE LIABILITY	12,241	12,020
OTHER LIABILITIES	7,063	6,584
SHAREHOLDERS' EQUITY		
Common stock, no par value-authorized 100,000,000 shares; issued – 27,161,823 shares; outstanding – 26,125,799 shares at December 31, 2004 and 25,429,642 shares at December 31, 2003.	116,598	113,960
Retained earnings	134,455	113,299
Accumulated other comprehensive income	924	1,025
	251,977	228,284
Less: Treasury stock at cost – 1,036,024 shares in 2004 and 1,732,181 shares in 2003.	(12,546)	(20,979)
TOTAL SHAREHOLDERS' EQUITY	239,431	207,305
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 406,966	$ 359,876

See accompanying notes.

INTER-TEL, INCORPORATED AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
Years Ended December 31, 2004, 2003 and 2002

(In thousands, except per share data)

	2004	2003	2002
NET SALES			
Telecommunications systems, software and related	$ 367,969	$ 330,014	$ 344,876
Resale of local, long distance and network services	48,924	43,822	36,580
TOTAL NET SALES	416,893	373,836	381,456
Cost of sales			
Telecommunications systems, software and related	165,345	150,237	165,006
Resale of local, long distance and network services	29,973	26,526	21,977
TOTAL COST OF SALES	195,318	176,763	186,983
GROSS PROFIT	221,575	197,073	194,473
Research and development	28,815	21,978	19,340
Selling, general and administrative	139,917	128,964	128,284
Amortization of purchased intangible assets	1,867	1,803	1,122
Other charge – E-Rate settlement	9,261	--	--
	179,860	152,745	148,746
OPERATING INCOME	41,715	44,328	45,727
Litigation settlement (net of costs except for taxes)	--	--	15,516
(Write-down)/recovery of investment in Inter-Tel.NET / Vianet	--	124	(1,200)
Interest and other income	2,654	1,683	1,936
Foreign currency transaction gains (losses)	(399)	18	330
Interest expense	(118)	(155)	(156)
INCOME BEFORE INCOME TAXES	43,852	45,998	62,153
INCOME TAXES (BENEFIT)			
Current	5,676	(12,784)	18,495
Deferred	11,122	30,264	5,021
	16,798	17,480	23,516
NET INCOME	$ 27,054	$ 28,518	$ 38,637
NET INCOME PER SHARE			
Basic	$ 1.05	$ 1.14	$ 1.58
Diluted	$ 0.99	$ 1.08	$ 1.49
DIVIDENDS PER SHARE	$ 0.26	$ 0.18	$ 0.10
Weighted average basic common shares	25,767	25,078	24,444
Weighted average diluted common shares	27,266	26,473	25,864

See accompanying notes.

INTER-TEL, INCORPORATED AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
Years Ended December 31, 2004, 2003 and 2002

(in thousands)

	Outstanding Shares	Common Stock	Share-holder Loans	Retained Earnings	Accum-ulated Other Compre-hensive Income (loss)	Treasury Stock	Total
Balance at December 31, 2001	24,166	$ 108,968	$ (942)	$ 54,877	$ 151	$ (36,217)	$ 126,837
Net income	--	--	--	38,637	--	--	38,637
Gain on currency translation	--	--	--	--	44	--	44
Comprehensive income	--	--	--	--	--	--	38,681
Stock repurchase	--	--	--	(16)	--	3	(13)
Exercise of stock options	682	--	--	(1,626)	--	8,234	6,608
Tax benefit from stock options	--	2,671	--	--	--	--	2,671
Shareholder loan repayments	--	--	604	--	--	--	604
Stock issued under ESPP	62	--	--	228	--	744	972
Dividends	--	--	--	(2,457)	--	--	(2,457)
Balance at December 31, 2002	24,910	111,639	(338)	89,643	195	(27,236)	173,903
Net income	--	--	--	28,518	--	--	28,518
Gain on currency translation	--	--	--	--	830	--	830
Comprehensive income	--	--	--	--	--	--	29,348
Stock repurchase	(8)	--	--	(58)	--	(149)	(207)
Exercise of stock options	470	--	--	(465)	--	5,701	5,236
Tax benefit from stock options	--	2,321	--	--	--	--	2,321
Shareholder loan repayments	--	--	338	--	--	--	338
Stock issued under ESPP	58	--	--	210	--	705	915
Dividends	--	--	--	(4,549)	--	--	(4,549)
Balance at December 31, 2003	25,430	113,960	--	113,299	1,025	(20,979)	207,305
Net income	--	--	--	27,054	--	--	27,054
Loss on currency translation	--	--	--	--	(101)	--	(101)
Comprehensive income	--	--	--	--	--	--	26,953
Exercise of stock options	646	--	--	380	--	7,830	8,210
Tax benefit from stock options	--	2,638	--	--	--	--	2,638
Stock issued under ESPP	50	--	--	448	--	603	1,051
Dividends	--	--	--	(6,726)	--	--	(6,726)
Balance at December 31, 2004	26,126	$ 116,598	$ --	$ 134,455	$ 924	$ (12,546)	$ 239,431

See accompanying notes.

INTER-TEL, INCORPORATED AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years ended December 31, 2004, 2003 and 2002

(In thousands)

	2004	2003	2002
OPERATING ACTIVITIES:			
Net income	$ 27,054	$ 28,518	$ 38,637
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation of fixed assets	7,915	7,109	7,310
Amortization of goodwill and purchased intangibles	1,867	1,803	1,122
Amortization of patents included in research and development expenses	222	222	222
Non-cash portion of other charges (recoveries)	--	(124)	1,200
Provision for losses on receivables	1,525	3,164	4,177
Provision for losses on leases	3,839	4,528	6,356
Provision for inventory valuation	1,378	991	1,526
Decrease in other liabilities	(2,380)	(3,564)	(3,937)
Loss on sale of property and equipment:	10	118	37
Deferred income tax expense	11,122	30,264	5,021
Changes in operating assets and liabilities	1,998	(18,969)	15,480
NET CASH PROVIDED BY OPERATING ACTIVITIES	54,550	54,060	77,151
INVESTING ACTIVITIES:			
Purchases of available for sale short-term investments	(78,411)	(170,464)	(67,682)
Maturities and sales of available for sale short-term investments	87,100	152,046	29,766
Purchases of held-to-maturity investments	(11,900)	--	--
Additions to property and equipment and equipment held under lease	(10,705)	(7,048)	(7,600)
Proceeds from sale of property and equipment and equipment held under lease	25	76	328
Proceeds from investment in Inter-Tel.NET/Vianet	--	1,450	--
Cash used in acquisitions and other investments	(6,205)	(3,100)	(11,377)
NET CASH USED IN INVESTING ACTIVITIES	(20,096)	(27,040)	(56,565)
FINANCING ACTIVITIES:			
Cash dividends paid	(6,422)	(3,756)	(2,192)
Payments on term debt	(59)	(102)	(481)
Treasury stock purchases	--	(207)	(13)
Proceeds from stock issued under the Employee Stock Purchase Plan	1,051	915	972
Proceeds from exercise of stock options, including shareholder loan repayments	8,210	5,574	7,212
NET CASH PROVIDED BY FINANCING ACTIVITIES	2,780	2,424	5,498
Effect of exchange rate changes	(101)	830	44
INCREASE IN CASH AND EQUIVALENTS	37,133	30,274	26,128
CASH AND EQUIVALENTS AT BEGINNING OF YEAR	115,197	84,923	58,795
CASH AND EQUIVALENTS AT END OF YEAR	$ 152,330	$ 115,197	$ 84,923

See accompanying notes.

NOTE A – SIGNIFICANT ACCOUNTING POLICIES

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

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

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

The Company accounts for short-term and long-term investments in accordance with Financial Accounting Standard No. 115, "Accounting for Certain Investments in Debt and Equity Securities." The Company's short-term investments are classified as available-for-sale, and have been recorded at fair value, which approximates cost. The Company's long-term investments in debt securities have been classified as held-to-maturity and are carried at cost.

Allowance for Doubtful Accounts. We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. Additional reserves or allowances for doubtful accounts are recorded for our sales-type leases, discussed below in "Sales-Leases." We establish and maintain reserves against estimated losses based upon historical loss experience, past due accounts and specific account analysis. Management reviews the level of the allowances for doubtful accounts on a regular basis and adjusts the level of the allowances as needed. In evaluating our allowance we consider accounts in excess of 60 days old as well as other risks in the more current portions of the accounts included. At December 31, 2004, our allowance for doubtful accounts for accounts receivable was $9.9 million of our $55.1 million in gross accounts receivable.

Inventories. We value our inventories at the lower of cost (principally on a standard cost basis, which approximates the first-in, first-out (FIFO) method) or market. Significant management judgment is required to determine the reserve for obsolete or excess inventory and we make our assessment primarily on a significant product-by-product basis and 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 our reserves for obsolescence, we primarily evaluate estimates of demand over a 12-month period and provide reserves for inventory on hand in excess of the estimated 12-month demand, as well as evaluating reserves for specific classifications of inventory, including new, used and staged inventory for specific customers. At December 31, 2004, our inventory reserves were $6.7 million of our $22.8 million gross inventories. Sales of scrap have not been significant for the years ended December 31, 2004, 2003 and 2002. We do not generally offer rights of return privileges to dealers or end users.

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

Goodwill and Other Intangible Assets. On January 1, 2002, Inter-Tel adopted SFAS No. 141, *Business Combinations*, and SFAS No. 142, *Goodwill and Other Intangible Assets.* Purchase prices of acquired businesses 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.

Prior to January 1, 2002, Inter-Tel amortized goodwill over the useful life of the underlying asset, not to exceed 40 years. On January 1, 2002, Inter-Tel began accounting for goodwill under the provisions of SFAS Nos. 141 and 142 and discontinued the amortization of goodwill after January 1, 2002. As of December 31, 2004, Inter-Tel had gross goodwill of $24.9 million and accumulated amortization of $5.0 million. Inter-Tel completed five acquisitions in 2004 and one in 2003 and has not recorded any amortization for these acquisitions on amounts allocated to goodwill in accordance with SFAS No. 141.

The Company performs an annual impairment test on Goodwill using the two-step process prescribed in SFAS No. 142. The first step is a screen for potential impairment, while the second step measures the amount of the impairment, if any. In addition, the Company will perform impairment tests during any reporting period in which events or changes in circumstances indicate that an impairment may have incurred. Inter-Tel performed the first step of the required impairment tests for goodwill as of December 31, 2004 and determined that goodwill is not impaired and it is not necessary to record any impairment losses related to goodwill. In 2004, $17.8 million of the Company's goodwill, net of amortization, relates to the Company's principal segment and $2.1 million relates to the Network Services segment. There is only one reporting unit (i.e., one component) as defined in paragraph 30 of SFAS 142 within each of the Company's two operating segments as defined in paragraph 10 of SFAS 131. Therefore the reporting units are identical to the segments. Fair value has been determined for each segment in order to determine the recoverability of the recorded goodwill. At December 31, 2004, the Company primarily considered an allocated portion of the market capitalization for the entire Company using average common stock prices in determining that no impairment has occurred. This allocated market capitalization value far exceeded the net carrying value of the goodwill included in the financial statements. Therefore, the second step for potential impairment was unnecessary.

The Company evaluates the remaining useful lives of its purchased intangible assets, all of which are subject to amortization, each reporting period. Any changes to estimated remaining lives prospectively effect the remaining period of amortization. In addition, the purchased intangible assets are reviewed for possible impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. A loss would be recognized for any excess of the carrying amount over the estimated fair value. As of December 31, 2004, Inter-Tel had gross purchased intangible assets of $19.1 million and accumulated amortization of $8.1 million.

At December 31, 2004 and December 31, 2003, goodwill, net of accumulated amortization, totaled $19.9 million and $18.0 million, respectively. Other acquisition-related intangibles, net of accumulated amortization, totaled $11.0 million at December 31, 2004 and $8.2 million at December 31, 2003. Accumulated amortization through December 2004 was $13.1 million, including $5.0 million of accumulated amortization attributable to goodwill and $8.1 million of accumulated amortization of other acquisition-related intangibles. Accumulated amortization through December 31, 2003 was $11.0 million, including $5.0 million of accumulated amortization attributable to goodwill and $6.0 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 year lives) and non-competition agreements (2-5 year lives), are amortized on a straight-line basis. The useful lives for developed technology are based on the remaining lives of patents acquired or the estimated useful life of the technology, whichever is shorter. The useful lives of the customer lists are based on the expected period of value for such lists. The useful lives for non-competition agreements are based on the contractual terms of the agreements.

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

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

Advertising. The cost of advertising is expensed as incurred. We incurred $373,000; $331,000; and $443,000 in advertising costs during 2004, 2003, and 2002, respectively.

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

Accordingly, 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 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.

For shipments to dealers and other distributors, our revenues are recorded as products are shipped and services are rendered, because 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). Long distance services revenues are recognized as service is provided. 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).

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

Sales Returns. We do not generally allow sales returns either by the terms of our contracts or in practice, except for returns related to warranty provisions. Once a product has been installed or delivered,

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

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

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

Shipping and Handling Costs. EITF 00-10 "Accounting for Shipping and Handling Fees and Costs," addresses the accounting for shipping and handling fees and costs. Our policy is primarily not to bill customers for shipping costs, unless the customer requests priority shipping. Such amounts are not significant to our operations. Shipping and handling costs recorded in 2004, 2003 and 2002 were approximately $1.3 million, $1.4 million, and $1.1 million, respectively, and are included in cost of sales.

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

We do not recognize compensation expense relating to employee stock options because we only grant options with an exercise price equal to the fair value of the stock on the effective date of grant. At December 31, 2004, the Company has four stock-based employee and director incentive plans and an employee stock purchase plan. The Company accounts for these plans under the recognition and measurement principles of APB No. 25, "Accounting for Stock Issued to Employees," and related interpretations. Stock-based employee compensation costs are not reflected in net income, as all options granted under the plans had an exercise price equal to the market value of the underlying common stock on the date of grant. If we had elected to recognize compensation expense using a fair value approach, and therefore determined the compensation based on the value as determined by the modified Black-Scholes option pricing model, the pro forma net income and earnings per share would have been as follows and in Note K:

	Years Ended December 31,		
(in thousands, except per share data)	2004	2003	2002
Net income, as reported	$ 27,054	$ 28,518	$ 38,637
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(3,340)	(3,007)	(3,062)
Pro forma net income	$ 23,714	$ 25,511	$ 35,575
Earnings per share:			
Basic – as reported	$ 1.05	$ 1.14	$ 1.58
Basic – pro forma	$ 0.92	$ 1.02	$ 1.46
Diluted – as reported	$ 0.99	$ 1.08	$1.49
Diluted – pro forma	$ 0.87	$ 0.96	$ 1.38

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

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

Contingencies. We are a party to various claims and litigation in the normal course of business. Management's current estimated range of liability related to various claims and pending litigation is based on claims for which our management can estimate the amount and range of loss, or can estimate a minimum amount of a loss. Because of the uncertainties related to both the amount and range of loss on the remaining pending claims and litigation, management is unable to make a reasonable estimate of the liability that could result from an unfavorable outcome. As additional information becomes available, we will assess the potential liability related to our claims and pending litigation, revise our estimates and accrue for any losses to the extent that they are probable and the amount is estimable. Such revisions in our estimates of the potential liability could materially impact our results of operations and financial position. However, at December 31, 2004, management did not believe that the ultimate impact of various claims and pending litigation would have a materially adverse impact on the Company.

On January 5, 2005, the Company received court approval of a civil settlement agreement (the "Civil Settlement") and a criminal plea agreement (the "Plea Agreement") with the United States of America, each dated as of December 8, 2004 and disclosed on that same date. The court approval of the Civil Settlement and Plea Agreement resolves the investigation of the Department of Justice into the participation of Inter-Tel Technologies, Inc., the Company's wholly-owned subsidiary ("Technologies") in a federally administered "E-Rate program" to connect schools and libraries to the Internet. In connection with the Civil Settlement, Technologies agreed to pay a penalty of $6,740,450 and forego the collection of certain accounts receivable of $259,540 related to Technologies' participation in the E-Rate program. In connection with the Plea Agreement, Technologies entered guilty pleas to charges of mail fraud and an antitrust violation. Under the Plea Agreement, Technologies agreed to pay a fine of $1,721,000 and observe a three-year probationary period, which will, among other things, require Technologies to implement a comprehensive corporate compliance program. The resolution is currently expected to cost Inter-Tel approximately $9.5 million in total, including criminal fines, civil settlement and restitution, uncompensated E-Rate work, accounts receivable forgiveness, and related remaining attorneys' fees and other expenses. The payments constituting the primary components of the settlement are not tax deductible. The effect of the resolution on fourth quarter results of operations was a reduction to net income by approximately $9.0 million, after considering (1) accounts receivable reserves previously accrued and (2) an income tax benefit of approximately $0.3 million related to attorneys' fees and other expenses.

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

Use of Estimates. The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

Reclassifications. Certain reclassifications have been made to the 2003 and 2002 financial statements to conform to the 2004 presentation.

Recent Accounting Pronouncements

In December 2004, the FASB issued SFAS No. 123R *"Share Based Payment."* This statement is a revision to SFAS No. 123, supersedes APB No. 25, *"Accounting for Stock Issued to Employees,"* and amends SFAS No. 95, *"Statement of Cash Flows."* This statement will require us to expense the cost of employee services received in exchange for an award of equity instruments. This statement also provides guidance on valuing and expensing these awards, as well as disclosure requirements, and is effective for the first interim reporting period that begins after June 15, 2005. SFAS No. 123R permits public companies to choose between the following two adoption methods:

1. A "modified prospective" method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of SFAS No. 123R for all share-based payments granted after the effective date and (b) based on the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of SFAS No. 123R that remain unvested on the effective date, or

3. A "modified retrospective" method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS No. 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

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

NOTE B – ACQUISITIONS, TECHNOLOGY INVESTMENTS, DISPOSITIONS AND RESTRUCTURING CHARGES

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

New Technology Investments in 2004. In October 2004, the Company acquired certain assets and assumed certain liabilities of Converging Technologies, Inc. The acquired assets primarily include Web-based conferencing solutions, notably Linktivity® software. Tangible assets acquired, liabilities assumed and purchased intangibles (all technology related) acquired were $0.5 million, $0.3 million and $3.0 million,

respectively. The purchased intangible is being amortized over five years. Also in October 2004, the Company obtained a license of intellectual property from eDial, a division of Alcatel USA Marketing, Inc. for a total price of $1.0 million. The eDial intangible is being amortized over five years.

New Sales Office in 2003. In connection with opening a new sales office in Philadelphia, Pennsylvania during December 2003, we acquired certain assets and assumed certain liabilities relating to a customer base of a former dealer. The total assets acquired and liabilities assumed were approximately $0.6 million and $0.9 million, respectively. Total goodwill and purchased intangibles recorded as a result of the transaction were $0.2 million and $0.1 million, respectively. The goodwill balance is non-amortizable. The balance included in the $0.1 million in other purchased intangible assets is being amortized over a period of five years.

Technology Investment in 2003. In connection with the acquisition of the rights to certain developed technology for a capitalized purchase price of $2.25 million (included in purchased intangible assets) during the year ended December 31, 2003, the Company entered into an arrangement with the selling entity under which the selling entity would perform additional development activities on a cost reimbursement basis through August 15, 2004. Under the terms of the arrangement, the selling entity could also earn bonus payments totaling up to $1,000,000 for meeting certain development milestones. Milestone bonuses totaling $750,000 for the year ended December 31, 2004 were achieved and expensed as research and development costs. Technological feasibility of the underlying technology has not yet been achieved to provide for viable product sales. As of December 31, 2004, the remaining milestone bonus of $250,000 is dependent on future events and is not considered to be probable or reasonably estimable. The following table summarizes details of the expenses in connection with this technology investment recorded during the respective periods:

(In thousands)	2004	2003	2002
Milestone bonus payments	$ 750	$ --	$ --
Development activities on a cost reimbursement basis	665	525	--
Totals	$ 1,415	$ 525	$ --

Swan. On December 3, 2002, Inter-Tel Integrated Systems, Inc., our wholly owned subsidiary, acquired 100% of the capital stock of Swan Solutions Limited (Swan) in England and Wales, for $4.0 million in cash. $3.0 million was paid at closing, $250,000 was paid in June 2003 and $250,000 was paid in December 2003. The remaining $500,000 was subject to the achievement of five performance milestones at $100,000 each. As of June 30, 2004, portions of all five $100,000 milestones had been achieved for which $450,436 was paid to the Swan shareholders. Of this amount, the final $100,000 milestone achievement was paid during the second quarter of 2004. Payments relating to the achievement of performance milestones were capitalized and are being amortized as purchased intangible assets. In total, the Company recorded amortizable intangible technology assets totaling $3.9 million in connection with this acquisition. These technology assets are being amortized over five years. During the years ended December 31, 2004, 2003 and 2002, the amortization of purchased intangible assets from Swan was approximately $788,000, $796,000 and 57,000, respectively.

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

The weighted-average amortization period for total purchased intangibles as of December 31, 2004 and December 31, 2003 was approximately 6.8 years and 7.0 years for each period, respectively. The weighted-average amortization period as of December 31, 2004 and December 31, 2003 for developed technology was approximately 7.0 and 7.5 years for each period, respectively, and 5.0 and 4.8 years as of December 31, 2004 and 2003, respectively, for customer lists and non-compete agreements.

Each of the acquisitions discussed above were not material business acquisitions either individually or collectively and has been accounted for using the purchase method of accounting. The results of operations

of each of these acquisitions have been included in our accompanying consolidated statements of operations from the date of acquisitions.

Inter-Tel.NET/Comm-Services/Vianet. Inter-Tel's management has not participated in the management of Inter-Tel.NET since its partial sale in July 2001. As a result, since July 24, 2001, we have accounted for the remaining Inter-Tel.NET/Comm-Services investment using the cost method of accounting. On December 30, 2001, Comm-Services entered into a merger agreement with Vianet. Inter-Tel's 17% investment in Comm-Services was converted to approximately 10% of Vianet stock and as a result, Vianet assumed the loan for the purchase and Inter-Tel continued to hold collateral from the former shareholders of Comm-Services until March 2003. During 2002, the net investment in the notes receivable and 10% interest in Vianet (formerly Comm-Services) was written down by $1.2 million and was recorded in other assets at a carrying value of approximately $2.5 million as of December 31, 2002, which approximated management's estimate of the related collateral value at that time.

During 1999, 2000 and 2001, Inter-Tel.NET entered into operating lease agreements totaling approximately $6.5 million from an equipment vendor for network equipment and software. The lease agreements required Inter-Tel.NET to purchase vendor maintenance on their products. Inter-Tel originally guaranteed the indebtedness. In February 2003, we executed an agreement with Vianet and this vendor releasing Inter-Tel from its guarantee of any and all of these obligations, and Inter-Tel and Vianet released the vendor from claims arising from the failure of the network equipment and software previously leased. As part of this agreement, Inter-Tel also received payment from the Vianet shareholders of $1.45 million, in exchange for the release of the remaining collateral and as payment of the loan. Inter-Tel had also retained a collateral interest in a Vianet shareholder's variable forward option contract that matured in April and May of 2003, and for which we received no value for the collateral interest. After an adjustment of $124,000 in 2003 related to a recovery of our investment and adjustment of projected costs to actual costs associated with the 2002 write-down in the Vianet investment, the estimated value received in this transaction was equivalent to our remaining investment value, less accruals for potential obligations to the vendor discussed above.

Inter-Tel retains its ownership interest in Vianet and will account for the remaining investment interest of approximately 10% in Vianet using the cost method of accounting. At December 31, 2004 and 2003, our net investment in Vianet was recorded at no value.

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

During the second quarter of 2000, we decided to close the primary Executone facility in Milford, Connecticut and to recognize a restructuring charge related to our exit plan and closure of the Executone operations. We have accounted for the restructuring of the Executone operations, including severance and related costs, the shut down and consolidation of the Milford facility and the impairment of assets associated with the restructuring. We finalized our plan for the exiting of activities and the involuntary termination or relocation of the employees. Accrued costs associated with this plan were estimates, although the original estimates made for the second quarter of 2000 for reserve balances have not changed significantly as of December 31, 2004.

Exit costs associated with the closure of the Milford facility also included liabilities for building, furniture and equipment lease, and other contractual obligations. We are liable for the lease on the Milford buildings through January 14, 2005. Various other furniture, computer and equipment leases terminated on varying dates through September 2002. To date, we have entered into sublease agreements with third parties to sublease portions of the facility. The reserve for lease and other contractual obligations is identified in the table below.

The total restructuring charge from this event totaled $50.9 million. The following table summarizes details of the restructuring charge in connection with the Executone acquisition, including the description of the type and amount of liabilities assumed, and activity in the reserve balances from the date of the charge through December 31, 2004. Activity represents payments made or amounts written off.

(In thousands)

Description	Cash/ Non-Cash	Restructuring Charge	2000 and 2001 Activity	2002 Activity	2003 Activity	2004 Activity	Reserve Balance At 12/31/04
Personnel Costs:							
Severance and termination costs	Cash	$ (1,583)	$ 1,560	$ 20	$ 3	$ --	$ --
Other Plant closure costs	Cash	(230)	230	--	--	--	--
Lease termination and other contractu obligations (net of anticipated recovery):							
Building and equipment leases	Cash	(7,444)	2,837	2,594	767	1,238	(8)
Other contractual obligations	Cash	(1,700)	1,700	--	--	--	--
Impairment of Assets:							
Inventories	Non-Cash	(3,454)	1,585	1,869	--	--	--
Prepaid inventory and other expenses	Non-Cash	(2,485)	2,485	--	--	--	--
Accounts receivable	Non-Cash	(1,685)	766	88	831	--	--
Fixed assets	Non-Cash	(3,151)	2,942	53	14	26	(116)
Net intangible assets	Non-Cash	(29,184)	29,184	--	--	--	--
Total		**$ (50,916)**	**$ 43,289**	**$ 4,624**	**$ 1,615**	**$ 1,264**	**$ (124)**

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

NOTE C – SHORT-TERM AND LONG-TERM INVESTMENTS

The Company accounts for its investments in accordance with Financial Accounting Standard No. 115, "Accounting for Certain Investments in Debt and Equity Securities." Most of the Company's short-term investments are classified as available-for-sale, and have been recorded at fair value, which approximates cost. Fair value has been determined to approximate cost based on broker statements. We have also historically purchased and sold similar investments at face value. The short-term investments that are classified as held-to-maturity have been recorded at cost and amortized to face value. The long-term investments, which are all classified as held-to-maturity, have been recorded at cost and amortized to face value. At December 31, 2004 and December 31, 2003, $50.6 million and $59.3 million, respectively, were recorded as short-term investments, available-for-sale. At December 31, 2004 $2.0 million were recorded as short-term investments, held-to-maturity. The Company had no assets classified as short-term investments, held-to-maturity at December 31, 2003. Short-term investments include certificates of deposit, auction rate certificates, auction rate preferred securities, municipal preferred securities, federal agency issues and mutual funds. The auction rate securities are adjustable-rate securities with dividend rates that are reset periodically by bidders through periodic "Dutch auctions" generally conducted every 7 to 49 days by a trust company or broker/dealer on behalf of the issuer. The Company believes these securities are highly liquid investments through the related auctions; however, the collateralizing securities have stated terms of up to thirty-one (31) years. At December 31, 2004, $9.9 million were recorded as long-term investments, held-to-maturity. The Company had no assets classified as long-term investments, held-to-maturity at December 31, 2003. All investment instruments are rated A or higher by Standard & Poor's Ratings Group, or equivalent.

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

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

December 31, 2004 (in thousands)	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Gross Fair Value
Short-term, available-for-sale:				
Equity securities	$ 42,148	$ --	$ --	$ 42,148
Mutual funds	6,662	--	--	6,662
Certificate of deposit	1,008	--	--	1,008
Municipal bonds	826	--	--	826
Totals	$ 50,644	$ --	$ --	$ 50,644
Short-term, held-to-maturity:				
Federal agency issues (mature in 2005)	$ 2,000	$ --	$ 18	$ 1,982
Totals	$ 2,000	$ --	$ 18	$ 1,982
Long-term, held-to-maturity:				
Federal agency issues (mature in 2006)	$ 9,900	$ --	$ 140	$ 9,760
Totals	$ 9,900	$ --	$ 140	$ 9,760

December 31, 2003 (in thousands)	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Gross Fair Value
Short-term, available-for-sale:				
Equity securities	$ 57,855	$ --	$ --	$ 57,855
Mutual funds	1,479	--	--	1,479
Totals	$ 59,334	$ --	$ --	$ 59,334

NOTE D – NET INVESTMENT IN SALES-LEASES

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

	December 31		
	2004	2003	2002
Lease balances included in consolidated accounts receivable, net of allowances of $1,177 in 2004; $1,774 in 2003; and $2,562 in 2002	$ 6,390	$ 7,240	$ 6,470
Net investment in Sales-Leases:			
Current portion, net of allowances of $886 in 2004; $749 in 2003; and $516 in 2002	17,151	15,502	13,344
Long-term portion, includes residual amounts of $510 in 2004; $652 in 2003; and $518 in 2002, net of allowances of $1,810 in 2004; $1,985 in 2003; and $1,411 in 2002	33,877	32,529	24,692
Total investment in Sales-Leases, net of allowances of $3,873 in 2004; $4,508 in 2003; and $4,489 in 2002	57,418	55,271	44,506
Sold rental payments remaining unbilled (subject to limited recourse provisions), net of allowances of $12,241 in 2004; $12,020 in 2003; and $11,125 in 2002	229,163	198,091	194,684

Total balance of sales-leases and sold rental payments remaining unbilled, net of allowances	$ 286,581	$ 253,362	$ 239,190
Total allowances for entire lease portfolio (including limited recourse liabilities)	$ 16,114	$ 16,528	$ 15,614

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

	Years Ended December 31		
(In thousands)	2004	2003	2002
Sales of rental payments	$ 113,172	$ 88,352	$ 83,141
Sold payments remaining unbilled at end of year	$ 241,404	$ 210,111	$ 205,809

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

At December 31, 2004, future minimum lease payments related to the sold rental streams remaining unbilled are: 2005 -- $73.4 million, 2006 -- $65.0 million, 2007 – $50.2 million, 2008 -- $35.6 million, 2009 -- $16.6 million, thereafter -- $215,000.

At December 31, 2004, future minimum lease receipts due from customers related to the lease portfolio included in our December 31, 2004 balance sheet are: 2005 -- $18.9 million, 2006 -- $12.9 million, 2007 – $9.1 million, 2008 -- $6.9 million, 2009 -- $5.4 million, thereafter – $30,000.

NOTE E – PROPERTY, PLANT & EQUIPMENT

	December 31	
(In thousands)	2004	2003
Computer systems, data processing and other office equipment	$ 46,397	$ 38,906
Transportation equipment	3,820	3,761
Furniture and fixtures	4,221	3,899
Leasehold improvements	4,673	4,501
Building	7,318	7,297
Land	2,499	2,499
	68,928	60,863
Less: Accumulated depreciation and amortization	(41,088)	(36,206)
Net property, plant & equipment	$ 27,840	$ 24,657

NOTE F – GOODWILL AND PURCHASED INTANGIBLE ASSETS

	December 31	
(In thousands)	2004	2003
Goodwill	$ 24,915	$ 22,992
Less: Accumulated amortization	(5,025)	(5,025)
Net Goodwill	$ 19,890	$ 17,967

Purchased intangible assets:		
Acquired developed technology	$ 15,517	$ 11,765
Customer lists and non-competition agreements	3,550	2,418
	19,067	14,183
Less: Accumulated amortization	(8,080)	(5,992)
Net Purchased intangible assets	$ 10,987	$ 8,191

For the years ending December 31, 2005, 2006, 2007, 2008 and 2009, the estimated amortization expense on purchased intangible assets is $2.6 million, $2.5 million, $2.1 million, $1.3 million and $1.0 million, respectively.

NOTE G – OTHER CURRENT LIABILITIES

	December 31	
(In thousands)	2004	2003
Compensation and employee benefits	$ 17,378	$ 18,118
Customer deposits	4,641	4,451
Restructuring charge	8	1,194
Deferred revenues	6,937	7,641
Miscellaneous taxes payable	2,842	3,331
E-Rate settlement	9,261	--
Other accrued expenses	11,129	12,850
	$ 52,196	$ 47,585

NOTE H – CREDIT LINE

We maintain a $10 million unsecured bank credit line at prime rate to cover international letters of credit and for other purposes. The credit agreement matures June 1, 2006 and contains certain restrictions and financial covenants. At December 31, 2004, none of the credit line was committed under letter of credit arrangements.

NOTE I – LEASES

Noncancellable operating leases are primarily for buildings. Certain of the leases contain provisions for renewal options and scheduled rent increases. Rental expense amounted to $9,381,000; $9,590,000; and $9,931,000; in 2004, 2003, and 2002, respectively, as follows:

(In thousands)	2004	2003	2002
Rental expense, gross (1)	$ 9,926	$ 9,811	$ 10,081
Less: Sublease receipts, gross	(545)	(221)	(150)
Net rental expense	$ 9,381	$ 9,590	$ 9,931

(1) The amounts in the table above do not include rental expense in connection with the Milford, Connecticut building, which we leased in connection with our acquisition in 2000 of selected assets and assumption of certain liabilities of Executone. The Milford lease expired on January 14, 2005 and we did not renew the lease. In connection with the Executone charge taken in 2000, we included in the charge the anticipated lease costs through the lease termination date, offset by expected sublease receipts. The net rental payments in Milford (offset by sublease receipts) were $1.3 million, $2.2 million, and $2.3 million in 2004, 2003, and 2002 respectively. The total costs excluded from the gross rental expense above associated with the Milford lease totaled $2.3 million in 2004, $2.9 million in 2003 and $3.0 million 2002, offset in part by sublease receipts totaling $1.0 million, $0.8 million and $0.7 million in 2004, 2003, and 2002 respectively. Refer to “Note B – Acquisitions, Technology Investments, Dispositions and Restructuring Charges” for additional information regarding the Executone charge and building lease.

At December 31, 2004, future minimum commitments under noncancellable leases are as follows: 2005 -- $7,584,000; 2006 -- $5,811,000; 2007 – $4,070,000; 2008 -- $1,782,000; 2009 -- $665,000.

NOTE J – INCOME TAXES

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

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

(in thousands)	December 31	
	2004	2003
Deferred tax liabilities:		
Lease—sales and capitalized costs	$ 80,921	$ 73,823
Write-off of Japan intercompany receivables	1,051	--
Tax over book depreciation	2,986	199
Other	3,579	5,642
Total deferred tax liabilities	88,537	79,664
Deferred tax assets:		
Net operating loss carryforward	2,905	7,916
Tax credit carryforward	4,026	3,421
Insurance reserves	1,559	906
Accounts receivable reserves	3,457	3,758
Accrued vacation pay	1,906	1,652
Foreign loss carryforwards	1,051	880
In-process R&D write-off	4,852	5,428
Restructuring reserves	1,167	1,968
Lease receivable reserves	8,047	5,169
Other – net	4,238	5,239
Deferred tax assets	33,208	36,337
Less valuation reserve	--	(880)
Net deferred tax assets	33,208	35,457
Net deferred tax liabilities (total deferred tax liabilities less net deferred tax assets)	$ 55,329	$ 44,207

The net deferred tax liabilities increased in 2004 due primarily to acceleration of fixed asset depreciation, temporary differences relating to leases in our Total Solution program and reduction of the net operating loss carryforward deferred tax asset. Effective May 6, 2003, the bonus depreciation increased from a 30% to a 50% bonus which favorably impacted the depreciation deduction for 2004 and 2003.

The Company filed a change in accounting method with the Internal Revenue Service for the 2002 tax year to utilize accelerated depreciation for dealer leases. This depreciation deduction generated a net operating loss in 2002 that was carried back to 2001 and carried forward to 2003 and 2004. We expect the net operating loss carryforward to be fully utilized in 2005. The net operating loss created deferred tax assets, not only for the loss, but also for research credits and minimum tax credits. The company was in a slight minimum tax credit filing position for 2004 and 2003 and anticipates full utilization of the credits in 2005.

During 2004, 2003 and 2002, we recorded income of $1,718,000; $1,037,000; and $295,000; respectively, from foreign operations. At December 31, 2004, we had foreign loss carryforwards of approximately $2,627,000 and expired losses of $235,000. In the fourth quarter of 2004, the Company's management decided to shut down the operations in Japan. Due to the anticipated recognition of income by Japan for forgiveness of debt in 2005, Japan will utilize its net operating losses. The 2004 valuation allowance was reduced to zero and the tax benefit was recognized. The Company also recognized a tax benefit for the write-off of the Japanese investment in the amount of $550,000 in 2004.

Federal and state income taxes consisted of the following:

(In thousands)	2004	2003	2002
Federal	$ 14,247	$ 15,126	$ 20,206
State	2,472	1,620	2,584
Foreign	79	734	726
	$ 16,798	$ 17,480	$ 23,516

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

	2004	2003	2002
Federal tax at statutory rates applied to pre-tax income	35.0 %	35.0 %	35.0 %
State tax net of federal benefit	3.7	2.3	2.1
Credit for research activities	(1.6)	(1.1)	(1.2)
Write-off of Japan	(3.4)	--	--
E-rate settlement	6.8	--	--
Tax exempt interest	(1.5)	(1.4)	--
Other – net	(0.7)	3.2	2.1
	38.3 %	38.0 %	38.0 %

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

The write off of Japan consists of the recognition of the valuation allowance and 2004 Japanese loss as well as a tax benefit for the write off of the investment. The company will write off an estimated $2.8 million of intercompany receivables for which the Japanese subsidiary will have corresponding income for the forgiveness of debt. This income will be offset by net operating loss carryforwards. The tax benefit is 3.4% or approximately $1.5 million. In prior years the tax benefit of the Japanese operations were offset by a valuation allowance due to historical losses and an inability to project future income by management.

Undistributed earnings of the Company's foreign subsidiaries totaling approximately $4.3 million and $1.9 million as of December 31, 2004 and 2003, respectively, are considered by the Company to be permanently reinvested; accordingly, deferred income taxes have not been provided on these earnings. Determining the tax liability that would arise if these earnings were remitted is not practicable. The amount would depend on a number of factors, including the amount of the earnings distributed and whether the U.S. operations were generating profits or losses.

The Company believes that it maintains adequate tax reserves to offset the potential liabilities that may arise upon audit. If such reserves ultimately prove to be unnecessary, the resulting reversal of such reserves would result in tax benefits being recorded in the period the reserves are no longer deemed necessary. If such reserves ultimately prove to be less than the ultimate assessment, a future charge to expense would result. The Company has included reserves for potential losses in deferred income tax liabilities.

NOTE K – EQUITY TRANSACTIONS

Treasury Stock. During the first quarter of 2001, we initiated a stock repurchase program under which the Board of Directors authorized the repurchase of up to 4,000,000 shares of Inter-Tel Common Stock. We did not repurchase shares during 2004. However, under this and prior authorizations, we repurchased 8,271 and 662 shares during 2003 and 2002, respectively, expending $207,000 and $13,000 to repurchase shares for cash pay-outs to former employees in place of ESOP share distributions during 2003 and 2002, respectively. During 2001, we expended approximately $28.9 million for stock repurchases, which was funded primarily through existing cash balances. We reissued approximately 696,000, 529,000 and 743,000 shares in 2004, 2003 and 2002, respectively, through stock option and employee stock purchase plan

exercises and issuances. The proceeds received for the stock reissued were greater than our total cost basis. Accordingly, the difference was recorded as an increase to retained earnings. Attached below is a summary of treasury share activity for the past three years.

Treasury shares	2004	2003	2002
Balance on January 1	1,732,181	2,252,840	2,995,393
Stock repurchases, including ESOP	--	8,271	662
Shares reissued	(696,157)	(528,930)	(743,215)
Balance on December 31	1,036,024	1,732,181	2,252,840

*Board Authorization to Repurchase up to $75 Million of Inter-Tel Stock***.** In February 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.

Dividend Policy. Since December 31, 1997, we have paid quarterly cash dividends (the "cash dividend") for every share of Common Stock to shareholders of record. Dividend payments commence on or about 15 days after the end of each fiscal quarter. Our Board of Directors has periodically increased the cash dividend and attached below is a summary of our dividends accrued and paid since December 31, 1997, the date we first declared cash dividends on our Common Stock.

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

Increase to Quarterly Dividend and One-Time Special Dividend. Inter-Tel's board of directors also made two dividend announcements in February 2005 affecting dividends:

- Increase of Inter-Tel's quarterly dividend by 14.3% from $0.07 per share per quarter (total of $0.28 per share per year) to $0.08 per share per quarter (total of $0.32 per share per year). The increase will be effective beginning the first dividend payment made in April 2005 for shareholders of record at March 31, 2005, and will continue in effect unless canceled or revised by the board of directors.
- One-time special dividend of $1.00 per share effective for shareholders of record at March 31, 2005 and paid on or about April 15, 2005.

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

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

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

In February 1997, the Board of Directors authorized the Inter-Tel, Incorporated 1997 Long-Term Incentive Plan ("the 1997 Long Term Plan"). Option must be granted at not less than 100% of the fair market value of our stock at the dates of grant. Options generally vest over four or five years and expire ten years from the date of grant. In March 2000, the Board of Directors authorized an amendment to the 1997 Long Term Plan to limit our ability to reprice options under the 1997 Long Term Plan. Prior to January 1, 2002, a total of 3,650,000 shares of Common Stock had been reserved for issuance under the 1997 Long Term Plan to selected officers and key employees.

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

Year	Shares
2002	604,161
2003	622,725
2004	635,741
2005	653,145

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

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

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

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

(Number of shares)	Years Ended December 31, 2004	2003	2002
Outstanding at beginning of year	4,416,131	4,188,641	4,567,945
Granted	484,000	879,950	608,000
Exercised (1)	(649,543)	(476,410)	(710,304)
Expired or canceled	(126,470)	(176,050)	(277,000)
Outstanding at end of year	4,124,118	4,416,131	4,188,641
Exercisable at end of year	2,002,768	1,877,151	1,628,533
Weighted-average grant price of options granted	$ 14.88	$ 13.66	$ 13.40
Weighted-average fair value (FAS 123) of options granted during the year	$ 10.38	$ 7.04	$ 9.32

(1) The difference between shares exercised in the table above and shares exercised as reflected in the Consolidated Statements of Shareholders' Equity relates to mature shares tendered in connection with the shares exercised. The Company permits the tendering of mature shares to exercise stock options provided that the shares have been held for six months or more. Mature shares tendered for the years ended December 31, 2004, 2003 and 2002 were 3,144, 5,722 and 29,349 shares, respectively.

At December 31, 2004, we have reserved 4,957,805 shares of Common Stock for issuance in connection with the stock option plans.

As permitted under Statement of Financial Accounting Standards No. 123 (FAS 123) "Accounting for Stock-Based Compensation," we have elected to follow Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related Interpretations, in accounting for stock based awards to employees. Under APB 25, we generally recognize no compensation expense with respect to such awards.

The following table summarizes information about stock options outstanding at December 31, 2004:

Range of Exercise Price	Number Outstanding at 12-31-04	Weighted-Average Remaining Contractual Life	Weighted Average Exercise Price
$2.24 - $5.24	379	1 years	$ 2.24
$5.25 - $7.68	67,250	2 years	$ 6.38
$7.69 - $15.12	2,518,870	6 years	$ 11.01
$15.13 - $43.44	1,537,619	7 years	$ 21.59

The following table summarizes information about stock options exercisable at December 31, 2004:

Range of Exercise Price	Number Exercisable at 12-31-04	Weighted-Average Remaining Contractual Life	Weighted Average Exercise Price
$2.24 - $5.24	379	1 years	$ 2.24
$5.25 - $7.68	67,250	2 years	$ 6.38
$7.69 - $15.12	1,252,570	6 years	$ 10.32
$15.13 - $43.44	682,569	7 years	$ 21.41

During 2004, the weighted average exercise price of options granted, exercised, and expired or canceled was $23.75, $12.79 and $16.85, respectively.

Pro forma information regarding net income and net income per share, as disclosed in Note A, has been determined as if the Company had accounted for its employee stock-based compensation plans under the fair value method of SFAS No. 123.

The fair value for these options was estimated at the date of grant using a Black-Scholes option pricing model using the low end of reasonable assumptions for input variables rather than attempting to identify a best-point estimate. The option pricing model utilized the following weighted average assumptions for 2004, 2003 and 2002, respectively: risk free interest rates of 3.29% for 2004, 3.05% for 2003 and 2.73% for 2002; dividend yields of 0.93% for 2004, 1.2% for 2003 and 0.75% for 2002; volatility factors of the expected market price of our stock averaged 0.478 for 2004, 0.560 for 2003 and 0.576 for 2002. Employee stock options vest over four to five year periods and director options vest at the end of six months from the grant date.

1997 Employee Stock Purchase Plan. In April 1997, the Board of Directors and stockholders adopted the Employee Stock Purchase Plan (the Purchase Plan) and reserved 500,000 shares for issuance to eligible employees. In April 2002, the Board of Directors and stockholders approved an amendment to the Plan to increase the number of authorized shares by 500,000 shares for a total of 1,000,000 authorized thereunder. Under the Purchase Plan, employees are granted the right to purchase shares of Common Stock at a price per share that is 85% of the lesser of the fair market value of the shares at: (i) the participant's entry date into each six-month offering period, or (ii) the end of each six-month offering period. Employees may designate up to 10% of their compensation for the purchase of stock. Under the Plan, we sold 49,758 shares for approximately $1,051,000 ($21.13 per share) to employees in 2004, 58,242 shares for approximately $915,000 ($15.71 per share) to employees in 2003, and 61,562 shares for approximately $972,000 ($15.80 per share) to employees in 2002. At December 31, 2004, 466,584 shares remained authorized under the Plan.

Stock Option Loans. During 1999, selected officers and employees of Inter-Tel were offered loans to acquire Inter-Tel common stock. Promissory Notes were established to cover the cost of exercise of stock options, including applicable taxes, or the cost of Inter-Tel common stock purchased in the open market during May and June of 1999. The loans were interest-only notes with balloon payments due on or before March 15, 2004. Interest was charged on the loans at the mid-term applicable federal interest rate, compounded annually. Interest payments were due on or before March 15 of each anniversary beginning on March 15, 2000. The loans were recorded in our balance sheet as reductions to shareholders' equity. The notes were full recourse loans and we retained the common stock certificates as collateral. All of the loans were paid in full prior to the end of 2003.

NOTE L – EARNINGS PER SHARE

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

	Years Ended December 31,		
(In thousands, except per share amounts)	2004	2003	2002
Numerator:			
Net income	$ 27,054	$ 28,518	$ 38,637
Denominator:			
Denominator for basic earnings per share – weighted average shares	25,767	25,078	24,444
Effect of dilutive securities:			
Employee and director stock options	1,499	1,395	1,420
Denominator for diluted earnings per share – adjusted weighted average shares and assumed conversions	27,266	26,473	25,864
Basic income per share	$ 1.05	$ 1.14	$ 1.58
Diluted income per share	$ 0.99	$ 1.08	$ 1.49

In 2004, 2003 and 2002, options to purchase 201,000; 227,150; and 280,580 shares, respectively, of Inter-Tel stock were excluded from the calculation of diluted net earnings per share because the exercise price of these options was greater than the average market price of the common shares for the respective fiscal years, and therefore the effect would have been antidilutive.

NOTE M – RETIREMENT PLANS

Inter-Tel maintains retirement plans for the benefit of our employees. Under our 401(k) Retirement Plan, participants may contribute on an annual basis up to the maximum amount allowed by the Internal Revenue Service. We make voluntary annual contributions to the Plan of 50% of contributions made by Plan participants of up to 6 percent of each participant's compensation. Our matching contributions to the Plan totaled $1,861,000; $1,627,000; and $1,567,000; in 2004, 2003 and 2002, respectively.

In 1992, we initiated an Employee Stock Ownership Plan (ESOP), advancing $500,000 to the ESOP Trust for the purpose of purchasing Common Stock of the Company. The Trust purchased 307,000 shares of Inter-Tel Common Stock in July 1992 and the loan was paid in full during 1997. As the principal amount of the loan was repaid to Inter-Tel through Company annual contributions, the equivalent number of shares released was allocated to employees' accounts to be held until retirement. Total shares so allocated were 32,380 in 1997. After the final allocation of shares in 1997, the ESOP plan was "frozen," so that all eligible participants as of July 1, 1997 became 100% vested in their accounts, regardless of length of service. In October 2002, our Board of Directors authorized the termination of this plan, requiring the shares in the ESOP to be distributed as one-time rollover contributions to accounts in our 401(k) Retirement Plan, or to other qualified plans or as early taxable distributions. With the exception of a few of our former employees whom we could not locate, the Plan assets were distributed in their entirety during 2003, as allowed pursuant to a favorable determination letter that was issued by the Internal Revenue Service on January 16, 2003.

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

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

(In thousands, except per share amounts)	Principal Segment (excluding E-Rate Settlement)	E-Rate Settlement	Subtotal Principal Segment	Resale of Local, Long Distance and Network Services	Total
2004					
Net sales	$ 367,969	$ --	$ 367,969	$ 48,924	$ 416,893
Gross profit	202,624	--	202,624	18,951	221,575
Operating income	43,177	(9,261)	33,916	7,799	41,715
Interest and other income	2,463	--	2,463	191	2,654
Loss on foreign currency transactions	(399)	--	(399)	--	(399)
Interest expense	(109)	--	(109)	(9)	(118)
Net income	$ 30,525	$ (8,957)	$ 21,568	$ 5,486	$ 27,054
Net income per diluted share (1)	$ 1.12	$ (0.33)	$ 0.79	$ 0.20	$ 0.99
Weighted average diluted shares (1)	27,266	27,266	27,266	27,266	27,266
Goodwill	17,755	--	17,755	2,135	19,890
Total assets	$ 397,901	$ --	$ 397,901	$ 9,065	$ 406,966
Depreciation and amortization	$ 9,897	$ --	$ 9,897	$ 107	$ 10,004

(In thousands, except per share amounts)	Principal Segment (excluding Litigation Settlement)	Litigation Settlement	Subtotal Principal Segment	Inter-Tel.NET /Vianet	Resale of Local, Long Distance and Network Services	Total
2003						
Net sales	$ 330,014	$ --	$ 330,014	$ --	$ 43,822	$ 373,836
Gross profit	179,777	--	179,777	--	17,296	197,073
Operating income	37,379	--	37,379	--	6,949	44,328
Interest and other income	1,526	--	1,526	124	157	1,807
Gain on foreign currency transactions	18	--	18	--	--	18
Interest expense	(153)	--	(153)	--	(2)	(155)
Net income	$ 24,009	$ --	$ 24,009	$ 77	$ 4,432	$ 28,518
Net income per diluted share (1)	$ 0.91	$ --	$ 0.91	$ -	$ 0.17	$ 1.08
Weighted average diluted shares (1)	26,473	26,473	26,473	26,473	26,473	26,473
Goodwill	15,832	--	15,832	--	2,135	17,967
Total assets	$ 338,637	$ --	$ 338,637	$ --	$ 21,239	$ 359,876
Depreciation and amortization	8,973	--	8,973	--	161	9,134

(In thousands, except per share amounts)	Principal Segment (excluding Litigation Settlement)	Litigation Settlement	Subtotal Principal Segment	Inter-Tel.NET /Vianet	Resale of Local, Long Distance and Network Services	Total
2002						
Net sales	$ 344,876	$ --	$ 344,876	$ --	$ 36,580	$ 381,456
Gross profit	179,869	--	179,869	--	14,604	194,473
Operating income	40,356	--	40,356	--	5,371	45,727
Interest and other income	1,772	15,516	17,288	(1,200)	164	16,252
Gain on foreign currency transactions	330	--	330	--	--	330
Interest expense	(155)	--	(155)	--	(1)	(156)
Net income (loss)	$ 25,891	$ 9,492	$ 35,383	$ (746)	$ 4,000	$ 38,637

Net income (loss) per diluted share (1)	$ 1.00	$ 0.37	$ 1.37	$ (0.03)	$ 0.15	$ 1.49
Weighted average diluted shares (1)	25,864	25,864	25,864	25,864	25,864	25,864
Goodwill	15,511	--	15,511	--	2,135	17,646
Total assets	$ 263,405	$ --	$ 263,405	$ --	$ 18,657	$ 282,062
Depreciation and amortization	8,464	--	8,464	--	190	8,654

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

Our revenues are generated predominantly in the United States. Total revenues generated from U.S. customers totaled $403.7 million, $362.8 million and $371.3 million, of total revenues for the years ended December 31, 2004, 2003 and 2002, respectively. Revenues from international sources were primarily generated from customers located in the United Kingdom, Europe, Asia, and Mexico. In 2004, 2003 and 2002, revenues from customers located internationally accounted for 3.2%, 3.0% and 2.7% of total revenues, respectively. Our applicable long-lived assets at December 31, 2004, included Property, Plant & Equipment; Goodwill; and Purchased Intangible Assets. The net amount located in the United States was $56.1 million and the amount in foreign countries was $2.6 million at December 31, 2004. The net amount located in the United States was $47.3 million and the amount in foreign countries was $3.5 million at December 31, 2003.

NOTE O – FINANCIAL INSTRUMENTS

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

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

NOTE P – SUPPLEMENTAL CASH FLOW

	Years Ended December 31,		
(In thousands)	2004	2003	2002
Cash paid for:			
Interest	$ 118	$ 155	$ 156
Income taxes paid (received)	$ (1,156)	$ (9,384)	$ 15,424
Additional disclosure of cash flow information:			
Tax benefit from stock options	$ (2,638)	$ (2,321)	$ (2,671)
Changes in operating assets and liabilities:			
(Increase) decrease in receivables and current net investment in sales-leases	$ (4,444)	$ (6,096)	$ 1,907
(Increase) decrease in inventories	(2,192)	(4,069)	9,759
(Increase) decrease in prepaid expenses and other assets	5,933	(2,935)	4,248
Increase in long-term net investment in sales-leases and other assets	(1,809)	(6,962)	(3,448)
Increase in accounts payable and other current liabilities	4,510	1,093	3,014
	$ 1,998	$ (18,969)	$ 15,480

NOTE Q – QUARTERLY RESULTS OF OPERATIONS (UNAUDITED)

A summary of the quarterly results of operations for the years ended December 31, 2004 and 2003 follows (quarterly amounts may not add to the year-end totals due to rounding):

(In thousands, except per share amounts)

2004	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr
Net sales	$ 98,031	$ 102,908	$ 105,506	$ 110,448
Gross profit	$ 52,098	$ 54,299	$ 55,934	$ 59,244
E–Rate settlement (pre-tax)	$ --	$ --	$ --	$ 9,261
Net income	$ 6,820	$ 8,117	$ 9,206	$ 2,911
Net income per share—Basic	$ 0.27	$ 0.32	$ 0.36	$ 0.11
Net income per share—Diluted	$ 0.25	$ 0.30	$ 0.34	$ 0.11
Weighted average basic common shares	25,543	25,715	25,816	25,994
Weighted average diluted common shares	27,350	27,262	26,944	27,509

2003	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr
Net sales	$ 84,169	$ 95,102	$ 94,545	$ 100,020
Gross profit	$ 44,074	$ 50,250	$ 49,244	$ 53,505
Net income	$ 4,672	$ 7,269	$ 7,218	$ 9,359
Net income per share—Basic	$ 0.19	$ 0.29	$ 0.29	$ 0.37
Net income per share—Diluted	$ 0.18	$ 0.28	$ 0.27	$ 0.35
Weighted average basic common shares	24,920	24,947	25,107	25,338
Weighted average diluted common shares	26,039	25,970	26,865	27,020

NOTE R – SUBSEQUENT EVENT

On February 28, 2005, Inter-Tel Lake Ltd, a wholly owned Irish subsidiary of Inter-Tel Incorporated ("Inter-Tel") executed an agreement for the purchase of 100% of the issued share capital of Lake Communications Limited and certain affiliated entities (collectively, "Lake") for $28.0 million, plus an earn-out of up to $17.6 million based upon certain targets relating to operating results for Lake through the first eighteen months following the closing date of the transaction. The transaction closed out of escrow on March 4, 2005 upon the release from escrow of closing documentation. Lake, based in Dublin, Ireland, is a provider of converged communications products in the under 40 user market, including EncoreCX® products currently being distributed by Inter-Tel in the United States. Lake designs and develops its products for sale through a distribution network of telecom operators and distributors, including Inter-Tel in the United States. Lake outsources its manufacturing to third-party suppliers. For more than a year, Lake has sold certain communications products to the Company in the ordinary course of its business.

EXHIBIT 21

SUBSIDIARIES OF INTER-TEL, INCORPORATED

Listed below are all the subsidiaries of Inter-Tel, Incorporated, as well as the jurisdiction under the laws of which each was organized, and the percentage of the outstanding voting stock of each owned by Inter-Tel, Incorporated as of December 31, 2004.

Name	Percentage of Voting Stock Owned	State or Jurisdiction of Organization
Inter-Tel Integrated Systems, Inc.	100%	Arizona
Inter-Tel Technologies, Inc.	100%	Arizona
Inter-Tel Leasing, Inc.	100%	Arizona
Inter-Tel Software and Services, Inc.	100%	Arizona
Inter-Tel Midwest, Inc.	100%	Delaware
Inter-Tel Incorporated-New Jersey	100%	Delaware
Inter-Tel NetSolutions, Inc.	100%	Texas
Inter-Tel DataCom, Inc.	100%	California
Southwest Telephone Systems, Inc.	100%	New Mexico
American Telcom Corp. of Georgia, Inc.	100%	Georgia
Access West, Inc.	100%	Delaware
Inter-Tel Europe, Limited	100%	United Kingdom
Swan Solutions Limited	100%	United Kingdom
Callview Limited	100%	United Kingdom
Inter-Tel Lake Limited	100%	Ireland
Inter-Tel Japan, Inc.	100%	Japan
Tri-Com Communications, Inc.	100%	North Carolina
Florida Telephone Systems, Inc.	100%	Florida
NTL Corporation dba ComNet of Ohio	100%	Ohio
Integrated Telecom Services Corporation	100%	Kentucky
Telephone Corporation of America, Inc. (Telcoa)	100%	Maryland
TDI Services Corporation, Technology Dynamics for the 21st Century	100%	Virginia
Inter-Tel Business Information Systems, Inc.	100%	Arizona

EXHIBIT 23.0--CONSENT OF ERNST & YOUNG LLP, INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in Registration Statement (Form S-8 No. 33-40353) pertaining to the 1990 Directors Stock Option Plan, Registration Statement (Form S-8 No. 33-83826) pertaining to the Inter-Tel, Incorporated 1994 Long Term Incentive Plan, Registration Statement (Form S-8 No. 33-73620) pertaining to the Inter-Tel, Incorporated Employee Stock Ownership Plan, Registration Statement (Form S-8 No. 333-41197) pertaining to the Inter-Tel, Incorporated 1997 Long Term Incentive Plan and Inter-Tel, Incorporated 1997 Employee Stock Purchase Plan, Registration Statement (Form S-8 No. 333-56872) pertaining to the Acquisition Stock Option Plan, Registration Statement (Form S-8 No. 333-67261) pertaining to the Acquisition Stock Option Plan, Registration Statement (Form S-8 No. 333-85098) pertaining to the Inter-Tel, Incorporated 1997 Long Term Incentive Plan and Acquisition Stock Option Plan, Registration Statement (Form S-8 No. 333-87474) pertaining to the Inter-Tel, Incorporated 1997 Employee Stock Purchase Plan, Registration Statement (Form S-8 No. 333-104642) pertaining to the Inter-Tel, Incorporated 1997 Long-Term Incentive Plan, Registration Statement (Form S-8 No. 333-016868) pertaining to the Inter-Tel, Incorporated Tax Deferred Savings Plan and Retirement Trust, and Registration Statement (Form S-3 No. 33-58161), Registration Statement (Form S-3 No. 33-61437), Registration Statement (Form S-3 No. 333-01735), Registration Statement (Form S-3 No. 333-12433), Registration Statement (Form S-3 No. 333-39221), of our report dated March 10, 2005, with respect to the consolidated financial statements and schedule of Inter-Tel, Incorporated, Inter-Tel, Incorporated management's assessment of the effectiveness of internal control over financial reporting, and the effectiveness of internal control over financial reporting of Inter-Tel, Incorporated, included in this Annual Report (Form 10-K) of Inter-Tel, Incorporated for the year ended December 31, 2004.

/s/ Ernst & Young LLP

Phoenix, Arizona
March 10, 2005

EXHIBIT 31.1

CERTIFICATION OF CHIEF EXECUTIVE OFFICER
AS ADOPTED PURSUANT TO
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Steven G. Mihaylo, certify that:

1. I have reviewed this annual report on Form 10-K of Inter-Tel, Incorporated;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and we have:
   a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
   b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
   c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this annual report based on such evaluation; and
   d) disclosed in this annual report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
   a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial data; and
   b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ STEVEN G. MIHAYLO

Date: March 14, 2005

Steven G. Mihaylo
Chairman and Chief Executive Officer (Principal Executive Officer)

EXHIBIT 31.2

CERTIFICATION OF CHIEF FINANCIAL OFFICER
AS ADOPTED PURSUANT TO
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Kurt R. Kneip, certify that:

1. I have reviewed this annual report on Form 10-K of Inter-Tel, Incorporated**;**

2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;

3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and we have:

   a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;

   b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this annual report based on such evaluation; and

   d) disclosed in this annual report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

   a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial data; and

   b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ KURT R. KNEIP

Date: March 14, 2005

Kurt R. Kneip,
Senior Vice President and Chief Financial Officer

(Principal Financial Officer)

EXHIBIT 32.1

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

Pursuant to section 906 of the Sarbanes-Oxley Act of 2002 (subsections (a) and (b) of section 1350, chapter 63 of title 18, United States Code), each of the undersigned officers of Inter-Tel, Incorporated ("Company"), does hereby certify, to such officer's knowledge, that:

The Annual Report on Form 10-K for the fiscal year ended December 31, 2004 ("Form 10-K") of the Company fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 and information contained in the Form10-K fairly presents, in all material respects, the financial condition and results of operations of the Company.

	/s/ STEVEN G. MIHAYLO
Date: March 14, 2005	Steven G. Mihaylo *Chairman and Chief Executive Officer (Principal Executive Officer)*
	/s/ KURT R. KNEIP
Date: March 14, 2005	Kurt R. Kneip, *Senior Vice President and Chief Financial Officer (Principal Financial Officer)*