XEROX CORP
Form 10-K
February 23, 2011
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended: December 31, 2010

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from: __ to ____

001-04471 (Commission File Number)

XEROX CORPORATION

(Exact name of registrant as specified in its charter)

New York	**16-0468020**
(State of incorporation)	**(I.R.S. Employer Identification No.)**

P.O. Box 4505, 45 Glover Avenue, Norwalk, Connecticut 06856-4505 (Address of principal executive offices)

Registrant s telephone number, including area code: (203) 968-3000

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

Title of each class	Name of each exchange on which registered
Common Stock, $1 par value	New York Stock Exchange Chicago Stock Exchange

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

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes x No ¨

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K 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 a check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company ¨

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

Table of Contents

The aggregate market value of the voting stock of the registrant held by non-affiliates as of June 30, 2010 was: $11,119,697,695.

Indicate the number of shares outstanding of each of the registrant s classes of common stock, as of the latest practicable date:

Class	Outstanding at January 31, 2011
Common Stock, $1 par value	1,399,441,447 Shares

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the following documents are incorporated herein by reference:

Document	Part of Form 10-K in Which Incorporated
Xerox Corporation 2010 Annual Report to Shareholders	I & II
Xerox Corporation Notice of 2011 Annual Meeting of Shareholders and Proxy Statement (to be filed not later than 120 days after the close of the fiscal year covered by this report on Form 10-K)	III

FORWARD-LOOKING STATEMENTS

From time to time, we and our representatives may provide information, whether orally or in writing, including certain statements in this Annual Report on Form 10-K, which are deemed to be forward-looking within the meaning of the Private Securities Litigation Reform Act of 1995 (the Litigation Reform Act). These forward-looking statements and other information are based on our beliefs as well as assumptions made by us using information currently available.

The words anticipate, believe, estimate, expect, intend, will, should and similar expressions, as they relate to us, are intended to identif forward-looking statements. Such statements reflect our current views with respect to future events and are subject to certain risks, uncertainties and assumptions. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those described herein as anticipated, believed, estimated, expected or intended or using other similar expressions. We do not intend to update these forward-looking statements, except as required by law.

In accordance with the provisions of the Litigation Reform Act, we are making investors aware that such forward-looking statements, because they relate to future events, are by their very nature subject to many important factors that could cause actual results to differ materially from those contemplated by the forward-looking statements contained in this Annual Report on Form 10-K, any exhibits to this Form 10-K and other public statements we make. Such factors include, but are not limited to: changes in economic conditions, political conditions, trade protection measures, licensing requirements, environmental regulations and tax matters in the United States and in the foreign countries in which we do business; changes in foreign currency exchange rates; the outcome of litigation and regulatory proceedings to which we may be a party; actions of competitors; our ability to expand equipment placements and to drive the expanded use of color in printing and copying; development of new products and services; interest rates, cost of borrowing and access to credit markets; our ability to protect our intellectual property rights; our ability to obtain adequate pricing for our products and services and to maintain and improve cost efficiency of operations, including savings from restructuring actions; the risk that unexpected costs will be incurred; reliance on third parties for manufacturing of products and provision of services; the risk that we will not realize all of the anticipated benefits from the acquisition of Affiliated Computer Services, Inc.; our ability to recover capital investments; the risk that subcontractors, software vendors and utility and network providers will not perform in a timely, quality manner; the risk that multi-year contracts with governmental entities could be terminated prior to the end of the contract term; the risk that individually identifiable information of customers, clients and employees could be inadvertently disclosed or disclosed as a result of a breach of our security; and other factors that are set forth in the Risk Factors section, the Legal Proceedings section, the Management s Discussion and Analysis of Financial Condition and Results of Operations section and other sections of this Annual Report on Form 10-K, as well as in our Quarterly Reports on Form 10-Q and Current Reports on Form 8-K.

Table of Contents

TABLE of CONTENTS

Table of Contents

PART I

ITEM 1. BUSINESS OVERVIEW

We provide the industry s broadest portfolio of document technology, services and software; and the most diverse array of business process and IT outsourcing support. Our document technology offerings serve businesses of all sizes and across industries to deliver solutions for both the workplace and production print environments. We leverage our technology and the document expertise of our employees to deliver further value for our customers through our document outsourcing solutions, which help customers improve their productivity and reduce costs. We have transformed our business with the acquisition of Affiliated Computer Services, Inc. (ACS) in February 2010, which allows Xerox to capitalize on the rapidly growing services market. Through our business process and IT outsourcing we offer global services from claims reimbursement and electronic toll transactions to the management of HR benefits and customer care centers to the operation of a company s technology infrastructure.

Table of Contents

Our Strategy

We are well-positioned to lead in the markets in which we participate. Our strategy leverages our core strengths to drive growth within our segments and lines of businesses.

Table of Contents

Our core strengths include:

Our Brand We have a strong and well-recognized brand that is known by businesses worldwide for delivering industry-leading document technology, services and solutions.

Global Presence Our geographic footprint spans 160 countries and allows us to serve customers of all sizes to deliver superior technology and services regardless of complexity or number of customer locations.

Renowned Innovation We have a history of innovation and, with more than 10,200 active U.S. patents and five global research centers, we are committed to continuing to lead in the document technology industry and to leverage our technology into new service areas.

Services Operational Excellence We have an operational excellence model that leverages our global delivery capabilities, production model, incentive-based compensation process, proprietary systems and financial discipline to deliver productivity and lower costs for our customers.

We organize our business around two segments: **Technology** and **Services**.

Our **Technology** segment comprises our business of providing customers with document technology and related supplies, technical service and equipment financing. Our product categories within this segment include Entry, Mid-range and High-end products.

Our **Services** segment is comprised of business process outsourcing, information technology outsourcing and document outsourcing services. Because we provide all three of these business services, we are uniquely positioned in the industry, and we believe this allows us to provide a differentiated solution and deliver greater value to our customers.

We will leverage our core strengths and market opportunities to grow our businesses by executing on the following growth initiatives:

Accelerating the Transition to Color We have the broadest color portfolio in the industry and leading technologies to help customers realize the communication benefits of printing in color. Cost and quality improvements are driving the transition from black-and-white to color. With only 23% of Xerox pages printed on color devices, we believe there remains tremendous opportunity to grow color pages and revenues.

Advancing Customized Digital Printing We are the leader in digital production printing, and we continue to create new market opportunities for digital printing through technology that enables personalized promotional and transactional documents, short-run book publishing, cross-media customized campaigns and more. Color digital production pages are estimated to grow over 20% CAGR from 2009 to 2014, according to internal market estimates.

Expand Distribution We strive to ensure Xerox is considered by every customer and potential customer. We will continue to broaden our distribution capacity through acquisitions and channel partnerships targeted at expanding our presence in the small and mid-size business (SMB) market and we will capitalize on our coverage investments and partnerships to drive growth in digital production printing.

Extending Lead in Document Outsourcing We lead the industry with end-to-end Document Management Services. Through offerings such as managed print services, we can help our customers save up to 30% on printing costs by optimizing their use of document systems across an entire enterprise. We will seek to grow our document outsourcing revenue by expanding our print services offerings to smaller companies, delivering solutions in new service categories such as multi-channel marketing communications, and leveraging our BPO and ITO presence to deliver even greater value to our customers.

Table of Contents

Expand BPO and ITO Globally In 2010, approximately 90% of our BPO and ITO revenues were from services provided to customers in the United States. We believe there is tremendous opportunity to leverage Xerox s global presence and customer relationships to expand our BPO and ITO services internationally.

Leverage Innovation We have a strong heritage in innovation and we continue to invest heavily in research and development. In 2010, together with Fuji Xerox, our research and development spending was $1,602 million. We see great opportunity in applying our document management technology to deliver industry-leading document solutions to the market, to increase ACS s existing BPO capabilities, and to deliver new services to help customers better manage their document-intensive business processes.

Acquisitions

In February 2010, we acquired **Affiliated Computer Services, Inc.** ACS is a premier provider of diversified business process outsourcing and information technology services and solutions to commercial and government clients worldwide.

Subsequent to the acquisition of ACS, we acquired three additional service companies, further expanding our BPO capabilities:

In July 2010, we acquired **ExcellerateHRO, LLP** (EHRO), a global benefits administration and relocation services provider. This acquisition establishes ACS as one of the world s largest pension plan administrators and a leading provider of outsourced health, welfare and relocation services.

In October 2010, we acquired **TMS Health, LLC** (TMS), a U.S.-based teleservices company that provides customer care services to the pharmaceutical, biotech and healthcare industries. Through TMS, we will improve communication between pharmaceutical companies, physicians, consumers and pharmacists. By providing customer education, product sales and marketing, and clinical trial solutions, we build on our ITO and BPO services we are already delivering to the healthcare and pharmaceutical industries.

In November 2010, we acquired **Spur Information Solutions, Limited** (Spur), one of the United Kingdom s leading providers of parking enforcement computer software used. Spur s core software helps governments implement and enforce local parking codes across municipalities. The acquisition strengthens our broad portfolio of services that support the transportation industry.

Additionally in 2010, we acquired two companies to further expand our distribution capacity:

In January 2010, we acquired **Irish Business Systems Limited** (IBS) to expand our reach into the small and mid-size business market in Ireland. IBS, a managed print services provider, has eight offices located throughout Ireland and is the largest independent supplier of digital imaging and printing solutions in Ireland.

In September 2010, we acquired **Georgia Duplicating Products, Inc.**, an office equipment supplier. This acquisition furthers our strategy of supporting business customers across the U.S. with an expanding network of office technology providers.

Business Model Fundamentals

Through our annuity-based business model, we deliver significant cash generation and have a strong foundation upon which we can expand earnings.

Table of Contents

Annuity Model

The fundamentals of our business rest upon an annuity model that drives significant recurring revenue and cash generation. Over 80% of our 2010 total revenue was annuity based revenue that includes contracted services, equipment maintenance and consumable supplies, among other elements. Some of the key indicators of annuity revenue growth include:

- The number of page-producing machines in the field (MIF) which is impacted by the number of equipment installations
- Page volume and the mix of color pages, as color pages generate more revenue per page than black-and-white
- Services signings growth, which reflects the year-over-year increase in estimated future revenues from contracts signed during the period as measured on a trailing 12 month basis
- Services pipeline growth, which measures the year-over-year increase in new business opportunities
- Expanding the digital production printing market, as this is key to increasing pages.

Cash Generation

The combination of consistent strong cash flow from operations and modest capital investments enabled us in 2010 to pay down a significant amount of the debt associated with the ACS acquisition. Cash generation in the future will continue to provide a return to shareholders through:

- Buying back shares under our share repurchase program once debt leverage targets are met
- Expanding our distribution and business process outsourcing capabilities through acquisitions
- Maintaining and, over time, increasing our quarterly dividend.

Expanded Earnings

We will expand our operating margin and future earnings through:

- Modest revenue growth
- Driving cost efficiencies to balance gross profit and expense
- Repurchasing shares
- Making accretive acquisitions.

Table of Contents

Segment Information

Our reportable segments are Technology, Services and Other. We present operating segment financial information in Note 2 Segment Reporting in the Consolidated Financial Statements, which we incorporate by reference here. We have a very broad and diverse base of customers by both geography and industry, ranging from SMB to graphic communications companies, governmental entities, educational institutions and Fortune 1000 corporate accounts. None of our business segments depends upon a single customer, or a few customers, the loss of which would have a material adverse effect on our business.

Technology

Table of Contents

Technology includes the sale of products and supplies, as well as the associated technical service and financing of those products. The Technology segment is centered around strategic product groups that share common technology, manufacturing and product platforms.

Table of Contents

Our strategic product groups are as follows:

Entry

Entry comprises products sold principally to small and mid-size businesses through a worldwide network of independent resellers, and includes desktop monochrome and color printers and multifunction printers (MFPs) ranging from small personal devices to larger workgroup printers designed to serve the needs of demanding office users. In 2010, we continued to build on our position in the market by:

- Leveraging the market transition from larger centralized devices to more-affordable desktop-centric devices with a full portfolio of products
- Making high-quality desktop color more affordable and easier to use for small businesses and large enterprises alike
- Expanding our channel reach, partner programs and capacity to support the needs of the SMB market

Our Entry business products include:

- **ColorQube 8570/8870:** Featuring advanced cartridge-free solid ink, the ColorQube 8570 and ColorQube 8870 color printers are powerful, no-fuss and waste-conscious printing solutions that are simple, highly productive and affordable, with the advantage of superior color output. At 40 pages-per-minute (ppm), these products are perfect for small to mid-size workgroups.
- **Phaser 7500:** This 35 ppm color laser printer allows small and mid-size workgroups to attain professional-quality results. Key features include improved print quality as a function of 1200 dpi, new Color by Words Xerox technology, a natural language technology enabling easy and intuitive color adjustments, enhanced media handling capabilities and longer lives on customer replaceable parts.
- **WorkCentre 6400:** The WC6400 is Xerox s first desktop multifunction printer that utilizes Xerox s Smart Controller platform and supports EIP, Xerox s open platform allowing customization of applications on the MFP. The WorkCentre 6400 is also able to handle busy volumes with print speeds up to 32 ppm color/37 ppm mono and offers basic finishing, Print Around and ID Card Copy.

Mid-range

Mid-range comprises products sold to enterprises of all sizes, principally through dedicated Xerox-branded partners and our direct sales force. We offer a wide range of multifunction printers, copiers, digital printing presses and light production devices that deliver flexibility and advanced features.

In 2010, our Mid-range business continued to build on our position in the market by:

- Enhancing our already strong product portfolio, making color more affordable, easier to use, faster and more reliable while maintaining our leadership position in black-and-white
- Driving to a leadership position in the combined color page printer and color MFP market segments
- Offering a complete range of services and solutions in partnership with independent software partners that allow our customers to analyze, streamline, automate, secure and track their document workflows.

The breadth of our Mid-range product portfolio is unmatched. We continued to build on this portfolio in 2010 with the launches of:

- **Xerox WorkCentre 7120:** Xerox s new multifunction printer combines affordable color with high-productivity workflow tools. Today s MFPs do far more than copy and print they improve the way work gets done; the WorkCentre 7120 helps SMBs maximize office productivity and produce affordable, impactful color documents.
- **WorkCentre 7545 and 7556:** These new multifunction printers are equipped with features to help mid-size businesses and large workgroups boost productivity and meet their sustainability goals. They offer speeds up to 45 and 50 ppm color and 45 and 55 ppm black-and-white, respectively. The MFPs, which can copy, scan, fax and email, include advanced document management and workflow tools to make office work easier.

Table of Contents

Xerox Color 550/560 Digital Color Printer: The new Xerox Color 550/560 printer, with an easy-to-use color touch-screen, benchmark image quality and flexible finishing options, is an efficient choice for quick-print shops, small commercial printers, in-plant operations, advertising agencies, creative shops and office settings. It is the perfect fit in any print setting for applications ranging from marketing pieces to office documents.

High-end

We provide High-end digital monochrome and color systems designed for customers in the graphic communications industry and for large enterprises. These High-end devices enable digital on-demand printing, digital full-color printing and enterprise printing. We are the leading provider in the market offering a complete family of monochrome and color production systems, business development tools and workflow solutions. We are creating new market opportunities in targeted application areas with digital printing as a complement to traditional offset printing.

For more than two decades, we have delivered innovative technologies that have revolutionized the production printing industry. We are the industry leader in the number of pages produced on digital production color presses. We continued to build on our award-winning lineup in 2010 with the launches of:

Xerox Color Press 800 and 1000: These new products are additions to the portfolio and are positioned below iGen4, and above the DocuColor 8002. They offer customers a set of new innovative features. The optional fifth housing for clear dry ink allows users to create new applications and/or add value to existing work. The clear dry ink allows for images and text to be highlighted for visual impact, or digital watermarks applied for artistic effect. Flexible finishing options include high-capacity stackers, booklet makers and a tape bind option exclusive to Xerox

Xerox iGen4 EXP: We added more capabilities to the flagship of the production color portfolio, iGen4. The industry s most reliable and productive press added a number of new options that expand the reach of iGen, enabling new applications that were previously done only on offset presses. The expanded sheet size of 26 , or 660mm, allows print providers to produce full-size trifold brochures and more multi-up images such as postcards and business cards per page. A new touchless workflow allows for jobs to be completed without manual intervention or setup, saving time, reducing errors and producing more-sellable prints. Integrating with the Adobe PDF print engine drives quick and reliable printing of native Adobe PDF files.

Table of Contents

We are enabling print providers in graphic communications, service bureaus and large enterprises to profit and grow by meeting their customers specific business needs with just-in-time, one-to-one and e-based services rather than simply manufacturing a printed piece.

FreeFlow Digital Workflow: Our FreeFlow digital workflow is a collection of software technology solutions that our customers can use to improve all aspects of their processes, from content creation and management to production and fulfillment. Our digital technology combined with total document solutions and services that enable personalization and printing on demand, delivers value that improves our customers business results.

Through our industry-leading FreeFlow Digital Workflow collection and FreeFlow Print Server, we deliver three primary values to our customers - the ability to Connect, Control and Enable. Our solutions:

- Connect our customers to their customers 24/7, enabling them to be open for business around the clock
- Control our customers costs, environmental impacts and security. Automated workflows provide extensive productivity gains and greatly increase document integrity by eliminating manual processes.
- Enable new applications and revenue streams such as photo books, secure event tickets and packaging.

Services

Our Services segment comprises three service offerings: Business Process Outsourcing (BPO), Document Outsourcing (DO) and Information Technology Outsourcing (ITO). We provide non-core, mission-critical services that our clients need to run their day-to-day business. The services we provide enable our clients to concentrate on their core operations, respond rapidly to changing technologies and reduce expenses associated with their business processes and information processing.

The majority of our Services business is the result of our acquisition of ACS in February 2010.

Table of Contents

Business Process Outsourcing

We are the largest worldwide diversified business process outsourcing company, with focused offerings in education, transportation, communication, healthcare, government, finance and accounting services, manufacturing, consumer goods and retail. Our BPO service offerings are focused, transaction-intensive, back-office functions. Our BPO services include:

Human Resources Services: We provide a comprehensive portfolio of human resources solutions that allow our clients to benefit from best practices, our subject matter expertise, consulting and technological solutions. Our human resources services include:

- HR consulting
- HR Outsourcing
- Total Benefits Outsourcing
- Learning

Table of Contents

Customer Care: One of our core values is delivering a positive customer care experience. We have years of experience providing customer care outsourcing services that can improve productivity, efficiency and customer retention. Services include:

- Strategic Advisory Services
- Account Activations
- Collections
- Device/Technical Support

Finance and Accounting Outsourcing: Our finance and accounting services allow our clients to benefit from our global delivery model and our quality management systems, resulting in better accuracy and, timeliness, and reduced risk for our clients. Services include:

- Accounts Payable, Accounts Receivable
- Billing
- General Accounting
- Tax Management
- Treasury and Risk Management
- Time and Expense Reporting

Healthcare Payer and Insurance: We deliver administrative efficiencies to our healthcare payer clients through our scalable and flexible transactional business solutions, which encompass both our global delivery model and domestic payer service centers. Services include:

- Healthcare Payer Claim Processing
- Healthcare Payer Customer Care
- Cost Recovery, Audit, Cost Avoidance

Healthcare Provider: Our healthcare provider business offers services and solutions to meet the critical financial, operational and clinical needs of the healthcare provider industry. We offer a full range of services, including:

- Consulting Solutions
- Revenue Cycle Management
- Application Services

Government Services and Solutions: We help federal, state and local government agencies by providing services that improve their operating efficiency, increase the level of service provided to their constituents, increase their revenue streams and reduce overall operating costs of service delivery. Our service offerings include:

- Child Support Payment Processing
- Electronic Benefits Transfer
- Student Loan Servicing
- Government Records Management
- Electronic Payment Cards

Government Healthcare: We provide our state government clients with health program management solutions to help them administer their programs and control the cost of healthcare. We support the full healthcare continuum, including member enrollment, claims processing and health management. Our service offerings include:

- Medicaid Program Administration
- Healthcare and Quality Management
- Eligibility and Enrollment Solutions
- Pharmacy Benefits Management

Transportation Solutions: We help transportation agencies worldwide address the unique challenges associated with revenue collection and regulation compliance services. From fare collection to toll and parking solutions and from back office processing to infrastructure installation, we provide systems and services that help governments with their transportation problems. New innovations include the **Smart Card Fare Payment Solution** - a streamlined and seamless fare payment system. By adopting a fare payment system based on the financial industry s open standards, transit agencies can now enable riders to tap contactless bankcards for point-of-entry payments.

Table of Contents

Information Technology Outsourcing

We specialize in designing, developing and delivering effective IT solutions. Our secure data centers, help desks and managed storage facilities around the world provide a reliable IT infrastructure that minimizes the chance of disruption to our clients daily operations.

With our global Information Technology Outsourcing solutions, commercial businesses and government organizations worldwide can focus on their competencies instead of their IT infrastructure.

Throughout our global IT services outsourcing portfolio, we:

- Infuse thought leadership and innovation
- Manage to the highest level of quality for service delivery
- Enable our customers to transform their organization

Our ITO services include:

- **Data Center Outsourcing:** We provide a 24/7 support organization that maintains a unified set of tools and processes to support our clients IT environments, including systems administration, database administration, systems monitoring, batch processing, data backup and capacity planning.
- **Mid-range Server Outsourcing:** We support our clients needs for adaptable computing environments and their potential growth. We provide comprehensive systems support services.
- **Network Outsourcing:** We provide telecommunications management services for voice and data networks. We are able to leverage our enterprise agreements, proprietary tools, procedures and skilled personnel to provide our clients with a scalable and automated processing environment.
- **Remote Infrastructure Management (RIM):** We provide RIM services that allow our clients to retain control of their IT assets but outsource the day-to-day IT operations management.
- **Help Desk/Service Desk Management:** We deliver specialized service desk support from self-service to remote management and diagnostics.
- **Desktop Outsourcing:** Our desktop services provide our clients with a comprehensive approach to managing their end-user platforms and devices. We design and execute desktop management strategies that address and resolve issues such as enterprise bandwidth constraints, unstable computing environments, areas of insecurity and unavailable network resources.
- **Managed Storage:** Data storage requirements have become larger and more complex. We help our clients define, monitor and optimize their data storage requirements while reducing the complexity of their storage environments and associated costs.
- **Utility Computing:** We support large corporations with our utility computing model. Utility computing provides pay for use pricing for mid-range server clients, which provides variable pricing and relieves our clients from the burden of asset ownership.
- **Disaster Recovery:** We approach disaster recovery as a multidisciplinary function. We assess our clients specific enterprise requirements and then deploy solutions based on these requirements.
- **Security Services:** Our solutions provide security from the desktop to LAN/WAN and Internet levels. We leverage a combination of mature methodologies and industry best practices that afford increased ability to protect valuable data while also satisfying industry audit requirements.
- **IT commercial services:** We possess category knowledge, tools and processes that allow us to reduce IT and telecommunication costs for our clients.

Table of Contents

Document Outsourcing

We are an industry leader in document outsourcing services with more than 20 years experience and 15,000 business professionals across 160 countries.

We help companies optimize their printing infrastructure and streamline their communication and business processes to grow revenue, reduce costs and operate more efficiently. We specialize in the planning and delivery of the following services:

- Managed print services for workplace, production environments and virtual worker printing sites
- Consolidating in-house production and commercial printing under a single point of control
- Improving communication processes and back-office functions associated with creating, capturing, managing and routing customer, employee and supplier information
- Designing, authoring and translating technical and user documentation
- Creating personalized, multi-channel marketing communications

Through these services, we:

- Help our clients save up to 30% on printing costs through managed print services that optimize the use of document systems across an entire enterprise
- Simplify document-driven processes, such as forms processing and records management
- Manage in-house print operations and special events by handling technology procurement and print/copy centers
- Make information easier to manage and find through digital imaging, archiving and indexing
- Generate a better return on investment through personalized, multi-channel marketing communications
- Improve commercial print operations, sales and profits through document outsourcing

As the market leader in managed print services, our approach to optimizing across all print environments allows our customers to print from anywhere to anywhere in a seamless way while ensuring compliance with budget targets, security protocols and environmental sustainability programs.

Other

The Other segment primarily includes revenue from paper sales, wide-format systems and GIS network integration solutions and electronic presentation systems. Paper comprised approximately 58% of the revenues in the Other segment.

Table of Contents

Geographic Information

Our global presence is one of our core strengths. Overall, approximately 36% of our revenue is generated by customers outside the U.S. Currently, ACS generates approximately 10% of its revenue outside the U.S. We have a significant opportunity to leverage our global presence and customer relationships to expand the ACS business in Europe and developing markets.

Research and Development

Investment in R&D is critical for competitiveness in our fast-paced markets. Approximately 55% of our equipment sales are from products launched during the last two years. Our R&D investment also enables innovation within our Services segment.

Research activities are conducted in the United States in Webster, New York and Palo Alto, California; in Canada in Mississauga, Ontario; in Europe in Grenoble, France; and Asia both at the India Innovation Hub in Chennai, India, and in collaboration with Fuji Xerox, Ltd. (Fuji Xerox).

To ensure our success, we have aligned our R&D investment portfolio with our growth initiatives, including accelerating our color transition, enhancing customer value by building on our services leadership, and by strengthening our leadership in digital color printing.

Table of Contents

Xerox conducts work in color science, computing, digital imaging, work practices, electromechanical systems, novel materials, linguistics, work practice analysis and other disciplines. Through our Smart Document Technologies, we are developing ways to apply innovation to automate and differentiate our Services offerings.

Sustaining engineering expenses, which are the hardware engineering and software development costs we incur after we launch a product, are included in our RD&E expenses.

Patents, Trademarks and Licenses

Xerox and its subsidiaries were awarded 1,031 U.S. utility patents in 2010. On that basis, we would have ranked 20th on the list of companies that were awarded the most U.S. patents during the year. Including our research partner Fuji Xerox, we were awarded over 1,600 U.S. utility patents in 2010. Our patent portfolio evolves as new patents are awarded to us and as older patents expire. As of December 31, 2010, we held almost 10,200 design and utility U.S. patents. These patents expire at various dates up to 20 years or more from their original filing dates. While we believe that our portfolio of patents and applications has value, in general no single patent is essential to our business or any individual segment. In addition, any of our proprietary rights could be challenged, invalidated or circumvented, or may not provide significant competitive advantages.

In the U.S., we are party to numerous patent-licensing agreements and, in a majority of them we license or assign our patents to others in return for revenue and/or access to their patents. Most patent licenses expire concurrently with the expiration of the last patent identified in the license. In 2010, we added 16 new agreements to our portfolio of patent-licensing and sale agreements, and Xerox and its subsidiaries were licensor or seller in 14 of the agreements. We are also a party to a number of cross-licensing agreements with companies that hold substantial patent portfolios, including Canon, Microsoft, IBM, Hewlett-Packard, Oce, Sharp, Samsung and Seiko Epson. These agreements vary in subject matter, scope, compensation, significance and time.

In the U.S., we own more than 650 trademarks, either registered or applied for. These trademarks have a perpetual life, subject to renewal every 10 years. We vigorously enforce and protect our trademarks.

Table of Contents

Marketing and Distribution

We manage our business based on the principal business segments described earlier. We have organized the marketing, selling and distribution of our products and services by geography, channel type and line of business.

We sell our products and services directly to customers through our world-wide sales force and through a network of independent agents, dealers, value-added resellers, systems integrators and the Web.

In large enterprises, we follow a services-led approach that enables us to address two basic challenges facing large enterprise customers:

- How to optimize infrastructure to be both cost-effective and globally consistent
- How to improve their value proposition and communication with their customers

Our go-to-market approach includes the largest direct sales force in the industry, with customers served by Client Managing Directors, Account General Managers and Sales Representatives.

For small and mid-size business, we continue to expand our distribution partnerships in North America with additional information technology resellers and by enhancing our network of independent agents. In 2010, we acquired two companies to further expand this distribution capacity.

In Europe, Africa, the Middle East and parts of Asia, we distribute our products through Xerox Limited, a company established under the laws of England, and related non-U.S. companies. Xerox Limited enters into distribution agreements with unaffiliated third parties to provide distribution of our products in many of the countries located in these regions, and previously entered into agreements with unaffiliated third parties providing distribution of our products in Iran, Sudan and Syria. Iran, Sudan and Syria, among others, have been designated as state sponsors of terrorism by the U.S. Department of State and are subject to U.S. economic sanctions. We maintain an export and sanctions compliance program and believe that we have been and are in compliance with U.S. laws and government regulations for these countries. We have no assets, liabilities or operations in these countries other than liabilities under the distribution agreements. After observing required prior notice periods, Xerox Limited terminated its distribution agreements with distributors servicing Sudan and Syria in August 2006 and terminated its distribution agreement with the distributor servicing Iran in December 2006. Now, Xerox only has legacy obligations to third parties, such as providing spare parts and supplies to these third parties. In 2010, total Xerox revenues of $21.6 billion included less than $0.2 million attributable to Iran, Sudan and Syria.

Table of Contents

Competition

Although we encounter competition in all areas of our business, we are the leader or among the leaders in each of our principal business segments. We compete on the basis of technology, performance, price, quality, reliability, brand, distribution and customer service and support.

Our competitors in the Technology business include Canon, Ricoh, Hewlett-Packard, Kodak, Oce, Konica Minolta and Lexmark. In the Services business, our larger competitors are Hewlett-Packard, Genpact, Teletech, Accenture, Aon Hewitt, Computer Services, IBM and Dell. In addition, in the Services segment, we compete with in-house departments performing the functions that we are seeking to have them outsource to us.

Table of Contents

We believe that our brand recognition, reputation for our business process and document management knowledge and expertise, innovative technology, service, breadth of product offerings, global distribution channels, customer relationships and large customer base are important competitive advantages. We and our competitors continue to develop and market new and innovative products and services at competitive prices and, at any given time, we may set new market standards for quality, speed, function and level of service.

Global Employment

Globally, we have approximately 136,500 direct employees. We have approximately 8,000 sales professionals, approximately 12,000 technical service employees and over 46,000 employees serving our customers through on-site operations or off-site delivery centers.

Customer Financing

We finance a large portion of our direct channel customer purchases of Xerox equipment through bundled lease agreements. We believe that financing facilitates customer acquisition of Xerox technology and enhances our value proposition while providing Xerox an attractive gross margin and a reasonable return on our investment in this business.

Because our lease contracts permit customers to pay for equipment over time rather than at the date of installation, we maintain a certain level of debt to support our investment in these lease contracts. We fund our customer financing activity through a combination of cash generated from operations, cash on hand and proceeds from capital market offerings. At December 31, 2010, we had $6.6 billion of finance receivables and $0.6 billion of equipment on operating leases, or Total Finance assets of $7.2 billion. We maintain an assumed 7:1 leverage ratio of debt to equity as compared to our Finance assets, and therefore, a significant portion of our $8.6 billion of debt is associated with our financing business.

Manufacturing and Supply

Our manufacturing and distribution facilities are located around the world. The company s largest manufacturing site is in Webster, New York, where we produce fusers, photoreceptors, Xerox iGen and Nuvera systems, components, consumables and other products and we have an EA Toner plant located in Webster. Our other primary manufacturing operations are located in: Dundalk, Ireland, for our high-end production products and consumables; and Wilsonville, Oregon, for solid ink products, consumable supplies and components for our Mid-range and Entry products. We also have a major facility in Venray, Netherlands, which handles supplies manufacturing and supply chain management for the Eastern Hemisphere.

Our master supply agreement with Flextronics, a global electronics manufacturing services company, to outsource portions of manufacturing for our Mid-range and Entry businesses, continues into 2011.

We also acquire products from various third parties in order to increase the breadth of our product portfolio and meet channel requirements. We have arrangements with Fuji Xerox under which we purchase and sell products, some of which are the result of mutual research and development agreements. Refer to Note 7 Investments in Affiliates, at Equity in the Consolidated Financial Statements in our 2010 Annual Report for additional information regarding our relationship with Fuji Xerox.

Services Global Production Model

We believe our global services production model is one of our key competitive advantages. This model encompasses employees in production centers around the world including India, Mexico, the Philippines, Jamaica, Ghana, Brazil, Guatemala, Chile, Argentina, Spain, Poland and Ireland, among others. Our global production model is enabled by the use of proprietary technology, which allows us to securely distribute client transactions within data privacy limits across a global workforce. This global production model allows us to leverage lower-cost production locations, consistent methodology and processes, and time zone advantages.

Table of Contents

Fuji Xerox

Fuji Xerox is an unconsolidated entity in which we currently own a 25% interest and FUJIFILM Holdings Corporation (FujiFilm) owns 75%. Fuji Xerox develops, manufactures and distributes document processing products in Japan, China, Hong Kong, other areas of the Pacific Rim, Australia and New Zealand. We retain significant rights as a minority shareholder. Our technology licensing agreements with Fuji Xerox ensure that the two companies retain uninterrupted access to each other s portfolio of patents, technology and products.

International Operations

We are incorporating by reference the financial measures by geographical area for 2010, 2009 and 2008 that are included in Note 2 - Segment Reporting in the Consolidated Financial Statements in our 2010 Annual Report. See also the risk factor entitled Our business, results of operations and financial condition may be negatively impacted by economic conditions abroad, including local economies, political environments, fluctuating foreign currencies and shifting regulatory schemes in Part I, Item 1A of Form 10-K.

Backlog

We believe that backlog, or the value of unfilled orders, is not a meaningful indicator of future business prospects because of the significant proportion of our revenue that follows contract signing and/or equipment installation, the large volume of products we deliver from shelf inventories, and the shortening of product life cycles.

Seasonality

Our technology revenues are affected by such factors as the introduction of new products, the length of sales cycles and the seasonality of technology purchases. These factors have historically resulted in lower revenue in the first quarter and the third quarter.

Other Information

Xerox is a New York corporation, organized in 1906, and our principal executive offices are located at 45 Glover Avenue, P.O. Box 4505, Norwalk, Connecticut 06856-4505. Our telephone number is (203) 968-3000.

In the Investor Information section of our Internet website, you will find our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and any amendments to these reports. We make these documents available as soon as we can after we have filed them with, or furnished them to, the Securities and Exchange Commission.

Our Internet address is **www.xerox.com**.

Table of Contents

ITEM 1A. RISK FACTORS

Our business, results of operations and financial condition may be negatively impacted by conditions abroad, including local economics, political environments, fluctuating foreign currencies and shifting regulatory schemes.

A significant portion of our revenues are generated from operations outside the United States. In addition, we manufacture or acquire many of our products and/or their components from, and maintain significant operations, outside the United States. Our future revenues, costs and results of operations could be significantly affected by changes in foreign currency exchange rates - particularly the Japanese Yen to U.S. Dollar and Japanese Yen to Euro exchange rates, as well as by a number of other factors, including changes in economic conditions from country to country, changes in a country s political conditions, trade protection measures, licensing requirements, local tax issues, capitalization and other related legal matters. We generally hedge foreign currency denominated assets, liabilities and anticipated transactions primarily through the use of currency derivative contracts. The use of derivative contracts is intended to mitigate or reduce transactional level volatility in the results of foreign operations, but does not completely eliminate volatility. We do not hedge the translation effect of international revenues and expenses, which are denominated in currencies other than our U.S. parent functional currency, within our consolidated financial statements. If our future revenues, costs and results of operations are significantly affected by economic conditions abroad and we are unable to effectively hedge these risks, they could materially adversely affect our results of operations and financial condition.

We face significant competition and our failure to compete successfully could adversely affect our results of operations and financial condition.

We operate in an environment of significant competition, driven by rapid technological advances and the demands of customers to become more efficient. Our competitors range from large international companies to relatively small firms. Some of the large international companies have significant financial resources and compete with us globally to provide document processing products and services and/or business process services in each of the markets we serve. We compete primarily on the basis of technology, performance, price, quality, reliability, brand, distribution and customer service and support. Our success in future performance is largely dependent upon our ability to compete successfully in the markets we currently serve and to expand into additional market segments. To remain competitive, we must develop new products, services and applications; periodically enhance our existing offerings and attract and retain key personnel and management. If we are unable to compete successfully, we could lose market share and important customers to our competitors and that could materially adversely affect our results of operations and financial condition.

Our profitability is dependent upon our ability to obtain adequate pricing for our products and services and to improve our cost structure.

Our success depends on our ability to obtain adequate pricing for our products and services which provides a reasonable return to our shareholders. Depending on competitive market factors, future prices we obtain for our products and services may decline from previous levels. In addition, pricing actions to offset the effect of currency devaluations may not prove sufficient to offset further devaluations or may not hold in the face of customer resistance and/or competition. If we are unable to obtain adequate pricing for our products and services, it could materially adversely affect our results of operations and financial condition.

We continually review our operations with a view towards reducing our cost structure, including but not limited to reducing employee base, exiting certain businesses, improving process and system efficiencies and outsourcing some internal functions. We from time to time engage in restructuring actions to reduce our cost structure. If we are unable to continue to maintain our cost base at or below the current level and maintain process and systems changes resulting from prior restructuring actions, it could materially adversely affect our results of operations and financial condition.

Our ability to sustain and improve profit margins is dependent on a number of factors, including our ability to continue to improve the cost efficiency of our operations through such programs as Lean Six Sigma, the level of pricing pressures on our products and services, the proportion of high-end as opposed to low-end equipment sales, the trend in our post-sale revenue growth and our ability to successfully complete information technology initiatives. If any of these factors adversely materialize or if we are unable to achieve productivity improvements through design efficiency, supplier and manufacturing cost improvements and information technology initiatives, our ability to offset labor cost inflation, potential materials cost increases and competitive price pressures would be impaired, all of which could materially adversely affect our results of operations and financial condition.

Table of Contents

Our operating results may be negatively impacted by lower equipment placements and usage trends.

Our ability to maintain a consistent trend of revenue growth over the intermediate to longer term is largely dependent upon expansion of our worldwide equipment placements, as well as sales of services and supplies occurring after the initial equipment placement (post sale revenue) in the key growth markets of digital printing, color and multifunction systems. We expect that revenue growth can be further enhanced through our document management and consulting services in the areas of personalized and product life cycle communications, enterprise managed print services and document content and imaging. The ability to achieve growth in our equipment placements is subject to the successful implementation of our initiatives to provide advanced systems, industry-oriented global solutions and services for major customers, improve direct and indirect sales productivity and expand our indirect distribution channels in the face of global competition and pricing pressures. Our ability to increase post sale revenue is largely dependent on our ability to increase the volume of pages printed, the mix of color pages, equipment utilization and color adoption, as well as our ability to retain a high level of supplies sales in unbundled contracts. Equipment placements typically occur through leases with original terms of three to five years. There will be a lag between the increase in equipment placement and an increase in post sale revenues. The ability to grow our customers usage of our products may continue to be adversely impacted by the movement toward distributed printing and electronic substitutes and the impact of lower equipment placements in prior periods. If we are unable to maintain a consistent trend of revenue growth, it could materially adversely affect our results of operations and financial condition.

We have outsourced a significant portion of our overall worldwide manufacturing operations and face the risks associated with relying on third-party manufacturers and external suppliers.

We have outsourced a significant portion of our overall worldwide manufacturing operations to third parties and various service providers. To the extent that we rely on third-party manufacturing relationships, we face the risk that those manufacturers may not be able to develop manufacturing methods appropriate for our products, they may not be able to quickly respond to changes in customer demand for our products, they may not be able to obtain supplies and materials necessary for the manufacturing process, they may experience labor shortages and/or disruptions, manufacturing costs could be higher than planned and the reliability of our products could decline. If any of these risks were to be realized, and assuming similar third-party manufacturing relationships could not be established, we could experience interruptions in supply or increases in costs that might result in our being unable to meet customer demand for our products, damage our relationships with our customers and reduce our market share, all of which could materially adversely affect our results of operations and financial condition.

For our services contracts, we rely to a significant extent on third-party providers, such as subcontractors, a relatively small number of primary software vendors, utility providers and network providers; if they cannot deliver or perform as expected or if our relationships with them are terminated or otherwise change, our business, results of operations and financial condition could be materially adversely affected.

Our ability to service our customers and clients and deliver and implement solutions depends to a large extent on third-party providers such as subcontractors, a relatively small number of primary software vendors and utility providers and network providers meeting their obligations to us and our expectations in a timely, quality manner. Our business, revenues, profitability and cash flows could be materially and adversely affected and we might incur significant additional liabilities if these third-party providers do not meet these obligations or our expectations or if they terminate or refuse to renew their relationships with us or were to offer their products to us with less advantageous prices and other terms than we previously had. In addition, a number of our facilities are located in jurisdictions outside of the United States where the provision of utility services, including electricity and water, may not be consistently reliable and, while there are backup systems in many of our operating facilities, an extended outage of utility or network services could have a material adverse effect on our operations, revenues, cash flow and profitability.

We need to develop and expand the use of color printing and copying.

Increasing the proportion of pages that are printed in color and transitioning color pages currently produced on offset devices to Xerox technology represent key growth opportunities. A significant part of our strategy and ultimate success in this changing market is our ability to develop and market technology that produces color prints and copies quickly, easily, with high quality and at reduced cost. Our continuing success in this strategy depends on our ability to make the investments and commit the necessary resources in this highly competitive market, as well as the pace of color adoption by our existing and prospective customers. If we are unable to develop and market advanced and competitive color technologies or the pace of color adoption by our existing and prospective customers is less than anticipated, or the price of color pages declines at a greater rate and faster pace than we anticipate, we may be unable to capture these opportunities and it could materially adversely affect our results of operations and financial condition.

Table of Contents

Our ability to recover capital investments in connection with our contracts is subject to risk.

In order to attract and retain large outsourcing contracts, we sometimes make significant capital investments to perform our services under the contract, such as purchases of information technology equipment and costs incurred to develop and implement software. The net book value of such assets recorded, including a portion of our intangible assets, could be impaired, and our earnings and cash flow could be materially adversely affected in the event of the early termination of all or a part of such a contract or the reduction in volumes and services thereunder for reasons such as, among other things, a customer s or client s merger or acquisition, divestiture of assets or businesses, business failure or deterioration, or a customer s or client s exercise of contract termination rights.

If we fail to successfully develop new products and technologies and service offerings and protect our intellectual property rights, we may be unable to retain current customers and gain new customers and our revenues would be reduced.

The process of developing new high technology products and solutions is inherently complex and uncertain. It requires accurate anticipation of customers changing needs and emerging technological trends. We must make long-term investments and commit significant resources before knowing whether these investments will eventually result in products that achieve customer acceptance and generate the revenues required to provide desired returns. In developing these new technologies and products, we rely upon patent, copyright, trademark and trade secret laws in the United States and similar laws in other countries, and agreements with our employees, customers, suppliers and other parties, to establish and maintain our intellectual property rights in technology and products used in our operations. However, the laws of certain countries may not protect our proprietary rights to the same extent as the laws of the United States and we may be unable to protect our proprietary technology adequately against unauthorized third-party copying or use, which could adversely affect our competitive position. In addition, some of our products rely on technologies developed by third parties. We may not be able to obtain or to continue to obtain licenses and technologies from these third parties at all or on reasonable terms, or such third parties may demand cross-licenses to our intellectual property. It is also possible that our intellectual property rights could be challenged, invalidated or circumvented, allowing others to use our intellectual property to our competitive detriment. We also must ensure that all of our products comply with existing and newly enacted applicable regulatory requirements in the countries in which they are sold, particularly European Union environmental directives. If we fail to accurately anticipate and meet our customers needs through the development of new products and technologies and service offerings or if we fail to adequately protect our intellectual property rights or if our new products are not widely accepted or if our current or future products fail to meet applicable worldwide regulatory requirements, we could lose market share and customers to our competitors and that could materially adversely affect our results of operations and financial condition.

Our ability to fund our customer financing activities at economically competitive levels depends on our ability to borrow and the cost of borrowing in the credit markets.

The long-term viability and profitability of our customer financing activities is dependent, in part, on our ability to borrow and the cost of borrowing in the credit markets. This ability and cost, in turn, is dependent on our credit ratings and is subject to credit market volatility. We are currently funding our customer financing activity through a combination of cash generated from operations, cash on hand, capital market offerings and other borrowings. Our ability to continue to offer customer financing and be successful in the placement of equipment with customers is largely dependent on our ability to obtain funding at a reasonable cost. If we are unable to continue to offer customer financing, it could materially adversely affect our results of operations and financial condition.

Our significant debt could adversely affect our financial health and pose challenges for conducting our business.

We have and will continue to have a significant amount of debt and other obligations, primarily to support our customer financing activities. As of December 31, 2010, we had $8.6 billion of total debt and a $650 million liability to a subsidiary trust issuing preferred securities. The total value of finance assets, shown on the balance sheet as Finance receivables and On-lease equipment, was $7.2 billion at December 31, 2010. The total cash and cash equivalents was $1.2 billion at December 31, 2010. Our substantial debt and other obligations could have important consequences. For example, it could (i) increase our vulnerability to general adverse economic and industry conditions; (ii) limit our ability to obtain additional financing for future working capital, capital expenditures, acquisitions and other general corporate requirements; (iii) increase our vulnerability to interest rate fluctuations because a portion of our debt has variable interest rates; (iv) require us to dedicate a substantial portion of our cash flows from operations to service debt and other obligations thereby reducing the availability of our cash flows from operations for other purposes; (v) limit our flexibility in planning for, or reacting to, changes in our business and the industry in which we operate; (vi) place us at a competitive disadvantage compared to our competitors that have less debt; and (vii) become due and payable upon a change in control. If new debt is added to our current debt levels, these related risks could increase.

Table of Contents

We need to maintain adequate liquidity in order to have sufficient cash to meet operating cash flow requirements, repay maturing debt and meet other financial obligations, such as payment of dividends to the extent declared by our Board of Directors. If we fail to comply with the covenants contained in our various borrowing agreements, it may adversely affect our liquidity, results of operations and financial condition.

Our liquidity is a function of our ability to successfully generate cash flows from a combination of efficient operations and improvement therein, access to capital markets and funding from third parties. As of December 31, 2010, total cash and cash equivalents was $1.2 billion, and our borrowing capacity under our Credit Facility was $2.0 billion, reflecting no outstanding borrowings or letters of credit. We believe our liquidity (including operating and other cash flows that we expect to generate) will be sufficient to meet operating requirements as they occur; however, our ability to maintain sufficient liquidity going forward depends on our ability to generate cash from operations and access to the capital markets and funding from third parties, all of which are subject to general economic, financial, competitive, legislative, regulatory and other market factors that are beyond our control.

The Credit Facility contains affirmative and negative covenants including limitations on: (i) liens of Xerox and certain of our subsidiaries securing debt; (ii) certain fundamental changes to corporate structure; (iii) changes in nature of business and (iv) limitations on debt incurred by certain subsidiaries. The Credit Facility contains financial maintenance covenants, including maximum leverage (debt for borrowed money divided by consolidated EBITDA, as defined) and a minimum interest coverage ratio (consolidated EBITDA divided by consolidated interest expense, as defined). The indentures governing our outstanding senior notes contain affirmative and negative covenants including limitations on: issuance of secured debt and preferred stock; investments and acquisitions; mergers; certain transactions with affiliates; creation of liens; asset transfers; hedging transactions; payment of dividends and certain other payments. They do not, however, contain any financial maintenance covenants, except the fixed charge coverage ratio applicable to certain types of payments. Some of the covenants under our senior notes are suspended while we are rated investment grade.

At December 31, 2010, we were in full compliance with the covenants and other provisions of the Credit Facility and the senior notes. Failure to comply with material provisions of or covenants in the Credit Facility or the senior notes could have a material adverse effect on our liquidity, results of operations and financial condition.

We need to successfully execute the transition of Affiliated Computer Services, Inc. in order to realize all of the anticipated benefits from the transaction.

Our ability to realize the anticipated benefits of the Affiliated Computer Services, Inc. (ACS) acquisition is subject to certain risks including, but not limited to, the risks that: the future business operations of ACS will not be successful; customer retention, cost synergies and revenue expansion goals for the ACS transaction will not be met; and disruptions from the ACS transaction will harm relationships with customers, employees and suppliers.

Our business, results of operations and financial condition may be negatively impacted by legal and regulatory matters.

We have various contingent liabilities that are not reflected on our balance sheet, including those arising as a result of being involved in a variety of claims, lawsuits, investigations and proceedings concerning securities law, intellectual property law, environmental law, employment law and the Employee Retirement Income Security Act (ERISA), as discussed in the Contingencies note in the Consolidated Financial Statements. Should developments in any of these matters cause a change in our determination as to an unfavorable outcome and result in the need to recognize a material accrual, or should any of these matters result in a final adverse judgment or be settled for significant amounts, they could have a material adverse effect on our results of operations, cash flows and financial position in the period or periods in which such change in determination, judgment or settlement occurs.

Table of Contents

Our operations and our products are subject to environmental regulations in each of the jurisdictions in which we conduct our business and sell our products. Some of our manufacturing operations use, and some of our products contain, substances that are regulated in various jurisdictions. For example, various countries and jurisdictions have adopted or are expected to adopt restrictions on the types and amounts of chemicals that may be present in electronic equipment or other items that we use or sell. If we do not comply with applicable rules and regulations in connection with the use of such substances and the sale of products containing such substances, then we could be subject to liability and could be prohibited from selling our products, which could have a material adverse effect on our results of operations and financial condition. Further, various countries and jurisdictions have adopted or are expected to adopt, programs that make producers of electrical goods, including computers and printers, responsible for certain labeling, collection, recycling, treatment and disposal of these recovered products. If we are unable to collect, recycle, treat and dispose of our products in a cost-effective manner and in accordance with applicable requirements, it could materially adversely affect our results of operations and financial condition. Other potentially relevant initiatives throughout the world include proposals for more extensive chemical registration requirements and/or possible bans on the use of certain chemicals, various efforts to limit energy use in products, and other environmentally related programs impacting products and operations, such as those associated with climate change accords, agreements and regulations. For example, the European Union s Energy-Using Products Directive (EUP) is expected to lead to the adoption of implementing measures intended to require certain classes of products to achieve certain design and/or performance standards, in connection with energy use and potentially other environmental parameters and impacts. It is possible that some or all of our products may be required to comply with EUP implementing measures. Another example is the European Union REACH Regulation (Registration, Evaluation, Authorization and Restriction of Chemicals), a broad initiative that will require parties throughout the supply chain to register, assess and disclose information regarding many chemicals in their products. Depending on the types, applications, forms and uses of chemical substances in various products, REACH could lead to restrictions and/or bans on certain chemical usage. Xerox continues its efforts toward monitoring and evaluating the applicability of these and numerous other regulatory initiatives in an effort to develop compliance strategies. As these and similar initiatives and programs become regulatory requirements throughout the world and/or are adopted as public or private procurement requirements, we must comply or potentially face market access limitations that could have a material adverse affect on our operations and financial condition.

Our government contracts are subject to termination rights, audits and investigations, which, if exercised, could negatively impact our reputation and reduce our ability to compete for new contracts.

A significant portion of our revenues are derived from contracts with U.S. federal, state and local governments and their agencies, as well as international governments and their agencies. Governments and their agencies may have the right to terminate many of these contracts at any time without cause. These contracts, upon their expiration or termination, are typically subject to a bidding process in which Xerox may not be successful. Also, our contracts with governmental entities are generally subject to the approval of annual appropriations by the United States Congress or other legislative/governing bodies to fund the expenditures of the governmental entities under those contracts. Additionally, government contracts are generally subject to audits and investigations by government agencies. If the government finds that we improperly charged any costs to a contract, the costs are not reimbursable or, if already reimbursed, the cost must be refunded to the government. If the government discovers improper or illegal activities in the course of audits or investigations, we may be subject to various civil and criminal penalties and administrative sanctions, which may include termination of contracts, forfeiture of profits, suspension of payments, fines and suspensions or debarment from doing business with the government. Any resulting penalties or sanctions could have a material adverse effect on our business, financial condition, results of operations and cash flows. Further, the negative publicity that arises from findings in such audits, investigations or the penalties or sanctions therefore could have an adverse effect on our reputation in the industry and reduce our ability to compete for new contracts and may also have a material adverse effect on our business, financial condition, results of operations and cash flow.

Table of Contents

We are subject to United States and foreign jurisdiction laws relating to individually identifiable information, and failure to comply with those laws, whether or not inadvertent, could subject us to legal actions and negatively impact our operations.

We process, transmit and store information relating to identifiable individuals, both in our role as a service provider and as an employer. As a result, we are subject to numerous United States (both federal and state) and foreign jurisdiction laws and regulations designed to protect individually identifiable information, including social security numbers, financial and health information. For example, in 1996, Congress passed the Health Insurance Portability and Accountability Act and as required therein, the Department of Health and Human Services established regulations governing, among other things, the privacy, security and electronic transmission of individually identifiable health information. We have taken measures to comply with each of those regulations on or before the required dates. Another example is the European Union Directive on Data Protection, entitled Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data. We have also taken steps to address the requirements of that Directive. Other United States (both federal and state) and foreign jurisdiction laws apply to the processing of individually identifiable information as well and additional legislation may be enacted at any time. Failure to comply with these types of laws may subject us to, among other things, liability for monetary damages, fines and/or criminal prosecution, unfavorable publicity, restrictions on our ability to process information and allegations by our customers and clients that we have not performed our contractual obligations, any of which may have a material adverse effect on our profitability and cash flow.

We are subject to breach of our security systems.

We have implemented security systems with the intent of maintaining the physical security of our facilities and protecting our, our customers and clients and our suppliers confidential information and information related to identifiable individuals against unauthorized access through our information systems or by other electronic transmission or through the misdirection, theft or loss of physical media. These include, for example, the appropriate encryption of information. Despite such efforts, we are subject to breach of security systems which may result in unauthorized access to our facilities and/or the information we are trying to protect. If unauthorized parties gain physical access to one of our facilities or electronic access to our information systems or such information is misdirected, lost or stolen during transmission or transport, any theft or misuse of such information could result in, among other things, unfavorable publicity, governmental inquiry and oversight, difficulty in marketing our services, allegations by our customers and clients that we have not performed our contractual obligations, litigation by affected parties and possible financial obligations for damages related to the theft or misuse of such information, any of which could have a material adverse effect on our profitability and cash flow.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None

ITEM 2. PROPERTIES

We own several manufacturing, engineering and research facilities and lease other facilities. Our principal manufacturing and engineering facilities, located in New York, California, Oklahoma, Oregon, Canada, U.K., Ireland and the Netherlands, are used primarily by the Technology Segment. Our principal research facilities are located in California, New York, Canada, France and the U.K. The research activities in our principal research centers benefit all of our operating segments. Our Corporate Headquaters is a leased facility located in Norwalk, Connecticut.

As a result of implementing our restructuring programs, (refer to Note 9 - Restructuring and Asset Impairment Charges in the Consolidated Financial Statements in our 2010 Annual Report, incorporated by reference), several leased and owned properties became surplus. As of December 31, 2010, the surplus portions of our Dundalk, Ireland facility were sold and the Oklahoma City, OK manufacturing plant was removed from surplus and placed back into operation. A portion of the Oklahoma facility is used as an ACS Call Center and we are developing plans for the balance of the facility. We are obligated to maintain our leased surplus properties through required contractual periods. With respect to United States properties, as of December 31, 2010, we are marketing 12 surplus leased facilities totaling 533,386 square feet. During 2010, the largest surplus leased site in Monrovia, California was subleased.

Table of Contents

We also own or lease numerous facilities globally, which house general offices, sales offices, service locations and distributions centers. It is our opinion that our properties have been well maintained, are in sound operating condition and contain all the necessary equipment and facilities to perform their functions. We believe that our current facilities are suitable and adequate for our current businesses.

In February 2010, we acquired Affiliated Computer Services, Inc. (ACS). As a result of this acquisition and subsequent 2010 business transactions, we added 533 locations comprising 11.3 million square feet of owned and leased property. The owned property consists of 23 locations for 1.2 million square feet in Texas, North Carolina, South Carolina, Kentucky, Illinois, Ohio, Mississippi, Mexico and France. The largest owned facility is the ACS headquarters complex located in Dallas, Texas, consisting of approximately 600,000 square feet, which also houses a data center and other operations. The leased property consists of 510 locations for 10.1 million square feet in numerous locations throughout the world. The leases have terms through 2029 and we do not anticipate any significant difficulty in obtaining lease renewals or alternate space. The ACS owned and leased space is used for general office, data centers and call center purposes principally in our Services segment operations. During 2010, we completed 31 Xerox and ACS consolidation projects to optimize our property portfolio.

ITEM 3. LEGAL PROCEEDINGS

The information set forth under the Contingencies note in the Consolidated Financial Statements, of the Xerox Corporation 2010 Annual Report is hereby incorporated by reference.

PART II

ITEM 5. MARKET FOR THE REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information, Holders and Dividends

The information set forth under the following captions of the Xerox Corporation 2010 Annual Report to Shareholders is hereby incorporated by reference:

Stock Exchange Information

Xerox Common Stock Prices and Dividends

Five Years in Review Common Shareholders of Record at Year-End

Performance Graph

(a) Sales of Unregistered Securities During the Quarter ended December 31, 2010

During the quarter ended December 31, 2010, Registrant issued the following securities in transactions that were not registered under the Securities Act of 1933, as amended (the Act):

Dividend Equivalents:

(a) Securities issued on October 31, 2010: Registrant issued 1,703 deferred stock units (DSU), representing the right to receive shares of Common Stock, par value $1 per share, at a future date.

(b) No underwriters participated. The shares were issued to each of the non-employee Directors of Registrant: Glenn A. Britt, Richard J. Harrington, William Curt Hunter, Robert A. McDonald, N. J. Nicholas, Jr., Charles Prince, Ann N. Reese and Mary Agnes Wilderotter.

(c) The DSUs were issued at a deemed purchase price of $10.395 per DSU (aggregate price $17,703), based upon the market value of our Common Stock on the date of record, in payment of the dividend equivalents due to DSU holders pursuant to Registrant s 2004 Equity Compensation Plan for Non-Employee Directors.

(d) Exemption from registration under the Act was claimed based upon Section 4(2) as a sale by an issuer not involving a public offering.

Table of Contents

(b) Issuer Purchases of Equity Securities during the Quarter ended December 31, 2010 Repurchases of Xerox Common Stock, par value $1.00 per Share

Board Authorized Share Repurchase Programs:

We did not purchase Common stock during the fourth quarter or full year 2010.

Of the cumulative $4.5 billion of share repurchase authority previously granted by our Board of Directors, exclusive of fees and expenses, approximately $2.9 billion has been used through December 31, 2010. Repurchases may be made on the open market, or through derivative or negotiated transactions. Open-market repurchases will be made in compliance with the SEC s Rule 10b-18, and are subject to market conditions, as well as applicable legal and other considerations.

Repurchases Related to Stock Compensation Programs [1]:

	Total Number of Shares Purchased	Average Price Paid per Share[2]	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares That May Yet Be Purchased under the Plans or Programs
October 1 through 31	19,866	$ 11.05	n/a	n/a
November 1 through 30	7,996	$ 11.68	n/a	n/a
December 1 through 31	4,532	$ 11.92	n/a	n/a
Total	32,394		n/a	n/a

(1) These repurchases are made under provisions in our restricted stock compensation programs for the indirect repurchase of shares through a net-settlement feature upon the vesting of shares in order to satisfy minimum statutory tax-withholding requirements.
(2) Exclusive of fees and costs.

ITEM 6. SELECTED FINANCIAL DATA

The following selected financial data for the five years ended December 31, 2010, as set forth and included under the caption Five Years in Review, of the Xerox Corporation 2010 Annual Report to Shareholders, is incorporated by reference in this Form 10-K.

Revenues

Income from continuing operations

Per-Share Data:

Income from continuing operations - Basic and Diluted

Earnings - Basic and Diluted

Common stock dividends

Total Assets

Long-term debt

Liability to subsidiary trust issuing preferred securities

Series A convertible preferred stock

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

The information set forth under the caption Management s Discussion and Analysis of Financial Condition and Results of Operations, of the Xerox Corporation 2010 Annual Report is hereby incorporated by reference.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The information set forth under the caption Financial Risk Management, in the Xerox Corporation 2010 Annual Report is hereby incorporated by reference.

Table of Contents

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The consolidated financial statements, together with the report thereon of PricewaterhouseCoopers LLP, included in the Xerox Corporation 2010 Annual Report, are incorporated by reference in this Form 10-K. With the exception of the aforementioned information and the information incorporated in Items 1, 3, 5, 6, 7, 7A and 8, the Xerox Corporation 2010 Annual Report is not to be deemed filed as part of this Form 10-K.

The quarterly financial data included under the caption Quarterly Results of Operations (Unaudited) of the Xerox Corporation 2010 Annual Report is incorporated by reference in this Annual Report on Form 10-K.

The financial statement schedule required herein is filed as referenced in Item 15 of this Form 10-K.

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

None

ITEM 9A. CONTROLS AND PROCEDURES

Management s Responsibility for Financial Statements

Our management is responsible for the integrity and objectivity of all information presented in this annual report. The consolidated financial statements were prepared in conformity with accounting principles generally accepted in the United States of America and include amounts based on management s best estimates and judgments. Management believes the consolidated financial statements fairly reflect the form and substance of transactions and that the financial statements fairly represent the Company s financial position and results of operations.

The Audit Committee of the Board of Directors, which is composed solely of independent directors, meets regularly with the independent auditors, PricewaterhouseCoopers LLP, the internal auditors and representatives of management to review accounting, financial reporting, internal control and audit matters, as well as the nature and extent of the audit effort. The Audit Committee is responsible for the engagement of the independent auditors. The independent auditors and internal auditors have access to the Audit Committee.

Disclosure Controls and Procedures

We have established disclosure controls and procedures to ensure that material information relating to the Company, including its consolidated subsidiaries, is made known to the officers who certify the Company s financial reports and to other members of senior management and the Board of Directors. Based on their evaluation as of December 31, 2010, our principal executive officer and principal financial officer have concluded that the Company s disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) were effective to ensure that the information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms and was accumulated and communicated to the Company s Management, including the principal executive officer and principal financial officer, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosures.

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 the rules promulgated under the Securities Exchange Act of 1934. Under the supervision and with the participation of our management, including our principal executive, financial and accounting officers, we have 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 the above evaluation, management concluded that our internal control over financial reporting was effective as of December 31, 2010.

The effectiveness of our internal control over financial reporting as of December 31, 2010 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which appears in our 2010 Annual Report to Shareholders which is incorporated by reference in Part II, Item 8 of this Form 10-K.

Table of Contents

Changes in Internal Control over Financial Reporting

In connection with the evaluation required by paragraph (d) of Rule 13a-15 under the Exchange Act, there was no change identified in our internal control over financial reporting that occurred during the last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

ITEM 9B. OTHER INFORMATION
Executive Compensation

On February 22, 2011, the Compensation Committee of the Board of Directors of the Company took the following actions:

2010 and 2011 Annual Performance Incentive Plan (APIP)

The Compensation Committee approved the payments of cash awards under the Xerox 2004 Performance Incentive Plan (2004 PIP), as amended, for 2010 APIP. The measures on which awards are based for the 2010 fiscal year are set out on Exhibit 10(e)(14) attached hereto. The Compensation Committee approved the payment of cash awards under the 2004 PIP for fiscal year 2010 to Ursula M. Burns, Chairman and Chief Executive Officer of the Company; Lawrence A. Zimmerman, Vice Chairman; and certain other officers, including Lynn Blodgett, Armando Zagalo de Lima and James A. Firestone, our next three most highly compensated executive officers for fiscal year 2010; and Anne M. Mulcahy, former Chairman of the Board (collectively, the Named Executive Officers). The Compensation Committee approved a cash award of $1,693,125 to Ms. Burns, $767,550 to Mr. Zimmerman, $1,615,989 to Mr. Blodgett, $704,951 to Mr. Zagalo de Lima, $767,550 to Mr. Firestone and $559,896 to Mrs. Mulcahy.

The Compensation Committee approved the measures for APIP awards for fiscal year 2011, which are set out on Exhibit 10(e)(19) attached hereto.

2008 E-LTIP Awards

The Compensation Committee determined that 60% of the original grant amount awarded under the 2008 Executive Long-Term Incentive Program (2008 E-LTIP) was earned based on the Company s three-year cumulative 2008, 2009 and 2010 performance against the three-year cumulative targets established for Earnings Per Share and Core Cash Flow from Operations. A description of the targets is set out on Exhibit 10(e)(5). The total number of shares earned for the three-year cumulative performance period ended December 31, 2010 that shall vest on July 1, 2011 for each Named Executive Officer is as follows: Ms. Burns, 179,916 shares; Mr. Zimmerman, 64,641 shares; Mr. Zagalo de Lima, 44,982 shares; Mr. Firestone, 89,958 shares; and Mrs. Mulcahy, 231,164 shares. Included in these share amounts are shares that were previously earned for 2009 annual performance, as previously disclosed in our 2009 Form 10-K (except for Mr. Zagalo de Lima who became a Named Executive Officer for 2010). No performance shares were earned for 2008 based on the Company s 2008 performance against the annual targets.

2009 E-LTIP Awards

In lieu of performance shares, 2009 E-LTIP awards were made in the form of Restricted Stock Units (RSUs) with a performance feature based on the price of Xerox common stock over a three-year period. The number of shares of stock that can be earned range between 80% and 120% of the original RSU award, based on the increase or decrease in the price of Xerox common stock over the three-year vesting period. No further action is required by the Compensation Committee.

2010 E-LTIP Awards

The Compensation Committee determined that 33.33% of the performance shares granted under the 2010 Executive Long-Term Incentive Program (2010 E-LTIP) were earned based on the Company s 2010 performance against the annual targets established for Earnings Per Share and Cash Flow from Operations. A description of the targets is set out on Exhibit 10(e)(15). The number of shares earned for 2010 for each Named Executive Officer is as follows: Ms. Burns, 313,676 shares; Mr. Blodgett, 83,650 shares; Mr. Zagalo de Lima, 62,736 shares; and Mr. Firestone, 83,650 shares. Earned shares vest three years from their grant date.

In lieu of a performance share award that vests over a three-year period, the Compensation Committee approved a performance share award for Mr. Zimmerman effective March 1, 2010 that will vest on March 1, 2011. Performance metrics were the same as those developed for the first year of the three-year 2010 E-LTIP performance share award and thus Mr. Zimmerman earned 209,425 shares.

ACS Performance Shares

In connection with the acquisition of ACS, Mr. Blodgett received a special one-time grant of performance shares that vest over a three year period contingent upon ACS meeting pre-determined annual targets for Earnings Before Interest and Taxes. The aggregate number of shares that may be delivered based on achievement of the targets was determined on the grant date and ranges in value as follows: 50% of base salary (threshold); 100% of base salary (target); and 200% of base salary plus 50% of the value of previously awarded stock options (maximum). The Compensation Committee determined that the maximum number of shares were earned for 2010 based on ACS s performance against the 2010 stated target. The number of shares earned for Mr. Blodgett is 171,330 shares, which will vest on February 5, 2013.

2011 E-LTIP Awards

2011 E-LTIP awards made to Named Executive Officers reflect their leadership role in the Company, their historical and future contributions, and competitive award levels. The purpose of the 2011 E-LTIP is to provide the necessary incentives to retain and reward executives for sustained performance improvements over the next three-year period. Awards under the 2011 E-LTIP for Named Executive Officers are comprised entirely of performance shares that may be earned based on achieving performance targets between threshold and maximum as determined by the Compensation Committee. All performance shares that are earned will vest in 2014. Named Executive Officers who retire, are involuntarily terminated (without cause) or voluntarily terminate due to a reduction in force prior to the end of the three-year performance cycle will vest in a portion of the performance shares earned on a pro rata basis.

Performance metrics for the 2011 E-LTIP are Revenue Growth (at constant currency) (weighted 10%), Adjusted Earnings Per Share (weighted 55%) and Core Cash Flow from Operations (weighted 35%). Revenue Growth, Adjusted Earnings Per Share and Core Cash Flow from Operations are defined in Exhibit 10(e)(20) attached hereto. The Compensation Committee has established annual targets for Revenue Growth and annual and cumulative targets for Adjusted EPS and Core Cash Flow from Operations. Based on actual performance versus targets, the number of performance shares earned by Named Executive Officers under the 2011 E-LTIP will range from 0% to 150% of the initial number of shares subject to the grant. The form of award agreement pursuant to which such grants were made is attached hereto as Exhibit 10(e)(21).

Participants in the 2011 E-LTIP are subject to meaningful ownership requirements and mandatory share holding requirements of 50% of the net vested shares until their ownership requirements have been met.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information regarding directors is incorporated herein by reference to the section entitled Proposal 1 - Election of Directors in our definitive Proxy Statement (2011 Proxy Statement) to be filed pursuant to Regulation 14A of the Securities Exchange Act of 1934, as amended, for our Annual Meeting of Stockholders to be held on May 26, 2011. The Proxy Statement will be filed within 120 days after the end of our fiscal year ended December 31, 2010.

The information regarding compliance with Section 16(a) of the Securities and Exchange Act of 1934 is incorporated herein by reference to the section entitled Section 16(a) Beneficial Ownership Reporting Compliance of our 2011 Proxy Statement.

The information regarding the Audit Committee, its members and the Audit Committee financial experts is incorporated by reference herein from the subsection entitled Committee Functions, Membership and Meetings in the section entitled Proposal 1 - Election of Directors in our 2011 Proxy Statement.

We have adopted a code of ethics applicable to our principal executive officer, principal financial officer and principal accounting officer. The Finance Code of Conduct can be found on our website at: http://www.xerox.com/investor and then clicking on Corporate Governance.

Executive Officers of Xerox

The following is a list of the executive officers of Xerox, their current ages, their present positions and the year appointed to their present positions.

Table of Contents

Each officer is elected to hold office until the meeting of the Board of Directors held on the day of the next annual meeting of shareholders, subject to the provisions of the By-Laws.

Name	Age	Present Position	Year Appointed to Present Position	Xerox Officer Since
Ursula M. Burns*	52	Chairman of the Board and Chief Executive Officer	2010	1997
Lawrence A. Zimmerman	68	Vice Chairman	2009	2002
Lynn R. Blodgett	56	Executive Vice President; President and Chief Executive Officer, Affiliated Computer Services, Inc.	2010	2010
James A. Firestone	56	Executive Vice President; President, Corporate Operations	2008	1998
Luca Maestri	47	Executive Vice President; Chief Financial Officer	2011	2011
Armando Zagalo de Lima	52	Executive Vice President; President, Xerox Global Customer Operations	2010	2000
Willem Appelo	46	Senior Vice President; President, Xerox Global Business and Services Group	2008	2004
Michael Stephen Cronin	57	Senior Vice President; President, Global Document Outsourcing	2008	2004
Don H. Liu	49	Senior Vice President; General Counsel and Secretary	2007	2007
Russell Peacock	52	Senior Vice President; President, Xerox North America	2010	2007
Eric Armour	52	Vice President; President, Graphic Communications Business Group	2010	2007
Richard M. Dastin	51	Vice President; President, Enterprise Business Group	2010	2008
Jacques Guers	55	Vice President; President, Xerox Europe	2010	2009

Gary R. Kabureck	57	Vice President and Chief Accounting Officer	2003	2000
James H. Lesko	59	Vice President; Vice President, Investor Relations	2004	1993
Rhonda L. Seegal	60	Vice President and Treasurer	2003	2003
Herve Tessler	47	Vice President; President Developing Markets Operations	2010	2010
Leslie F. Varon	54	Vice President; Vice President, Finance and Corporate Controller	2010	2001
Kevin M. Warren	48	Vice President; President United States Customer Operations	2010	2010

* Member of Xerox Board of Directors

Table of Contents

Each officer named above, with the exception of Lynn R. Blodgett, Luca Maestri, Don H. Liu and Eric Armour, has been an officer or an executive of Xerox or its subsidiaries for at least the past five years.

Prior to joining Xerox in 2010 through our acquisition of Affiliated Computer Services, Inc. (ACS), Mr. Blodgett was President and Chief Executive Officer of ACS since 2006. Prior to that he served as Executive Vice President and Chief Operating Officer of ACS from 2005-2006 and before that he served as Executive Vice President and Group President Commercial Solutions of ACS since July 1999.

Prior to joining Xerox in 2011, Mr. Maestri was with Nokia Siemens Networks where he was Chief Financial Officer from 2008 to 2011. Prior to that, he had a 20-year career with General Motors Corporation, where he served as Chief Financial Officer of GM Europe and GM Brazil, was executive-in-charge of the Fiat Alliance for GM Europe in Switzerland and held several executive finance positions with General Motors Corporation in Europe and Asia Pacific.

Prior to joining Xerox in 2007, Mr. Liu was with Toll Brothers where he was Senior Vice President, General Counsel and Corporate Compliance Officer from 2005 to 2007. Prior to that, he was General Counsel, Corporate Secretary and Corporate Compliance Officer for IKON Office Solutions from 1999 to 2005. Prior to that, he was Vice President and Deputy Chief Legal Officer for Aetna U.S. Healthcare from 1992 to 1999.

Prior to joining Xerox in 2007, Mr. Armour was an industrial partner at the investment firm RHJ International from 2006 to 2007. Prior to that, he was President and General Manager from 2003 2006 at The Gillette Company s BRAUN global business division. From 1990 2003, he was a partner with Marakon Associates, a consulting firm in the consumer products, financial services, pharmaceuticals, aerospace and other industries.

ITEM 11. EXECUTIVE COMPENSATION

The information included under the following captions under Proposal 1-Election of Directors in our 2011 definitive Proxy Statement is incorporated herein by reference: Compensation Discussion and Analysis , Summary Compensation Table , Grants of Plan-Based Awards in 2010 , Outstanding Equity Awards at 2010 Fiscal Year-End , Option Exercises and Stock Vested in 2010 , Pension Benefits for the 2010 Fiscal Year , Nonqualified Deferred Compensation , Potential Payments upon Termination or Change in Control , Summary of Director Annual Compensation and Compensation Committee . The information included under the heading Compensation Committee Report in our 2011 definitive Proxy Statement is incorporated herein by reference; however, this information shall not be deemed to be soliciting material or to be filed with the Commission or subject to Regulation 14A or 14C, or to the liabilities of Section 18 of the Exchange Act of 1934, as amended.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Information regarding security ownership of certain beneficial owners and management and securities authorized for issuance under equity compensation plans is incorporated herein by reference to the subsections entitled Ownership of Company Securities, and Equity Compensation Plan Information under Proposal 1 Election of Directors in our 2011 definitive Proxy Statement.

ITEM 13. CERTAIN RELATIONSHIPS, RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

Information regarding certain relationships and related transactions is incorporated herein by reference to the subsection entitled Certain Relationships and Related Person Transactions under Proposal 1 Election of Directors in our 2011 definitive Proxy Statement. The information regarding director independence is incorporated herein by reference to the subsections entitled Corporate Governance and Director Independence in the section entitled Proposal 1 Election of Directors in our 2011 definitive Proxy Statement.

ITEM 14. PRINCIPAL AUDITOR FEES AND SERVICES

The information regarding principal auditor fees and services is incorporated herein by reference to the section entitled Proposal 2 Ratification of Election of Independent Registered Public Accounting Firm in our 2011 definitive Proxy Statement.

Table of Contents

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) (1) Index to Financial Statements and Financial Statement Schedule, incorporated by reference or filed as part of this report:

Report of Independent Registered Public Accounting Firm;

Consolidated Statements of Income for each of the years in the three-year period ended December 31, 2010;

Consolidated Balance Sheets as of December 31, 2010 and 2009;

Consolidated Statements of Cash Flows for each of the years in the three-year period ended December 31, 2010;

Consolidated Statements of Shareholders Equity for each of the years in the three-year period ended December 31, 2010;

Notes to the Consolidated Financial Statements;

Report of Independent Registered Public Accounting Firm on Financial Statement Schedule;

Schedule II Valuation and Qualifying Accounts for the three years ended December 31, 2010; and

All other schedules are omitted as they are not applicable, or the information required is included in the financial statements or notes thereto.

(2) Supplementary Data:

Quarterly Results of Operations (unaudited); and

Five Years in Review.

(3) The exhibits filed herewith or incorporated herein by reference are set forth in the Index of Exhibits included herein.

(b) The management contracts or compensatory plans or arrangements listed in the Index of Exhibits that are applicable to the executive officers named in the Summary Compensation Table which appears in Registrant s 2011 Proxy Statement are preceded by an asterisk (*).

Table of Contents

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

XEROX CORPORATION

/s/ Ursula M. Burns
Ursula M. Burns

Chairman of the Board and

Chief Executive Officer

February 23, 2011
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 and in the capacities and on the date indicated.

February 23, 2011

Signature	Title
Principal Executive Officer:	
/s/ Ursula M. Burns **Ursula M. Burns**	Chairman of the Board, Chief Executive Officer and Director
Principal Financial Officer:	
/s/ Luca Maestri **Luca Maestri**	Executive Vice President and Chief Financial Officer
Principal Accounting Officer:	
/s/ Gary R. Kabureck **Gary R. Kabureck**	Vice President and Chief Accounting Officer
/s/ Glenn A. Britt **Glenn A. Britt**	Director
/s/ Richard J. Harrington **Richard J. Harrington**	Director
/s/ William Curt Hunter **William Curt Hunter**	Director
/s/ Robert J. Keegan **Robert J. Keegan**	Director
/s/ Robert A. McDonald	Director

Robert A. McDonald	
/s/ N. J. NICHOLAS, JR. **N. J. Nicholas, Jr.**	Director
/s/ CHARLES PRINCE **Charles Prince**	Director
/s/ ANN N. REESE **Ann N. Reese**	Director
/s/ MARY AGNES WILDEROTTER **Mary Agnes Wilderotter**	Director

Table of Contents

Report of Independent Registered Public Accounting Firm on Financial Statement Schedule

To the Board of Directors of Xerox Corporation:

Our audits of the consolidated financial statements and of the effectiveness of internal control over financial reporting referred to in our report dated February 23, 2011 appearing in the 2010 Annual Report to Shareholders of Xerox Corporation (which report and consolidated financial statements are incorporated by reference in this Annual Report on Form 10-K) also included an audit of the financial statement schedule listed in Item 15(a)(1) of this Form 10-K. In our opinion, this financial statement schedule presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements.

/s/ PricewaterhouseCoopers LLP
PricewaterhouseCoopers LLP
Stamford, Connecticut
February 23, 2011

Table of Contents

SCHEDULE II

VALUATION AND QUALIFYING ACCOUNTS

For the three years ended December 31, 2010

(in millions)	Balance at beginning of period	Additions charged to bad debt provision (1)	Amounts (credited) charged to other income statement accounts (1)	Deductions and other, net of recoveries (2)	Balance at end of period
2010					
Allowance for Losses on:					
Accounts Receivable	$ 148	$ 60	$ (14)	$ (82)	$ 112
Finance Receivables	222	128	6	(144)	212
	$ 370	$ 188	$ (8)	$ (226)	$ 324
2009					
Allowance for Losses on:					
Accounts Receivable	$ 131	$ 114	$ (5)	$ (92)	$ 148
Finance Receivables	198	177	3	(156)	222
	$ 329	$ 291	$ (2)	$ (248)	$ 370
2008					
Allowance for Losses on:					
Accounts Receivable	$ 128	$ 64	$ 8	$ (69)	$ 131
Finance Receivables	203	124	3	(132)	198
	$ 331	$ 188	$ 11	$ (201)	$ 329

(1) Bad debt provisions relate to estimated losses due to credit and similar collectability issues. Other charges (credits) relate to adjustments to reserves necessary to reflect events of non-payment such as customer accommodations and contract terminations.

(2) Deductions and other, net of recoveries primarily relates to receivable write-offs, but also includes the impact of foreign currency translation adjustments and recoveries of previously written off receivables.

Table of Contents

INDEX OF EXHIBITS

Document and Location

3(a)	Restated Certificate of Incorporation of Registrant filed with the Department of State of the State of New York on November 7, 2003, as amended by: Certificate of Amendment to Certificate of Incorporation filed with the Department of State of the State of New York on August 19, 2004; Certificate of Change filed with the Department of State of the State of New York on October 31, 2007; Certificate of Amendment to Certificate of Incorporation filed with the Department of State of the State of New York on May 29, 2008; Certificate of Amendment to Certificate of Incorporation filed with the Department of State of the State of New York on February 13, 2009 and; Certificate of Amendment to Certificate of Incorporation filed with the Department of State of the State of New York on February 3, 2010.
	Incorporated by reference to Exhibit 3.1 to Registrant s Current Report on Form 8-K dated February 3, 2010.
3(b)	By-Laws of Registrant, as amended through May 21, 2009.
	Incorporated by reference to Exhibit 3(b) to Registrant s Current Report on Form 8-K dated May 21, 2009 (filed May 28, 2009).
4(a)(1)	Indenture dated as of December 1, 1991, between Registrant and Citibank, N.A., as trustee, relating to unlimited amounts of debt securities, which may be issued from time to time by Registrant when and as authorized by or pursuant to a resolution of Registrant s Board of Directors (the December 1991 Indenture).
	Incorporated by reference to Exhibit 4(a) to Registrant s Registration Statement Nos. 33-44597, 33-49177 and 33-54629.
4(a)(2)	Instrument of Resignation, Appointment and Acceptance dated as of February 1, 2001, among Registrant, Citibank, N.A., as resigning trustee, and Wilmington Trust Company, as successor trustee, relating to the December 1991 Indenture.
	Incorporated by reference to Exhibit 4(a)(2) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2000 filed on June 7, 2001.
4(a)(3)	Instrument of Resignation, Appointment and Acceptance dated as of July 30, 2008, among Registrant, Wilmington Trust Company, as prior trustee, Citibank,, N.A. as prior paying agent, registrar and issuing and paying agent, and The Bank of New York Mellon, as successor trustee, relating to the December 1991 Indenture.
	Incorporated by reference to Exhibit 4(a)(3) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2008.
4(b)(1)	Indenture dated as of January 29, 1997, between Registrant and Bank One, National Association (as successor by merger with The First National Bank of Chicago) (Bank One), as trustee (the January 1997 Indenture), relating to Registrant s Junior Subordinated Deferrable Interest Debentures (Junior Subordinated Debentures).
	Incorporated by reference to Exhibit 4.1 to Registration Statement No. 333-24193.
4(b)(2)	Form of Certificate of Exchange relating to Junior Subordinated Debentures.
	Incorporated by reference to Exhibit A to Exhibit 4.1 to Registration Statement No. 333-24193.
4(b)(3)	Certificate of Trust of Xerox Capital Trust I executed as of January 23, 1997.
	Incorporated by reference to Exhibit 4.3 to Registration Statement No. 333-24193.
4(b)(4)	Amended and Restated Declaration of Trust of Xerox Capital Trust I dated as of January 29, 1997.
	Incorporated by reference to Exhibit 4.4 to Registration Statement No. 333-24193.
4(b)(5)	Form of Exchange Capital Security Certificate for Xerox Capital Trust I.
	Incorporated by reference to Exhibit A-1 to Exhibit 4.4 to Registration Statement No. 333-24193.
4(b)(6)	Series A Capital Securities Guarantee Agreement of Registrant dated as of January 29, 1997, relating to Series A Capital Securities of Xerox Capital Trust I.
	Incorporated by reference to Exhibit 4.6 to Registration Statement No. 333-24193.

1

[Table of Contents](#)

4(b)(7)	Registration Rights Agreement dated January 29, 1997, among Registrant, Xerox Capital Trust I and the initial purchasers named therein.
	Incorporated by reference to Exhibit 4.7 to Registration Statement No. 333-24193.
4(b)(8)	Instrument of Resignation, Appointment and Acceptance dated as of November 30, 2001, among Registrant, Bank One as resigning trustee, and Wells Fargo Bank Minnesota, National Association (Wells Fargo), as successor Trustee, relating to the January 1997 Indenture.
	Incorporated by reference to Exhibit (c)(8) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2001.
4(c)(1)	Indenture, dated as of June 25, 2003, between Registrant and Wells Fargo, as trustee, relating to unlimited amounts of debt securities which may be issued from time to time by Registrant when and as authorized by or pursuant to a resolution of Registrant s Board of Directors (the June 25, 2003 Indenture).
	Incorporated by reference to Exhibit 4.1 to Registrant s Current Report on Form 8-K dated June 25, 2003.
4(c)(2)	Form of Second Supplemental Indenture to the June 25, 2003 Indenture.
	Incorporated by reference to Exhibit (4)(b)(3) to Registrant s Registration Statement No. 333-111623.
4(c)(3)	Form of Third Supplemental Indenture, dated as of March 20, 2006, to the June 25, 2003 Indenture.
	Incorporated by reference to Exhibit 4(b)(6) to Registrant s Current Report on Form 8-K dated March 20, 2006.
4(c)(4)	Form of Fourth Supplemental Indenture, dated as of August 18, 2006, to the June 25, 2003 Indenture.
	Incorporated by reference to Exhibit 4(b)(7) to Registrant s Current Report on Form 8-K dated August 18, 2006.
4(c)(5)	Form of Fifth Supplemental Indenture, dated as of August 18, 2006, to the June 25, 2003 Indenture.
	Incorporated by reference to Exhibit 4(b)(8) to Registrant s Current Report on Form 8-K dated August 18, 2006.
4(c)(6)	Form of Sixth Supplemental Indenture, dated as of May 17, 2007 to the June 25, 2003 Indenture.
	Incorporated by reference to Exhibit 4(b)(2) to Registrant s Registration Statement No. 333-142900.
4(d)(1)	Form of Credit Agreement dated as of April 30, 2007 between Registrant and the Initial Lenders named therein, Citibank, N.A., as Administrative Agent, and Citigroup Global Markets Inc. and J.P. Morgan Securities Inc., as Joint Lead Arrangers and Joint Bookrunners (the Credit Agreement).
	Incorporated by reference to Exhibit 10(j) to Registrant s Current Report on Form 8-K dated April 30, 2007.
4(d)(2)	Amendment No. 1 to Credit Agreement, dated as of October 27, 2008, among Registrant, the Lenders named therein, and Citibank, ,N.A., as agent for the Lenders.
	Incorporated by reference to Exhibit 4(g)(2) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2008.
4(d)(3)	Amendment No. 2 to Credit Agreement, dated as of April 23, 2009, between Registrant and the Initial Lenders named therein, Citibank, N.A., as Administrative Agent, and Citigroup Global Markets Inc. and J.P. Morgan Securities Inc., as Joint Lead Arrangers and Joint Bookrunners.
	Incorporated by reference to Exhibit 4(g)(3) to Registrant s Quarterly Report on Form 10-Q for the Quarter ended March 31, 2009.
4(d)(4)	Amendment No. 3 to Credit Agreement, dated as of October 19, 2009, between Registrant and the Initial Lenders named therein, Citibank, N.A., as Administrative Agent, and Citigroup Global Markets Inc. and J.P. Morgan Securities Inc., as Joint Lead Arrangers and Joint Bookrunners.

Table of Contents

	Incorporated by reference to Exhibit 4(g)(4) to Registrant s Quarterly Report on Form 10-Q for the Quarter ended September 30, 2009.
4(e)	Master Demand Note dated December 10, 2003 between Registrant and Xerox Credit Corporation.
	Incorporated by reference to Exhibit 4(m) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2003.
4(f)	Form of Indenture dated as of December 4, 2009 between Xerox Corporation and the Bank of New York Mellon, as trustee, relating to an unlimited amount of senior debt securities.
	Incorporated by reference to Exhibit 4(b)(5) to Post-Effective Amendment No. 1 to Registrant s Registration Statement No. 333-142900.
4(g)(1)	Indenture, dated as of June 6, 2005, by and between Affiliated Computer Services, Inc. (ACS) as Issuer and The Bank of New York Trust Company, N.A. as Trustee (the June 6, 2005 Indenture).
	Incorporated by reference to Exhibit 4.1 to ACS s Current Report on Form 8-K, filed June 6, 2005.
4(g)(2)	Second Supplemental Indenture, dated as of June 6, 2005, to the June 6, 2005 Indenture.
	Incorporated by reference to Exhibit 4.3 to ACS s Current Report on Form 8-K, filed June 6, 2005.
4(g)(3)	Third Supplemental Indenture, dated as of February 5, 2010, to the June 6, 2005 Indenture between Boulder Acquisition Corp., the successor to ACS, and The Bank of New York Trust Company, N.A.
	Incorporated by reference to Exhibit 4(j)(4) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2009.
4(h)	Instruments with respect to long-term debt where the total amount of securities authorized thereunder does not exceed 10 percent of the total assets of Registrant and its subsidiaries on a consolidated basis have not been filed. Registrant agrees to furnish to the Commission a copy of each such instrument upon request.
10	The management contracts or compensatory plans or arrangements listed below that are applicable to the executive officers named in the Summary Compensation Table which appears in Registrant s 2010 Proxy Statement are preceded by an asterisk (*).
*10(a)(1)	Registrant s Form of Separation Agreement (with salary continuance) February 2010.
	Incorporated by reference to Exhibit 10(a)(1) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2009.
*10(a)(2)	Registrant s Form of Separation Agreement (without salary continuance) February 2010.
	Incorporated by reference to Exhibit 10(a)(2) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2009.
*10(b)(1)	Registrant s 1991 Long-Term Incentive Plan, as amended and restated December 4, 2007 (1991 LTIP).
	Incorporated by reference to Exhibit 10(b)(1) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2007.
*10(b)(2)	Form of Agreements under 1991 LTIP, as amended through July 12, 2007.
	Incorporated by reference to Exhibit 10(b)(2) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2007.
*10(b)(3)	Amendment dated December 4, 2007 to 1991 LTIP.
	Incorporated by reference to Exhibit 10(b)(3) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2007.
10(c)(1)	Registrant s 1996 Non-employee Director Stock Option Plan, as amended and restated December 5, 2007 (1996 NDSOP).
	Incorporated by reference to Exhibit 10(c)(1) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2007.
10(c)(2)	Amendment dated December 5, 2007 to 1996 NDSOP.

Incorporated by reference to Exhibit 10(c)(2) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2007.

3

Table of Contents

10(d)(1)	Registrant s 2004 Equity Compensation Plan for Non-Employee Directors, as amended and restated December 5, 2007 (2004 ECPNED).
	Incorporated by reference to Exhibit 10(d)(1) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2007.
10(d)(2)	Form of Agreement under 2004 ECPNED.
	Incorporated by reference to Exhibit 10(d)(2) to Registrant s Quarterly Report on Form 10-Q for the Quarter ended March 31, 2005.
10(d)(3)	Form of Grant Summary under 2004 ECPNED.
	Incorporated by reference to Exhibit 10(d)(3) to Registrant s Quarterly Report on Form 10-Q for the Quarter ended March 31, 2005.
10(d)(4)	Form of DSU Deferral under 2004 ECPNED.
	Incorporated by reference to Exhibit 10(d)(4) to Registrant s Quarterly Report on Form 10-Q for the Quarter ended March 31, 2005.
10(d)(5)	Amendment dated December 5, 2007 to 2004 ECPNED.
	Incorporated by reference to Exhibit 10(d)(5) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2007.
*10(e)(1)	Registrant s 2004 Performance Incentive Plan, as amended and restated as of December 6, 2005 (2004 PIP).
	Incorporated by reference to Exhibit 10(e)(1) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2005.
*10(e)(2)	Form of Amendment to Agreements under 2004 PIP.
	Incorporated by reference to Exhibit 10(e)(7) to Registrant s Current Report on Form 8-K dated May 19, 2005.
*10(e)(3)	Registrant s 2004 Performance Incentive Plan, as amended and restated as of February 15, 2007 (2007 PIP).
	Incorporated by reference to Exhibit 10(e)(10) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2006.
*10(e)(4)	Registrant s 2004 Performance Incentive Plan, as amended and restated as of December 4, 2007 (2007-2 PIP).
	Incorporated by reference to Exhibit 10(e)(15) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2007.
*10(e)(5)	Performance Elements for 2008 Executive Long-Term Incentive Program (2008 ELTIP).
	Incorporated by reference to Exhibit 10(e)(17) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2007.
*10(e)(6)	Form of Executive Long-Term Incentive Program Award Summary under 2008 ELTIP.
	Incorporated by reference to Exhibit 10(e)(18) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2007.
*10(e)(7)	2008 Form of Executive Long-Term Incentive Program Award Agreement under the 2007-2 PIP.
	Incorporated by reference to Exhibit 10(e)(19) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2007.
*10(e)(8)	Amendment dated December 4, 2007 to 2007-2 PIP.
	Incorporated by reference to Exhibit 10(e)(20) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2007.

Table of Contents

*10(e)(9)	Amendment No. 1 dated December 17, 2008 to 2007-2 PIP.
	Incorporated by reference to Exhibit 10(e)(22) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2008.
*10(e)(10)	Amendment No. 2 dated February 16, 2009 to 2007-2 PIP.
	Incorporated by reference to Exhibit 10(e)(23) to Registrant s Quarterly Report on Form 10-Q for the quarter ended March 31, 2009.
*10(e)(11)	Performance Elements for 2009 Executive Long-Term Incentive Program (2009 ELTIP).
	Incorporated by reference to Item 5.02 of Registrant s Current Report on Form 8-K dated June 30, 2009.
*10(e)(12)	Form of Executive Long-Term Incentive Program Award Agreement under 2009 ELTIP.
	Incorporated by reference to Exhibit 10(e)(23) to Registrant s Current Report on Form 8-K dated June 30, 2009.
*10(e)(13)	Form of Executive Long-Term Incentive Program Award Summary under 2009 ELTIP.
	Incorporated by reference to Exhibit 10(e)(24) to Registrant s Current Report on Form 8-K dated June 30, 2009.
*10(e)(14)	Annual Performance Incentive Plan for 2010.
*10(e)(15)	Performance Elements for 2010 Executive Long-Term Incentive Program (2010 ELTIP).
	Incorporated by reference to Exhibit 10(e)(21) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2009.
*10(e)(16)	Form of Executive Long-Term Incentive Program Award Agreement under 2010 ELTIP.
	Incorporated by reference to Exhibit 10(e)(22) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2009.
*10(e)(17)	Form of Executive Long-Term Incentive Program Award Summary under 2010 ELTIP.
	Incorporated by reference to Exhibit 10(e)(23) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2009.
*10(e)(18)	Registrant s 2004 Performance Incentive Plan, as amended and restated May 20, 2010.
	Incorporated by reference to Exhibit 10(e)(24) to Registrant s Current Report on Form 8-K dated May 20, 2010.
*10(e)(19)	Annual Performance Incentive Plan 2011
*10(e)(20)	Performance Elements for 2011 Executive Long-Term Incentive Program (2011 ELTIP)
*10(e)(21)	Form of Executive Long-Term Incentive Award under 2011 ELTIP
*10(e)(22)	Form of Executive Long-Term Incentive Program Award Summary under 2011 ELTIP
*10(f)(1)	2008 Restatement of Registrant s Unfunded Retirement Income Guarantee Plan, as amended through February 12, 2008 (2008 URIGP).
	Incorporated by reference to Exhibit 10(f)(1) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2008.
*10(f)(2)	Amendment No. 1 to 2008 URIGP.
	Incorporated by reference to Exhibit 10(f)(2) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2008.
*10(f)(3)	Amendment No. 2 dated March 6, 2009 to 2008 URIGP.
	Incorporated by reference to Exhibit 10(f)(3) to Registrant s Quarterly Report on Form 10-Q for the Quarter ended March 31, 2009.
*10(f)(4)	Amendment No. 3 dated May 5, 2009 to 2008 URIGP.

Table of Contents

	Incorporated by reference to Exhibit 10(f)(3) to Registrant s Quarterly Report on Form 10-Q for the Quarter ended June 30, 2009.
*10(f)(5)	Amendment No. 4 dated October 9, 2009 to 2008 URIGP.
	Incorporated by reference to Exhibit 10(f)(3) to Registrant s Quarterly Report on Form 10-Q for the Quarter ended September 30, 2009.
*10(f)(6)	Amendment No. 5 dated December 1, 2009 to 2008 URIGP.
	Incorporated by reference to Exhibit 10(f)(6) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2009.
*10(f)(7)	Amendment No. 6 dated March 10, 2010 to 2008 URIGP.
	Incorporated by reference to Exhibit 10(f)(7) to Registrant s Quarterly Report on Form 10-Q for the Quarter ended March 31, 2010.
*10(g)(1)	2004 Restatement of Registrant s Unfunded Supplemental Executive Retirement Plan, as amended and restated December 4, 2007 (2007 USERP).
	Incorporated by reference to Exhibit 10(g)(1) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2007.
*10(g)(2)	Amendment dated December 4, 2007 to Registrant s 2007 USERP.
	Incorporated by reference to Exhibit 10(g)(2) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2007.
*10(g)(3)	Amendment No. 1 dated December 11, 2008 to Registrant s 2007 USERP.
	Incorporated by reference to Exhibit 10(g)(3) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2008.
10(h)	1996 Amendment and Restatement of Registrant s Restricted Stock Plan for Directors, as amended through February 4, 2002.
	Incorporated by reference to Exhibit 10(h) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2004.
*10(i)(1)	Form of Severance Letter Agreement entered into with various executive officers, effective October 12, 2007 (2007 Severance Letter).
	Incorporated by reference to Exhibit 10(i)(1) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2007.
*10(i)(2)	Amendment dated December 4, 2007 to 2007 Severance Letter.
	Incorporated by reference to Exhibit 10(i)(2) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2007
*10(i)(3)	Amendment dated December 17, 2008 to 2007 Severance Letter.
	Incorporated by reference to Exhibit 10(i)(3) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2008.
*10(j)(1)	Registrant s Universal Life Plan effective July 1, 2003.
	Incorporated by reference to Exhibit 10(j) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2004.
*10(j)(2)	Amendment No. 3 to Registrant s Universal Life Plan.
	Incorporated by reference to Exhibit 10(j)(2) to Registrant s Quarterly Report on Form 10-Q for the Quarter ended September 30, 2006.
*10(j)(3)	Amendment No. 4 dated September 28, 2009 to Registrant s Universal Life Plan.

Table of Contents

	Incorporated by reference to Exhibit 10(j)(3) to Registrant s Quarterly Report on Form 10-Q for the Quarter ended September 30, 2009.
10(k)(1)	Registrant s Deferred Compensation Plan for Directors, as amended and restated December 5, 2007 (DCPD).
	Incorporated by reference to Exhibit 10(k)(1) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2007.
10(k)(2)	Amendment dated December 5, 2007 to DCPD.
	Incorporated by reference to Exhibit 10(k)(2) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2007
10(k)(3)	Amendment No. 2 dated May 17, 2010 to DCPD.
	Incorporated by reference to Exhibit 10(k)(3) to Registrant s Quarterly Report on Form 10-Q for the quarter ended March 31, 2010.
*10(l)	Registrant s Deferred Compensation Plan for Executives, 2004 Restatement, as amended through August 11, 2004.
	Incorporated by reference to Exhibit 10(l) to Registrant s Quarterly Report on Form 10-Q for the Quarter ended September 30, 2004.
*10(m)	Registrant s 1998 Employee Stock Option Plan, as amended through October 9, 2000.
	Incorporated by reference to Exhibit 10(m) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2008.
10(n)	Separation Agreement dated May 11, 2000 between Registrant and G. Richard Thoman, former President and Chief Executive Officer of Registrant.
	Incorporated by reference to Exhibit 10(n) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2005.
*10(o)	Letter Agreement dated May 20, 2002 between Registrant and Lawrence A. Zimmerman, Senior Vice President and Chief Financial Officer of Registrant.
	Incorporated by reference to Exhibit 10(o) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2008.
*10(p)	Uniform Rule dated December 17, 2008 for all Deferred Compensation Promised by Registrant.
	Incorporated by reference to Exhibit 10(r) to Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2008.
10(q)	2006 Technology Agreement, effective as of April 1, 2006, by and between Registrant and Fuji Xerox Co., Ltd.
	Incorporated by reference to Exhibit 99.1 to Registrant s Current Report on Form 8-K dated March 9, 2006.**
*10(r)	Form of 2009 Long-Term Cash Incentive Award for Anne M. Mulcahy.
	Incorporated by reference to Exhibit 10(t) to Registrant s Current Report on Form 8-K dated June 30, 2009.
*10(s)	Form of 2009 Long-Term Cash Incentive Award for Lawrence A. Zimmerman.
	Incorporated by reference to Exhibit 10(u) to Registrant s Current Report on Form 8-K dated June 30, 2009.
*10(t)	Form of Severance Agreement entered into with various executive officers, effective October 2010.
*10(u)	Senior Executive Agreement dated September 27, 2009 among ACS, Registrant and Lynn Blodgett.
	Incorporated by reference to Exhibit 10.2 to ACS s Current Report on Form 8-K dated September 27, 2009.

Table of Contents

*10(v)(1)	Affiliated Computer Services, Inc. (ACS) 1997 Stock Incentive Plan (ACS 1997 SIP)
	Incorporated by reference to Appendix D to ACS s Joint Proxy Statement on Schedule 14A, filed November 14, 1997.
*10(v)(2)	Amendment No. 1 dated October 28, 2004 to ACS 1997 SIP.
	Incorporated by reference to Exhibit 4.6 to ACS s Registration Statement on Form S-8, filed December 6, 2005.
*10(w)	ACS Amended and Restated 2007 Equity Incentive Plan.
	Incorporated by reference to Exhibit 10.1 to ACS s Current Report on Form 8-K filed August 21, 2009.
*10(x)	ACS Senior Executive Annual Incentive Plan.
	Incorporated by reference to Exhibit A to ACS s Proxy Statement on Schedule 14A, filed April 14, 2009.
*10(y)	ACS 401(k) Supplemental Plan. Effective as of July 1, 2000, as amended.
	Incorporated by reference to Exhibit 10.15 to ACS s Annual Report on Form 10-K for the fiscal year ended June 30, 2004.
*10(z)	ACS Executive Benefit Plan, effective as of January 1, 2002, as amended.
	Incorporated by reference to Exhibit 10.15 to ACS s Annual Report on Form 10-K for the fiscal year ended June 30, 2005.
*10(aa)	Letter Agreement dated December 20, 2010 between Registrant and Luca Maestri, Executive Vice President and Chief Financial Officer of Registrant.
	Incorporated by reference to Exhibit 10(cc) to Registrant s Current Report on Form 8-K dated January 25, 2011.
12	Computation of Ratio of Earnings to Fixed charges and the Ratio of Earnings to Combined Fixed Charges and Preferred Stock Dividends.
13	Registrant s 2010 Annual Report to Shareholders.
21	Subsidiaries of Registrant.
23	Consent of PricewaterhouseCoopers LLP.
31(a)	Certification of CEO pursuant to Rule 13a-14(a) or Rule 15d-14(a).
31(b)	Certification of CFO pursuant to Rule 13a-14(a) or Rule 15d-14(a).
32	Certification of CEO and CFO pursuant to 18 U.S.C. §1350 as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002.
	Incorporated by reference to Exhibit 99.2 to Registrant s Current Report on Form 8-K dated April 11, 2002.
101.CAL	XBRL Taxonomy Extension Calculation Linkbase.
101.DEF	XBRL Taxonomy Extension Definition Linkbase.
101.INS	XBRL Instance Document.

Table of Contents

101.LAB	XBRL Taxonomy Extension Label Linkbase.
101.PRE	XBRL Taxonomy Extension Presentation Linkbase.
101.SCH	XBRL Taxonomy Extension Schema Linkbase.

** Pursuant to the Freedom of Information Act and/or a request for confidential treatment filed with the Securities and Exchange Commission under Rule 24b-2 of the Securities Exchange Act of 1934, as amended, the confidential portion of this material has been omitted and filed separately with the Securities and Exchange Commission.

9

nbsp;$ $

Total

$77 $77 $ $ $

Delisting from the Nasdaq National Market

As a result of the delisting by the Nasdaq on December 20, 2002, the shares of our common stock have traded in interdealer and over-the-counter transactions and price quotations have been available in the pink sheets. Since January 30, 2003, price quotations also have been available on the OTC Bulletin Board. Delisting from the Nasdaq National Market resulted in a reduction in the liquidity of our common stock. This lack of liquidity will likely also make it more difficult for us to raise additional capital, if necessary, through equity financings. In addition, the delisting of our common stock from the Nasdaq National Market resulted in an event of non-compliance under the provisions of our preferred stock. As we have been unable to obtain a waiver of this event of non-compliance, the Apollo Stockholders are entitled to elect a majority of the members of our board of directors.

Supplementary Unaudited Quarterly Financial Information

	2004				2005			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
	(in thousand, except per share data)							
Revenue	$ 817	$ 543	$ 418	$ 339	$ 135	$ 112	$ 196	$ 172
Gross margin	69	(45)	20	37	(2)	17	149	125
Net income (loss)	36	23,301	(1,033)	(5,138)	(7,175)	3,273	5,558	57,669
Net (loss) income attributable to common stockholders	(2,425)	20,828	(3,525)	(7,630)	(9,668)	781	3,066	55,177
Basic (loss) income per share	(0.16)	1.38	(0.23)	(0.50)	(0.56)	0.04	0.17	3.12
Diluted (loss) income per share	(0.16)	1.33	(0.23)	(0.50)	(0.56)	0.04	0.16	2.81

Recently Issued Accounting Standards

In December 2004, the FASB issued SFAS No. 123R, Share-Based Payment (SFAS No. 123R), a revision of SFAS No. 123. SFAS No. 123R requires entities to recognize compensation expense for all share-based payments to employees, including stock options, based on the estimated fair value of the instrument on the date it is granted. The expense will be recognized over the vesting period of the award. SFAS No. 123R is effective for us on January 1, 2006 and provides entities two transition methods. We have elected to use the modified prospective method and therefore will not restate our prior period results. Under the modified prospective method, compensation expense is recognized beginning with the effective date for all awards granted to employees prior to the effective date that are unvested on the effective date. As we currently account for share-

43

based payments using the intrinsic value method as allowed by APB Opinion No. 25, the adoption of the fair value method under SFAS No. 123R will have an impact on our results of operations. The unrecognized compensation expense associated with unvested stock options was approximately $1.5 million as of January 1, 2006. Of this amount, we expect to record approximately $1.0 million of compensation expense during the year ended December 31, 2006. Additional compensation expense will be impacted by various factors, including the number of awards granted and their related fair value at the date of grant.

In December 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets an amendment of APB Opinion No. 29 (SFAS No. 153). SFAS No. 153 eliminates the exception for nonmonetary exchanges of similar productive assets of APB Opinion No. 29 and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS No. 153 is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The adoption of SFAS No. 153 did not have a material impact on our financial position or results of operations.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3 (SFAS No. 154). SFAS No. 154 applies to all voluntary changes in accounting principle and changes the requirements for accounting for and reporting a change in accounting principle. SFAS No. 154 requires the retrospective application to prior periods financial statements of the direct effect of a voluntary change in accounting principle unless it is impracticable to determine either the period-specific effects or the cumulative effective of the change. SFAS No. 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005. The adoption of SFAS No. 154 is not expected to have a material impact on our financial position or results of operations.

In November 2005, the FASB issued Staff Position FAS 115-1, The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments (FSP 115-1). FSP 115-1 provides accounting guidance for determining and measuring other-than-temporary impairments of debt and equity securities, and confirms the disclosure requirements for investments in unrealized loss positions as outlined in Emerging Issues Task Force (EITF) Issue No. 03-01, The Meaning of Other-Than-Temporary Impairments and its Application to Certain Investments. FSP 115-1 is effective for us on January 1, 2006 and is not expected to have a material impact on our financial position or results of operations.

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140 (SFAS No. 155). SFAS No. 155 permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS No. 133, establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and amends SFAS No. 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity s first fiscal year that begins after September 15, 2006. The adoption of SFAS No. 155 is not expected to have a material impact on our financial position or results of operations.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate Risk

As of December 31, 2005, we had $28.0 million of cash, cash equivalents and short-term cash investments. These cash, cash equivalents and short-term cash investments are subject to market risk due to changes in interest rates. In accordance with our investment policy, we diversify our investments among United States Treasury securities and other high credit quality debt instruments that we believe to be low risk. We are averse to principal loss and seek to preserve our invested funds by limiting default risk and market risk.

Item 8. Financial Statements and Supplementary Data

The financial statements and supplementary financial data required by this Item 8 are set forth in Item 15 of this report. All information which has been omitted is either inapplicable or not required.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We carried out an evaluation required by the Exchange Act, under the supervision and with the participation of our principal executive officer and principal accounting officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rule 13a-15(e) of the Exchange Act, as of December 31, 2005. Based on such evaluation, our chief executive officer and principal accounting officer have concluded that, as of December 31, 2005, our disclosure controls and procedures were effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by us in the reports that we file or submit under the Exchange Act.

Management s Report on Internal Control over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting, as defined in Rule 13a-15(f) of the Exchange Act. Management has assessed the effectiveness of our internal control over financial reporting as of December 31, 2005 based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. As a result of this assessment, management concluded that, as of December 31, 2005, our internal control over financial reporting was effective in providing reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Deloitte & Touche LLP has issued an attestation report on management s assessment of internal control over financial reporting, a copy of which is included in this Annual Report on Form 10-K.

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of

SkyTerra Communications, Inc.

New York, New York

We have audited management s assessment, included in the accompanying Management s Report on Internal Control Over Financial Reporting, that SkyTerra Communications, Inc. and subsidiaries (the Company) maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company 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 opinions.

A company s internal control over financial reporting is a process designed by, or under the supervision of, the company s principal executive and principal financial officers, or persons performing similar functions, and effected by the company s board of directors, management, and other personnel 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 the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the 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 the Company maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on the criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on the criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements and financial statement schedule as of and for the year ended December 31, 2005 of the Company and our report dated March 29, 2006 expressed an unqualified opinion on those financial statements and the financial statement schedule.

/s/ DELOITTE & TOUCHE LLP

Baltimore, Maryland

March 29, 2006

Changes in Internal Control Over Financial Reporting

There has been no change in our internal control over financial reporting during the fourth quarter of 2005 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. Other Information

None.

PART III

Item 10. Directors and Executive Officers of the Registrant

The following table sets forth information concerning the Company s directors and executive officers as of March 27, 2006:

Name	Age	Position
Jeffrey A. Leddy	50	Chief Executive Officer and President
Robert C. Lewis	40	Senior Vice President, General Counsel and Secretary
Craig J. Kaufmann	30	Controller and Treasurer
Jeffrey M. Killeen (1)(2)	52	Director
William F. Stasior (1)	65	Director
Andrew D. Africk (1)(2)	39	Director
Aaron J. Stone	33	Director
Michael D. Weiner	53	Director

(1) Member of the Audit Committee of the Board of Directors.

(2) Member of the Compensation Committee of the Board of Directors.

Executives

Jeffrey A. Leddy Chief Executive Officer and President. Mr. Leddy has been the Company s Chief Executive Officer and President since April 2003, having served as its President and Chief Operating Officer since October 2002 and its Senior Vice President of Operations since June 2002. From September 1980 to December 2001, Mr. Leddy worked for EMS Technologies, most recently as a Vice President. Mr. Leddy also currently serves on the Board of Directors of Hughes Communications, Inc., Mobile Satellite Ventures GP Inc. and Hughes Systique Corporation.

Robert C. Lewis Senior Vice President, General Counsel and Secretary. Mr. Lewis has been the Company s Vice President and General Counsel since May 1998 and Secretary of the Company since August 1998. Mr. Lewis was appointed the Company s Senior Vice President on July 26, 2000. Prior to joining the Company, Mr. Lewis was an associate at the law firm of Fried, Frank, Harris, Shriver & Jacobson from October 1992.

Craig J. Kaufmann Controller and Treasurer. Mr. Kaufmann has been the Company s Controller and Treasurer since April 2003, having served as its Director of Financial Reporting since November 2000. Prior to joining the Company, Mr. Kaufmann was the Financial Reporting Manager of Kozmo.com since March 2000 and an associate at PricewaterhouseCoopers from August 1998 to March 2000.

Directors

Jeffrey M. Killeen Director. Mr. Killeen has been a director of the Company since October 1998. Since January 1, 2002, Mr. Killeen has been Chairman and Chief Executive Officer of Globalspec, Inc., an information services company. Mr. Killeen was the Chief Executive Officer of Forbes.com from August 1999 to March 2001. Prior to that, from January 1998 to March 1999, Mr. Killeen was the Chief Operating Officer of barnesandnoble.com. Before joining barnesandnoble.com, Mr. Killeen served as President and Chief Executive Officer of Pacific Bell Interactive Media from August 1994 to January 1998.

William F. Stasior Director. Mr. Stasior joined the Board of Directors in April 2000. Mr. Stasior was the Chairman and Chief Executive Officer of Booz Allen & Hamilton Inc., a management and technology consulting firm, from 1991 to 1999. Since October 1999, Mr. Stasior has been the Senior Chairman of Booz Allen. Mr. Stasior also serves on the Board of Directors of OPNET Technologies, Inc., a software company that specializes in enhancing network performance for enterprises and service providers, and Vanu, Inc., a leading developer of software-defined radio technology.

Andrew D. Africk Director. Mr. Africk has been a director of the Company since June 1999. Mr. Africk is a partner of Apollo Advisors, L.P. Mr. Africk is also a director of Hughes Communications, Inc., Intelsat Holdings, Ltd., Superior Essex, Inc., Mobile Satellite Ventures GP Inc., TerreStar Networks, Inc. and several private venture companies.

Aaron J. Stone Director. Mr. Stone has been a director since June 2005. Mr. Stone is a partner of Apollo Advisors, L.P. where he has worked since 1997. Mr. Stone also serves on the Board of Directors of Hughes Communications, Inc., AMC Entertainment Inc., Educate Inc. and Intelsat Holdings, Ltd. Prior to Apollo, Mr. Stone worked for Smith Barney Inc. in its Mergers & Acquisitions group.

Michael D. Weiner Director. Mr. Weiner has been a director since June 2005. Mr. Weiner joined Apollo Advisors, L.P. and Apollo Real Estate Advisors in 1992 and has served as general counsel of the Apollo organization since that time. Prior to joining Apollo, Mr. Weiner was a partner in the law firm of Morgan, Lewis & Bockius specializing in securities law, public and private financings, and corporate and commercial transactions. Mr. Weiner serves on the Board of Directors of Hughes Communications, Inc. and Quality Distribution.

Audit Committee

The Company s Audit Committee is currently composed of two outside directors, Mr. Killeen and Mr. Stasior, both of whom are independent under Rule 4200(a)(15) of the National Association of Securities Dealers (NASD) listing standards, and Mr. Africk. The Board of Directors has determined that Mr. Africk is an audit committee financial expert within the applicable definition of the SEC.

Code of Ethics

The Company has adopted a Code of Ethics for its Senior Executive and Senior Financial Officers. A copy of the Code is publicly available on the Company s website at www.skyterracom.com. Amendments to the Code or any grant of a waiver from a provision of the Code requiring disclosure under applicable SEC rules will also be disclosed on the Company s website.

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires the Company s directors and executive officers, and persons who own more than 10% of a registered class of the Company s securities, to file with the SEC initial reports of ownership and reports of changes in ownership of our common stock and other equity securities. Officers, directors and greater than 10% stockholders are required by SEC regulations to furnish the Company with copies of all Section 16(a) forms they file.

To the Company s knowledge, based solely on a review of the copies of such reports furnished to the Company, the Company believes that during the year ended December 31, 2005 its officers, directors and greater than 10% stockholders complied with all Section 16(a) filing requirements, with the exception of the late filing of a Statement of Changes in Beneficial Ownership of Securities on Form 4 for each of Messrs. Lewis, Kaufmann and Leddy in connection with option grants at fair market value in late January 2005 that were filed in February 2005, and the late filing of a Statement of Changes in Beneficial Ownership of Securities on Form 4 for each of Messrs. Africk, Killeen, Stasior, Stone and Weiner in connection with option grants at fair market value in June 2005 that were filed in early July 2005.

Item 11. Executive Compensation
Summary Compensation Table

The following Summary Compensation Table sets forth, for the three years ended December 31, 2005, the compensation for services in all capacities earned by the Company s Chief Executive Officer and its next most highly compensated executive officers.

Name and Principal Position	Year	Salary	Bonus (1)	Other Annual Compensation	Securities Underlying Options/ SARs (#)	LTIP Payouts ($)	All Other Compensation (2)
Jeffrey A. Leddy	2005	$ 310,000	$ 350,000	$	30,000	$	$ 10,000
Chief Executive Officer and	2004	309,180	300,000		70,000		9,000
President	2003	232,950	168,750		100,000		
Robert C. Lewis	2005	205,000	200,000		10,000		9,159
Senior Vice President, General	2004	203,846	100,000		20,000		8,823
Counsel and Secretary	2003	187,615	90,000		40,000		3,304
Craig J. Kaufmann	2005	120,000	150,000		10,000		5,105
Controller and Treasurer	2004	118,269	50,000		25,000		4,677
	2003	94,490	37,500		15,000		1,465

(1) Bonuses for services provided in the year ended December 31, 2003 were granted in January 2004 and are reflected in 2003. Bonuses for services provided in the year ended December 31, 2004 were granted in February 2005 and are reflected in 2004. Bonuses for services provided in the year ended December 31, 2005 were granted in January 2006 and are reflected in 2005.

(2) Represents employer matching contributions to retirement accounts.

Option / SAR Grants in the Last Year

The following table sets forth information concerning grants of stock options to purchase common stock during the year ended December 31, 2005 to the named executive officers.

Name	Number of Securities Underlying Options/SARs Granted	Percent of Total Options/SARs Granted to Employees in Fiscal Year	Exercise or Base Price ($/Share)	Expiration Date	Potential Realizable Value at Assumed Annual Rates of Stock Appreciation for Option Term 5%	10%
Jeffrey A. Leddy	30,000(1)	37.5%	$ 32.80	1/28/15	$ 618,832	$ 1,568,243
Robert C. Lewis	10,000(1)	12.5%	$ 32.80	1/28/15	$ 206,277	$ 522,748
Craig J. Kaufmann	10,000(1)	12.5%	$ 32.80	1/28/15	$ 206,277	$ 522,748

(1) These options were granted on January 28, 2005 at an exercise price of $32.80, the per share fair market value of the common stock at that time. The options have a term of ten years. These options are exercisable cumulatively in three equal annual installments, beginning on January 28, 2006.

Aggregated Option/SAR Exercises in the Last Year and Year-End Option/SAR Values

The following table sets forth information concerning the exercise of options to purchase shares of common stock by the named executive officers during the year ended December 31, 2005, as well as the number and potential value of unexercised options (both options which are presently exercisable and options which are not presently exercisable) as of December 31, 2005.

Name	Number of Securities Underlying Options/SARs Acquired on Exercise (#)	Value Realized (1)	Number of Securities Underlying Options/SARs at Fiscal Y/E (#) Exercisable/ Unexercisable	Value of Unexercised In-the-Money Options/SARs at Fiscal Y/E ($) Exercisable/ Unexercisable
Jeffrey A. Leddy			190,001/109,999	7,047,953/3,092,797
Robert C. Lewis			63,334/36,666	2,306,951/1,033,009
Craig J. Kaufmann			13,334/31,666	487,141/842,009

Employment Contracts and Change in Control Arrangements

The Company has an employment agreement with Mr. Lewis. Under this agreement, if, either (i) after 90 days following a change in control, Mr. Lewis terminates his employment or (ii) Mr. Lewis is terminated for other than cause as such term is defined in his agreement, then Mr. Lewis is entitled to receive severance compensation and benefits in a lump sum payment consisting of one year of his then current salary and the right to exercise all vested stock options and unvested stock options through the option expiration date for such options.

Compensation of Directors

Each non-employee director receives a per meeting fee of $1,000 for each meeting of the Board of Directors and $500 for each committee meeting attended, along with expenses incurred in connection with attending each meeting. Furthermore, from time to time, directors may be granted options to purchase common stock under our 1998 Long-Term Incentive Plan.

Item 12. Security Ownership Of Certain Beneficial Owners And Management and Related Stockholder Matters

The following table and notes thereto set forth certain information, as of March 27, 2006 (except as noted otherwise), regarding beneficial ownership of the shares of voting common stock of the Company by (i) each person who is known to the Company to be the beneficial owner of more than 5% of the outstanding shares of such common stock, (ii) each of the Company s named executive officers under the Summary Compensation Table under the heading Executive Compensation, (iii) each director and nominee for director, and (iv) all executive officers and directors of the Company as a group. Unless otherwise indicated, the stockholders listed possess sole voting and investment power with respect to the shares indicated as owned by them.

Name and Address	Position	Number of Shares of Common Stock Beneficially Owned (1)	Percentage of Class
Jeffrey A. Leddy	Chief Executive Officer and President	256,667	2.8%(2)
Robert C. Lewis	Senior Vice President, General Counsel and Secretary	96,166	1.1%(3)
Craig J. Kaufmann	Controller and Treasurer	37,300	*(4)
Jeffrey M. Killeen	Director	37,500	*(5)
William F. Stasior	Director	45,000	*(5)
Andrew D. Africk c/o SkyTerra Communications, Inc. 19 West 44th Street, Suite 507 New York, New York 10036	Director	5,141,572	41.9%(6)
Aaron J. Stone c/o SkyTerra Communications, Inc. 19 West 44th Street, Suite 507 New York, New York 10036	Director	5,099,072	41.7%(7)
Michael D. Weiner c/o SkyTerra Communications, Inc. 19 West 44th Street, Suite 507 New York, New York 10036	Director	5,099,072	41.7%(8)
Apollo Investment Fund IV, L.P. Two Manhattanville Road Purchase, New York 10577		5,099,072	41.7%(9)
Harbinger Capital Partners Master Fund, Ltd c/o International Fund Services Third Floor Bishop Square Redmonds Hill Dublin Ireland L2		2,117,800	23.9%(10)
OZ Management, LLC 9 West 57th Street, 39th Floor		687,750	7.7%(11)

New York, NY 10019		
All executive officers, directors and nominees as a group (8 persons)	5,614,205	44.1%(12)

* Represents beneficial ownership of less than 1%.

(1) Beneficial ownership has been determined pursuant to Rule 13d-3 under the Exchange Act, and therefore excludes 8,990,212 shares of non-voting common stock held by the Apollo Stockholders.

(2) Represents options to purchase shares of common stock that are currently exercisable, but does not include options that become exercisable upon a change of control and upon termination of employment with the Company.

(3) Includes 9,500 shares of common stock and options to purchase an additional 86,666 shares of common stock that are currently exercisable, but does not include options that become exercisable upon a change of control of the Company and upon certain other conditions.

(4) Includes 7,300 shares of common stock and options to purchase an additional 30,000 shares of common stock that are currently exercisable.

(5) Represents options to purchase shares of common stock that are currently exercisable.

(6) Includes an aggregate of (i) 1,270,948 shares of common stock acquired through the exercise of Series 1-A warrants, (ii) 474,427 shares of common stock acquired in a tender offer and (iii) 3,353,697 shares of common stock issuable to Apollo Stockholders upon conversion of the Series A Preferred Stock and exercise of the Series 1-A warrants and the Series 2-A warrants owned by them. Excludes an aggregate of 8,990,212 shares of non-voting common stock held by the Apollo Stockholders which were acquired pursuant to the rights offering.
Mr. Africk is a principal of Apollo Advisors IV, L.P., which together with an affiliated investment manager, serves as the manager of each of the Apollo Stockholders. Mr. Africk disclaims beneficial ownership of such shares. Includes options to purchase 42,500 shares of common stock held by Mr. Africk that are currently exercisable, but does not include options that become exercisable upon a change of control.

(7) Includes an aggregate of (i) 1,270,948 shares of common stock acquired through the exercise of Series 1-A warrants, (ii) 474,427 shares of common stock acquired in a tender offer and (iii) 3,353,697 shares of common stock issuable to Apollo Stockholders upon conversion of the Series A Preferred Stock and exercise of the Series 1-A warrants and the Series 2-A warrants owned by them. Excludes an aggregate of 8,990,212 shares of non-voting common stock held by the Apollo Stockholders which were acquired pursuant to the rights offering.
Mr. Stone is a principal of Apollo Advisors IV, L.P., which together with an affiliated investment manager, serves as the manager of each of the Apollo Stockholders. Mr. Stone disclaims beneficial ownership of such shares.

(8) Includes an aggregate of (i) 1,270,948 shares of common stock acquired through the exercise of Series 1-A warrants, (ii) 474,427 shares of common stock acquired in a tender offer and (iii) 3,353,697 shares of common stock issuable to Apollo Stockholders upon conversion of the Series A Preferred Stock and exercise of the Series 1-A warrants and the Series 2-A warrants owned by them. Excludes an aggregate of 8,990,212 shares of non-voting common stock held by the Apollo Stockholders which were acquired pursuant to the rights offering.
Mr. Weiner is a principal of Apollo Advisors IV, L.P., which together with an affiliated investment manager, serves as the manager of each of the Apollo Stockholders. Mr. Weiner disclaims beneficial ownership of such shares.

(9) Represents the aggregate of (i) 1,270,948 shares of common stock acquired through the exercise of Series 1-A warrants, (ii) 474,427 shares of common stock acquired in a tender offer and (iii) 3,353,697 shares of common stock issuable upon conversion of the aggregate of 1,199,007 shares of our Series A Preferred Stock and the exercise of an aggregate of 234,633 Series 1-A warrants and 9,810,033 Series 2-A warrants held by the Apollo Stockholders. Assuming conversion of all the Series A Preferred Stock and the exercise of all the Series 1-A warrants and Series 2-A warrants held by the Apollo Stockholders, such 5,099,072 shares of common stock would consist of 3,541,765 shares of common stock beneficially owned by Apollo Investment Fund IV, L.P., 189,929 shares of common stock beneficially owned by Apollo Overseas Partners IV, L.P., 892,951 shares of common stock beneficially owned by AIF IV/RRRR LLC and 474,427 shares of common stock owned by AP/RM Acquisition, LLC. The holders of our Series A Preferred Stock are only entitled to an aggregate of 975,000 votes with respect to the Series A Preferred Stock, or 0.813 votes per share of Series A Preferred Stock. Excluded from the table are 8,990,212 shares of non-voting common stock of which 7,999,359 shares are held by Apollo Investment Fund IV, L.P., 391,644 shares are held by Apollo Overseas Partners IV, L.P. and 599,209 shares are held by ST/RRRR LLC. Messrs. Africk, Stone and Weiner, members of our Board of Directors and associated with Apollo Advisors IV, L.P., disclaim beneficial ownership of the shares held by the Apollo Stockholders.

(10) Based on the Form 4 filed on March 16, 2006 by Harbinger Capital Partners Master Fund I, Ltd. (formerly known as Harbert Distressed Investment Master Fund, Ltd.). Harbinger Capital Partners Master Fund I, Ltd. may be deemed to share beneficial ownership of and voting power with respect to 2,052,495 shares of our common stock with Harbinger Capital Partners Offshore Manager LLC, HMC Investors LLC, Philip

Falcone, Raymond J. Harbert and Michael D. Luce. Alpha US Sub Fund VI, LLC may be deemed to share beneficial ownership of and voting power with respect to 65,305 shares of our common stock with HMC Investors LLC, Philip Falcone, Raymond J. Harbert and Michael D. Luce. Such persons disclaim beneficial ownership in the shares except to the extent of their pecuniary interest therein.

(11) Based on the Schedule 13G filed on March 6, 2006 by OZ Management, LLC. OZ Management, LLC serves as principal investment manager to a number of investment funds and discretionary accounts with respect to which it has voting and dispositive authority over 687,750 shares of the Company s common stock, including an account for OZ Master Fund, Ltd., which holds 646,150 of the reported shares. Mr. Daniel S. Och is the Senior Managing Member of OZ Management, LLC and is the Director of OZ Master Fund, Ltd. and, as such, may be deemed to control such entities and therefore may be deemed to be the beneficial owner of the reported shares. OZ Management, LLC, Mr. Och and Oz Master Fund, Ltd. disclaim beneficial ownership of such shares.

(12) Messrs. Africk, Stone and Weiner, members of the Board of Directors and associated with Apollo Advisors IV, L.P., disclaim beneficial ownership of shares held by the Apollo Stockholders. See footnote numbers 5, 6 and 7 above. Includes options to purchase an aggregate of 445,832 shares of common stock that are currently exercisable, but does not include options that become exercisable upon a change of control.

Securities Authorized for Issuance under Equity Compensation Plans and Individual Arrangements

The following table and notes thereto set forth, as of December 31, 2005, information with respect to shares of the Company s common stock which may be issued under existing equity compensation plans and individual arrangements.

Plan Category	Number of Shares of Common Stock To Be Issued upon Exercise of Outstanding Options, Warrants and Rights	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights	Number of Shares of Common Stock Remaining for Future Issuance under Equity Compensation Plans (Excluding Securities Reflected in First Column)
Equity compensation plans approved by stockholders	1,070,726	$ 11.65	841,054
Equity compensation plans and individual arrangements not approved by stockholders (1)	131,367	18.63	
Total	1,202,093	$ 12.41	841,054

(1) Includes a warrant to purchase 110,000 shares of common stock issued to the placement agent in connection with the December 2004 private placement, options to purchase 4,700 shares of common stock issued to a former consultant in settlement of various disputes and an option to purchase 16,667 shares of common stock issued to a former director for services provided.

Item 13. Certain Relationships and Related Transactions.

Hughes Systique

On October 12, 2005, through Hughes, the Company acquired Series A Preferred Shares from Hughes Systique for $3.0 million, representing an ownership of approximately 26% on an undiluted basis. The founders of Hughes Systique include the Chief Executive Officer and President of Hughes, as well as certain current and former employees of HNS, including the Chief Executive Officer and President s brother. The Chief Executive Officer and President of Hughes and his brother own an aggregate of approximately 21% of Hughes Systique on an undiluted basis.

Separation Agreement

On December 30, 2005, in preparation for the Distribution, the Company and Hughes entered into a Separation Agreement pursuant to which the Company contributed to Hughes, effective December 31, 2005, all of its assets, liabilities and operations other than those associated with the MSV Joint Venture and TerreStar, $12.5 million of cash, cash equivalents and short-term investments and the obligations pursuant to the Series A Preferred Stock. Upon a change of control of the Company, the remaining balance of the $12.5 million of cash at such time, if any, will be transferred to Hughes. The Separation Agreement also provides that Hughes is responsible for paying all fees, costs and expenses directly related to the Distribution, except to the extent such fees have already been paid by the Company. In addition, the Separation Agreement provides for certain indemnifications, tax sharing, consulting services and access to facilities.

Indemnification. The Separation Agreement provides that Hughes will indemnify the Company against losses based on, arising out of or resulting from (i) the ownership or the operation of the assets or properties transferred to Hughes under the Separation Agreement, and the operation or conduct of the business of, including contracts entered into and any activities engaged in by, Hughes, whether in the past or future; (ii) any other activities Hughes engages in; (iii) any guaranty, keepwell, of or by the Company provided to any parties with respect to any of Hughes s actual or contingent obligations and (iv) certain other matters described in the Separation Agreement. The Separation Agreement provides that the Company will indemnify Hughes against losses based on, arising out of or resulting from the ownership or operation of the assets or properties of the MSV Joint Venture or TerreStar, or the operation or conduct of their businesses, including the contracts entered into by them, and certain other matters described in the Separation Agreement.

Tax sharing agreement. The tax sharing agreement governs the allocation between Hughes and the Company of tax liabilities and related tax matters, such as the preparation and filing of tax returns and tax contests, for all taxable periods. Hughes will generally be responsible for, and indemnify the Company and its subsidiaries against, all tax liabilities imposed on or attributable to (i) Hughes and any of its subsidiaries relating to all taxable periods and (ii) the Company and any of its subsidiaries for all taxable periods or portions thereof ending on or prior to a change of control of the Company, in each case, after taking into account any tax attributes of the Company or any of its subsidiaries that are available to offset such tax liabilities. Notwithstanding the foregoing, Hughes is not responsible for any taxes relating to the MSV Joint Venture, TerreStar or a change of control of the Company. Additionally, under the tax sharing agreement, the Company is responsible for, and indemnifies Hughes and its subsidiaries against, all tax liabilities imposed on or attributable to the MSV Joint Venture and TerreStar relating to all taxable periods, the Company and any of its subsidiaries relating to all taxable periods or portions thereof beginning and ending after a change of control, and any change of control of the Company.

Consulting services. The Company will provide Hughes with the consulting services of its officers, not to exceed an aggregate of 200 hours per month, for a monthly fee of $25,000. Such services may be terminated by either party at any time with or without cause by providing ten business days notice to the non-terminating party.

Access to facilities. The Company will provide Hughes with use of its facilities, including information technology and communications equipment and services at such premises, until the earlier of a change of control of the Company or such other time that the parties mutually agree. In exchange, Hughes will pay the Company $7,500 per month.

Investment in Miraxis

In May 2002, the Company acquired Series B Preferred Shares and a warrant from Miraxis for approximately $0.4 million, representing an ownership of approximately 30%. Miraxis is a development stage, privately held telecommunications company that has access to a Ka-band license with which is striving to provide satellite based multi-channel, broadband data and video services in North America. The Company entered into a management support agreement with Miraxis under which the Company s current Chief Executive

Officer and President provided certain services to Miraxis through February 2003 in exchange for additional Series B Preferred Shares and warrants being issued to the Company. In addition, in December 2002, the Company acquired Series C Preferred Shares and warrants from Miraxis for approximately $0.1 million.

In February 2003, the Company entered into a consulting agreement with Miraxis pursuant to which Miraxis personnel provided services to the Company through May 2003. In addition, Miraxis extended the management support agreement whereby the Company s current Chief Executive Officer and President continued to provide certain services to Miraxis through May 2003. In connection with these agreements, the Company paid Miraxis approximately $40,000 but also received additional Series C Preferred Shares and warrants.

In April 2003, the Company acquired additional Series C Preferred Shares and warrants for approximately $40,000. Between June 2003 and September 2003, the Company purchased promissory notes from Miraxis with an aggregate principal amount of approximately $0.1 million. In November 2003, the promissory notes were converted to Series D Preferred Shares. From January 2004 through July 2005, the Company purchased additional promissory notes with an aggregate principal balance of approximately $0.1 million. In September 2005, the board of managers of Miraxis approved the dissolution of the company. The dissolution of Miraxis will not have a material impact on the Company s financial position or results of operations. Currently, the Company holds approximately 40% of the ownership interests of Miraxis. The Company s Chief Executive Officer and President currently holds an approximate 1% interest in Miraxis.

Miraxis License Holdings, LLC (MLH) and a subsidiary, entities unaffiliated with Miraxis, other than as described herein, hold the rights to certain orbital slots, one of which Miraxis had the ability to use so long as it implemented its business plan. Miraxis issued 10% of its outstanding common equity on a fully diluted basis to MLH as partial consideration for access to that slot. In addition, Miraxis was required to pay certain royalties to MLH for use of the slot if it ever launched satellites. Miraxis ceased operations during the year ended December 31, 2005 and, accordingly, the arrangement with MLH terminated. Prior to becoming affiliated with the Company, its current Chief Executive Officer and President acquired a 2% interest in MLH. In addition, prior to the Company acquiring an interest in Miraxis, an affiliate of the Company s preferred stockholders acquired an approximate 70% interest in MLH.

Employment Agreements

For a description of the employment agreements between the Company and certain of its executive officers, please see the descriptions above in Item 11. Executive Compensation under the heading Employment Contracts and Change in Control Arrangements.

Other

Certain of the Company s directors and officers serve on the board of directors of affiliates, including the MSV Joint Venture and TerreStar. Such directors and officers have received stock-based compensation from such affiliates for their service. The amount of stock-based compensation received by the Company s directors and officers is comparable to stock-based compensation awarded to other non-executive members of the affiliates board of directors.

Item 14. Principal Accounting Fees and Services

Aggregate fees for professional services rendered to the Company by Deloitte & Touche LLP (Deloitte) for work performed during the year ended December 31, 2005 and KPMG LLP (KPMG) for work performed during the year ended December 31, 2004 are summarized in the table below. The Company engaged Deloitte to replace KPMG as its independent registered public accounting firm effective April 18, 2005.

	2005	**2004**
Audit fees (1)	$ 806,700	382,507
Audit related fees (2)		50,325
Tax fees (3)		220,225
All other fees		
	$ 806,700	$ 653,057

(1) Audit fees consisted of fees billed or expected to be billed for professional services rendered for the audit of the Company s consolidated annual financial statements included in the Company s Form 10-K, the reviews of the Company s consolidated financial statements included in the Company s Form 10-Q, services related to Sarbanes-Oxley Act compliance or any other services rendered to comply with generally accepted auditing standards and include comfort and consent letters in connection with SEC filings and financing transactions. During 2005, Deloitte performed an audit of the Company s consolidated financial statements as of December 31, 2004 and 2003 and for each of the years in the three-year period ended December 31, 2004. The approximately $0.4 million of fees paid for such audit is reflected in 2005.

(2) Audit related fees consisted of fees billed for assurance and related services that are reasonably related to the performance of an audit or review of the Company s consolidated financial statements, including assistance with acquisitions and other accounting and auditing consultation services.

(3) Tax fees consisted of fees paid for assistance related to tax compliance and consulting services. The Audit Committee did not believe the provision of these tax services was incompatible with maintaining KPMG s independence.

Pursuant to a pre-approval policy, the Audit Committee approved all audit services and the payment of audit and audit related fees during the years ended December 31, 2005 and 2004. In addition, the Audit Committee approved all of the tax fees paid to KPMG during the year ended December 31, 2004.

PART IV

Item 15. Exhibits, Financial Statement Schedules, and Reports on Form 8-K

(a) The following is a list of certain documents filed as a part of this report:

(1) Financial Statements of the Registrant.

(i) Report of Independent Registered Public Accounting Firm.

(ii) Consolidated Balance Sheets as of December 31, 2005 and 2004.

(iii) Consolidated Statements of Operations for the years ended December 31, 2005, 2004 and 2003.

(iv) Consolidated Statements of Cash Flows for the years ended December 31, 2005, 2004 and 2003.

(v) Consolidated Statements of Changes in Stockholders Equity (Deficit) for the years ended December 31, 2005, 2004 and 2003.

(vi) Notes to Consolidated Financial Statements.

(vii) Schedule II Valuation and Qualifying Accounts

All other schedules specified in Item 8 or Item 15(d) of Form 10-K are omitted because they are not applicable or not required, or because the required information is included in the Financial Statements or notes thereto.

(b) The following sets forth those exhibits filed pursuant to Item 601 of Regulation S-K:

Exhibit Number	Description
3.1.1	Restated Certificate of Incorporation of the Company, was filed as Exhibit 3.1.1 to the Company s Form 10-K for the year ended December 31, 2003 and is hereby incorporated herein by reference.
3.1.2	Certificate of Amendment, dated July 17, 2002, to the Restated Certificate of Incorporation of the Company, was filed as Exhibit 3.1.2 to the Company s Form 10-K for the year ended December 31, 2003 and is hereby incorporated herein by reference.
3.1.3	Certificate of Ownership and Merger, dated September 23, 2003, merging SkyTerra Communications, Inc. into Rare Medium Group, Inc., was filed as Exhibit 3.1.1 to the Company s Form 10-K for the year ended December 31, 2003 and is hereby incorporated herein by reference.
3.2	Amended and Restated By-Laws of the Company, was filed as Exhibit 3.2 to the Company s Form 10-K for the year ended December 31, 1999 and is hereby incorporated herein by reference.
10.1	The Company s Nonqualified Stock Option Plan as amended and restated, which was filed as Exhibit C to the Company s Definitive Proxy Statement dated November 18, 1994, for Stockholders Meeting held December 15, 1994, and is hereby incorporated herein by reference.
10.2	Amended and Restated Securities Purchase Agreement, dated as of June 4, 1999, among the Company, Apollo Investment Fund IV, L.P., Apollo Overseas Partners IV, L.P. and AIF/RRRR LLC, which was filed as Exhibit 10.1 to the Company s Current Report on Form 8-K filed on June 21, 1999, and is hereby incorporated herein by reference.
10.3	Form of Series 1-A Warrant of the Company, which was filed as Exhibit 4.3 to the Company s Current Report on Form 8-K filed on June 21, 1999, and is hereby incorporated herein by reference.
10.4	Form of Series 2-A Warrant of the Company, which was filed as Exhibit 4.5 to the Company s Current Report on Form 8-K filed on June 21, 1999, and is hereby incorporated herein by reference.
10.5	The Company s Amended and Restated 1998 Long-Term Incentive Plan, which was filed as Exhibit 4(d) to the Company s Form S-8 filed on November 3, 2000 and is hereby incorporated herein by reference.
10.6	Amended and Restated Investment Agreement, dated as of October 12, 2001, by and among Motient Corporation, Mobile Satellite Ventures LLC, TMI Communications and Company, Limited Partnership, MSV Investors, LLC and the other investors named therein, which was filed as Exhibit 99.1 to the Company s Current Report on Form 8-K dated December 3, 2001 and is incorporated herein by reference.
10.7	Amended and Restated Limited Partnership Agreement, dated as of November 12, 2004, by and among MSV Investors, LLC, Mobile Satellite Ventures LP, et al. which was filed as Exhibit 10.1 to the Company s Current Report on Form 8-K dated November 18, 2004 and is hereby incorporated herein by reference.
10.8	Amended and Restated Stockholders Agreement, dated as of November 12, 2004, by and among MSV Investors, LLC, Mobile Satellite Ventures LP, et al. which was filed as Exhibit 10.2 to the Company s Current Report on Form 8-K dated November 18, 2004 and is hereby incorporated herein by reference.

Exhibit Number	Description
10.9	Second Amended and Restated Parent Transfer/Drag Along Agreement by and among the Company, et al. which was filed as Exhibit 10.3 to the Company s Current Report on Form 8-K dated November 18, 2004 and is hereby incorporated herein by reference.
10.10	Voting Agreement, dated November 12, 2004, by and among MSV Investors, LLC, et al. which was filed as Exhibit 10.18 to the Company s Form 10-K for the year ended December 31, 2004 and is hereby incorporated herein by reference.
10.11	Note Exchange and Conversion Agreement, dated as of November 12, 2004, by and among MSV Investors, LLC, Mobile Satellite Ventures LP, et al. which was filed as Exhibit 2.1 to the Company s Current Report on Form 8-K dated November 18, 2004 and is hereby incorporated herein by reference.
10.12	Amendment to Employment Agreement, dated as of February 15, 2001, between the Company and Robert C. Lewis, which was filed as exhibit 10.3 to the Company s Form 10-Q for the period ended March 31, 2001 and is hereby incorporated herein by reference.
10.13	Investment Agreement, dated as of April 2, 2002, between the Company and the Apollo Stockholders, which was filed as Exhibit 99.2 to the Company s Current Report filed on Form 8-K, filed on April 4, 2002, and is hereby incorporated herein by reference.
10.14	Stipulation of Settlement in the matter *In Re Rare Medium Group, Inc. Shareholders Litigation*, Consolidated C.A. No. 18879 NC, which was filed as Exhibit 99.3 to the Company s Current Report on Form 8-K, filed on April 4, 2002, and is hereby incorporated herein by reference.
10.15	Amended and Restated Limited Liability Company Agreement, dated as of April 22, 2005, by and between Hughes Network Systems, Inc. and the Company, which was filed as Exhibit 99.4 to the Company s Current Report on Form 8-K for dated April 26, 2005 and is hereby incorporated herein by reference.
10.16	Registration Rights Agreement, dated as of April 22, 2005, by and between the Company and Hughes Network Systems, Inc., which was filed as Exhibit 99.4 to the Company s Current Report on Form 8-K for dated April 26, 2005 and is hereby incorporated herein by reference.
10.17	Investor Rights Agreement, dated as of April 22, 2005, by and among Hughes Network Systems, LLC, Hughes Network Systems, Inc. and the Company, which was filed as Exhibit 99.5 to the Company s Current Report on Form 8-K for dated April 26, 2005 and is hereby incorporated herein by reference.
10.18	First Lien Credit Agreement, dated as of April 22, 2005, among Hughes Network Systems, LLC, as borrower, the lenders party thereto, JPMorgan Chase Bank, N.A., as Administrative Agent, Bear Stearns Corporate Lending Inc., as Syndication Agent, and J.P. Morgan Securities Inc. and Bear, Stearns & Co. Inc., as joint lead arrangers and joint bookrunners, which was filed as Exhibit 99.6 to the Company s Current Report on Form 8-K for dated April 26, 2005 and is hereby incorporated herein by reference.
10.19	Second Lien Credit Agreement, dated as of April 22, 2005 among Hughes Network Systems, LLC, as borrower, the lenders parties thereto, Bear Stearns Corporate Lending, Inc., as administrative agent, JPMorgan Chase Bank, N.A., as syndication agent, and J.P. Morgan Securities Inc. and Bear, Stearns & Co. Inc., as joint lead arrangers and joint book managers , which was filed as Exhibit 99.7 to the Company s Current Report on Form 8-K for dated April 26, 2005 and is hereby incorporated herein by reference.

Exhibit Number	Description
10.20	First Lien Parent Pledge Agreement, dated as of April 22, 2005, made by the Company and Hughes Network Systems, Inc., in favor of JPMorgan Chase Bank, N.A., as administrative agent for the lenders parties to the Credit Agreement, dated as of April 22, 2005, among Hughes Network Systems, LLC, as borrower, the lenders party thereto, JPMorgan Chase Bank, N.A., as Administrative Agent, Bear Stearns Corporate Lending Inc., as Syndication Agent, and J.P. Morgan Securities Inc. and Bear, Stearns & Co. Inc., as joint lead arrangers and joint bookrunners, which was filed as Exhibit 99.8 to the Company s Current Report on Form 8-K for dated April 26, 2005 and is hereby incorporated herein by reference.
10.21	Second Lien Parent Pledge Agreement, dated as of April 22, 2005, made by the Company and Hughes Network Systems, Inc. in favor of Bear Stearns Corporate Lending Inc., as administrative agent, for the lenders parties to the Second Lien Credit Agreement, dated as of April 22, 2005 among Hughes Network Systems, LLC, as borrower, the lenders parties thereto, Bear Stearns Corporate Lending, Inc., as administrative agent, JPMorgan Chase Bank, N.A., as syndication agent, and J.P. Morgan Securities Inc. and Bear, Stearns & Co. Inc., as joint lead arrangers and joint book managers, which was filed as Exhibit 99.9 to the Company s Current Report on Form 8-K dated April 26, 2005 and is hereby incorporated herein by reference.
10.22	Stockholders Agreement, dated as of May 11, 2005, by and among TerreStar Networks, Inc., MSV Investors, LLC, et al., which was filed as Exhibit 10.1 to the Company s Form 10-Q for the period ended March 31, 2005 and is hereby incorporated herein by reference.
10.23	Parent Transfer/Drag Along Agreement, dated as of May 11, 2005, by and among TerreStar Networks, Inc., the Company, et al., which was filed as Exhibit 10.2 to the Company s Form 10-Q for the period ended March 31, 2005 and is hereby incorporated herein by reference.
10.24	Conditional Waiver and Consent Agreement, dated as of May 11, 2005, by and among the Company, Motient Corporation, et al., which was filed as Exhibit 10.3 to the Company s Form 10-Q for the period ended March 31, 2005 and is hereby incorporated herein by reference.
10.25	Separation Agreement, dated as of December 30, 2005, by and between Hughes Communications, Inc. and the Company, which was filed as Exhibit 10.1 to the Company s Current Report on Form 8-K for dated January 3, 2006 and is hereby incorporated herein by reference.
10.26	Tax Sharing Agreement, dated as of December 30, 2005, by and between Hughes Communications, Inc. and SkyTerra Communications, Inc. which was filed as Exhibit 10.2 to the Company s Current Report on Form 8-K for dated January 3, 2006 and is hereby incorporated by reference.
16.1	Letter of KPMG LLP, dated April 21, 2005, which was filed as Exhibit 16.1 to the Company s Current Report on Form 8-K for dated April 21, 2005 and is hereby incorporated herein by reference.
21	Subsidiaries of the Company are MSV Investors Holdings, Inc., a Delaware corporation, and MSV Investors, LLC, a Delaware limited liability company.
23.1	Consent of Deloitte & Touche LLP.
23.2	Consent of Ernst & Young LLP.
23.3	Consent of Deloitte & Touche LLP.
31.1	Certification of Jeffrey A. Leddy, Chief Executive Officer and President of the Company, required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

Exhibit Number	Description
31.2	Certification of Craig J. Kaufmann, Controller and Treasurer of the Company, required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Jeffrey A. Leddy, Chief Executive Officer and President of the Company, Pursuant to 18 U.S.C Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Craig J. Kaufmann, Controller and Treasurer of the Company, Pursuant to 18 U.S.C Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(c) The following is a list of financial statements required by Regulation S-X for a 50 percent or less owned person accounted for by the equity method:

(1) Financial Statements of Mobile Satellite Ventures LP.

(i) Report of Independent Auditors.

(ii) Consolidated Balance Sheets as of December 31, 2004 and 2005.

(iii) Consolidated Statements of Operations for the years ended December 31, 2003, 2004 and 2005.

(iv) Consolidated Statements of Partners Equity (Deficit) for the years ended December 31, 2003, 2004 and 2005.

(v) Consolidated Statements of Cash Flows for the years ended December 31, 2003, 2004 and 2005.

(vi) Notes to Consolidated Financial Statements.

(2) Financial Statements of Hughes Network Systems.

(i) Report of Independent Auditors.

(ii) Statements of Operations for the years ended December 31, 2005, 2004 and 2003.

(iii) Balance Sheets as of December 31, 2005 and 2004.

(iv) Statements of Changes in Equity for the years ended December 31, 2005, 2004 and 2003.

(v) Statements of Cash Flows for the years ended December 31, 2005, 2004 and 2003.

(vi) Notes to Financial Statements.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of

SkyTerra Communications, Inc.

New York, New York

We have audited the accompanying consolidated balance sheets of SkyTerra Communications, Inc. and subsidiaries (the Company) as of December 31, 2005 and 2004, and the related consolidated statements of operations, changes in stockholders equity (deficit), and cash flows for each of the three years in the period ended December 31, 2005. Our audits also included the consolidated financial statement schedule, Schedule II Valuation and Qualifying Accounts. These consolidated financial statements and financial statement schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We did not audit the financial statements of Mobile Satellite Ventures LP (an equity investee), which constitute 21 percent of consolidated total assets as of December 31, 2005, and contributed a loss to income before taxes and discontinued operations of $9,469,000 for the year ended December 31, 2005. Such financial statements were audited by other auditors whose report (which includes an explanatory paragraph indicating that Mobile Satellite Ventures LP adopted Financial Accounting Standards Board Interpretation No. 46, *Consolidation of Variable Interest Entities*) has been furnished to us, and our opinion, insofar as it relates to such amounts included for Mobile Satellite Ventures LP, is based solely on the report of such other auditors.

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 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, based on our audits and the report of other auditors, such consolidated financial statements present fairly, in all material respects, the financial position of SkyTerra Communications, Inc. and subsidiaries as of December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly in all material respects the information set forth therein.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company s internal control over financial reporting as of December 31, 2005, based on the criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 29, 2006 expressed an unqualified opinion on management s assessment of the effectiveness of the Company s internal control over financial reporting and an unqualified opinion on the effectiveness of the Company s internal control over financial reporting based on our audits.

/s/ DELOITTE & TOUCHE LLP

Baltimore, Maryland

March 29, 2006

SKYTERRA COMMUNICATIONS, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands, except share data)

	December 31, 2005	December 31, 2004
Assets		
Current assets:		
Cash and cash equivalents	$ 21,964	$ 34,734
Short-term investments	6,000	59,748
Total cash, cash equivalents and short-term investments	27,964	94,482
Restricted cash	2,295	
Accounts receivable, net of allowance for bad debt of $78 and $78, respectively	47	29
Prepaid expenses	268	418
Deferred income taxes	23,378	
Deferred transaction costs	557	4,989
Other current assets	210	393
Assets held for sale	468	646
Total current assets	55,187	100,957
Investment in Hughes Network Systems, LLC	75,282	
Investment in Mobile Satellite Ventures LP	42,761	50,098
Investments in affiliates	4,362	3,361
Deferred income taxes	26,956	
Restricted cash	765	
Property and equipment, net	18	39
Other assets	6	115
Total assets	$ 205,337	$ 154,570
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 2,380	$ 2,041
Accrued liabilities	2,473	8,205
Deferred revenue		20
Liabilities held for sale	525	246
Total current liabilities	5,378	10,512
Commitments and contingencies		
Minority interest	8,474	9,974
Series A Redeemable Convertible Preferred Stock, $.01 par value, net of unamortized discount of $28,194 and $32,589, respectively	93,100	88,706
Stockholders equity:		
Preferred stock, $.01 par value. Authorized 10,000,000 shares; issued 1,199,007 shares as Series A Redeemable Convertible Preferred Stock at December 31, 2005 and 2004		
Common stock, $.01 par value. Authorized 200,000,000 shares; issued and outstanding 8,731,976 shares at December 31, 2005 and 8,384,809 shares at December 31, 2004	87	84
Non-voting common stock, $.01 par value. Authorized 100,000,000 shares; issued and outstanding 8,990,212 shares at December 31, 2005 and 2004	90	90
Additional paid-in capital	473,609	475,827

Accumulated other comprehensive loss	(4,106)	(3)
Accumulated deficit	(371,295)	(430,620)
Total stockholders equity	98,385	45,378
Total liabilities and stockholders equity	$ 205,337	$ 154,570

See accompanying notes to consolidated financial statements.

SKYTERRA COMMUNICATIONS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except share data)

	Years Ended December 31, 2005	2004	2003
Revenues	$ 615	$ 2,117	$ 699
Cost of revenues	(326)	(2,036)	(913)
Gross margin	289	81	(214)
Selling, general and administrative expenses	(9,588)	(9,367)	(6,733)
Loss from operations	(9,299)	(9,286)	(6,947)
Interest income, net	1,436	10,548	6,304
Equity in earnings of Hughes Network Systems, LLC	24,054		
Equity in loss of Mobile Satellite Ventures LP	(9,469)	(1,020)	
Loss on investments in affiliates	(638)	(1,336)	(404)
Other income, net	877	21,030	244
Minority interest	1,925	(810)	(1,126)
Income (loss) before taxes and discontinued operations	8,886	19,126	(1,929)
Income tax benefit	50,334		
Income (loss) from continuing operations	59,220	19,126	(1,929)
Loss from discontinued operations	(956)	(1,960)	
Gain from wind-down of discontinued operations	1,061		1,211
Net income (loss)	59,325	17,166	(718)
Cumulative dividends and accretion of redeemable convertible preferred stock to liquidation value	(9,969)	(9,918)	(9,687)
Net income (loss) attributable to common stockholders	$ 49,356	$ 7,248	$ (10,405)
Basic earnings (loss) per common share:			
Continuing operations	$ 2.79	$ 0.61	$ (0.76)
Discontinued operations	0.01	(0.13)	0.08
Net earnings (loss) per share	$ 2.80	$ 0.48	$ (0.68)
Diluted earnings (loss) per common share:			
Continuing operations	$ 2.66	$ 0.58	$ (0.76)
Discontinued operations	0.01	(0.12)	0.08
Net earnings (loss) per share	$ 2.67	$ 0.46	$ (0.68)
Weighted average common shares outstanding:			
Basic	17,614,474	15,115,895	15,341,518
Diluted	18,488,021	15,837,370	15,341,518

See accompanying notes to consolidated financial statements.

SKYTERRA COMMUNICATIONS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	Years ended December 31, 2005	2004	2003
Cash flows from operating activities:			
Net income (loss)	$ 59,325	$ 17,166	$ (718)
Adjustments to reconcile net income (loss) to net cash (used in) provided by operating activities:			
Gain from adjustment to reserve for note receivable and accrued interest from Motient Corporation		(22,516)	
(Gain) loss from discontinued operations	(105)	1,960	(1,211)
Depreciation and amortization	27	44	43
Equity in earnings of Hughes Network Systems, LLC	(24,054)		
Equity in loss of Mobile Satellite Ventures LP	9,469	1,020	
Loss on investments in affiliates	638	1,336	404
Minority interest	(1,925)	810	1,126
Gain on sale of property and equipment	(49)		
Non-cash compensation charges	965	3,095	107
Non-cash charge for issuance of warrants by consolidated subsidiary		296	27
Changes in assets and liabilities, net of acquisitions:			
Accounts receivable, net	(18)	208	219
Deferred income taxes	(50,334)		
Prepaid expenses, interest receivable, deferred transaction costs and other assets	4,863	10,314	(5,465)
Accounts payable and accrued liabilities	(4,153)	4,114	(838)
Deferred revenue	(20)	(138)	(15)
Net cash (used in) provided by continuing operations	(5,371)	17,709	(6,321)
Net cash used in discontinued operations	(1,093)	(1,565)	(427)
Net cash (used in) provided by operating activities	(6,464)	16,144	(6,748)
Cash flows from investing activities:			
Purchase interest in Hughes Network Systems, LLC	(50,000)		
Repayments (purchases) of notes receivable		21,500	(2,500)
Purchases of short-term investments	(12,228)	(68,602)	(23,637)
Sales of short-term investments	65,977	30,649	5,850
Restricted cash	(3,060)		
Cash paid for investments in affiliates	(3,562)	(1,928)	(482)
Sales of investments in affiliates	1,923		1
Sales of property and equipment	62		
Purchases of property and equipment, net	(3)	(11)	(7)
Cash paid for acquisitions, net of cash acquired and acquisition costs		19	125
Net cash used in continuing operations	(891)	(18,373)	(20,650)
Net cash used in discontinued operations	(63)	(952)	
Net cash used in investing activities	(954)	(19,325)	(20,650)
Cash flows from financing activities:			
Proceeds from contributions to a consolidated subsidiary			48
Distribution to minority interest of consolidated subsidiary		(3,361)	
Proceeds from issuance of common stock, net of costs		35,044	
Proceeds from issuance of common stock in connection with the exercise of options	140	284	6
Payment of dividend on preferred stock	(5,575)	(1,394)	
Repurchase of common stock of consolidated subsidiary	(4)	(2)	
Cash paid in connection with tender offer			(1,243)
Net cash (used in) provided by continuing operations	(5,439)	30,571	(1,189)
Net cash provided by discontinued operations	76	450	

Net cash (used in) provided by financing activities	(5,362)	31,021	(1,189)
Effect of exchange rate changes on cash and cash equivalents	11	(3)	
Net (decrease) increase in cash and cash equivalents	(12,770)	27,837	(28,587)
Cash and cash equivalents, beginning of period	34,734	6,897	35,484
Cash and cash equivalents, end of period	$ 21,964	$ 34,734	$ 6,897
Noncash investing activities:			
Conversion of notes receivable to partnership interests in Mobile Satellite Ventures LP	$	$ 51,118	$

See accompanying notes to consolidated financial statements.

64

SKYTERRA COMMUNICATIONS, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY (DEFICIT)

(In thousands, except share data)

	Preferred Stock	Voting Common Stock ($.01 par value)	Non-Voting Common Stock ($.01 par value)	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Accumulated Deficit	Treasury Stock at Cost	Total Stockholders Equity (Deficit)	Comprehensive (Loss) Income
Balance, January 1, 2003	$	$ 67	$ 90	$ 457,884	$	$ (447,068)	$ (171)	$ 10,802	
Issuance of 357,143 shares of common stock in connection with the settlement of the class action lawsuit		4		85				89	
Issuance of 4,367 shares of common stock through exercise of stock options				6				6	
Retirement of 968,398 shares of common stock in connection with the tender offer		(10)		(1,233)				(1,243)	
Non-cash compensation charge for option repricing				107				107	
Non-cash charge for issuance of option by consolidated subsidiary				28				28	
Dividends on and accretion of preferred stock				(9,687)				(9,687)	
Comprehensive loss:									
Net loss						(718)		(718)	$ (718)
Total comprehensive loss									$ (718)
Balance, December 31, 2004		61	90	447,190		(447,786)	(171)	(616)	
Issuance of 2,000,000 shares of common stock and certain warrants in private placement		20		35,024				35,044	
Issuance of 321,966 shares of common stock through exercise of stock options		3		281				284	
Retirement of 6,262 shares of common stock in connection with acquired businesses									
Retirement of 6,622 shares held in treasury				(171)			171		
Non-cash compensation charge for option repricing				2,814				2,814	
Non-cash charge for issuance of option and warrants by consolidated subsidiaries				343				343	
Sale of stock by consolidated subsidiary				264				264	
Dividends on and accretion of preferred stock				(9,918)				(9,918)	
Comprehensive income:									
Net income						17,166		17,166	$ 17,166
Net foreign currency translation adjustments					(3)			(3)	(3)
Total comprehensive income									$ 17,163
Balance, December 31, 2004	$	$ 84	$ 90	$ 475,827	$ (3)	$ (430,620)	$	$ 45,378	

See accompanying notes to consolidated financial statements.

SKYTERRA COMMUNICATIONS, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY (DEFICIT)

(In thousands, except share data)

	Preferred Stock	Voting Common Stock ($.01 par value)	Non-Voting Common Stock ($.01 par value)	Additional Paid-In Capital	Accumulated Other Comprehensive Loss	Accumulated Deficit	Treasury Stock at Cost	Total Stockholders Equity (Deficit)	Comprehensive (Loss) Income
Balance, December 31, 2004	$	$ 84	$ 90	$ 475,827	$ (3)	$ (430,620)	$	$ 45,378	
Issuance of 300,000 shares of common stock in connection with acquisition of Hughes Network Systems, LLC		3		5,157				5,160	
Issuance of 47,167 shares of common stock through exercise of stock options				140				140	
Non-cash compensation charge for option repricing				397				397	
Non-cash compensation charge for option issued to a consultant				336				336	
Non-cash compensation contra-expense for issuance of warrants by a consolidated subsidiary				(151)				(151)	
Non-cash compensation expense for options issued by Mobile Satellite Ventures LP and Hughes Network Systems, LLC				1,713				1,713	
Distribution of TerreStar Networks, Inc. by Mobile Satellite Ventures LP				159				159	
Dividends on and accretion of preferred stock				(9,969)				(9,969)	
Comprehensive income:									
Net income						59,325		59,325	$ 59,325
Net foreign currency translation adjustments					(4,103)			(4,103)	(4,103)
Total comprehensive income									$ 55,222
Balance, December 31, 2005	$	$ 87	$ 90	$ 473,609	$ (4,106)	$ (371,295)	$	$ 98,385	

See accompanying notes to consolidated financial statements.

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) Summary of Significant Accounting Policies

(a) Description of Business and Basis of Presentation

SkyTerra Communications, Inc. (the Company) operates its business through a group of complementary companies in the telecommunications industry. The Company s consolidated financial statements include the results of operations and financial position of the Company, its controlled majority-owned subsidiaries and variable interest entities (VIEs), as defined by Financial Accounting Standards Board (FASB) Interpretation No. 46R (FIN 46R), for which the Company is deemed the primary beneficiary, as defined by FIN 46R. As such, the consolidated financial statements of the Company include the accounts of Electronic System Products, Inc. (ESP), the Company s 80% owned subsidiary (the MSV Investors Subsidiary) that holds the interest in Mobile Satellite Ventures LP (the MSV Joint Venture) and Miraxis, LLC (Miraxis).

The Company accounts for subsidiaries which are VIEs but for which the Company is not the primary beneficiary under the equity method of accounting, whereby the Company records its proportionate share of the subsidiary s operating results. As such, the Company accounts for its interest in Hughes Network Systems, LLC (HNS), Hughes Systique Corporation (Hughes Systique) and Navigauge, Inc. (Navigauge) under the equity method. The Company also accounts for minority owned subsidiaries in which the Company owns greater than 20% of the outstanding voting interests but less than 50% and for which the Company possesses significant influence over their operations under the equity method of accounting. As such, the Company accounts for its interest in the MSV Joint Venture under the equity method.

At the end of the third quarter of 2001, a decision to discontinue the operations of Rare Medium, Inc., along with those of its LiveMarket, Inc. subsidiary (LiveMarket), was made as a result of the weakening of general economic conditions that caused many companies to reduce spending on Internet-focused business solutions and in light of their performance and prospects (see Note 15). In December 2005, the Company made a decision to discontinue operating AfriHUB, LLC (AfriHUB) and signed a letter of intent to sell its interests in AfriHUB for a promissory note with a principal amount of approximately $0.2 million (see Note 15). The discontinuance of these businesses represents the disposal of a business segment under Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. Accordingly, the results of these operations have been classified as discontinued operations, and prior period results have been reclassified.

All material intercompany balances and transactions have been eliminated.

(b) Cash and Cash Equivalents

The Company considers all highly liquid investments with maturities of three months or less at the time of purchase to be cash equivalents.

(c) Short-Term Investments

The Company considers all debt securities with maturities of more than three months but less than one year as short-term investments and classifies investments in such short-term debt securities as either held to maturity or available for sale. These investments are diversified among high credit quality securities in accordance with the Company s investment policy. Auction rate securities are classified as available for sale given the long-term stated maturities of 20 to 30 years. As of December 31, 2005 and 2004, the Company had nil and $36.2 million, respectively, of auction rate securities. The remainder of the Company s short-term investments are classified as held to maturity as the Company has both the intent and ability to hold them to maturity. The cost of these securities is adjusted for amortization of premiums and accretion of discounts to maturity over the contractual life of the security. Such amortization and accretion are included in interest income.

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

During the year ended December 31, 2004, the Company sold a debt security with a face value of $1.0 million which was previously classified as held to maturity. This sale occurred to ensure that all of the Company s debt securities had a maturity less than one year in accordance with the Company s investment policy and did not have a material impact on the Company s financial position, results of operations or cash flow from operations.

(d) Property and Equipment

The Company uses the straight-line method of depreciation. The estimated useful lives of property and equipment are as follows:

	Years
Computer equipment and software	3 to 5
Furniture and fixtures	5 to 7
Machinery and equipment	2 to 5

Leasehold improvements are amortized on a straight-line basis over the term of the lease or the estimated useful life of the improvement, whichever is shorter.

(e) Goodwill and Intangibles

The Company records goodwill when consideration paid in a purchase acquisition exceeds the fair value of the net tangible assets and the identifiable intangible assets acquired. In accordance with SFAS No. 142, Goodwill and Other Intangible Assets, goodwill and the identified intangible assets with an indefinite life are not amortized but are tested for impairment at least annually or whenever changes in circumstances indicate that the carrying value may not be recoverable. The Company amortizes the identified intangible assets with a finite life over their respective useful lives on a straight-line basis.

(f) Impairment of Long-Lived Assets

Long-lived assets and certain identifiable intangibles are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net undiscounted cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying value of the assets exceeds the fair value of the assets.

As a result of AfriHUB s projected operating losses with respect to its university initiative (see Note 15), at December 31, 2004, the Company evaluated AfriHUB s long-lived assets for recoverability and determined that the undiscounted cash flows over the remaining expected life of the two established centers was less than the carrying value of the long-lived assets relating to those centers. Accordingly, the Company assessed the fair value of these assets by using market prices for recently purchased computers and equipment and using a discounted cash flow model for the intangible asset and building improvements for which market prices were not available. The Company recognized a non-cash impairment loss relating to the intangible asset and building improvements as their carrying value exceeded the fair value by approximately $0.8 million. This loss is included in loss from discontinued operations on the accompanying consolidated statements of operations.

As a result of the Company s decision to cease providing funding to AfriHUB and the uncertainty with respect to AfriHUB s future prospects, at June 30, 2005, the Company evaluated AfriHUB s long-lived assets for recoverability and determined that the undiscounted cash flows over the remaining expected life of the two

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

established centers was less than the carrying value of the assets relating to those centers. Accordingly, the Company assessed the fair value of these assets by estimating the recoverability of the computers and equipment upon a sale. The Company recognized a non-cash impairment loss relating to the computers and equipment as their carrying value exceeded the fair value by approximately $0.4 million. This loss is included in loss from discontinued operations on the accompanying consolidated statements of operations.

(g) Revenue Recognition

Revenues from contracts for consulting and engineering services are recognized using the percentage-of-completion method for fixed price contracts and as time is incurred for time and materials contracts, provided the collection of the resulting receivable is reasonably assured. Unbilled receivables represent time and costs incurred on projects in process in excess of amounts billed and are recorded as other current assets in the accompanying balance sheets. Deferred revenue represents amounts billed in excess of revenue recognized and are recorded as liabilities. To the extent costs incurred and anticipated costs to complete projects in progress exceed anticipated billings, a loss is recognized in the period such determination is made for the excess.

A handling and finance charge is added to materials and equipment purchased for certain product development engagements. These charges, as well as those relating to reimbursement of other out-of-pocket expenses billed to clients, are included in revenues. The costs of these reimbursable items are included in cost of revenues.

(h) Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and for operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning in making these assessments.

(i) Stock Option Plans

The Company accounts for its stock option plan in accordance with SFAS No. 123, Accounting for Stock-Based Compensation (SFAS No. 123), which allows entities to continue to apply the provisions of APB Opinion No. 25, Accounting for Stock Issued to Employees (APB Opinion No. 25), as clarified by Financial Accounting Standards Board (FASB) Interpretation No. 44, Accounting For Certain Transactions Involving Stock Compensation, and provides pro forma net income and pro forma earnings per share disclosures for employee stock option grants made in 1995 and future years as if the fair-value-based method, as defined in SFAS No. 123, had been applied. The Company has elected to apply the provisions of APB Opinion No. 25 and provide the pro forma disclosure required by SFAS No. 123 (see Note 16).

APB Opinion No. 25 does not require the recognition of compensation expense for stock options granted to employees at fair market value. However, any modification to previously granted awards generally results in compensation expense or contra-expense recognition using the cumulative expense method, calculated based on

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

quoted prices of the Company s common stock and vesting schedules of underlying awards. As a result of the re-pricing of certain stock options in 2001 and 2002, for the years ended December 31, 2005, 2004 and 2003, the Company recognized compensation expense of approximately $0.4 million, $2.8 million and $0.1 million, respectively.

The following table provides a reconciliation of net income (loss) to pro forma net income (loss) as if the fair value method had been applied to all employee awards:

	Years Ended December 31,		
	2005	2004	2003
	(in thousands, except share data)		
Net income (loss), as reported	$ 59,325	$ 17,166	$ (718)
Add: Stock-based employee compensation expense, as reported	397	2,814	107
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards	(1,358)	(315)	(415)
Pro forma net income (loss)	$ 58,364	$ 19,665	$ (1,026)
Basic earnings (loss) per common share:			
As reported	$ 2.80	$ 0.48	$ (0.68)
Pro forma	$ 2.75	$ 0.64	$ (0.70)
Diluted earnings (loss) per common share:			
As reported	$ 2.67	$ 0.46	$ (0.68)
Pro forma	$ 2.62	$ 0.61	$ (0.70)

The per share weighted average fair value of stock options granted during 2005, 2004 and 2003 was $16.82, $2.70 and $0.83, respectively, on the date of grant using the Black-Scholes option pricing model with the following assumptions: (1) a risk free interest rate ranging from 2.9% to 3.7% in 2005, 1.2% to 3.2% in 2004 and 1.1% to 4.0% in 2003, (2) an expected life of three years in 2005, 2004 and 2003, (3) volatility of approximately 93% in 2005, 172% in 2004 and 175% in 2003, and (4) an annual dividend yield of 0% for all years.

(j) Foreign Currency Translation

Financial statements of AfriHUB s Nigerian operations are prepared using the Nigerian Naira as the functional currency. Consequently, revenues and expenses of the Nigerian operations are translated into United States dollars using weighted average exchange rates, while assets and liabilities are translated using period end exchange rates. Translations adjustments are included in stockholders equity as accumulated other comprehensive loss in the accompanying consolidated balance sheets. Gains and losses from foreign currency transactions are reflected in loss from discontinued operations on the accompanying consolidated statements of operations. During the year ended December 31, 2005, the Company recorded a loss of approximately $14,000 resulting from foreign currency transactions. During the year ended December 31, 2004, the Company recorded a gain of approximately $15,000 resulting from foreign currency transactions. The Company did not have any foreign operations during the year ended December 31, 2003.

(k) Comprehensive (Loss) Income

Comprehensive (loss) income is defined as the change in equity during a period from non-owner sources. Comprehensive (loss) income for the years ended December 31, 2005, 2004 and 2003 has been disclosed within the accompanying consolidated statements of changes in stockholders equity (deficit). As of December 31, 2005 and 2004, accumulated other comprehensive loss was approximately $4.1 million and $3,000, respectively, consisting primarily of accumulated foreign currency translation adjustments. As of December 31, 2003, the Company did not have any items of accumulated other comprehensive (loss) income.

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(l) Use of Estimates

The preparation of these consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires the use of management estimates and assumptions that affect reported amounts and related disclosures. These estimates are based on historical experience and information that is available to management about current events and actions the Company may take in the future. Significant items subject to estimates and assumptions include the carrying value of long-lived assets (including the impairment charge), valuation allowances for accounts and notes receivable and deferred income tax assets, accrued restructuring charges and other contingent obligations. Actual results could differ from those estimates and assumptions.

(m) Earnings (Loss) Per Common Share

Basic earnings (loss) per common share is computed by dividing net income (loss) attributable to the common stockholders by the weighted average number of common shares outstanding for the period. Diluted earnings (loss) per common share reflects the potential dilution from the exercise or conversion of securities into common stock. The potential dilutive effect of outstanding stock options and warrants is calculated using the treasury stock method, and the potential dilutive effect of the convertible preferred stock is calculated using the if-converted method.

The following table provides a reconciliation of the shares used in calculating earnings (loss) per common share:

	Years Ended December 31,		
	2005	**2004**	**2003**
Weighted average common shares outstanding basic	17,614,474	15,115,895	15,341,518
Common shares issuable upon exercise of stock options	873,547	721,475	
Weighted average common shares outstanding diluted	18,488,021	15,837,370	15,341,518

During all periods presented, the Company had certain stock options and warrants outstanding, which could potentially dilute basic earnings (loss) per common share in the future, but were excluded in the computation of diluted earnings (loss) per common share in such periods, as their effect would have been antidilutive. For the years ended December 31, 2005, 2004 and 2003, stock options and warrants exercisable for 1,589,109, 1,722,976 and 2,405,168 shares of common stock, respectively, were excluded from the computation of diluted earnings (loss) per common share, as they were either antidilutive or their exercise price exceeded the average trading price of the Company s common stock during the year.

During all periods presented, the conversion of the preferred stock could potentially dilute basic earnings (loss) per common share in the future, but the shares issuable upon the conversion were excluded from the computation of diluted earnings (loss) per common share in such periods, as their effect would have been antidilutive. For the years ended December 31, 2005, 2004 and 2003, there were 1,912,484, 1,912,484 and 1,710,423 shares of common stock, respectively, issuable upon the conversion of the preferred stock were excluded from the computation of diluted earnings per common share, as they were either antidilutive or their conversion price exceeded the average trading price of the Company s common stock during the year.

(n) Fair Value of Financial Instruments

The Company s financial instruments include cash, cash equivalents, short-term investments, accounts receivable, accounts payable, a letter of credit and the Series A redeemable convertible preferred stock (the Series A Preferred Stock). The fair value of these instruments, other than the Series A Preferred Stock, approximates book value due to their short-term duration. As of December 31, 2005 and 2004, the fair value of

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

the Series A Preferred Stock approximated $121.3 million based on its liquidation preference, including accrued but undeclared dividends. As of December 31, 2005 and 2004, the carrying value of the Series A Preferred Stock was $93.1 million and $88.7 million, respectively.

(o) Concentration of Credit Risk

Financial instruments which potentially subject the Company to a concentration of credit risk consist of cash, cash equivalents and short-term investments. Although the Company maintains cash balances at financial institutions that exceed federally insured limits, these balances are placed with various high credit quality financial institutions. Further, in accordance with an investment policy, the Company diversifies its short-term investments among debt instruments that are believed to be low risk.

ESP s revenues are generated principally from customers located in the United States. For the years ended December 31, 2005 and 2004 and for the period from the August 25, 2003 acquisition of ESP through December 31, 2003, one, three and two customers, respectively, individually accounted for more than 10% of the Company s revenues. Combined, these customers account for approximately $0.5 million and $1.1 million of revenues for the years ended December 31, 2005 and 2004, respectively, and $0.4 million for the period from the August 25, 2003 acquisition of ESP through December 31, 2003. As of December 31, 2005 and 2004, accounts receivable from these significant customers was approximately $46,000 and $14,000, respectively.

(p) Sales of Stock by a Subsidiary

The Company accounts for the sale of stock by a consolidated subsidiary as a capital transaction whereby the change in the Company s proportionate share of the subsidiary equity resulting from the additional equity raised by the subsidiary is reflected in stockholders equity on the accompanying consolidated balance sheets.

In October 2004, AfriHUB agreed to sell membership interests to an unaffiliated third party for approximately $0.5 million in cash (see Note 15). The Company increased additional paid in capital on the accompanying consolidated balance sheets by approximately $0.3 million related to this transaction.

(q) Reclassifications

Certain reclassifications, primarily related to discontinued operations (see Note 15), have been made to the prior years financial statements to conform to the current year s presentation.

(r) Recently Issued Accounting Standards

In December 2004, the FASB issued SFAS No. 123R, Share-Based Payment (SFAS No. 123R), a revision of SFAS No. 123. SFAS No. 123R requires entities to recognize compensation expense for all share-based payments to employees, including stock options, based on the estimated fair value of the instrument on the date it is granted. The expense will be recognized over the vesting period of the award. SFAS No. 123R is effective for the Company on January 1, 2006 and provides entities two transition methods. The Company has elected to use the modified prospective method and therefore will not restate its prior period results. Under the modified prospective method, compensation expense is recognized beginning with the effective date for all awards granted to employees prior to the effective date that are unvested on the effective date. As the Company currently accounts for share-based payments using the intrinsic value method as allowed by APB Opinion No. 25, the adoption of the fair value method under SFAS No. 123R will have an impact on the Company s results of operations. The unrecognized compensation expense associated with unvested stock options was approximately $1.5 million as of January 1, 2006. Of this amount, the Company expects to record approximately $1.0 million of compensation expense during the year ended December 31, 2006. Additional compensation expense will be impacted by various factors, including the number of awards granted and their related fair value at the date of grant.

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In December 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets an amendment of APB Opinion No. 29 (SFAS No. 153). SFAS No. 153 eliminates the exception for nonmonetary exchanges of similar productive assets of APB Opinion No. 29 and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS No. 153 is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The adoption of SFAS No. 153 did not have a material impact on the Company s financial position or results of operations.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3 (SFAS No. 154). SFAS No. 154 applies to all voluntary changes in accounting principle and changes the requirements for accounting for and reporting a change in accounting principle. SFAS No. 154 requires the retrospective application to prior periods financial statements of the direct effect of a voluntary change in accounting principle unless it is impracticable to determine either the period-specific effects or the cumulative effective of the change. SFAS No. 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005. The adoption of SFAS No. 154 is not expected to have a material impact on the Company s financial position or results of operations.

In November 2005, the FASB issued Staff Position FAS 115-1, The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments (FSP 115-1). FSP 115-1 provides accounting guidance for determining and measuring other-than-temporary impairments of debt and equity securities, and confirms the disclosure requirements for investments in unrealized loss positions as outlined in Emerging Issues Task Force (EITF) Issue No. 03-01, The Meaning of Other-Than-Temporary Impairments and its Application to Certain Investments. FSP 115-1 is effective for the Company on January 1, 2006 and is not expected to have a material impact on the Company s financial position or results of operations.

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140 (SFAS No. 155). SFAS No. 155 permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS No. 133, establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and amends SFAS No. 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity s first fiscal year that begins after September 15, 2006. The adoption of SFAS No. 155 is not expected to have a material impact on the Company s financial position or results of operations.

(2) Distribution

On February 21, 2006, the Company separated into two publicly owned companies (the Distribution): (i) the Company and (ii) Hughes Communications, Inc. (Hughes), a newly formed entity. On December 30, 2005, in preparation for the Distribution, the Company and Hughes entered into an agreement (the Separation Agreement) pursuant to which the Company contributed to Hughes, effective December 31, 2005, all of its assets, liabilities and operations other than those associated with the MSV Joint Venture and TerreStar, $12.5 million of cash, cash equivalents and short-term investments and the obligations pursuant to the Series A Preferred Stock. Upon a change of control of the Company, including in connection with a consolidation of the ownership of the MSV Joint Venture and TerreStar described in Note 3, the remaining balance of the $12.5 million of cash at such time, if any, will be transferred to Hughes.

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

To effect the Distribution, the Company distributed to each of its stockholders one-half of one share of Hughes common stock for each share of the Company s common or non-voting common stock held as of the close of business on February 13, 2006 (or, in the case of the Series A Preferred Stock and Series 1-A and 2-A warrants, in accordance with their terms, one-half of one share of Hughes common stock for each share of the Company s common stock issuable upon conversion or exercise of such preferred stock and warrants held as of the close of business on February 13, 2006).

Notwithstanding the legal form of the Distribution, due to, among other things, (i) the businesses transferred to Hughes generated all of the Company s historical consolidated revenues and constituted a majority of the book value of the Company s assets and (ii) the businesses transferred to Hughes include the Company s discontinued operating subsidiaries and all of the assets and liabilities relating to such subsidiaries, the Distribution will be accounted for as a reverse spin-off in accordance with EITF Issue No. 02-11, Accounting for Reverse Spin-offs. Accordingly, Hughes will be considered the divesting entity and treated as the accounting successor to the Company for financial reporting purposes, and the Company will be treated as if it had been distributed by Hughes beginning with the consolidated financial statements for the three months ended March 31, 2006.

(3) Interest in the MSV Joint Venture

MSV Joint Venture

On November 26, 2001, through the MSV Investors Subsidiary, the Company purchased an interest in the MSV Joint Venture in the form of a convertible note with a principal amount of $50.0 million. The note yielded interest at a rate of 10% per year, had a maturity date of November 26, 2006, and was convertible at any time at the option of the MSV Investors Subsidiary into equity interests in the MSV Joint Venture. Immediately prior to the purchase of the convertible note, the Company contributed $40.0 million to the MSV Investors Subsidiary and a group of unaffiliated third parties collectively contributed $10.0 million. The ownership interest of these unaffiliated third parties in the MSV Investors Subsidiary is classified as minority interest in the accompanying combined financial statements.

On August 13, 2002, the MSV Joint Venture completed a rights offering allowing its investors to purchase their pro rata share of an aggregate $3.0 million of newly issued convertible notes with terms similar to the convertible note already held by the MSV Investors Subsidiary. The MSV Investors Subsidiary exercised its basic and over subscription rights and purchased approximately $1.1 million of the convertible notes. The group of unaffiliated third parties collectively contributed $0.2 million to the MSV Investors Subsidiary in connection with the MSV Joint Venture rights offering.

On November 12, 2004, the MSV Joint Venture raised $145.0 million in cash by selling partnership units for $29.45 per unit and exchanged or converted approximately $84.9 million of debt securities and accrued interest. In connection with this financing, the convertible notes held by the MSV Investors Subsidiary converted into approximately 23% of the limited partnership interests of the MSV Joint Venture on an undiluted basis, at their original conversion price of $6.45 per unit. As a result of these transactions, the MSV Investors Subsidiary also received approximately $17.1 million in cash from the MSV Joint Venture to pay the accrued interest on the convertible notes. The MSV Investors Subsidiary distributed approximately $13.6 million of this cash to the Company and $3.4 million of cash to the unaffiliated third parties who own the 20% minority interest in the MSV Investors Subsidiary.

Following the November 12, 2004 conversion of its notes receivable into limited partnership interests, the Company accounts for its interest in the MSV Joint Venture under the equity method. Accordingly, on the date of conversion, the remaining $51.1 million carrying amount of the notes receivable was reclassified to investment in

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Mobile Satellite Venture LP and will be adjusted thereafter for the Company s proportionate share of the net income (loss) of the MSV Joint Venture, subject to certain adjustments. These adjustments relate primarily to the amortization of the excess of the Company s $51.1 million carrying amount over the Company s proportionate share of the carrying amount of the MSV Joint Venture s net assets on the date of conversion. This excess will be amortized over the remaining useful life of certain MSV Joint Venture long-lived assets on a straight line basis. As of December 31, 2005, the carrying value of the Company s investment exceeded its proportionate share of the carrying amount of the MSV Joint Venture s net assets by approximately $1.4 million.

The following table presents summarized consolidated financial information for the MSV Joint Venture and is derived from the MSV Joint Venture s audited consolidated financial statement. The net loss of the MSV Joint Venture for the year ended December 31, 2005 includes a gain of approximately $0.7 million for the cumulative effect of change in accounting principle recognized by the MSV Joint Venture upon the adoption of FIN 46R in 2005.

	December 31, 2005	December 31, 2004
	(in thousands)	
Consolidated balance sheet:		
Current assets	$ 119,806	$ 139,978
Noncurrent assets	96,978	106,245
Current liabilities	11,811	11,873
Noncurrent liabilities	23,713	21,386
Partners equity	181,260	212,964

	Years Ended December 31, 2005	Years Ended December 31, 2004
	(in thousands)	
Consolidated statement of operations:		
Revenues	$ 29,381	$ 29,007
Loss from continuing operations	(39,153)	(26,755)
Net loss	(40,955)	(33,455)

The MSV Investors Subsidiary and the other partners of the MSV Joint Venture have agreed that the disposition by the MSV Joint Venture of all or substantially all of its assets, certain acquisitions or dispositions of a limited partner s interest in the MSV Joint Venture, subsequent investment into the MSV Joint Venture by any person, and any merger or other business combination of the MSV Joint Venture, are subject to the control restrictions contained in the Amended and Restated Limited Partnership Agreement and the Amended and Restated Stockholders Agreement. The control restrictions include, but are not limited to, rights of first refusal, tag along rights and drag along rights. Certain of these actions cannot occur without the consent of the majority of the ownership interests of the MSV Joint Venture. In addition, the MSV Investors Subsidiary and two of the three other joint venture partner groups have entered into a voting agreement pursuant to which three of the four joint venture partner groups must consent to certain transactions involving the MSV Joint Venture or the partners or none of the parties to the voting agreement will support such actions.

On May 7, 2004, in connection with services being provided which support the regulatory effort of the MSV Joint Venture, an unaffiliated consultant was issued an option to purchase a less than one percent ownership interest in the MSV Investors Subsidiary. The option is immediately exercisable and will expire on the earlier of the dissolution of the MSV Investors Subsidiary or December 31, 2010. During 2004, the Company recognized expense of approximately $0.3 million related to the issuance of the option, which was the approximate fair value of the option using the Black-Scholes option valuation model. To provide additional incentive to the consultant, the MSV Investors Subsidiary agreed to pay the consultant a one-time fee of $0.4 million upon a liquidity event, as defined in the agreement. The MSV Investors Subsidiary will recognize an expense related to this fee if and

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

when a liquidity event becomes probable. A consolidation transaction described below, if such a transaction is consummated, would likely be considered a liquidity event which would require payment of the one-time fee.

TerreStar Networks

TerreStar was formed by the MSV Joint Venture to develop business opportunities related to the proposed receipt of certain licenses in the 2 GHz band. In December 2004, the MSV Joint Venture issued rights (the TerreStar Rights) to receive all of the shares of common stock of TerreStar, then a wholly-owned subsidiary of the MSV Joint Venture, to the limited partners of the MSV Joint Venture, pro rata in accordance with each limited partner s percentage ownership. The TerreStar Rights were to automatically be exchanged for shares of TerreStar common stock on May 20, 2005. In connection with the distribution of the TerreStar Rights, TerreStar issued warrants to purchase shares of its common stock representing 3% of the outstanding equity for an exercise price of $0.21 per share to certain of the Other MSV Investors. These warrants were exercised in March 2005. On May 11, 2005, the TerreStar Rights were exchanged for shares of TerreStar common stock in connection with the sale by TerreStar of $200.0 million of its common stock to Motient at a purchase price of $24.42 per share (the TerreStar Private Placement), increasing Motient s ownership of TerreStar to approximately 61% on an undiluted basis. Following these transactions, the Company s MSV Investors Subsidiary owns 5,303,315 shares of TerreStar common stock, or approximately 17% of TerreStar on an undiluted basis, and is accounting for its interest in TerreStar under the cost method. In accordance with Accounting Principles Board Opinion No. 29, Accounting for Nonmonetary Transactions, the Company s carrying value for its interest in TerreStar is based on its pro rata share of the MSV Joint Venture s carrying value for TerreStar before the distribution. As the MSV Joint Venture had no carrying value for its interest in TerreStar, the Company has not recorded any carrying value for its interest in TerreStar on the accompanying condensed consolidated balance sheets.

In connection with the TerreStar Private Placement, the minority shareholders of TerreStar, including the Company s MSV Investors Subsidiary, TMI and the Other MSV Investors, entered into certain agreements with TerreStar and Motient providing the MSV Investors Subsidiary (and the other minority shareholders) with certain protections, including tag along rights, pre-emptive rights and representation on the TerreStar Board of Directors. In addition, the TerreStar shares held by the minority shareholders, including the MSV Investors Subsidiary, under certain conditions, may be subject to drag along rights of Motient. In connection with the TerreStar Private Placement, the MSV Joint Venture licensed TerreStar certain intellectual property and agreed to provide TerreStar with certain services. Also, in connection with the transaction, Motient agreed, subject to satisfaction of certain conditions, to waive certain rights in order to facilitate a transaction in which one of the minority shareholders in TerreStar who also holds interests in the MSV Joint Venture acquires all of the interests in the MSV Joint Venture held by the other minority shareholders in TerreStar, resulting in control of the MSV Joint Venture being held by such party. The minority shareholders have not agreed to such a transaction or committed to consummate such a transaction. As described below, on September 22, 2005, the Company, Motient, TMI Communications and Company and the Other MSV Investors executed a non-binding letter of intent that would result in the consolidation of the MSV Joint Venture and TerreStar into Motient. If that transaction is consummated, an agreement with the other minority shareholders of TerreStar would not occur. There can be no assurance that the agreement with Motient will be consummated or, in the alternative, that any discussions among the minority shareholders in TerreStar to consolidate their interests in the MSV Joint Venture and TerreStar will take place or otherwise result in a definitive binding agreement.

Proposed Ownership Consolidation

Both prior to and since September 22, 2005, when the Company executed a non-binding letter of intent with Motient, TMI and the other partners in the MSV Joint Venture and the other stockholders of TerreStar, the Company has been in discussions that would result in the consolidation of the ownership of the MSV Joint

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Venture and TerreStar. These discussions have included a potential merger of the Company with and into Motient and, more recently, a variety of other structures. The consummation of any such consolidation transaction is subject to, among other things, definitive documentation, filing of the appropriate registration statements with the Securities and Exchange Commission and the requisite approvals from the Company s board of directors.

(4) Interest in Hughes Network Systems

In April 2005, the Company acquired 50% of the Class A membership interests of HNS from DTV Network Systems, Inc. (formerly known as Hughes Network Systems, Inc., DTV Networks), a wholly owned subsidiary of The DIRECTV Group, Inc. (DIRECTV), for $50.0 million in cash and 300,000 shares of the Company s common stock. The acquisition occurred pursuant to an agreement among the Company, DIRECTV, DTV Networks and HNS, dated December 3, 2004, as amended. Immediately prior to the acquisition, DTV Networks contributed substantially all of the assets and certain liabilities of its very small aperture terminal, mobile satellite and carrier businesses, as well as the certain portions of its SPACEWAY Ka-band satellite communications platform that is under development, to HNS, which at the time was a wholly-owned subsidiary of DTV Networks. In consideration for the contribution of assets by DTV Networks, HNS paid DTV Networks $190.7 million of cash. This payment represented the $201.0 million stated in the agreement less an estimated purchase price adjustment of $10.3 million, which was subject to further adjustment depending principally upon the closing value of HNS working capital (as defined in the agreement). On January 3, 2006, HNS paid DTV Networks $10.0 million in final satisfaction of all purchase price adjustments.

Concurrent with the acquisition, HNS incurred $325.0 million of term indebtedness and obtained a $50.0 million revolving credit facility. The Company and DTV Networks each pledged their respective membership interests of HNS to secure the obligations of HNS under the term indebtedness. The indebtedness is otherwise non-recourse to the Company or DTV Networks. Following the acquisition, the Company served as the managing member of HNS.

The HNS limited liability agreement allows for the issuance of Class B membership interests which are entitled to receive a pro rata share of any capital gains upon, among other things, a sale of HNS. In the second quarter of 2005, Class B membership interests were issued to certain members of HNS senior management and the Company s Chief Executive Officer and President, entitling the holders to approximately 4% of any capital gains resulting from a qualifying transaction. These Class B membership interests are subject to certain vesting requirements, with 50% of the Class B membership interests subject to time vesting over five years and the other 50% vesting based upon certain performance milestones. Following January 1, 2007, at the holders election, vested Class B membership interests can be exchanged for common stock of Hughes. The number of shares of Hughes common stock to be issued upon such exchange would be based upon the fair market value of such vested Class B membership interest divided by the value of the Hughes common stock at the time of such exchange. The issuance of such shares of Hughes common stock is subject to the authorization of the board of directors of Hughes and compliance with applicable securities laws.

In addition, in July 2005, HNS adopted an incentive plan pursuant to which bonus units representing up to approximately 4% of the increase in the value of HNS are available for grant to its employees. The bonus units provide for time vesting over five years subject to a participant s continued employment with HNS. Pursuant to the plan, if a participant in the plan is still employed by HNS on April 22, 2008, then at such time, the participant s vested bonus units would be exchanged for common stock of the Company. A second exchange will take place on April 22, 2010 for participants in the plan still employed by the Company at such time. Following the contribution of the Company s Class A membership interests to Hughes, Hughes succeeded to the obligations of the Company under the plan. As such, the number of shares of Hughes common stock to be issued upon such

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

exchange would be based upon the fair market value of such vested bonus unit divided by the value of Hughes common stock at the time of the exchange. The issuance of such shares of Hughes common stock is subject to the authorization of the board of directors of Hughes and compliance with applicable securities laws.

In January 2006, through Hughes, the Company acquired the remaining 50% of the Class A membership interests of HNS from DTV Networks for $100.0 million in cash. The acquisition occurred pursuant to an agreement among Hughes, DIRECTV, DTV Networks and HNS, dated November 10, 2005. Following closing of the acquisition, Hughes pledged its Class A membership interests of HNS to secure the obligations of HNS under the term indebtedness and serves as the managing member of HNS. To finance the transaction, Hughes obtained $100.0 million of short-term debt financing from Apollo Investment Fund IV, L.P. and Apollo Overseas Partners IV, L.P. (together with AIF IV/RRRR LLC, ST/RRRR LLC and AP/RM Acquisition LLC, the Apollo Stockholders). Concurrent with the Distribution, Hughes conducted a rights offering to its stockholders in order to repay the short-term debt financing provided by the Apollo Stockholders. In connection with such rights offering, in March 2006, the Apollo Stockholders converted approximately $68.4 million of the short-term debt financing into shares of common stock of Hughes at the $12.75 per share subscription price in the rights offering. The remaining $31.6 million of principal and interest obligations under the short-term debt financing was repaid in cash from the proceeds from the proceeds from the rights offering.

Through December 31, 2005, the Company accounted for its interest in HNS under the equity method in accordance with FIN 46R, as HNS is a variable interest entity as defined in FIN 46R and the Company was not the primary beneficiary as defined in FIN 46R. Accordingly, the Company recorded its proportionate share of the net income of HNS, subject to certain adjustments. These adjustments relate primarily to the amortization of the excess the Company s proportionate share of HNS net assets over the Company s carrying amount on the date of acquisition. This excess was being amortized over the remaining useful life of certain HNS long-lived assets on a straight line basis. As of December 31, 2005, the Company s proportionate share of HNS net assets exceeded its book investment by approximately $7.0 million. Following the January 2006 acquisition of the remaining 50% of the Class A membership interests of HNS, the Company s consolidated financial statements will include the financial position and operating results of HNS.

The following table presents summarized consolidated financial information for HNS for the period indicated and is derived from HNS audited consolidated financial statements:

	December 31, 2005 (in thousands)
Consolidated balance sheet information:	
Current assets	$ 449,958
Noncurrent assets	306,566
Current liabilities	230,471
Noncurrent liabilities	354,867
Minority interest	6,594
Owners equity	164,592

	April 23, 2005 to December 31, 2005 (in thousands)
Consolidated statement of operations:	
Revenues	$ 583,468
Income from operations	66,608
Net income	46,571

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As of December 31, 2005 and 2004, the Company had incurred approximately $0.6 million and $5.0 million, respectively, of transaction costs, including legal, accounting and other costs directly related to the HNS acquisition transactions. These costs are included in deferred transaction costs on the accompanying consolidated balance sheets.

(5) Business Transactions

(a) Interest in Electronic System Products

On August 25, 2003, for nominal consideration, the Company acquired all of the outstanding common stock of ESP, a product development and engineering services firm that has historically created products for and provides consulting and engineering services to the telecommunications, broadband, satellite communications, and wireless industries. ESP is currently focused on exploiting its existing intellectual property portfolio. In November 2003, ESP made restricted stock grants to its employees representing an aggregate of 30% of ESP s outstanding equity, diluting the Company s ownership to 70%. In October 2004, ESP repurchased shares of its common stock from terminated employees for an aggregate of approximately $2,000, raising the Company s ownership to approximately 78%. In August 2005, ESP repurchased additional shares of its common stock from terminated employees for an aggregate of approximately $4,000, raising the Company s ownership to approximately 92%.

The following table summarizes the estimated fair value of the identifiable assets acquired and liabilities assumed at the date of acquisition:

	August 25, 2003 (in thousands)	
Current assets	$	666
Property and equipment		54
Investment in affiliates		349
Total assets acquired		1,069
Current liabilities		(983)
Net assets acquired	$	86

(b) Interest in Hughes Systique

On October 12, 2005, through Hughes, the Company acquired Series A Preferred Shares from Hughes Systique for $3.0 million, representing an ownership of approximately 26% on an undiluted basis. Hughes Systique plans to provide software development services with technology resources and expertise in wireless broadband communications for terrestrial and satellite applications. Hughes Systique will also support other application areas such as wireless based networking, RFID enterprise applications and multimedia applications for in-home broadband entertainment networks. The founders of Hughes Systique include the Chief Executive Officer and President of Hughes, as well as certain current and former employees of HNS, including the Chief Executive Officer and President s brother. The Chief Executive Officer and President of Hughes and his brother own an aggregate of approximately 21% of Hughes Systique on an undiluted basis.

Although Hughes Systique is a variable interest entity as defined in FIN 46R, the Company is not the primary beneficiary as defined in FIN 46R. Accordingly, this investment is included in investments in affiliates on the accompanying consolidated balance sheets and is being accounted for under the equity method with the Company s share of Hughes Systique s loss being recorded in loss on investments in affiliates on the accompanying consolidated statements of operations. For the year ended December 31, 2005, the Company s share of Hughes Systique s loss was $0.1 million.

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(c) Interest in Miraxis

On May 28, 2002, the Company acquired Series B Preferred Shares and a warrant from Miraxis for approximately $0.4 million, representing an ownership of approximately 30%. Miraxis is a development stage telecommunications company that has access to a Ka-band license with which it is striving to provide satellite based multi-channel, broadband data and video services in North America. The Company has the right to appoint two of the five directors of the manager of Miraxis. Additionally, the Company entered into a management support agreement with Miraxis under which the Company s current Chief Executive Officer and President provided certain services to Miraxis through February 2003 in exchange for additional Series B Preferred Shares and warrants being issued to the Company. In addition, on December 20, 2002, the Company acquired Series C Preferred Shares and warrants from Miraxis for approximately $0.1 million.

In February 2003, the Company entered into a consulting agreement with Miraxis pursuant to which Miraxis personnel provided services to the Company through May 2003. In addition, Miraxis extended the management support agreement whereby the Company s current Chief Executive Officer and President continued to provide certain services to Miraxis through May 2003. In connection with these agreements, the Company paid Miraxis approximately $40,000 but also received additional Series C Preferred Shares and warrants.

In April 2003, the Company acquired additional Series C Preferred Shares and warrants for approximately $40,000. Between June 2003 and September 2003, the Company purchased promissory notes from Miraxis with an aggregate principal amount of approximately $0.1 million. In November 2003, the promissory notes were converted to Series D Preferred Shares. From January 2004 through July 2005, the Company purchased additional promissory notes with an aggregate principal balance of approximately $0.1 million. In September 2005, the board of managers of Miraxis approved the dissolution of the company. The dissolution of Miraxis will not have a material impact on the Company s financial position or results of operations. As of December 31, 2005, the Company held approximately 40% of the ownership interests of Miraxis. The Company s President and Chief Executive Officer currently holds an approximate 1% interest in Miraxis.

In accordance with FIN No. 46R, beginning January 1, 2004, the operating results and financial position of Miraxis have been included in the consolidated financial statements. Prior to January 1, 2004, this investment was included in investments in affiliates on the accompanying consolidated balance sheets and was accounted for under the equity method with the Company s share of Miraxis loss being recorded in loss on investments in affiliates on the accompanying consolidated statements of operations. The consolidation of Miraxis did not have a material impact on the Company s operating results or financial position.

(d) Interest in Navigauge

On April 21, 2003, the Company acquired Series B Preferred Shares from Navigauge, Inc., formerly known as IQStat, for approximately $0.3 million, representing an ownership interest of approximately 5%. Navigauge was a privately held media and marketing research firm that intended to collect data on in-car radio usage and driving habits of consumers and market the aggregate data to radio broadcasters, advertisers and advertising agencies in the United States.

In connection with the acquisition of ESP in August 2003, the Company obtained indirect ownership of Series A Preferred Shares representing an additional 16% ownership interest in Navigauge. In December 2003, the Company acquired additional Series B Preferred Shares and warrants for approximately $0.1 million. From January 2004 through April 2004, the Company acquired additional Series B Preferred Shares and warrants from Navigauge for approximately $0.5 million. Furthermore, from April 2004 through June 2004, the Company purchased short-term promissory notes from Navigauge with an aggregate principal amount of approximately $0.4 million.

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

On June 14, 2004, Navigauge completed a recapitalization in which all outstanding Series A Preferred Shares and Series B Preferred Shares were converted to new Series A Preferred Shares with substantially similar rights as the old Series B Preferred Shares. Following the exchange, the Company converted the outstanding short-term promissory notes into new Series A Preferred Shares and purchased additional Series A Preferred Shares for approximately $0.4 million. The Company also obtained direct ownership of the old Series A Preferred Shares held by ESP in exchange for the forgiveness of intercompany promissory notes.

On August 16, 2004, the Company purchased additional Series A Preferred Shares for approximately $0.2 million. Furthermore, from October 2004 through June 2005, the Company purchased short-term promissory notes from Navigauge with an aggregate principal amount of $1.1 million. Following the impairment discussed below, the short-term promissory notes have no carrying value on the accompanying consolidated balance sheets.

Although Navigauge is a variable interest entity as defined in FIN 46R, the Company is not the primary beneficiary as defined in FIN 46R. Accordingly, prior to the impairment discussed below, this investment was included in investments in affiliates on the accompanying consolidated balance sheets and was being accounted for under the equity method with the Company s share of Navigauge s loss being recorded in loss on investments in affiliates on the accompanying consolidated statements of operations. For the years ended December 31, 2005, 2004 and 2003, the Company s share of Navigauge s loss was $0.3 million, $1.3 million and $0.1 million, respectively.

As Navigauge was unsuccessful in raising the capital necessary to expand its service beyond the Atlanta market and in light of its prospects, during the year ended December 31, 2005, the Company recognized a loss of approximately $1.3 million relating to the impairment of the aggregate remaining carrying amount of its equity interest in Navigauge and the short-term promissory notes. This loss is included in loss on investments in affiliates on the accompanying consolidated statements of operations. In July 2005, Navigauge signed a non-binding letter of intent to sell substantially all of its assets. The sale of the assets was subject to, among other things, completion of the buyer s due diligence and negotiation and execution of definitive documentation satisfactory to the parties. In September 2005, the negotiations pursuant to the letter of intent were terminated. Navigauge is pursuing other options with respect to maximizing value from its intellectual property.

(e) Verestar Transactions

On August 29, 2003, the Company signed a securities purchase agreement to acquire, through a newly formed subsidiary, approximately 67% (on a fully-diluted basis) of Verestar. Concurrent with the signing of the securities purchase agreement, the Company purchased a 10% senior secured note with a principal balance of $2.5 million and a due date of August 2007. The Company terminated the securities purchase agreement on December 22, 2003. Subsequently, Verestar filed for bankruptcy protection under Chapter 11 of the United States Bankruptcy Code.

On March 8, 2004, the Company executed an asset purchase agreement to acquire, through a newly formed subsidiary, substantially all of the assets and business of Verestar pursuant to Section 363 of the Bankruptcy Code. The transaction was subject to a number of contingencies, including an auction on March 30, 2004 at which Verestar considered higher and better offers. At the auction, a bid was accepted from a strategic buyer at a price higher than the Company was willing to offer.

In connection with the Verestar bankruptcy, the Company entered into a stipulation with Verestar pursuant to which the parties agreed to, among other things, the validity and enforcement of the obligation under the senior secured note and the Company s security interest in Verestar s assets. On April 30, 2004, Verestar paid the Company approximately $2.9 million representing the $2.5 million outstanding principal amount of the senior

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

secured note and approximately $0.4 million as a break-up fee in connection with the termination of the March 2004 asset purchase agreement.

On July 9, 2004, the Company settled its dispute with Verestar s parent company regarding the break-up fee in connection with the termination of the August 2003 securities purchase agreement. As consideration for the settlement, Verestar s parent company paid the Company $1.5 million. This amount is included in other income (expense), net on the accompanying consolidated statements of operations.

On July 29, 2004, the Company entered into a stipulated settlement with Verestar and its Creditor Committee pursuant to which Verestar agreed to pay the Company approximately $0.4 million representing certain amounts owed, including unpaid accrued interest, in connection with the senior secured note. On August 13, 2004, the Bankruptcy Court approved the stipulated settlement. This settlement amount is included in interest income, net on the accompanying consolidated statements of operations.

(6) Notes Receivable from Motient

On April 2, 2001, the Company agreed to purchase from Motient 12.5% secured promissory notes, issuable in two tranches, each in the principal amount of $25.0 million. The notes were collateralized by five million shares of XM Satellite Radio common stock owned by Motient. The first tranche was purchased on April 4, 2001, and the second tranche was purchased on July 16, 2001. The principal of and accrued interest on the notes were payable on October 1, 2001 in either cash, shares of XM Satellite Radio, or any combination thereof at Motient s option, as set forth in the agreement. At the option of the Company, the notes were exchangeable for a number of XM Satellite Radio shares based on a formula, as set forth in the agreement.

On May 14, 2001, the Company entered into an agreement to merge with a subsidiary of Motient. By a letter agreement dated October 1, 2001, Motient and the Company terminated the planned merger. As a result of the termination, neither the Company nor Motient had any obligation to the other party with respect to the merger, except for repayment by Motient to the Company of amounts outstanding under the promissory notes.

On October 1, 2001, and again on October 8, 2001, the Company extended the maturity date of the notes. On October 12, 2001, in accordance with the terms of the notes, the Company received five million shares of XM Satellite Radio as payment for $26.2 million of the notes and accrued interest. The maturity date for the remaining balance of the Motient notes in the principal amount of approximately $26.2 million, and interest thereon, was extended for 60 days. On January 10, 2002, Motient and its subsidiaries filed for protection under Chapter 11 of the United States Bankruptcy Code. As part of its filing, Motient indicated that it would likely challenge the Company s right to the $26.2 million outstanding principal balance and accrued interest thereon, as well as the delivery of the shares of XM Satellite Radio common stock as partial repayment of the aggregate $50.0 million principal amount of the notes. As a result of uncertainty with respect to the ultimate collection on the notes, a reserve was recognized for the entire amount. This loss of approximately $26.9 million was partially offset by a gain of $5.3 million that resulted from the difference between the value of the XM Satellite Radio common stock received in connection with the partial repayment of the Motient notes in accordance with their terms and the value of the XM Satellite Radio common stock using its closing price on the date of the partial repayment. The results of these transactions are reflected in other income (expense), net on the accompanying consolidated statements of operations.

On May 1, 2002, to mitigate the risk, uncertainties and expenses associated with Motient s plan of reorganization, the Company cancelled the outstanding amounts due under the original promissory notes issued by Motient and accepted a new note in the principal amount of $19.0 million (the New Motient Note) that was issued by a new, wholly-owned subsidiary of Motient that owns 100% of Motient s interests in the MSV Joint

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Venture. The New Motient Note was due on May 1, 2005 and yielded interest at a rate of 9% per annum. As a result of the uncertainty with respect to the ultimate collection on the remaining amounts due on the New Motient Note, a reserve was maintained for the entire principal amount of the note and unpaid interest accrued thereon.

On April 7, 2004, as a result of a payment received by Motient pursuant to a promissory note from the MSV Joint Venture, Motient paid the Company approximately $0.5 million of interest accrued on the New Motient Note. Following several financings by Motient, on July 15, 2004, Motient paid the Company approximately $22.6 million representing all outstanding principal and accrued interest due on the New Motient Note. Accordingly, the reserve was adjusted resulting in the recognition of $23.1 million of income which is reflected in the accompanying consolidated statements of operations as $19.0 million in other income (expense), net and $4.1 million in interest income, net.

(7) Investments in Affiliates

The following is a summary of the carrying value of investments held by the Company at December 31:

	December 31,	
	2005	2004
	(in thousands)	
Equity method investments	$ 2,932	$ 1,081
Cost method investments	1,430	2,280
	$ 4,362	$ 3,361

For the years ended December 31, 2005, 2004 and 2003, the Company recognized a loss on investments in affiliates of approximately $0.6 million, $1.3 million and $0.4 million, respectively. For the year ended December 31, 2005, the loss on investments in affiliates consisted of approximately $1.3 million relating to the impairment of the short-term promissory notes purchased from Navigauge, $0.4 million relating to our proportionate share of affiliates operating losses for those affiliates accounted for under the equity method and $0.2 million relating to the impairment of the investment in an affiliate, partially offset by a $1.3 million gain relating to the sale of the Company s interest in two affiliates. For the years ended December 31, 2004 and 2003, the loss on investment in affiliates consisted primarily of the Company s proportionate share of affiliates operating losses for those affiliates accounted for under the equity method.

The aggregate carrying value of the Company s cost method investments totaled approximately $1.4 million as of December 31, 2005. Such cost method investments were not evaluated for impairment because (i) the Company did not identify any events or changes in circumstances that may have had a significant adverse effect on the fair value of those investments and (ii) the Company did not estimate the fair value of those investments in accordance with SFAS No. 107, Disclosures about Fair Value of Financial Instruments as the cost to make such estimation was prohibitive.

(8) Short-Term Investments

Short-term investments consisted of the following debt securities:

	December 31,	
	2005	2004
	(in thousands)	
Government agencies securities	$ 6,000	$ 19,356
Auction rate securities		36,150
Municipal bonds		4,242

	$ 6,000	$ 59,748

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The government agencies securities and municipal bonds are classified as held to maturity. The amortized cost of these securities approximated fair value as of December 31, 2005 and 2004. Auction rate securities are classified as available for sale. As of December 31, 2005 and 2004, there were no unrealized gains or losses associated with these investments and the adjusted fair market value equaled the adjusted costs.

(9) Property and Equipment

Property and equipment is stated at cost less accumulated depreciation and consisted of the following:

	December 31,	
	2005	2004
	(in thousands)	
Computer equipment and software	$ 258	$ 258
Furniture and fixtures	32	29
Leasehold improvements		21
Machinery and equipment	5	5
	295	313
Less accumulated depreciation	(277)	(274)
Property and equipment, net	$ 18	$ 39

Depreciation expense for the years ended December 31, 2005, 2004 and 2003 was approximately $12,000, $29,000 and $28,000, respectively.

(10) Accrued Liabilities

Accrued liabilities consisted of the following:

	December 31,	
	2005	2004
	(in thousands)	
Accrued professional fees	$ 1,475	$ 1,225
Accrued compensation	900	652
Accrued transaction costs		4,647
Accrued restructuring charges	47	1,550
Other accrued liabilities	51	131
	$ 2,473	$ 8,205

(11) Income Taxes

For Federal income tax purposes, the Company has unused net operating loss (NOL) carryforwards of approximately $227.2 million expiring in 2008 through 2025 and capital loss carryforwards of approximately $93.3 million expiring in 2006 through 2010. Based on a private letter ruling issued by the Internal Revenue Service (IRS) and a closing agreement entered into by the IRS and the Company with respect to whether an ownership change as defined by Section 382 of the Internal Revenue Code occurred during the period from June 5, 1999 through December 31, 2004, the Company believes that its carryforwards are not subject to limitation under Section 382 and, therefore, are available to offset future taxable income of the Company and its affiliates unless subject to other limitation.

84

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The tax effect of temporary differences that give rise to significant portions of the deferred tax assets are as follows:

	December 31, 2005	December 31, 2004
	(in thousands)	
Deferred tax assets:		
Net operating loss carryforwards	$ 86,336	$ 79,804
Capital loss carryforwards	35,451	32,475
Impairment loss on investments in affiliates	7,039	9,639
Investment in Mobile Satellite Ventures LP	1,031	122
Other assets	869	913
Total gross deferred tax assets	130,726	122,953
Less valuation allowance	(70,009)	(122,953)
Total deferred tax assets	60,717	
Deferred tax liability:		
Investment in Hughes Network Systems, LLC	10,383	
Total deferred tax liability	10,383	
Net deferred tax assets	$ 50,334	$

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning in making these assessments.

As the Distribution did not qualify as a tax-free spin-off, the Company expects to generate significant taxable income in 2006 for Federal and state income tax purposes. Accordingly, during the year ended December 31, 2005, the Company recognized a $50.3 million income tax benefit related to the reversal of the valuation allowance related to the loss carryforwards which are expected to be utilized to offset the Federal taxable income on the Distribution. Of the remaining valuation allowance of approximately $64.8 million, subsequently recognized tax benefits, if any, in the amount of approximately $7.7 million will be applied directly to contributed capital. This amount relates to the tax effect of employee stock option deductions included in the Company s net operating loss carryforward. Due to the Company s operating losses and the uncertainty surrounding whether the Company would ultimately realize its deferred tax assets, as of December 31, 2004, a valuation allowance was maintained on all of the deferred tax assets.

For the years ended December 31, 2005 and 2004, the Company s income from continuing operations before income tax benefit was approximately $8.9 million and $19.1 million, respectively, all of which was generated in the United States. For the year ended December 31, 2003, the Company s loss from continuing operations before income taxes was approximately $1.9 million.

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The income tax benefit consists of the following:

	Years Ended December 31, 2005	2004	2003
Current benefit:			
Federal	$	$	$
State			
Total current benefit			
Deferred benefit:			
Federal	50,334		
State			
Total deferred benefit	50,334		
Total income tax benefit	$ 50,334	$	$
Effective income tax rate	(566)%	0%	0%

The income tax benefit differs from the amount computed by applying the statutory rate to the Company s income from continuing operations before income taxes as follows:

	Years Ended December 31, 2005	2004	2003
Income tax (expense) benefit at statutory rate	$ (3,110)	$ (6,694)	$ 675
Valuation allowance and other	53,444	6,694	(675)
	$ 50,334	$	$

The difference between the statutory Federal income tax rate and the Company s effective tax rate for the year ended December 31, 2005 is principally due to the release of the valuation of allowance related to loss carryforwards expected to be utilized to offset the taxable income generated as a result of the Distribution. The difference between the statutory Federal income tax rate and the Company s effective tax rate for the years ended December 31, 2004 and 2003 is principally due to the Company incurring net operating losses for which no tax benefit was recorded.

(12) Redeemable Preferred Stock

On June 4, 1999, the Company issued and sold to Apollo Investment Fund IV, LP, Apollo Overseas Partners IV, LP and AIF IV/RRRR LLC, for an aggregate purchase price of $87.0 million, 126,000 shares of the Company s Series A Preferred Stock, 126,000 Series 1-A Warrants (the Series 1-A Warrants), 1,916,994 Series 2-A Warrants (the Series 2-A Warrants), 744,000 shares of the Company s Series B Preferred Stock (the Series B Preferred Stock), 744,000 Series 1-B Warrants (the Series 1-B Warrants) and 10,345,548 Series 2-B Warrants (the Series 2-B Warrants). As approved at the Company s 1999 annual meeting of stockholders, all Series B securities were converted to Series A securities.

The Series A Preferred Stock is subject to mandatory and optional redemption. On June 30, 2012, the Company will be required to redeem all Series A Preferred Stock plus any accrued and unpaid dividends. At the option of the Company, the Series A Preferred Stock can be redeemed after June 30, 2002 provided that the trading price of the Company s common stock for each of the preceding 30 trading days is greater than $120.00

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

per share, or after June 30, 2004 at a price of 103% of the face value of the Series A Preferred Stock plus any accrued and unpaid dividends. In the event of a change of control, as defined, at the option of the holders of the majority of the then outstanding shares of the Series A Preferred Stock, the Company is required to redeem all or any number of such holders shares of Series A Preferred Stock plus any accrued and unpaid dividends. As a result of the July 2002 rights offering, the conversion price of the Series A Preferred Stock was adjusted, pursuant to certain anti-dilution provisions as defined, from $70.00 to $68.50 per share. As a result of the December 2004 private placement, the conversion price of the Series A Preferred Stock was further adjusted to $62.69 per share. The conversion price is subject to further adjustment pursuant to the anti-dilution provisions.

From the date of issuance to June 30, 2002, the quarterly dividends on the Series A securities were based on a rate of 7.5% per annum and were paid in additional shares of Series A securities. Under the terms of the securities purchase agreement, from July 1, 2002 through June 30, 2004, the quarterly dividend was based on a rate of 4.65% per annum and was payable, at the option of the holder, in additional shares of Series A securities or cash. As part of the settlement of a class action lawsuit filed against the Company, the Apollo Stockholders agreed to accept payment in additional shares of Series A securities. Dividends paid from July 1, 2004 through the date of redemption will be based on a rate of 4.65% per annum and will be payable quarterly in arrears in cash. The quarterly payment of approximately $1.4 million for the three months ended December 31, 2005 was declared on January 30, 2006 and paid on February 2, 2006. The quarterly payment of approximately $1.4 million for the three months ended December 31, 2004 was declared and paid on January 13, 2005. Each of these dividends are reflected are reflected in the accompanying consolidated financial statements in the carrying amount of the Series A Preferred Stock and in net loss attributable to common stockholders.

The Series 1-A and Series 2-A warrants are exercisable at any time and expire ten years from the date issued. The holders of the Series 1-A and Series 2-A warrants have the option to pay the exercise price of the warrants in cash, Company common stock previously held, or instructing the Company to withhold a number of Company shares with an aggregate fair value equal to the aggregate exercise price. Pursuant to the original terms of the Series 1-A warrants, each warrant was exercisable into 1.35 shares of the Company s common stock, and the exercise price was dependent on the trading price of the Company s common stock. The exercise price ranged from $0.10, if the trading price is equal to or greater than $70.00 per share, to $42.00 if the trading price is equal to or less than $40.00 per share. Pursuant to their original terms, each Series 2-A warrant was exercisable into 0.1 share of the Company s common stock at an exercise price of $70.00.

The exercise price and the number of shares for which the Series 1-A and Series 2-A warrants are exercisable for is subject to adjustment under certain anti-dilution and other provisions as defined. As such, as a result of the issuance of additional shares of common stock in the July 2002 rights offering to shareholders other than the Apollo Stockholders at a price below the exercise price of the warrants at the time of the offering, the highest exercise price of the Series 1-A warrants was adjusted from $42.00 to $41.12, and the number of shares of the Company s common stock issuable upon the exercise of each Series 1-A warrant became a range dependent on the trading price of the Company s common stock. The number of shares issuable upon the exercise of each Series 1-A warrant ranged from 1.35 shares, if the trading price is equal to or greater than $70.00 per share to 1.379 shares if the trading price was less than or equal to $40.00 per share. The exercise price of the Series 2-A warrants was adjusted from $70.00 to $68.50, and the number of shares of the Company s common stock issuable upon the exercise of each Series 2-A warrant was adjusted from 0.1 to 0.1022 shares.

As a result of the December 2004 private placement in which additional shares of common stock were sold at a price below the exercise price of the warrants at the time of the placement, the highest exercise price of the Series 1-A warrants was adjusted from $41.12 to $38.48, and the highest number of shares of the Company s common stock issuable upon the exercise of each Series 1-A warrant was adjusted from 1.379 shares to 1.4737 shares. The exercise price of the Series 2-A warrants was adjusted from $68.50 to $62.69, and the number of

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

shares of the Company s common stock issuable upon the exercise of each Series 2-A warrant was further adjusted to 0.111665 shares.

On January 2, 2003, pursuant to the settlement of a class action lawsuit, 22,218 Series 1-A warrants and 2,452,509 Series 2-A warrants were cancelled. As of December 31, 2004, the 1,199,007 shares of Series A Preferred Stock are convertible into 1,912,485 shares of common stock, and the 234,633 Series 1-A warrants and the 9,810,033 Series 2-A warrants are exercisable for 345,776 shares and 1,095,436 shares of common stock, respectively. Assuming all the Series A securities are either converted or exercised, as of December 31, 2005, the Apollo Stockholders would own approximately 63% of SkyTerra s outstanding common stock and 35% of SkyTerra s outstanding voting power on a fully diluted basis.

At the time of issuance, the Company ascribed value to the Series A securities based on their relative fair value. As such, $29.9 million was allocated to Series A Preferred Stock and the remaining $57.1 million was allocated to the related Series 1-A and Series 2-A warrants. This transaction was accounted for in accordance with EITF Issue No. 98-5 Accounting for Convertible Securities with Beneficial Conversion Features. Subsequently, dividends have been recorded representing the accrual of the quarterly paid-in-kind dividends and the accretion of the carrying value up to the face redemption over 13 years. For each of the years ended December 31, 2005, 2004 and 2003, such accretion totaled approximately $4.4 million.

(13) Stockholders Equity

On December 23, 2004, the Company sold 2,000,000 shares of its common stock for gross proceeds of $36.5 million (net proceeds of $35.1 million) in a private placement to a group of institutional investors. In connection with this sale, the Company entered into a registration rights agreement with the investors requiring that, among other things, the Company register the resale of the shares. If the Company does not meet certain deadlines between June 30, 2005 and December 31, 2005 with respect to making the registration effective, then warrants, which were issued to the investors in connection with the transaction, to purchase up to an additional 600,000 shares of common stock at an exercise price of $18.25 per share will vest and be exercisable at any time through December 23, 2009. The number of warrants that vest, if any, will depend on when the registration statement becomes effective. If the Company meets the June 30, 2005 deadline and otherwise complies with certain registration obligations, none of the warrants will vest. As part of the placement fees incurred in connection with the transaction, the Company also issued a warrant to purchase 110,000 shares at an exercise price of $18.25 per share to the placement agent. This warrant is exercisable at any time through December 23, 2009 and had an estimated fair value of approximately $2.2 million using the Black-Scholes option valuation model with the following assumptions: $21.50 price per share on date of grant, an expected life of five years, a risk free interest rate of 3.6%, volatility of 166% and an annual dividend yield of 0%.

On March 13, 2003, the Company commenced a cash tender offer at a price of $1.00 per share for up to 2,500,000 shares of its outstanding voting common stock. The tender offer expired on April 23, 2003 with 968,398 shares purchased for an aggregate cost, including all fees and expenses applicable to the tender offer, of approximately $1.2 million. The primary purpose of the tender offer was to provide public stockholders with additional liquidity for their shares of common stock, particularly in light of decreased liquidity arising from the decision of Nasdaq to delist the Company s common stock, and to do so at a premium over the stock price before the tender offer and without the usual transaction costs associated with open market sales. The Apollo Stockholders (as defined in Note 4) did not sell any shares of common stock in the tender offer.

On January 10, 2003, as part of the settlement of a class action lawsuit, the Company issued 357,143 shares of the Company s common stock to the plaintiff s counsel as attorney s fees. During the year ended December 31, 2002, the Company recognized a charge of $0.3 million relating to this settlement based on the $0.25 trading price of the common stock on January 2, 2003, the date the shares were issuable.

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Pursuant to an April 2002 investment agreement, the Apollo Stockholders may exchange shares of non-voting common stock for an equal number of shares of voting common stock if, after giving effect to such exchange, they collectively will own no more than 29.9% of the outstanding voting power of the Company. Following the issuance of common stock in the December 2004 private placement, the Apollo Stockholders voting power declined below 29.9%. Accordingly, as of December 31, 2005, the Apollo Stockholders may exchange 656,437 shares of non-voting common stock for an equal number of shares of voting common stock.

In connection with certain acquisitions made in 1999, the former shareholders agreed to indemnify the Company for any losses resulting from a breach of, among other things, their respective representations, warranties and covenants. To secure the indemnification obligations of these shareholders thereunder, 1,336 shares of the Company s common stock delivered to these shareholders, included as part of the consideration, remain in escrow at December 31, 2005, and the liability of these shareholders under such indemnification obligations is expressly limited to the value of such shares held in escrow. During the year ended December 31, 2004, the Company retired 6,262 shares of its common stock as a reduction of consideration for acquisitions made during 1999 and 2000.

(14) Segment Information

The segment information is reported along the same lines that the Company s chief operating decision maker reviews the operating results in assessing performance and allocating resources. Accordingly, the Company s consolidated operations have been classified into four reportable segments: HNS, the MSV Joint Venture, ESP and Parent and other. HNS, which became a reportable segment following the April 2005 acquisition by the Company, is a provider of broadband satellite networks and services to the enterprise market and satellite Internet access to the North American consumer market. The MSV Joint Venture, which became a reportable segment following the November 2004 conversion of the notes receivable into limited partnership interests of the MSV Joint Venture, provides mobile digital voice and data communications services via satellite. ESP, which became a reportable segment following the August 2003 acquisition by the Company, is an engineering services firm with expertise in the design and manufacturing of electronic products and systems across many disciplines of electrical engineering. Parent and other includes the Company, other consolidated entities other than ESP and eliminations. Following the December 2005 decision to discontinue operating AfriHUB, AfriHUB is no longer a reportable segment.

The following table presents certain financial information on the Company s reportable segments for the year ended December 31, 2005. The HNS column represents the results of operations for the period following the April 22, 2005 acquisition through December 31, 2005. Since our 23% share of the results of MSV Joint Venture s operations and our 50% share of the results of HNS operations are already included in the Parent and Other column, the Eliminate MSV Joint Venture and HNS column removes the results of the MSV Joint Venture and HNS shown in the MSV Joint Venture and HNS columns.

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	HNS	MSV Joint Venture	ESP	Parent and Other (in thousands)	Eliminate HNS and MSV Joint Venture	Consolidated
Revenues	$ 583,468	$ 29,381	$ 615	$	$ (612,849)	$ 615
Operating expenses	(516,860)	(68,534)	(592)	(9,322)	585,394	(9,914)
Gain (loss) from operations	66,608	(39,153)	23	(9,322)	(27,455)	(9,299)
Interest (expense) income, net	(22,744)	3,345	(59)	1,495	19,399	1,436
Equity in earnings of Hughes Network Systems, LLC				24,054		24,054
Equity in loss of Mobile Satellite Ventures LP				(9,469)		(9,469)
Loss on investments in affiliates				(638)		(638)
Other income, net	2,707	3,682	65	812	(6,389)	877
Minority interest				1,925		1,925
Net income (loss) before taxes, discontinued operations and cumulative effect of change in accounting principle	$ 46,571	$ (32,126)	$ 29	$ 8,857	$ (14,445)	$ 8,886
Total assets	$ 756,524	$ 216,784	$ 120	$ 205,217	$ (973,308)	$ 205,337

The following table presents certain financial information on the Company s reportable segments as of or for the year ended December 31, 2004. Although the MSV Joint Venture became a reportable segment in November 2004 following the conversion of the notes receivable, the MSV Joint Venture column represents the results of operations for the full year ended December 31, 2004 due to the significance to the Company s operations. Since our 23% share of the results MSV Joint Venture s operations for the period following the conversion is already included in the Parent and Other column, the MSV Joint Venture Elimination column removes the full year results of the MSV Joint Venture shown in the MSV Joint Venture column.

	MSV Joint Venture	ESP	Parent and Other (in thousands)	Eliminate MSV Joint Venture	Consolidated
Revenues	$ 29,007	$ 2,117	$	$ (29,007)	$ 2,117
Operating expenses	(55,762)	(2,932)	(8,471)	55,762	(11,403)
Loss from operations	(26,755)	(815)	(8,471)	26,755	(9,286)
Interest (expense) income, net	(8,109)	(56)	10,604	8,109	10,548
Equity in loss of Mobile Satellite Ventures LP			(1,020)		(1,020)
Loss on investments in affiliates	(275)	(164)	(1,172)	275	(1,336)
Other income, net	3,623	866	20,164	(3,623)	21,030
Minority interest			(810)		(810)
Net (loss) income before taxes and discontinued operations	$ (31,516)	$ (169)	$ 19,295	$ 31,516	$ 19,126
Total assets	$ 246,223	$ 268	$ 154,302	$ (246,223)	$ 154,570

90

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table presents certain financial information on the Company s reportable segments as of or for the year ended December 31, 2003:

	ESP	Parent and Other	Consolidated
Revenues	$ 699	$	$ 699
Operating expenses	(1,412)	(6,234)	(7,646)
Loss from operations	(713)	(6,234)	(6,947)
Interest (expense) income, net	(11)	6,315	6,304
Loss on investments in affiliates	(112)	(292)	(404)
Other income, net	24	220	244
Minority interest		(1,126)	(1,126)
Net loss before taxes and discontinued operations	$ (812)	$ (1,117)	$ (1,929)
Total assets	$ 555	$ 97,544	$ 98,099

As of December 31, 2005 and 2004, all of the Company s long-lived assets were located in the United States.

(15) Discontinued Operations

Rare Medium

At the end of the third quarter of 2001, a decision to discontinue the operations of Rare Medium, Inc. and the LiveMarket subsidiary was made as a result of the weakening of general economic conditions that caused many companies to reduce spending on Internet-focused business solutions and in light of their performance and prospects. As of December 31, 2005 and 2004, cash of approximately $47,000 and $15,000, respectively, (excluding the $0.3 million of cash collateralizing a letter of credit as of December 31, 2004) was the remaining asset of Rare Medium, Inc. and LiveMarket. As of December 31, 2005 and 2004, the liabilities of these subsidiaries totaled approximately $0.8 million and $2.3 million, respectively, consisting of accounts payable and accrued expenses. As of December 31, 2004, Rare Medium, Inc. held $0.3 million of cash in a certificate of deposit which was maintained as collateral for a letter of credit supporting a lease obligation. The lease obligation and the letter of credit expired during the year ended December 31, 2005, and the collateral was released. For the years ended December 31, 2005, 2004 and 2003, the Company recognized a gain of approximately $1.1 million, nil and $1.2 million, respectively, as a result of the settlement of Rare Medium, Inc. liabilities at amounts less than their recorded amounts.

AfriHUB

In April 2004, the Company signed an agreement to acquire 80% of the outstanding membership interests of AfriHUB for an aggregate purchase price of $1.5 million in cash. AfriHUB planned to provide instructor led and distance based technical training and satellite based broadband Internet access and domestic and international calling services through exclusive partnerships with certain Nigerian based universities. While establishing centers which provide these services on two university campuses during the fourth quarter of 2004, AfriHUB experienced significant unanticipated delays and costs in opening these facilities, as well as greater price sensitivity within the university communities. As a result, AfriHUB suspended its planned roll out of service to additional campuses and is actively pursuing other opportunities to provide technical training in the Nigerian market, including establishing a facility on a single additional campus.

In connection with the allocation of the purchase price to the fair value of the identifiable net assets acquired, the Company ascribed approximately $0.6 million to a significant contract. This intangible asset was

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

being amortized over the approximate five-year minimum life of the contract, and for the year ended December 31, 2004, such amortization was approximately $34,000. As a result of AfriHUB s strategy shift, the Company recognized an impairment loss of approximately $0.8 million during the year ended December 31, 2004 relating to this intangible asset and certain building improvements (see Note 1(f)).

In October 2004, AfriHUB agreed to sell membership interests to an unaffiliated third party for approximately $0.5 million in cash (see Note 1(p)). As a result of this sale of membership units, the Company s ownership of AfriHUB s outstanding membership interests decreased to approximately 70%.

In August 2005, the Company decided to cease providing funding to AfriHUB. As a result of this decision, the Company evaluated AfriHUB s long-lived assets for recoverability and determined that the undiscounted cash flows over the remaining expected life of the two established centers was less than the carrying value of the assets relating to those centers. Accordingly, the Company assessed the fair value of these assets by estimating the recoverability of the computers and equipment upon a sale. The Company recognized a non-cash impairment loss relating to the computers and equipment as their carrying value exceeded the fair value by approximately $0.4 million.

In August 2005, AfriHUB s Nigerian subsidiary borrowed approximately $0.2 million from a Nigerian bank under a term loan to fund the investment necessary to establish a facility on an additional university campus. The short-term borrowing, which is denominated in Nigerian Naira, is due in August 2006 and bears interest at an annual rate of 19% as of December 31, 2005. The interest rate is subject to change based on fluctuations of the bank s money market rate. The Company has not guaranteed any amounts owed under the short-term borrowing.

In December 2005, the Company decided to discontinue operating AfriHUB and signed a letter of intent to sell its interests in AfriHUB for a promissory note with a principal amount of approximately $0.2 million and a maturity date one year following the execution of definitive documentation. In accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the results of operations of AfriHUB have been classified as discontinued operations on the accompanying statements of operations and prior period results have been reclassified. For the years ended December 31, 2005 and 2004, AfriHUB s revenues of approximately $0.3 million and $10,000, respectively, have been included in loss from discontinued operations on the accompanying consolidated statements of operations. The following table presents the major classes of assets and liabilities of AfriHUB which are classified as held for sale on the accompanying consolidated balance sheets:

	December 31,	
	2005	2004
	(in thousands)	
Assets:		
Cash	$ 74	$ 25
Other current assets	205	40
Property and equipment	189	566
Other assets		15
Total assets	$ 468	$ 646
Liabilities		
Accounts payable	$ 210	$ 169
Accrued liabilities	77	77
Deferred revenue	162	
Short-term borrowing	76	
Total liabilities	$ 525	$ 246

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(16) Stock-Based Compensation Plans

The Company provides incentive and nonqualified stock option plans for directors, officers, and key employees of the Company and others. The Company has reserved a total of 2.3 million shares of authorized common stock for issuance under the 1998 Long-Term Incentive Plan (Stock Incentive Plan). The Company has options outstanding under the Nonqualified Stock Option Plan, but no new grants are being made under this plan. The number of options to be granted and the option prices are determined by the Compensation Committee of the Board of Directors in accordance with the terms of the plans. Options generally expire five to ten years after the date of grant.

During 1998, the Board of Directors approved the Stock Incentive Plan under which non-qualified stock options (NQSOs) to acquire shares of common stock may be granted to non-employee directors and consultants of the Company, and incentive stock options (ISOs) to acquire shares of common stock may be granted to employees. The Stock Incentive Plan also provides for the grant of stock appreciation rights, shares of restricted stock, deferred stock awards, dividend equivalents, and other stock-based awards to the Company s employees, directors, and consultants. Under the Stock Incentive Plan, the option price of any ISO may not be less than the fair market value of a share of common stock on the date on which the option is granted. The option price of an NQSO may be less than the fair market value on the date the NQSO is granted if the Board of Directors so determines. An ISO may not be granted to a ten percent stockholder (as such term is defined in section 422A of the Internal Revenue Code) unless the exercise price is at least 110% of the fair market value of the common stock and the term of the option may not exceed five years from the date of grant. Common stock subject to a restricted stock purchase or a bonus agreement is transferable only as provided in such agreement. The maximum term of each stock option granted to persons other than ten percent stockholders is ten years from the date of grant.

Under the Nonqualified Stock Option Plan, which provided for the issuance of up to 510,000 shares, the option price as determined by the Compensation Committee was permitted to be greater or less than the fair market value of the common stock as of the date of the grant, and the options were generally exercisable for three to five years subsequent to the grant date. The Nonqualified Stock Option Plan expired on July 18, 2000, and thereafter, no new options can be granted under the plan.

On October 5, 2001, the Compensation Committee of the Company s Board of Directors determined that because the outstanding options held by certain executive officers and employees were exercisable at prices that were significantly above prevailing market prices for the Company s common stock, they no longer provided an adequate level of incentive. Accordingly, to reincentivize certain executive officers and employees of the Company and in recognition of their service to the Company, the Compensation Committee approved the repricing of the exercise prices of options to purchase an aggregate of 32,833 shares of common stock to $1.30 per share, the fair market value at the date of the repricing. On December 21, 2001, the Compensation Committee approved an additional repricing of the exercise prices of options to purchase an aggregate of 40,000 shares of common stock held by non-management directors to $6.00 per share, the fair market value at the date of the repricing. On October 15, 2002, in recognition of the former Chief Executive Officer s contribution to the Company, among other things, the Compensation Committee of the Company s Board of Directors approved the repricing of the exercise price of the former Chief Executive Officer s outstanding options to purchase 140,000 shares of common stock to $0.85, the fair market value at the date of the repricing. As a result of these actions, the Company recorded non-cash compensation expense during the years ended December 31, 2005, 2004 and 2003 of approximately $0.4 million, $2.8 million and $0.1 million, respectively.

Pursuant to the Stock Incentive Plan, the Compensation Committee is required to make an equitable adjustment to the terms of options issued under that plan in the event a special, large and nonrecurring dividend or distribution affects the Company s common stock such that an adjustment is appropriate in order to prevent

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

dilution or enlargement of the rights of the participants under such plan. The Compensation Committee has discretion to make such an adjustment to any option issued under the Stock Incentive Plan by adjusting the number and kind of shares that may be issued in respect of outstanding options or the exercise price relating to such options. Pursuant to this provision, the holders of stock options who are current members of the Company s management and Board of Directors, as well as a consultant and former directors who were involved with the acquisition of HNS, received an option to purchase one share of Hughes common stock for each option to purchase two shares of the Company s common stock that they held as of the date of the Distribution. The exercise price and number of shares subject to the Company and Hughes options was adjusted so that the two options have a combined intrinsic value equal to the intrinsic value of the Company option before taking into account the effect of the Distribution. The options are otherwise exercisable on substantially the same terms and conditions set forth in the Stock Incentive Plan. The issuance of such options to purchase Hughes common stock were in lieu of a larger adjustment to the exercise price of the Company options that such holders would have been otherwise entitled had they not received options to purchase Hughes common stock. A reduction in the exercise price (or in some cases, an increase in the number of shares) is the manner in which all other options outstanding under the Stock Incentive Plan were adjusted.

Stock option activity under the various option plans is shown below:

	Weighted Average Exercise Prices	Number of Shares
Outstanding at January 1, 2003	$ 10.91	923,824
Granted	1.02	235,000
Forfeited	19.38	(37,650)
Exercised	1.30	(4,367)
Outstanding at December 31, 2003	8.58	1,116,807
Granted	3.35	220,000
Forfeited	62.01	(28,081)
Exercised	0.88	(321,966)
Outstanding at December 31, 2004	8.40	986,760
Granted	31.21	152,500
Exercised	2.98	(47,167)
Outstanding at December 31, 2005	$ 11.81	1,092,093

The following table summarizes weighted-average option price information:

Range of Exercise Prices		Number Outstanding at December 31, 2005	Weighted Average Remaining Life	Weighted Average Exercise Price	Number Exercisable at December 31, 2005	Weighted Average Exercise Price
$ 0.85	$ 0.85	288,000	6.18	$ 0.85	288,000	$ 0.85
$ 0.91	$ 1.55	230,000	7.33	$ 1.02	151,668	$ 1.02
$ 1.80	$ 6.00	244,833	6.82	$ 3.16	124,836	$ 3.68
$ 6.60	$38.44	221,867	8.12	$ 25.95	45,201	$ 19.82
$51.10	$95.00	107,393	3.12	$ 54.80	107,393	$ 54.80

1,092,093	6.29	$ 11.81	717,098	$ 10.65

94

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(17) Related Party Transactions

Hughes Systique

On October 12, 2005, through Hughes, the Company acquired Series A Preferred Shares from Hughes Systique for $3.0 million, representing an ownership of approximately 26% on an undiluted basis. The founders of Hughes Systique include the Chief Executive Officer and President of Hughes, as well as certain current and former employees of HNS, including the Chief Executive Officer and President s brother. The Chief Executive Officer and President of Hughes and his brother own an aggregate of approximately 21% of Hughes Systique on an undiluted basis.

Separation Agreement

On December 30, 2005, in preparation for the Distribution, the Company and Hughes entered into a Separation Agreement pursuant to which the Company contributed to Hughes, effective December 31, 2005, all of its assets, liabilities and operations other than those associated with the MSV Joint Venture and TerreStar, $12.5 million of cash, cash equivalents and short-term investments and the obligations pursuant to the Series A Preferred Stock. Upon a change of control of the Company, the remaining balance of the $12.5 million of cash at such time, if any, will be transferred to Hughes. The Separation Agreement also provides that Hughes is responsible for paying all fees, costs and expenses directly related to the Distribution, except to the extent such fees have already been paid by the Company. In addition, the Separation Agreement provides for certain indemnifications, tax sharing, consulting services and access to facilities.

Indemnification. The Separation Agreement provides that Hughes will indemnify the Company against losses based on, arising out of or resulting from (i) the ownership or the operation of the assets or properties transferred to Hughes under the Separation Agreement, and the operation or conduct of the business of, including contracts entered into and any activities engaged in by, Hughes, whether in the past or future; (ii) any other activities Hughes engages in; (iii) any guaranty, keepwell, of or by the Company provided to any parties with respect to any of Hughes s actual or contingent obligations and (iv) certain other matters described in the Separation Agreement. The Separation Agreement provides that the Company will indemnify Hughes against losses based on, arising out of or resulting from the ownership or operation of the assets or properties of the MSV Joint Venture or TerreStar, or the operation or conduct of their businesses, including the contracts entered into by them, and certain other matters described in the Separation Agreement.

Tax sharing agreement. The tax sharing agreement governs the allocation between Hughes and the Company of tax liabilities and related tax matters, such as the preparation and filing of tax returns and tax contests, for all taxable periods. Hughes will generally be responsible for, and indemnify the Company and its subsidiaries against, all tax liabilities imposed on or attributable to (i) Hughes and any of its subsidiaries relating to all taxable periods and (ii) the Company and any of its subsidiaries for all taxable periods or portions thereof ending on or prior to a change of control of the Company, in each case, after taking into account any tax attributes of the Company or any of its subsidiaries that are available to offset such tax liabilities. Notwithstanding the foregoing, Hughes is not responsible for any taxes relating to the MSV Joint Venture, TerreStar or a change of control of the Company. Additionally, under the tax sharing agreement, the Company is responsible for, and indemnifies Hughes and its subsidiaries against, all tax liabilities imposed on or attributable to the MSV Joint Venture and TerreStar relating to all taxable periods, the Company and any of its subsidiaries relating to all taxable periods or portions thereof beginning and ending after a change of control, and any change of control of the Company.

Consulting services. The Company will provide Hughes with the consulting services of its officers, not to exceed an aggregate of 200 hours per month, for a monthly fee of $25,000. Such services may be terminated by either party at any time with or without cause by providing ten business days notice to the non-terminating party.

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Access to facilities. The Company will provide Hughes with use of its facilities, including information technology and communications equipment and services at such premises, until the earlier of a change of control of the Company or such other time that the parties mutually agree. In exchange, Hughes will pay the Company $7,500 per month.

Miraxis

In May 2002, the Company acquired ownership interests in Miraxis (see Note 5(c)). Prior to joining the Company, the Company s Chief Executive Officer and President served as President of Miraxis, a position he continues to hold. The Company s Chief Executive Officer and President currently holds shares, options and warrants of Miraxis representing approximately 1% of the outstanding ownership interests.

Miraxis License Holdings, LLC (MLH) and a subsidiary, entities unaffiliated with Miraxis, other than as described herein, hold the rights to certain orbital slots, one of which Miraxis had the ability to use so long as it implemented its business plan. Miraxis issued 10% of its outstanding common equity on a fully diluted basis to MLH as partial consideration for access to that slot. In addition, Miraxis was required to pay certain royalties to MLH for use of the slot if it ever launched satellites. Miraxis ceased operations during the year ended December 31, 2005 and, accordingly, the arrangement with MLH terminated. Prior to becoming affiliated with the Company, its Chief Executive Officer and President acquired a 2% interest in MLH. In addition, prior to the Company acquiring an interest in Miraxis, an affiliate of the Company s preferred stockholders acquired an approximate 70% interest in MLH.

Other

During the years ended December 31, 2005 and 2004 and from the August 25, 2003 acquisition through December 31, 2003, ESP recognized revenues totaling approximately $18,000, $0.6 million and $0.3 million, respectively, for services provided to Navigauge and the MSV Joint Venture.

Certain of the Company s directors and officers serve on the board of directors of affiliates, including the MSV Joint Venture and TerreStar. Such directors and officers have received stock-based compensation from such affiliates for their service. The amount of stock-based compensation received by the Company s directors and officers is comparable to stock-based compensation awarded to other non-executive members of the affiliates board of directors.

(18) Contingencies and Commitments

Regulatory

In April 2005, the Federal Communications Commission (FCC) approved a license application submitted by the Company which provides the Company with access to a satellite orbital slot. To ensure that the Company complies with certain milestones with respect to the construction, launch and initial operation of a satellite in the orbital slot, the FCC requires the Company to maintain a surety bond with an initial amount of $3.0 million. As the milestones are achieved over a five year schedule, the amount of the surety bond will be reduced. To secure the insurance company s obligation under the surety bond, the Company must maintain a letter of credit in an amount equal to the value of the surety bond. The letter of credit agreement requires the Company to maintain a restricted cash account for 102% of the amount of the letter of credit. As of December 31, 2005, the Company had approximately $3.1 million in the restricted cash account. Restricted cash balances which are expected to be restricted for more than one year have been classified as non-current assets on the accompanying consolidated balance sheets.

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Leases

The Company has non-cancelable operating leases with future minimum payments totaling approximately $0.1 million that expire during the year ending December 31, 2006. Excluded from the future minimum lease payments is $1.0 million, net of secured letters of credit issued by the assignee, relating to leases that have been assigned and require no future payments by the Company unless there is a default by the party to which the respective lease has been assigned.

Total expense under operating leases amounted to approximately $0.2 million, $0.3 million and $0.2 million for 2005, 2004 and 2003, respectively.

Litigation

The Company and certain of its subsidiaries (along with the Engelhard Corporation (Engelhard)) were parties to an arbitration relating to certain agreements that existed between or among the claimant and ICC Technologies, Inc., the Company s former name, and the Engelhard/ICC (E/ICC) joint venture arising from the desiccant air conditioning business that the Company and its subsidiaries sold in 1998. The claimant sought $8.5 million for (1) its alleged out of pocket losses in investing in certain of E/ICC s technology; (2) unjust enrichment resulting from the reorganization of E/ICC in 1998; and (3) lost profits arising from the fact that it was allegedly forced to leave the air conditioning business when the E/ICC joint venture was dissolved. On December 30, 2005, the parties to the arbitration executed a definitive binding settlement agreement. Pursuant to the settlement agreement, Engelhard agreed to pay the claimant $0.7 million. In return, the Company and Engelhard exchanged general releases with the claimants, settling the arbitration. In connection with the settlement, the Company and Engelhard exchanged general releases, and the Company reimbursed Engelhard for approximately $0.2 million of the settlement payment.

From time to time, the Company is subject to litigation in the normal course of business. The Company is of the opinion that, based on information presently available, the resolution of any such additional legal matters will not have a material adverse effect on the Company s financial position, results of operations or its cash flows.

Other

On May 7, 2004, in connection with services being provided which support the regulatory effort of the MSV Joint Venture, the MSV Investors Subsidiary agreed to pay an unaffiliated consultant a one-time fee of $0.4 million upon a liquidity event, as defined in the agreement. The MSV Investors Subsidiary will recognize an expense related to this fee if and when a liquidity event becomes probable. A consolidation transaction described in Note 3, if such a transaction is consummated, would likely be considered a liquidity event which would require payment of the one-time fee.

(19) Subsequent Events

HNS Acquisition

In January 2006, through Hughes, the Company acquired the remaining 50% of the Class A membership interests of HNS from DTV Networks for $100.0 million in cash. Following closing of the acquisition, Hughes pledged its Class A membership interests of HNS to secure the obligations of HNS under the term indebtedness and serves as the managing member of HNS.

SKYTERRA COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Apollo Loan and Rights Offering

To finance the January 2006 acquisition of the remaining 50% of the Class A membership interests of HNS, Hughes obtained $100.0 million of short-term debt financing from certain of the Apollo Stockholders. Concurrent with the Distribution, Hughes conducted a rights offering to its stockholders in order to repay the short-term debt financing provided by the Apollo Stockholders. In connection with such rights offering, in March 2006, the Apollo Stockholders converted approximately $68.4 million of the short-term debt financing into shares of common stock of Hughes at the $12.75 per share subscription price in the rights offering. The remaining $31.6 million of principal and interest obligations under the short-term debt financing was repaid in cash from the proceeds from the proceeds from the rights offering.

Distribution

On February 21, 2006, the Company completed the Distribution and distributed to each of its stockholders one-half of one share of Hughes common stock for each share of the Company s common or non-voting common stock held as of the close of business on February 13, 2006 (or, in the case of the Series A Preferred Stock and Series 1-A and 2-A warrants, in accordance with their terms, one-half of one share of Hughes common stock for each share of the Company s common stock issuable upon conversion or exercise of such preferred stock and warrants held as of the close of business on February 13, 2006).

Series A Preferred Stock Dividend

The terms of the Company s Series A Preferred Stock provide for dividends of 4.65% of the then current face value to be paid quarterly in arrears. The payment of approximately $1.4 million, for the three months ended December 31, 2005, was declared by the Company s board of directors on January 30, 2006 and paid on February 2, 2006 and is reflected in the accompanying consolidated financial statements in the carrying amount of the Series A Preferred Stock and in net loss attributable to common stockholders.

SKYTERRA COMMUNICATIONS, INC.

Schedule II Valuation and Qualifying Accounts

Deductions Descriptions	Balance at Beginning of Year	Additions Charged to Costs and Expenses	Additions Charged to Other Accounts	Deductions	Balance at End of Year
Reserves and allowances deducted from asset accounts:					
Allowances for uncollectible accounts receivable					
Year ended December 31, 2003		$ 43,672			$ 43,672
Year ended December 31, 2004	$ 43,672	$ 38,093		$ (3,915)	$ 77,850
Year ended December 31, 2005	$ 77,850				$ 77,850
Allowances for uncollectible notes receivable					
Year ended December 31, 2003	$ 20,160,774	$ 1,855,292			$ 22,016,066
Year ended December 31, 2004	$ 22,016,066			$ (22,016,066)(1)	
Year ended December 31, 2005					

(1) Relates to adjustment to reserve for note receivable from Motient Corporation as a result of repayment of amounts owed thereunder.

99

Report of Independent Auditors

General Partner and Unit Holders

Mobile Satellite Ventures LP

We have audited the accompanying consolidated balance sheets of Mobile Satellite Ventures LP (a Delaware limited partnership) (the Company) as of December 31, 2004 and 2005, and the related consolidated statements of operations, partners equity (deficit), and cash flows for each of the three years in the period ended December 31, 2005. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the 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. We were not engaged to perform an audit of the Company s internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and 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 Mobile Satellite Ventures LP at December 31, 2004 and 2005, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States.

As discussed in Note 2 to the consolidated financial statements, in 2005 the Company adopted Financial Accounting Standards Board Interpretation No. 46, *Consolidation of Variable Interest Entities.*

/s/ Ernst & Young LLP

McLean, Virginia

February 22, 2006

Mobile Satellite Ventures LP

Consolidated Balance Sheets

(In Thousands)

	December 31	
	2004	**2005**
Assets		
Current assets:		
Cash and cash equivalents	$ 129,124	$ 59,925
Investments		52,278
Restricted cash	75	1,664
Accounts receivable, net of allowance of $70 and $103	3,344	3,370
Management fee due from TerreStar		769
Inventory	698	710
Prepaid expenses and other current assets	782	1,090
TerreStar assets, discontinued	5,955	
Total current assets	139,978	119,806
Restricted cash, long-term		4,600
Property and equipment, net	14,054	10,600
Intangible assets, net	71,506	61,958
Goodwill	16,495	16,936
Other assets	85	2,884
TerreStar assets, discontinued	4,105	
Total assets	$ 246,223	$ 216,784
Liabilities and partners equity		
Current liabilities:		
Accounts payable and accrued expenses	$ 6,171	$ 6,974
Vendor note payable, current portion	206	225
Deferred revenue, current portion	4,882	4,538
Other current liabilities	65	74
TerreStar liabilities, discontinued	549	
Total current liabilities	11,873	11,811
Deferred revenue, net of current portion	20,690	23,243
Vendor note payable, net of current portion	696	470
Total liabilities	33,259	35,524
Commitments and contingencies		
Partners equity:		
MSV general partner		
MSV limited partners	217,643	186,803
Deferred compensation	(4,185)	(4,420)
Accumulated other comprehensive loss	(494)	(1,123)
Total partners equity	212,964	181,260
Total liabilities and partners equity	$ 246,223	$ 216,784

See accompanying notes.

Mobile Satellite Ventures LP

Consolidated Statements of Operations

(In Thousands)

	Year ended December 31		
	2003	**2004**	**2005**
Revenues:			
Services and related revenues	$ 25,536	$ 26,664	$ 27,200
Equipment sales and other revenues	1,588	2,343	2,181
Total revenues	27,124	29,007	29,381
Operating expenses:			
Satellite operations and cost of services (exclusive of depreciation and amortization shown separately below)	15,640	16,618	14,264
Next generation expenditures (exclusive of depreciation and amortization shown separately below)	4,268	8,593	18,516
Sales and marketing	1,973	4,762	4,093
General and administrative	4,319	7,350	15,552
Depreciation and amortization	17,928	18,439	16,109
Total operating expenses	44,128	55,762	68,534
Loss from continuing operations before other income (expense)	(17,004)	(26,755)	(39,153)
Other income (expense):			
Rights and services fee from MSV Canada	3,200	3,568	
Equity in losses of MSV Canada	(1,030)	(275)	
Interest income	41	442	3,490
Interest expense	(9,616)	(8,551)	(145)
Management fee from TerreStar			3,621
Other income, net	737	55	61
Loss from continuing operations before cumulative effect of change in accounting principle	(23,672)	(31,516)	(32,126)
Loss from TerreStar discontinued operations	(4,328)	(1,939)	(9,553)
Loss before cumulative effect of change in accounting principle	(28,000)	(33,455)	(41,679)
Cumulative effect of change in accounting principle			724
Net loss	$ (28,000)	$ (33,455)	$ (40,955)

See accompanying notes.

Mobile Satellite Ventures LP

Consolidated Statements of Partners Equity (Deficit)

(In Thousands, except number of units)

	General Partner		Limited Partners			Accumulated Other Comprehensive	Total Partners	
	Number of Units	Amount	Number of Units	Amount	Deferred Compensation	Income (Loss)	Equity (Deficit)	Comprehensive Loss
Balance, December 31, 2002		$	16,642,732	$ 23,259	$	$ 7	$ 23,266	
Issuance of MSV Class A Preferred Units			573,951	3,700			3,700	
Net loss				(28,000)			(28,000)	$ (28,000)
Change in market value of derivative instruments						82	82	82
Foreign currency translation adjustment						(32)	(32)	(32)
Balance, December 31, 2003			17,216,683	(1,041)		57	(984)	
Total, year ended December 31, 2003								$ (27,950)
Issuance of MSV Class A Preferred Units			2,735,317	17,633			17,633	
Conversion of Notes			9,911,234	84,922			84,922	
Issuance of MSV Common Units			4,923,599	145,000			145,000	
Issuance of stock options				4,680	(4,680)			
Amortization of deferred compensation					495		495	
Distribution of warrant in subsidiary				(96)			(96)	
Net loss				(33,455)			(33,455)	$ (33,455)
Change in market value of derivative instruments						(45)	(45)	(45)
Foreign currency translation adjustment						(506)	(506)	(506)
Balance, year ended December 31, 2004			34,786,833	217,643	(4,185)	(494)	212,964	
Total, year ended December 31, 2004								$ (34,006)
Issuance of stock options				8,717	(8,717)			
Amortization of deferred compensation					8,369		8,369	
Distribution to unit holders for TerreStar				869	113		982	
Exercise of employee options			86,852	529			529	
Net loss				(40,955)			(40,955)	$ (40,955)
Change in market value of derivative instruments						(37)	(37)	(37)
Foreign currency translation adjustment						(592)	(592)	(592)
Balance, December 31, 2005		$	34,873,685	$ 186,803	$ (4,420)	$ (1,123)	$ 181,260	
Total, year ended December 31, 2005								$ (41,584)

See accompanying notes.

Mobile Satellite Ventures LP

Consolidated Statements of Cash Flows

(In Thousands)

	Year ended December 31		
	2003	**2004**	**2005**
Operating activities			
Net loss	$ (28,000)	$ (33,455)	$ (40,955)
Loss from TerreStar discontinued operations	4,328	1,939	9,553
Loss from continuing operations	(23,672)	(31,516)	(31,402)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:			
TerreStar discontinued operations	(1,755)	(7,236)	113
Cumulative effect of change in accounting principle			(724)
Depreciation and amortization	17,928	18,439	16,109
Equity in losses of MSV Canada	1,030	275	
Amortization of deferred compensation		495	8,369
Changes in operating assets and liabilities:			
Accounts receivable	(1,062)	917	53
Management fee due from TerreStar			(769)
Inventory	712	708	(12)
Prepaid expenses and other assets	(938)	333	(3,478)
Accounts payable and accrued expenses	307	2,765	672
Other current liabilities	(752)	(120)	9
Accrued interest	7,385	(12,589)	
Deferred revenue	1,274	(2,677)	(988)
Net cash provided by (used in) operating activities	457	(30,206)	(12,048)
Investing activities			
Purchase of Motient Satellite business, net of cash acquired	(2,200)		
Purchase of property and equipment	(967)	(344)	(294)
Purchase of intangible assets and other assets		(500)	
Restricted cash	579	(1)	(6,134)
Purchase of investments			(52,278)
Investing activities of TerreStar discontinued operations	(1,944)	(3,791)	
Net cash used in investing activities	(4,532)	(4,636)	(58,706)
Financing activities			
Proceeds from issuance of Class A Preferred Units	3,700	17,633	
Proceeds from issuance of Common Units		145,000	529
Principal payment on notes payable to investors	(1,575)	(2,370)	
Principal payment on vendor note payable			(206)
Financing activities of TerreStar discontinued operations		4	
Net cash provided by financing activities	2,125	160,267	323
Effect of exchange rates on cash and cash equivalents	134	(66)	1,232
Net (decrease) increase in cash and cash equivalents	(1,816)	125,359	(69,199)
Cash and cash equivalents, beginning of period	5,581	3,765	129,124
Cash and cash equivalents, end of period	$ 3,765	$ 129,124	$ 59,925
Supplemental information			
Cash paid for interest	$ 2,125	$ 21,395	$ 102

Distribution of TerreStar	$		$		$	869
Non-cash financing information						
Equipment obtained through issuance of vendor note	$	1,029	$		$	
Conversion of Notes	$		$	84,922	$	

See accompanying notes.

Mobile Satellite Ventures LP

Notes to Consolidated Financial Statements (Continued)

December 31, 2005

1. Organization and Business

Mobile Satellite Venture LP s predecessor company, Motient Satellite Ventures LLC, was organized as a limited liability company pursuant to the Delaware Limited Liability Company Act on June 16, 2000, by Motient Corporation (Motient). On December 19, 2000, Motient Satellite Ventures LLC changed its name to Mobile Satellite Ventures LLC (MSV LLC). On November 26, 2001, MSV LLC was converted into a limited partnership, Mobile Satellite Ventures LP (MSV or the Company), subject to the laws of the state of Delaware. Concurrent with such conversion, the Company acquired certain assets and liabilities of the Motient and TMI Communications LP (TMI) satellite businesses. In connection with its purchase of TMI s satellite business, the Company acquired a 20% equity interest in Mobile Satellite Ventures (Canada) Inc. (MSV Canada) and a 33 $^{1}/3$% equity interest in Mobile Satellite Ventures Holdings (Canada) Inc. (MSV Canada Holdings). In February 2002, the Company established TerreStar Networks Inc. (TerreStar), a wholly owned subsidiary, to develop business opportunities related to the planned receipt of certain licenses in the S-band radio frequency band (see Note 10). On May 11, 2005, holders of the Company s Limited Partnership units exercised previously distributed rights to acquire all of the shares of TerreStar owned by the Company. As a result of this transaction, TerreStar is no longer a subsidiary of the Company. The assets and liabilities and operating performance of the TerreStar business are classified as TerreStar discontinued operations in the accompanying consolidated financial statements (see Note 10).

The Company provides mobile satellite and communications services to individual and corporate customers in the United States and Canada via its own satellite and leased satellite capacity. The Company s operations are subject to significant risks and uncertainties including technological, competitive, financial, operational, and regulatory risks associated with the wireless communications business. Uncertainties also exist regarding the Company s ability to raise additional debt and equity financing and the ultimate profitability of the Company s proposed next generation integrated network. The Company will require substantial additional capital resources to construct its next generation integrated network.

The Company s current operating assumptions and projections, which reflect management s best estimate of future revenue, capital commitments, and operating expenses, indicate that anticipated operating expenditures through 2006 can be met by cash flows from operations and available working capital; however, the Company s ability to meet its projections is subject to uncertainties, and there can be no assurance that the Company s current projections will be accurate. If the Company s cash requirements are more than projected, the Company may require additional financing.

The type, timing, and terms of financing, if required, selected by the Company will be dependent upon the Company s cash needs, the availability of financing sources, and the prevailing conditions in the financial markets. There can be no assurance that such financing will be available to the Company at any given time or available on favorable terms.

2. Significant Accounting Policies

Basis of Presentation

The consolidated financial statements as of December 31, 2004 and 2005, and for the years ended December 31, 2003 and 2004, include the accounts of the Company and its majority owned subsidiaries prepared in accordance with accounting principles generally accepted in the United States (GAAP). The consolidated financial statements as of December 31, 2005 include the accounts of the Company and its majority-owned subsidiaries and all variable interest entities for which the Company is the primary beneficiary, in accordance with GAAP. All intercompany accounts are eliminated upon consolidation.

Mobile Satellite Ventures LP

Notes to Consolidated Financial Statements (Continued)

December 31, 2005

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Significant estimates affecting the consolidated financial statements include management s judgments regarding the allowance for doubtful accounts, reserves for inventory, future cash flows expected from long-lived assets, accrued expenses, and the fair value of the Company s partnership units for purposes of accounting for options. Actual results could differ from those estimates.

Cash and Cash Equivalents

Cash and cash equivalents include investments such as money market accounts with an original maturity of three months or less.

Investments

The Company s investments are all either United States Treasury securities or obligations of United States government agencies, with original maturities of not more than 12 months. All of the Company s investments are considered held-to-maturity and are reported at amortized cost. The following is a summary of our held-to-maturity securities (in thousands):

	December 31 2005
Amortized cost and net carrying amount	$ 52,278
Gross unrealized loss	(57)
Estimated fair value	$ 52,221

Restricted Cash

In connection with the purchase of the satellite business in 2001, the Company retained a portion of the purchase price, which was restricted to pay Motient s rent obligation to the Company for the lease of office space in the Company s headquarters and to ensure the provision of certain services to the Company by Motient under a transition services agreement. During the year ended December 31, 2003, approximately $531,000 was used to satisfy Motient s obligations under its sublease with the Company, and approximately $51,000 was remitted to Motient for services provided to MSV. As of December 31, 2004, the restricted cash balance for this purpose was $74,000. During March, 2005, all obligations under this transition services agreement were satisfied and all remaining funds were released to Motient and MSV.

On January 10, 2005, and on May 23, 2005, the Federal Communication Commission s (FCC) International Bureau authorized MSV to launch and operate new L-Band mobile satellite services (MSS) systems that will occupy orbital locations that are in addition to the Company s existing orbital slots, and satellites. The International Bureau requires all grants for new systems to be supported by a performance bond. In accordance with this requirement, the Company secured a five-year, $3.0 million bond for each satellite system. The bonds are fully collateralized by a $3.0 million letter of credit for each bond, secured by $6.0 million cash on deposit, which is reflected as restricted cash in the accompanying consolidated balance sheet as of December 31, 2005.

Mobile Satellite Ventures LP

Notes to Consolidated Financial Statements (Continued)

December 31, 2005

Inventory

Inventories consist of finished goods that are communication devices and are stated at the lower of cost or market, average cost method. The Company periodically assesses the market value of its inventory, based on sales trends and forecasts and technological changes, and records a charge to current-period income when such factors indicate that a reduction in net realizable value has occurred.

Property and Equipment

Property and equipment acquired in business combinations are recorded at their estimated fair value on the date of acquisition. Purchases of property and equipment are recorded at cost. Depreciation is computed using the straight-line method over estimated useful lives, ranging from three to ten years. The Company capitalized $1.8 million related to a ground station to which it does not yet hold legal title. Title will pass to the Company upon completion of all payments for that equipment under the related vendor note payable (see Note 5). As of December 31, 2005 the cost, net of accumulated depreciation related to this equipment, was $1.4 million. During the year ended December 31, 2004, MSV initiated inclined orbit of the MSAT-2 satellite, effectively extending its fuel life. In March 2005, the Company completed a formal evaluation of the impact of this action and concluded that the satellite s useful life had been extended by approximately five years to December 2010. The depreciable life of this satellite was extended by five years on a prospective basis. This change in estimate decreased the net loss for the year ended December 31, 2005, by approximately $4.1 million.

Leasehold improvements are amortized over the shorter of the estimated useful life of the asset or the remaining lease term.

Long-Lived Assets

In accordance with Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, the Company reviews its long-lived assets, including property and equipment and intangible assets other than goodwill, whenever events or changes in circumstances indicate that the carrying amount of the assets may not be fully recoverable. To determine the recoverability of its long-lived assets, the Company evaluates the probability that future estimated undiscounted net cash flows will be less than the carrying amount of the assets. If such estimated cash flows are less than the carrying amount of the long-lived assets, then such assets are written down to their fair value. No impairment charges were recorded related to the continuing operations of the Company in the years ended December 31, 2003, 2004, or 2005. The Company s estimates of anticipated cash flows and the remaining estimated useful lives of long-lived assets could be reduced significantly in the future. As a result, the carrying amount of long-lived assets may be reduced in the future.

Goodwill

SFAS No. 142, *Goodwill and Other Intangible Assets*, requires the use of a non-amortization approach to account for purchased goodwill. Under a non-amortization approach, goodwill is not amortized into results of operations, but instead is reviewed for impairment and written down and charged to results of operations only in the periods in which the recorded value of goodwill is determined to be more than its estimated fair value. The Company performs its annual impairment test on December 31 or when certain triggering events occur. No impairment charges were recorded in the years ended December 31, 2003, 2004, or 2005.

Mobile Satellite Ventures LP

Notes to Consolidated Financial Statements (Continued)

December 31, 2005

Concentrations of Credit Risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash and cash equivalents, investments, and accounts receivable. The Company maintained cash balances at financial institutions that exceeded federally insured limits as of December 31, 2004 and 2005. The Company maintains its cash and cash equivalents at high-credit-quality institutions, and as a result, management believes that credit risk related to its cash is not significant.

The Company generally grants credit to customers on an unsecured basis. The Company performs ongoing evaluations of probability of collection of amounts owed to the Company. The Company records an allowance for doubtful accounts equal to the amount estimated to be potentially uncollectible.

The Company s significant customers, as measured by percentage of total revenues, were as follows:

	Year ended December 31		
	2003	2004	2005
Customer A	12%	*	*
Customer B	11%	*	*
Customer C	13%	14%	12%

The Company s significant customers, as measured by percentage of total accounts receivable, were as follows:

	December 31	
	2004	2005
Customer B	12%	*
Customer C	12%	*
Customer D	11%	*

* *Customer did not represent more than 10% for the period presented.*

Fair Value of Financial Instruments

SFAS No. 107, *Disclosure about Fair Value of Financial Instruments*, requires disclosures regarding the fair value of certain financial instruments. The carrying amount of the Company s cash and cash equivalents, investments, restricted cash, accounts receivable, accounts payable, and accrued expenses approximates their fair value because of the short-term maturity of these instruments. The fair value of the vendor note payable approximates fair value as of December 31, 2005.

Stock-Based Compensation

SFAS No. 123, *Accounting for Stock-Based Compensation*, encourages, but does not require, companies to record compensation cost for stock-based employee compensation plans using the fair value method. The Company accounts for employee stock-based compensation using the intrinsic value method as prescribed in Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and its related interpretations. The Company recognizes compensation expense on a straight-line basis over the vesting period. The Company accounts for stock-based compensation awarded to non-employees as prescribed in SFAS No. 123.

Mobile Satellite Ventures LP

Notes to Consolidated Financial Statements (Continued)

December 31, 2005

The following illustrates the effect on net loss if the Company had applied the fair value method of SFAS No. 123 (in thousands):

	Year ended December 31		
	2003	2004	2005
Net loss, as reported	$ (28,000)	$ (33,455)	$ (40,955)
Add stock-based compensation included in reported net loss		495	8,482
Stock-based compensation expense determined under fair value method	(1,080)	(1,952)	(10,709)
Pro forma net loss	$ (29,080)	$ (34,912)	$ (43,182)

The weighted-average fair value of unit options granted during the years ended December 31, 2003, 2004, and 2005 was $0.91, $4.61, and $11.11, respectively. The fair value of the options granted was estimated at the grant date using the Black-Scholes option-pricing model with the following weighted-average assumptions:

	Year ended December 31		
	2003	2004	2005
Expected life	5	5	5
Risk-free rate	3.16%	3.31%	2.91%
Volatility	0%	0%	0%
Dividend yield	0%	0%	0%

Revenue Recognition

The Company generates revenue primarily through the sale of wireless airtime service and equipment. The Company recognizes revenue when the services are performed or delivery has occurred, evidence of an arrangement exists, the fee is fixed and determinable, and collectibility is probable. The Company receives activation fees related to initial registration for retail customers. Revenue from activation fees is deferred and recognized ratably over the customer s contractual service period, generally one year. The Company records equipment sales upon transfer of title and accordingly recognizes revenue upon shipment to the customer.

Next Generation Expenditures

The Company classifies costs it incurs related to the financing, development and deployment of its next generation integrated network as next generation expenditures in the accompanying consolidated statements of operations in order to distinguish these costs from the costs related to its existing satellite-only MSS. Next generation expenditures include costs associated with the Company s next generation integrated network as follows (in thousands):

	Year ended December 31		
	2003	2004	2005
Employee-related costs	$ 2,270	$ 3,425	$ 6,918
Research and development expenses		769	5,010
Professional and consulting expenses	833	2,663	3,941
Legal and regulatory fees	944	1,053	1,413
Patent costs and fees	221	683	1,234

Total next generation expenditures	$ 4,268	$ 8,593	$ 18,516

Mobile Satellite Ventures LP

Notes to Consolidated Financial Statements (Continued)

December 31, 2005

Income Taxes

As a limited partnership, the Company is not subject to income tax directly. Rather, each unit holder is subject to income taxation based on the unit holder s portion of the Company s income or loss as defined in the limited partnership agreement. The Company s Canadian subsidiary and MSV Canada are taxed as corporations in Canada, and as such, are subject to entity-level tax (see Note 11).

Foreign Currency and International Operations

The functional currency of the Company s Canadian subsidiary and MSV Canada is the Canadian dollar. The financial statements of these companies are translated to United States dollars using period-end rates for assets and liabilities, and period-average rates for revenues and expenses. The impact of translation is included as a component of accumulated other comprehensive income in the accompanying consolidated balance sheets. In addition, the Company realized foreign exchange transaction gains, which are a component of other income in the accompanying consolidated statements of operations. For the years ended December 31, 2003, 2004, and 2005, foreign exchange transaction gains were approximately $445,000, $41,000, and $23,000, respectively.

Derivatives

The Company accounts for derivatives in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, which requires the recognition of all derivatives as either assets or liabilities measured at fair value with changes in fair value of derivatives reflected as current-period income (loss) unless the derivatives qualify as hedges of future cash flows. For derivatives qualifying as hedges of future cash flows, the effective portion of changes in fair value is recorded temporarily in equity and subsequently recognized in earnings along with the related effects of the hedged items. Any ineffective portion of hedges is reported in earnings as it occurs.

In the normal course of business, the Company is exposed to the impact of fluctuations in the exchange rate of the Canadian dollar. The Company limits this risk by following an established foreign currency financial management policy. This policy provides for the use of forward and option contracts, which limit the effects of exchange rate fluctuations of the Canadian dollar on financial results. The Company does not use derivatives for trading or speculative purposes. As of December 31, 2003, 2004, and 2005, the Company hedged portions of its forecasted expenses and equipment purchases, payable in Canadian dollars or Euros, totaling approximately $2.8 million, $923,000, and $1.2 million, respectively, by entering into forward contracts and option contracts. In general, these contracts have varying maturities up to, but not exceeding, one year with cash settlements made at maturity based upon rates agreed to at contract inception. All derivatives held by the Company satisfy the hedge criteria of SFAS No. 133. The Company s unrealized gains on these contracts were $81,000, $36,000, and $0 as of December 31, 2003, 2004, and 2005, respectively, which are reflected as a component of accumulated other comprehensive income and an asset within prepaid expenses and other current assets in the accompanying consolidated balance sheets.

Comprehensive Income

Comprehensive income is the change in equity of a business enterprise during a period from transactions and other events and circumstances from non-owner sources. Other comprehensive income refers to revenue, expenses, gains and losses that under GAAP are included in comprehensive income, but excluded from net income. For the period presented, the elements within other comprehensive income, net of tax, consisted of foreign currency translation adjustments and the changes in the market value and expiration of the Company s derivative instruments.

Mobile Satellite Ventures LP

Notes to Consolidated Financial Statements (Continued)

December 31, 2005

The components of accumulated other comprehensive income was as follows (in thousands):

	December 31	
	2004	**2005**
Unrealized gain in market value of derivative instruments	$ 37	$
Foreign currency translation adjustment	(531)	(1,123)
Accumulated other comprehensive loss	$ (494)	$ (1,123)

Investments in MSV Canada and MSV Canada Holdings

For the years ended December 31, 2003 and 2004, the Company accounted for its equity investments in MSV Canada and MSV Canada Holdings pursuant to the equity method of accounting. The carrying value of these investments was $0 at each balance sheet date. Because the Company is obligated to provide working capital financial support to MSV Canada, and rights and services to MSV Canada, the Company recorded losses related to such funding as equity in losses of MSV Canada in the accompanying consolidated statements of operations.

In January 2003, the FASB issued Financial Interpretation No. 46 (FIN 46), *Consolidation of Variable Interest Entities an Interpretation of Accounting Research Bulletin No. 51.* FIN 46 provides a new framework for identifying variable interest entities (VIEs) and determining when a company should include the assets, liabilities, noncontrolling interests, and results of activities of a VIE in its consolidated financial statements.

In general, a VIE is a corporation, partnership, limited-liability corporation, trust, or any other legal structure used to conduct activities or hold assets that either (1) has an insufficient amount of equity to carry out its principal activities without additional subordinated financial support, (2) has a group of equity owners that is unable to make significant decisions about its activities, or (3) has a group of equity owners that does not have the obligation to absorb losses or the right to receive returns generated by its operations.

FIN 46 requires a VIE to be consolidated if a party with an ownership, contractual or other financial interest in the VIE (a variable interest holder) is obligated to absorb a majority of the risk of loss from the VIE s activities, is entitled to receive a majority of the VIE s residual returns (if no party absorbs a majority of the VIE s losses), or both. A variable interest holder that consolidates the VIE is called the primary beneficiary. Upon consolidation, the primary beneficiary generally must initially record all of the VIE s assets, liabilities, and noncontrolling interests at fair value and subsequently account for the VIE as if it were consolidated based on majority voting interest. FIN 46 also requires disclosures about VIEs that the variable interest holder is not required to consolidate but in which it has a significant variable interest.

FIN 46 was effective immediately for VIEs created after January 31, 2003, and was effective January 1, 2005, for VIEs created before February 1, 2003. The provisions of FIN 46, as revised, were adopted as of January 1, 2005, for the Company s interest in MSV Canada, which was created prior to February 1, 2003.

The Company determined that it is the primary beneficiary of MSV Canada as a result of its direct and indirect ownership interests in MSV Canada, its obligation to fund MSV Canada, and the rights and services and capacity agreements between the Company and MSV Canada. The Company is obligated, by contract, to fund MSV Canada. This obligation continues indefinitely, but may terminate upon written agreement between the Company and MSV Canada, or upon one party becoming the beneficial owner of all of the shares of MSV Canada.

Mobile Satellite Ventures LP

Notes to Consolidated Financial Statements (Continued)

December 31, 2005

In accordance with the transition provisions of FIN 46, the assets, liabilities, and noncontrolling interests of newly consolidated VIEs such as MSV Canada were initially recorded at the amounts at which they would have been carried in the consolidated financial statements if FIN 46 had been effective when the Company first met the conditions to be the primary beneficiary of the VIE. The assets, as consolidated by MSV, of MSV Canada consist primarily of its satellite, which has a carrying value of approximately $1.3 million at December 31, 2005 and is included in property, plant, and equipment in the Company s consolidated balance sheet. The consolidated liabilities of MSV Canada consist primarily of its deferred revenue, which has a carrying value of approximately $1.4 million at December 31, 2005 and is included in deferred revenue in the Company s consolidated balance sheet.

The difference between the net amount added to the Company s consolidated balance sheet related to MSV Canada and the Company s previously recognized interest in MSV Canada represented a gain of approximately $724,000 and was recognized as a cumulative effect of change in accounting principle during the year ended December 31, 2005. The adoption of FIN 46 on January 1, 2005 also increased total assets by approximately $3.3 million and total liabilities by approximately $2.6 million. Prior periods were not restated. Had FIN 46 been applied retroactively, the impact on prior periods would not have been material. Neither the assets nor liabilities of MSV Canada have been reported in any of the Company s financial statements prior to January 1, 2005.

Recent Pronouncements

In December 2004, the FASB issued SFAS No. 123(R), *Share-Based Payment*, which is a revision of SFAS No. 123, supersedes APB Opinion No. 25, and amends SFAS No. 95*, Statement of Cash Flows.* SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. The Company will be required to adopt SFAS No. 123(R) using the prospective method, as the Company used the minimum-value method for disclosure purposes. The new standard will be effective for the Company for the year beginning January 1, 2006. As the Company currently accounts for share-based payments using the intrinsic value method as allowed by APB Opinion No. 25, the adoption of the fair value method under SFAS No. 123(R) will have an impact on the Company s results of operations. However, the extent of impact of the adoption of SFAS No. 123(R) cannot be predicted at this time because it will depend on levels of share-based payments granted in the future.

Reclassifications

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

3. Intangible Assets and Goodwill

The Company s intangible assets and goodwill arose primarily as a result of the Company s 2001 acquisitions of the Motient and TMI satellite businesses. These transactions were accounted for using the purchase method of accounting. At the time of the acquisition, the Company allocated the purchase price to the assets acquired and liabilities assumed based on their respective estimated fair values. In addition, under the terms of the purchase agreement, during 2003, the Company paid $2.2 million in contingent consideration to Motient for the provision of services to a customer under a contract assumed by the Company. This payment was accounted for as contingent consideration and was included in the determination of the purchase price when paid to Motient.

Mobile Satellite Ventures LP

Notes to Consolidated Financial Statements (Continued)

December 31, 2005

The Company s identifiable intangible assets consist of the following (in thousands):

	December 31	
	2004	2005
Customer contracts	$ 18,178	$ 18,219
Next generation intellectual property	82,600	82,600
	100,778	100,819
Accumulated amortization	(29,272)	(38,861)
Intangible assets, net	$ 71,506	$ 61,958

Customer contracts are amortized over a period ranging from 4.5 to 5 years. Next generation intellectual property is amortized over periods ranging from 4.5 to 15 years. During the years ended December 31, 2003, 2004, and 2005, the Company recorded approximately $9.4 million, $9.5 million, and $9.5 million, respectively, of amortization expense related to these intangible assets. The Company s next generation intellectual property consists of a combination of licenses and contractual rights to various authorizations, various applications, certain technology, and certain other rights. The changes in the recorded balance of goodwill and customer contracts are primarily the result of the fluctuation of the exchange rate between the United States dollar and Canadian dollar.

Future amortization of intangible assets is as follows as of December 31, 2005 (in thousands):

2006	$ 7,512
2007	5,585
2008	5,585
2009	5,474
2010	5,474
Thereafter	32,328
	$ 61,958

4. Balance Sheet Details

Property and equipment consisted of the following (in thousands):

	December 31	
	2004	2005
Space and ground segments	$ 40,578	$ 48,510
Office equipment and furniture	927	958
Leasehold improvements	435	493
	41,940	49,961
Accumulated depreciation	(27,886)	(39,361)

Property and equipment, net	$ 14,054	$ 10,600

Mobile Satellite Ventures LP

Notes to Consolidated Financial Statements (Continued)

December 31, 2005

Accounts payable and accrued expenses consisted of the following (in thousands):

	December 31	
	2004	**2005**
Accounts payable	$ 2,448	$ 2,342
Accrued expenses	1,369	1,738
Accrued compensation and benefits	2,012	2,502
Accrued interest	342	392
Total accounts payable and accrued expenses	$ 6,171	$ 6,974

5. Long-Term Debt

Notes Payable

In November 2001, the Company issued $55.0 million of Convertible Notes and $26.5 million of Non-Convertible Notes (collectively, the Notes) to finance the acquisitions of the Motient and TMI satellite businesses. In August 2002, the Company issued an additional $3.0 million of Convertible Notes. The Notes were scheduled to mature on November 26, 2006, and bore interest at 10% per annum, compounded semiannually and payable at maturity. In August 2003, the Company repaid approximately $1.6 million of the principal, and all of the accrued interest of approximately $2.1 million, on one of the Non-Convertible Notes.

In April 2004, the Company made payments totaling approximately $2.4 million for principal and $2.6 million for accrued interest, on the Non-Convertible Notes. In November 2004, $25.9 million of Non-Convertible Notes and accrued interest were exchanged for 878,115 Common Units of MSV. The principal balance of $22.6 million and accrued interest of $3.3 million were exchanged for 765,843 and 112,272 Common Units, respectively, and approximately $56,000 of accrued interest was paid in cash.

At the same time, $58.0 million of Convertible Notes were converted into 8,997,074 Class A Preferred Units at a rate of $6.45 per unit. At the date of the transaction, accrued interest on the Convertible Notes was approximately $19.2 million, of which $18.2 million was paid in cash and $1.0 million was exchanged for 36,045 Common Units (see Note 6). At the completion of this transaction, all outstanding principal and interest obligations on the Notes were extinguished.

Vendor Note Payable

In February 2003, the Company entered into an agreement with a satellite communications provider that is a related party (the Vendor) for the construction and procurement of a ground station. The Vendor provided financing for this project totaling approximately $1.0 million at an interest rate of 9.5%. Future payments on the Vendor note payable as of December 31, 2005, are as follows (in thousands):

2006	$ 279
2007	279
2008	233
Total future payments	791
Less: interest	(96)
Principal portion	695
Less: current portion	(225)

Long-term portion of vendor note payable	$ 470

Mobile Satellite Ventures LP

Notes to Consolidated Financial Statements (Continued)

December 31, 2005

6. Partners Equity

Pursuant to the Limited Partnership Agreement of the Company, the partners interests in the Company consisted of MSV Common Units and MSV Class A Preferred Units. The Company s general partner, Mobile Satellite Ventures GP Inc., a Delaware corporation, has no economic interest in the Company and is owned by the Company s limited partners in proportion to their fully diluted interests in the Company.

Profits and losses are allocated to the partners in proportion to their economic interests. Losses allocated to any partner for any fiscal year will not exceed the maximum amount of losses that may be allocated to such partner without causing such partner to have an adjusted capital account deficit at the end of such fiscal year. Any losses in excess of this limitation shall be specially allocated solely to the other partners. Thereafter, subsequent profits shall be allocated to reverse any such losses specially allocated pursuant to the preceding sentence. Except for certain capital proceeds and upon liquidation, the Company shall make distributions as determined by the Board of Directors to the partners in proportion to their respective percentage interests. Upon dissolution of the Company, a liquidating trustee shall be appointed by the Board, or under certain circumstances, the required investor majority, as defined, who shall immediately commence to wind up the Company s affairs. The proceeds of liquidation shall be distributed in the following order:

First, to creditors of the Company, including partners, in the order provided by law

Thereafter, to the partners in the same order as other distributions

The Class A Preferred Units and Common Units had many of the same rights and privileges, except the Class A Preferred Units had preference over the Common Units in receiving proceeds resulting from a distribution of assets in certain circumstances.

In August 2003, the Company received $3.7 million in exchange for the issuance of 573,951 Class A Preferred Units at $6.45 per unit. In March 2004, the Company received $17.6 million in exchange for the issuance in April 2004 of 2,735,317 Class A Preferred Units. In November 2004, the Company s limited partnership agreement was amended to eliminate the distinction between Class A Preferred and Common Units; all Class A Preferred Units were converted to Common Units. Also in November 2004, the Company received $145.0 million in proceeds from its existing investors in exchange for the issuance of 4,923,599 Common Units. Concurrently, $25.9 million of Non-Convertible Notes and accrued interest was exchanged for 878,115 Common Units. The principal balance of $22.6 million and accrued interest of $3.3 million were exchanged for 765,843 and 112,272 Common Units, respectively, and approximately $56,000 of accrued interest were paid in cash. Additionally, $58.0 million of Convertible Notes were converted into 8,997,074 Common Units in accordance with their terms. At the date of the transaction, accrued interest on the Convertible Notes was approximately $19.2 million, of which $18.2 million was paid in cash and $1.0 million was exchanged for 36,045 Common Units.

7. Unit and Stock Option Plan

In December 2001, the Company adopted a unit option incentive plan (Unit Option Incentive Plan), which allows for the granting of options and other unit based awards to employees and directors upon approval by the Board of Directors. Options to acquire units generally vest over a three-year period and have a 10-year life. As of February 2006, the total options or other unit based awards available for grant were 6.5 million.

Beginning in July 2004, the Company granted options with exercise prices at less than the estimated fair market value of the related units on the option s grant date, for which the intrinsic value is recorded as deferred compensation. The deferred compensation is amortized over the options vesting period.

Mobile Satellite Ventures LP

Notes to Consolidated Financial Statements (Continued)

December 31, 2005

Determining the fair value of units underlying employee options (Limited Investor Units) requires complex and subjective judgments. We utilized the market approach to estimate the fair value of Limited Investor Units at each date on which options were granted. The market approach uses an analysis of the observable market price of equity instruments for companies with similar assets and businesses. We estimated the value of a Limited Investor Unit based on the values implied for partnership units (Common Units) held by limited partners, which hold significant interests in the Company, and whose equity securities are publicly traded. In order to derive the amount of the publicly traded security s value attributable to the Common Units, we used the market approach to estimate the value of other equity investments and assets owned by the respective limited partner, and therefore included in the public equity value of those securities. We made adjustments to account for the differences in volatility and liquidity between the publicly traded reference securities and a private Common Unit. We determined the estimated value of a Limited Investor Unit by making further adjustments to account for differences in rights attributable to a Common Unit as compared to those of a Limited Investor Unit. There is inherent uncertainty in making these estimates.

During 2005, the Company s Compensation Committee of the Board of Directors determined that a Change of Control of the Company, as defined in the Unit Option Incentive Plan, occurred. This interpretation was related to Motient s acquisition, in February 2005, of MSV interests previously held by other MSV limited partners. This Change of Control in turn triggered the acceleration of vesting of all of the Company s then outstanding options that were subject to accelerated vesting, and recognition as additional compensation expense of approximately $3.8 million of previously deferred compensation expense associated with these options in the year ended December 31, 2005.

	Options to Acquire Units	Weighted-Average Exercise Price
Options outstanding at December 31, 2002	1,388,500	$ 6.45
Granted	1,621,500	6.45
Canceled	(115,833)	6.45
Options outstanding at December 31, 2003	2,894,167	6.45
Granted	1,497,750	6.81
Canceled	(78,334)	6.45
Options outstanding at December 31, 2004	4,313,583	6.58
Granted	866,000	22.43
Canceled	(110,333)	8.95
Exercised	(82,045)	6.45
Options outstanding at December 31, 2005	4,987,205	9.49

At December 31, 2004 and 2005, 1,807,167 and 3,596,896 options, respectively, were exercisable. The following table summarizes the weighted-average option information as of December 31, 2005:

Range of Exercise Prices	Number Outstanding	Weighted-Average Remaining Life	Weighted-Average Exercise Price	Number Exercisable
$6.45	4,363,705	7.30	$ 6.45	3,542,396
$29.45	592,500	9.43	$ 29.45	54,500

$56.33	31,000	9.92	$	56.33	
$6.45-$56.33	4,987,205	7.12	$	9.49	3,596,896

116

Mobile Satellite Ventures LP

Notes to Consolidated Financial Statements (Continued)

December 31, 2005

8. Related Party Transactions

During the years ended December 31, 2003, 2004, and 2005, the Company incurred approximately $151,000, $1,000, and $0 of administrative expenses related primarily to services provided by Motient. In addition, the Company provided facilities-related services to Motient of approximately $134,000 during the year ended December 31, 2003.

The Company has a rights and services agreement with MSV Canada, under which the Company provides various technical support and other services to MSV Canada, such as allowing access to its intellectual property; providing voice- and data-switching capabilities; providing backup, restoral, and emergency spectrum and satellite capacity; and providing accounting, customer service, and billing services. The Company also leases satellite capacity from MSV Canada pursuant to a lease agreement. The term of the lease extends for 25 years and may be terminated by the Company with one year s notice or by either party in certain circumstances. The amount of the lease payments is determined by the parties periodically based upon the amount of capacity usage by the Company and market rates. Prior to consolidating MSV Canada in 2005 (see Note 2), the capacity fee was included in the satellite operations cost in the accompanying consolidated income statement. During the years ended December 31, 2003, 2004, and 2005, the capacity fee paid by the Company to MSV Canada was approximately $4.9 million, $5.8 million and $6.3 million, respectively. The rights and services fee received by the Company from MSV Canada during the years ended December 31, 2003, 2004 and 2005 was $3.2 million, $3.6 million and $4.5 million, respectively.

During the years ended December 31, 2003, 2004, and 2005, the Company incurred approximately $36,000, $193,000, and $159,000 respectively, of consulting expenses for services provided by a company controlled by a former limited partner and former member of the Company s general partner s board of directors. Certain of the Company s intellectual property was acquired by assignment from entities controlled by this former limited partner of the Company and former member of the Company s general partner s board of directors. In certain circumstances where the Company generates royalties from licensing its ancillary terrestrial component (ATC) intellectual property to third parties, the Company may be required to share a portion of such royalty payments with such person and/or related entities.

During the years ended December 31, 2003, 2004 and 2005, the Company incurred approximately $, $2.5 million and $1.3 million, respectively, of expenses for services provided by Hughes Network Systems LLC. During the years ended December 31, 2003, 2004, and 2005, the Company purchased certain services from Electronic System Products, Inc. of approximately $, $210,000, and $11,000, respectively. Hughes Network Systems LLC and Electronic System Products, Inc., were controlled by SkyTerra Communications, Inc., which indirectly holds limited partnership units in the Company. SkyTerra Communications, Inc., is controlled by Apollo Advisors L.P., an investment company for which two of the directors of the Company s general partner are partners.

The Company leases office space from Telesat, an affiliate of TMI (see Note 9). Under its lease agreement, the Company paid approximately $361,000, $429,000, and $507,000, during the years ended December 31, 2003, 2004, and 2005, respectively. The Company has entered into an operational services agreement with Telesat to provide regular maintenance and tracking of space debris of the MSAT-1 satellite. The Company paid approximately $2.3 million, $2.4 million, and $1.9 million, respectively, in the years ended December 31, 2003, 2004, and 2005. The Company has entered into an agreement with Telesat to obtain telemetry, tracking, and control services for its MSAT-2 satellite. The agreement ends April 30, 2006, with automatic extension for three successive additional renewal periods of one year each. The agreement may be terminated at any time, provided that the Company makes a payment equal to the lesser of 12 months of service or the remaining service fee. For

Mobile Satellite Ventures LP

Notes to Consolidated Financial Statements (Continued)

December 31, 2005

the years ended December 31, 2003, 2004, and 2005 the Company paid approximately $704,000, $1.1 million, and $1.1 million respectively. During the years ended December 31, 2003, 2004, and 2005 the company paid Telesat approximately $66,000, $74,000, and $143,000 respectively for consulting services and $135,000, $130,000, and $135,000, respectively, for administrative support services.

The Company has entered into an agreement whereby it has agreed to provide Infosat Communications Inc., (Infosat) a subsidiary of Telesat and an affiliate of TMI, with satellite services in Canada, a portion of which have been prepaid. As of December 31, 2004 and 2005, the balance of this prepayment was approximately $21.0 million and $21.4 million, respectively. In the years ended December 31, 2003, 2004 and 2005, the Company provided approximately $1.7 million, $2.5 million and $2.3 million, respectively, of services to Infosat pursuant to this agreement, of which $1.4 million, $2.1 million and $2.0 million was paid in cash, respectively, and $0.3 million, $0.4 million and $0.3 million, respectively was applied against the prepayment.

The Company s vendor note payable is held by a related party (see Note 5).

The Company s transactions with TerreStar are related party transactions (see Note 10).

9. Commitments and Contingencies

Leases

As of December 31, 2005, the Company has non-cancelable operating leases, expiring through August 2008. Rental expense, net of sublease income, for the years ended December 31, 2003, 2004, and 2005, was approximately $1.1 million, $1.2 million, and $1.3 million, respectively.

Future minimum lease payments under noncancelable operating leases with initial terms of one year or more are as follows for the years ended December 31 (in thousands):

2006	$ 1,303
2007	1,303
2008	958
	$ 3,564

Office facility leases may provide for periodic escalations of rent, rent abatements during specified periods of the lease, and payment of pro rata portions of building operating expenses, as defined. The Company records rent expense for operating leases using the straight-line method over the term of the lease agreement.

L-Band Space-Based Network Contract

The Company has entered into a firm-fixed price contract with Boeing Satellite Systems Inc. (Boeing) to construct a space-based network that consists of a space segment and ground segment. Boeing is responsible for the comprehensive design, development, construction, manufacturing, testing, and installation of a space-based network, providing satellite launch support and other services related to mission operations and system training.

Under the terms of the contract, MSV will purchase up to three satellites with options for two additional satellites that must be exercised no later than October 2008. Each satellite is contracted to have a mission life of 15 years with a portion of the contract value payable if certain performance incentives are met, paid over the

118

Mobile Satellite Ventures LP

Notes to Consolidated Financial Statements (Continued)

December 31, 2005

intended 15-year operating life. Under the Company s contract with Boeing, Boeing has a first lien on each satellite and related work until title and risk of loss transfers to the Company upon launch (assuming the Company is then current in its payments under the contract). Should the Company become subject to a bankruptcy proceeding before Boeing s lien is released, any interest the Company has in the satellites would secure the Company s obligations to Boeing on a first priority basis.

Future maximum contractual payments under this contract, including all potential performance incentives and related interest payments on the incentives, not including options, are as follows for the years ended December 31, including the performance incentives payable (in thousands):

2006	$ 59,058
2007 through 2009	572,425
2010 through 2011	179,417
Thereafter	271,858
	$ 1,082,758

If the Company elects to terminate the contract in whole or in part, the Company will be subject to termination liability charges that are in excess of contractual payments made prior to the termination date. The additional termination charges vary based upon the portion of the program being terminated and the state of completion of the terminated portion. In-part termination charges are spread over the remaining satellite payment milestones, while a full program termination charge is due upon termination. Generally, these charges range from $3 million to $200 million, declining after 2007. The Company also has an option to defer certain contractual payments after full construction commences with any deferrals to be repaid in full prior to satellite shipment.

Executive Employment Agreements

Certain executives have employment agreements that provide for severance and other benefits, as well as acceleration of option vesting in certain circumstances following a Change of Control. The agreement for one executive entitles that executive to a severance payment equal to 1.5 times the executive s prior-year salary and bonus as well as acceleration of vesting for options currently held by the executive, should the executive terminate employment within the period defined in the agreement (originally six months following a change of control). Based on the February 2005 change in control (see Note 7), this executive could terminate employment and trigger the severance and vesting portions of the executive agreement. The executive has not elected to terminate employment, and accordingly, no amounts have been accrued or expensed in the accompanying consolidated financial statements for this contingency as of December 31, 2005 other than the compensation expense for the intrinsic value of the options that vested during the year ended December 31, 2005.

On February 9, 2006 the Compensation Committee of the Board of Directors approved a modification to the agreement to extend the executive s ability to exercise this change in control provision to February 9, 2007. Under SFAS No.123(R), this modification triggers the recognition of expense of approximately $4.4 million during the quarter ended March 31, 2006.

Other Agreements

In September 2005, the Company entered into an agreement with a third-party that will provide the Company with rights to the use of certain intangible assets in future periods. The Company has prepaid

Mobile Satellite Ventures LP

Notes to Consolidated Financial Statements (Continued)

December 31, 2005

approximately $3.0 million related to this agreement, $2.8 million of which is included in other assets, and $150,000 included in prepaid expenses and other current assets as of December 31, 2005, in the accompanying consolidated balance sheet. The Company has also agreed to provide additional annual payments of approximately $158,000 for the remainder of the contract. The Company is amortizing the costs of the contract ratably over the 20-year term of the agreement.

Litigation and Claims

The Company is periodically a party to lawsuits and claims in the normal course of business. While the outcome of the lawsuits and claims against the Company cannot be predicted with certainty, management believes that the ultimate resolution of the matters will not have a material adverse effect on the financial position or results of operations of the Company.

Contingencies

From time to time, the Company may have certain contingent liabilities that arise in the ordinary course of its business activities. The Company recognizes a liability for these contingencies when it is probable that future expenditures will be made and such expenditures can be reasonably estimated.

Regulatory Matters

During 2001, Motient applied to the Federal Communications Commission (FCC) to transfer licenses and authorizations related to its L-Band MSS system to MSV. This transfer was approved in November 2001. In connection with this application, Motient sought FCC authority to launch and operate a next generation integrated network that will include the deployment of satellites and terrestrial base stations operating in the same frequencies. In February 2003, the FCC adopted general rules based on the Company s proposal to develop a next generation integrated network, subject to the requirement that the Company file an additional application for a specific terrestrial component consistent with the broader guidelines issued in the February 2003 order. These broad guidelines govern issues such as aggregate system interference to other MSS operators, the level of integration between satellite and terrestrial service offerings, and specific requirements of the satellite component that the Company currently meets by virtue of its existing satellite system. While the Company s current satellite assets satisfy these requirements, the Company has signed a contract to construct and deploy more powerful satellites and has relevant regulatory authorizations for these satellites.

The Company believes that the ruling allows for significant commercial opportunity related to the Company s next generation integrated network. Both proponents and opponents of ATC, including the Company, asked the FCC to reconsider the rules adopted in the February 2003 order. Opponents of the ruling advocated changes that could adversely impact the Company s business plans. The Company also sought certain corrections and relaxations of technical standards that would further enhance the commercial viability of the next generation integrated network. The FCC issued an order on reconsideration of the February 2003 order in February 2005. The FCC granted some of the corrections and relaxations of technical standards the Company has advocated and has rejected the requests for changes advocated by opponents of the FCC s February 2003 order. Only Inmarsat Ventures Ltd. has filed a petition for reconsideration of the February 2005 order, which is currently pending. One terrestrial wireless carrier filed an appeal of the FCC s February 2003 order with the United States Court of Appeals. This appeal has been withdrawn.

In November 2003, the Company applied for authority to operate ATC in conjunction with the current and next generation satellites of MSV and MSV Canada. The FCC s International Bureau granted this authorization,

Mobile Satellite Ventures LP

Notes to Consolidated Financial Statements (Continued)

December 31, 2005

in part, in November 2004 and deferred certain issues to the FCC s rule-making proceeding, which was resolved in February 2005. One opponent of the Company s application has asked the FCC to review the Company s ATC authorization. This challenge is pending. The Company has also filed an application to modify its ATC authorization. Only one party has filed comments in opposition to this application. This application is pending. The Company has also received authorization to construct, launch, and operate two satellites from the FCC. MSV Canada has also received authorization from Industry Canada to construct, launch, and operate a satellite. MSV and MSV Canada must meet certain milestone dates for each of these satellites. In January 2006, MSV entered into a contract with Boeing to construct these three satellites as required by the first FCC and Industry Canada milestone requirement for these satellite authorizations.

There can be no assurance that, following the conclusion of the rule-making and the other legal challenges, the Company will have authority to operate a commercially viable next generation integrated network.

10. TerreStar Discontinued Operations

In February 2002, the Company established TerreStar, then a wholly owned subsidiary, to develop business opportunities related to the proposed receipt of certain licenses in the S-band. TMI holds the approval issued by Industry Canada for an S-Band space station authorization and related spectrum licenses for the provision of MSS in the S-band as well as an authorization from the FCC for the provision of MSS in the S-band. These authorizations are subject to FCC and Industry Canada milestones relating to construction, launch, and operational date of the system. TMI plans to transfer the Canadian authorization to an entity that is eligible to hold the Canadian authorization and in which TerreStar and/or TMI will have an interest, subject to obtaining the necessary Canadian regulatory approvals.

The operating losses and cash used by TerreStar related to its activities to acquire rights to assets associated with its proposed receipt of the S-band license. In addition, TerreStar incurred costs related to its contract to construct a satellite system.

Distribution of TerreStar Stock

On December 20, 2004, the Company issued rights (the Rights) to receive all of the 23,265,428 shares of TerreStar Common Stock, which were owned by the Company, to the limited partners of the Company, pro rata in accordance with each limited partner s percentage ownership in the Company. In addition, in connection with this transaction, TerreStar issued warrants to purchase an aggregate of 666,972 shares of TerreStar Common Stock to one of the Company s limited partners, which had an exercise price of $0.21491 per share, which were valued using the Black-Scholes pricing model.

On May 11, 2005, the limited partners of MSV exercised the Rights to acquire shares of Common Stock of TerreStar. As a result of this transaction, MSV divested its ownership interest in TerreStar, thereby affecting a spin-off, which was recorded as a distribution to the limited partners at book value in the accompanying consolidated statement of partners equity (deficit) in the year ended December 31, 2005. Immediately following the spin-off, Motient Ventures Holdings, Inc., a subsidiary of Motient, invested $200 million in TerreStar and thereby gained a majority interest in TerreStar. In May 2005, MSV and TerreStar entered into a management services agreement whereby MSV agreed to provide certain services, to include technical and program management efforts associated with ATC network development as well as administrative support required to accomplish these tasks. TerreStar continues to be a related party, as Motient has a significant ownership interest in both the Company and TerreStar.

Mobile Satellite Ventures LP

Notes to Consolidated Financial Statements (Continued)

December 31, 2005

Subsequent to the spin-off, as MSV no longer has an ownership interest in TerreStar and is not the primary economic beneficiary of TerreStar, the accompanying consolidated financial statements do not include the assets or liabilities of TerreStar, which were approximately $9.7 million and $10.4 million, respectively, on May 11, 2005. The assets of TerreStar consisted primarily of intangible assets related to its S-band spectrum and satellite construction in progress. The liabilities of TerreStar consisted primarily of its obligations under the satellite construction contract and amounts payable to the Company. The accompanying consolidated financial statements include the results of TerreStar since its inception through May 11, 2005, which are presented as discontinued operations in the accompanying consolidated statements of operations and as TerreStar assets and liabilities, discontinued, in the accompanying December 31, 2004 consolidated balance sheet.

11. Income Taxes

The Company s Canadian subsidiaries pay a Canadian provincial capital tax that is included in general and administrative expenses in the accompanying consolidated statements of operations. The components of net loss by country are as follows (in thousands):

	Year ended December 31		
	2003	**2004**	**2005**
United States	$ (23,760)	$ (30,228)	$ (37,795)
Canadian	(4,240)	(3,227)	(3,160)
Total net loss	$ (28,000)	$ (33,455)	$ (40,955)

Deferred income tax balances related to the Canadian entities result principally from temporary differences in the recognition of certain revenue and expense items for financial and tax reporting purposes, as well as net operating loss (NOL) carry forwards from operations as follows (in thousands):

	December 31	
	2004	**2005**
Net operating losses	$ 6,968	$ 5,721
Net differences in the treatment of book and tax differences	283	1,717
Valuation allowance	(7,251)	(7,438)
Deferred tax assets, net	$	$

The Company s Canadian subsidiaries are taxed as corporations in Canada. As of December 31, 2005, the Company had approximately $15.8 million of losses available to be applied against future taxable income. These losses will begin to expire in 2008.

In assessing the realizability of future income tax assets, management considers whether it is more likely than not that some or the entire future income tax asset will be realized. The ultimate realization of the future income tax asset is dependent on the generation of future taxable income during the periods in which the NOL carry forwards are available. Management considers projected future taxable income, the scheduled reversal of future income tax liabilities, and available tax planning strategies that can be implemented by the Company in making this assessment. Based on the level of historical taxable income and projections for future taxable income over the period in which the NOL carry forwards are available to reduce income taxes payable, management has established a full valuation allowance against the Company s deferred tax assets.

Mobile Satellite Ventures LP

Notes to Consolidated Financial Statements (Continued)

December 31, 2005

12. Retirement Plan

The Company has a tax-deferred savings plan (the Plan) that qualifies under Section 401(k) of the Internal Revenue Code (IRC). United States employees are eligible to participate in the Plan upon employment and attainment of age 21. Such employees may contribute a percentage of their income, subject to limitation of the IRC. The Plan contains provisions that allow the Company to make discretionary contributions and matching contributions. The Company made contributions of approximately $101,000, $171,000, and $235,000 in the years ended December 31, 2003, 2004, and 2005 respectively. Employees vest immediately in the Company s contributions.

13. Subsequent Events

Leases

In February 2006, the Company entered into an amended and restated operating lease agreement that provided for, among other things, an extension of term and expansion of its premises in Reston, Virginia. As a result of this amendment, the Company s lease obligations as disclosed in Note 9 have increased by the following amounts (in thousands):

2006	$ 602
2007	743
2008	1,067
2009	1,703
2010	1,751
Thereafter	298
	$ 6,164

Grant of Restricted Units

On February 9, 2006, the Compensation Committee of the Board of Directors approved the issuance of 50,000 Restricted Units (the Award) to an executive. The Award will vest over five years; 20,000 units will vest after the second anniversary of the grant date and 10,000 units will vest annually thereafter, subject to certain acceleration provisions. As the Award vests, the Company is obligated to issue to the executive units (or successor equity) or pay in cash an amount equal to the fair value of the related MSV units or stock, depending on the occurrence of certain events in the future. The Company intends to account for the Award under the provisions of SFAS No. 123(R), which will require the recognition of a liability and expense based on the fair value of the vested Award, each reporting period.

INDEPENDENT AUDITORS REPORT

To the Board of Managers and Members of

Hughes Network Systems, LLC

Germantown, Maryland

We have audited the accompanying consolidated balance sheet of Hughes Network Systems, LLC and subsidiaries (the Company) as of December 31, 2005, and the related consolidated statements of operations, changes in equity, and cash flows for the period from April 23, 2005 to December 31, 2005. We have also audited the accompanying combined consolidated balance sheet of Hughes Network Systems (the Predecessor) as of December 31, 2004, and the related combined consolidated statements of operations, changes in equity, and cash flows for the period from January 1, 2005 to April 22, 2005, and the years ended December 31, 2004 and 2003. These financial statements are the responsibility of management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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.

As discussed in Note 4, the accompanying combined consolidated financial statements of the Predecessor have been prepared from the separate records maintained by the Predecessor, a component of the DIRECTV Group, Inc., and may not necessarily be indicative of the conditions that would have existed or the results of operations if the Predecessor had been operated as an unaffiliated company. Portions of certain income and expenses represent allocations made from The DIRECTV Group, Inc. applicable to The DIRECTV Group, Inc. as a whole.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2005, and the results of its operations and its cash flows for the period from April 23, 2005 to December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such combined consolidated financial statements present fairly, in all material respects, the financial position of the Predecessor as of December 31, 2004, and the results of its operations and its cash flows for the period from January 1, 2005 to April 22, 2005, and the years ended December 31, 2004 and 2003, in conformity with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP

Baltimore, Maryland

March 27, 2006

HUGHES NETWORK SYSTEMS

STATEMENTS OF OPERATIONS

(Dollars in Thousands)

	Consolidated Successor April 23, 2005 December 31,	Combined Consolidated Predecessor January 1, 2005 April 22,	Years ended December 31,	
	2005	**2005**	**2004**	**2003**
Revenues				
Services	$ 303,467	$ 121,917	$ 383,519	$ 328,989
Hardware sales	280,001	101,524	405,831	422,159
Total Revenues	583,468	223,441	789,350	751,148
Operating Costs and Expenses				
Cost of services	209,226	88,092	290,365	299,796
Cost of hardware products sold	206,431	86,467	338,650	389,513
Research and development	19,102	18,194	55,694	34,073
Sales and marketing	47,077	27,108	72,564	75,420
General and administrative	33,581	23,034	85,538	89,887
Restructuring costs	1,443	1,625	10,993	4,113
SPACEWAY impairment provision			1,217,745	
Asset impairment provision			150,300	
Total Operating Costs and Expenses	516,860	244,520	2,221,849	892,802
Operating income (loss)	66,608	(21,079)	(1,432,499)	(141,654)
Interest expense	(22,744)	(1,631)	(7,466)	(12,197)
Other income (expense), net	2,707	187	6,481	(3,175)
Net Income (Loss)	$ 46,571	$ (22,523)	$ (1,433,484)	$ (157,026)

Reference should be made to the Notes to the Financial Statements.

125

HUGHES NETWORK SYSTEMS

BALANCE SHEETS

(Dollars in Thousands)

	Consolidated Successor	Combined Consolidated Predecessor
	December 31,	
	2005	2004
ASSETS		
Current Assets		
Cash and cash equivalents	$ 113,267	$ 14,807
Short-term investments	13,511	
Receivables, net	200,982	173,013
Inventories	73,526	99,892
Prepaid expenses and other	48,672	42,192
Total Current Assets	449,958	329,904
Property, net	259,578	226,744
Capitalized software costs, net	16,664	
Other assets	30,324	30,236
Total Assets	$ 756,524	$ 586,884
LIABILITIES AND EQUITY		
Current Liabilities		
Accounts payable	$ 51,294	$ 72,966
Short-term borrowings	29,616	52,757
Accrued liabilities	130,601	128,190
Due to affiliates	18,960	3,098
Total Current Liabilities	230,471	257,011
Long-term debt	342,406	37,465
Due to affiliates long-term	8,967	17,464
Other long-term liabilities	3,494	6,118
Total Liabilities	585,338	318,058
Commitments and contingencies		
Minority interests	6,594	7,328
Equity		
Predecessor owner s equity		267,044
Class A membership units	125,768	
Class B membership units		
Retained earnings	46,571	
Subtotal equity	172,339	267,044
Accumulated other comprehensive loss	(7,747)	(5,546)

Total Equity	164,592	261,498
Total Liabilities and Equity	$ 756,524	$ 586,884

Reference should be made to the Notes to the Financial Statements.

HUGHES NETWORK SYSTEMS

STATEMENTS OF CHANGES IN EQUITY

(Dollars in Thousands)

	Equity	Consolidated Successor Retained Earnings	Subtotal Equity	Accumulated Other Comprehensive Income (Loss)	Total Equity	Comprehensive Income (Loss)
Predecessor						
Balance at January 1, 2003	$ 1,913,619		$ 1,913,619	$ (15,277)	$ 1,898,342	
Net loss	(157,026)		(157,026)		(157,026)	$ (157,026)
Net capital contributions from parent	199,506		199,506		199,506	
Foreign currency translation adjustments				5,645	5,645	5,645
Unrealized holding gains on securities				589	589	589
Comprehensive loss						$ (150,792)
Balance at December 31, 2003	1,956,099		1,956,099	(9,043)	1,947,056	
Net loss	(1,433,484)		(1,433,484)		(1,433,484)	$ (1,433,484)
Net capital distributions to parent	(255,571)		(255,571)		(255,571)	
Foreign currency translation adjustments				2,868	2,868	2,868
Unrealized holding gains on securities				629	629	629
Comprehensive loss						$ (1,429,987)
Balance at December 31, 2004	267,044		267,044	(5,546)	261,498	
Net loss	(22,523)		(22,523)		(22,523)	$ (22,523)
Net capital distributions to parent	(108,868)		(108,868)		(108,868)	
Foreign currency translation adjustment				6,050	6,050	6,050
Unrealized holding losses on securities				(270)	(270)	(270)
Comprehensive loss						$ (16,743)
Balance at April 22, 2005	135,653		135,653	234	135,887	
Successor						
Net income		$ 46,571	46,571		46,571	$ 46,571
Capital distribution to parent	(10,000)		(10,000)		(10,000)	
Equity plan compensation	115		115		115	
Foreign currency translation adjustment				(7,865)	(7,865)	(7,865)
Unrealized holding losses on securities				(116)	(116)	(116)
Comprehensive income						$ 38,590
Balance at December 31, 2005	$ 125,768	$ 46,571	$ 172,339	$ (7,747)	$ 164,592	

Reference should be made to the Notes to the Financial Statements.

HUGHES NETWORK SYSTEMS

STATEMENTS OF CASH FLOWS

(Dollars in Thousands)

	Consolidated Successor	Combined Consolidated Predecessor		
	April 23, 2005 December 31, 2005	January 1, 2005 April 22, 2005	Years ended December 31, 2004	2003
Cash Flows from Operating Activities				
Net income (loss)	$ 46,571	$ (22,523)	$ (1,433,484)	$ (157,026)
Adjustments to reconcile net income (loss) to cash flows from operating activities:				
Depreciation and amortization	27,209	13,734	96,973	94,839
Amortization of debt issuance costs	970	60		
Equity plan compensation expense	115			
Equity in (gains) losses from unconsolidated affiliates	(26)			1,297
(Gain) loss on disposal of assets			(5,804)	6,100
SPACEWAY impairment provision			1,217,745	
Asset impairment provision			150,300	
Other	(198)			
Change in other operating assets and liabilities:				
Receivables, net	(37,886)	5,438	41,471	89,784
Inventories	22,987	2,738	22,863	21,916
Prepaid expenses and other	(1,681)	(3,965)	8,197	(6,538)
Accounts payable	11,093	(31,721)	9,920	5,022
Accrued liabilities and other	24,298	(16,457)	(20,445)	(4,822)
Net Cash Provided by (Used in) Operating Activities	93,452	(52,696)	87,736	50,572
Cash Flows from Investing Activities				
Change in restricted cash	(4,860)	1,978	(1,152)	(1,881)
Purchases of short-term investments	(13,544)			
Expenditures for property	(53,694)	(22,912)	(122,158)	(195,456)
Proceeds from sale of property	1,263		17,016	
Expenditures for capitalized software	(12,871)	(3,273)	(16,673)	(20,073)
Other	224	(958)	148	591
Net Cash Used in Investing Activities	(83,482)	(25,165)	(122,819)	(216,819)
Cash Flows from Financing Activities				
Net (decrease) increase in notes and loans payable	(3,309)	871	(7,955)	(32,889)
(Distributions to) additional contributions from parent, net		(108,868)	52,429	199,506
Long-term debt borrowings	18,882	327,775	33,245	46,803
Repayment of long-term debt	(31,222)	(30,141)	(70,659)	(77,625)
Debt issuance costs		(10,482)		
Net Cash (Used in) Provided by Financing Activities	(15,649)	179,155	7,060	135,795
Effect of exchange rate changes on cash and cash equivalents	(2,824)	5,669	865	1,237
Net (decrease) increase in cash and cash equivalents	(8,503)	106,963	(27,158)	(29,215)

Cash and cash equivalents at beginning of the period	121,770	14,807	41,965	71,180
Cash and cash equivalents at end of the period	$ 113,267	$ 121,770	$ 14,807	$ 41,965
Supplemental Cash Flow Information				
Cash paid for interest	$ 22,138	$ 1,496	$ 10,422	$ 7,443
Cash paid for foreign income taxes	$ 1,121	$ 208	$ 732	$ 2,722
Non-cash investing and financing activities:				
Property transferred to parent			$ 308,000	

Reference should be made to the Notes to the Financial Statements.

128

HUGHES NETWORK SYSTEMS

NOTES TO THE FINANCIAL STATEMENTS

Note 1: Description of the Transactions

On April 22, 2005, Hughes Network Systems, LLC (HNS or the Company) consummated the transactions contemplated by the Contribution and Membership Interest Purchase Agreement dated December 3, 2004, as amended (the December 2004 Agreement) with SkyTerra Communications, Inc. (SkyTerra), The DIRECTV Group, Inc. (DTVG), and DTV Networks, Inc., formerly known as Hughes Network Systems, Inc. (DTV Networks). Pursuant to the terms of the December 2004 Agreement, DTV Networks contributed substantially all of the assets and certain liabilities of its very small aperture terminal (VSAT), mobile satellite, and terrestrial microwave businesses (collectively, the Business) along with certain portions of its investment in SPACEWAY, a satellite-based broadband network system that is under development (SPACEWAY) (see Note 14). Pursuant to the terms of the December 2004 Agreement, the Company paid DTV Networks $190.7 million, subject to certain adjustments at closing based principally upon the value of HNS working capital (as defined in the December 2004 Agreement). In connection with the consummation of the January 2006 Transaction on January 1, 2006, as described below, the Company paid DTV Networks $10.0 million to resolve a dispute with respect to the working capital and other purchase price adjustments. Pursuant to the terms of the December 2004 Agreement, DTVG retained responsibility for all of the pre-closing domestic and international tax liabilities of the Company and is entitled to any refunds. The Company has recorded a liability in due to affiliates in the balance sheet for the estimated amount the Company may be required to pay to DTVG resulting from prepaid taxes exceeding tax liabilities as of April 22, 2005.

To finance, among other things, the $190.7 million payment made to DTV Networks, on April 22, 2005, the Company issued $325.0 million of term indebtedness and obtained a $50.0 million revolving credit facility, which was undrawn at April 22, 2005. Immediately following the payment by the Company, SkyTerra acquired 50% of the Class A membership units of the Company from DTV Networks for $50.0 million in cash and 300,000 shares of SkyTerra s common stock. The events of April 22, 2005 described herein are collectively referred to as the April 2005 Transaction.

As a result of entering into the December 2004 Agreement, HNS performed an impairment analysis and determined that its net assets were valued at $265.9 million, which was $150.3 million less than the book value of the net assets. This differential represented an impairment loss (the Asset Impairment Provision) that HNS recognized in the fourth quarter of 2004. In recording the Asset Impairment Provision of $150.3 million, HNS provided a reserve of $5.0 million against certain remaining contract obligations with a vendor that was formerly a related party and allocated the remaining $145.3 million to long-term assets of the business other than certain real estate assets with an appreciated market value, VSAT operating lease assets that are recoverable from customer leases, and the remaining net assets of SPACEWAY, which had previously been adjusted to fair value as described in Note 14. The Asset Impairment Provision related to the VSAT business segment was $125.7 million, and the balance of $24.6 million was charged to the Company s Telecom Systems segment.

On November 10, 2005, SkyTerra, through its wholly owned subsidiary Hughes Communications, Inc. (HCI), entered into the Membership Interest Purchase Agreement (the November 2005 Agreement) with DTVG to acquire the remaining 50% of the Class A membership interests of the Company for $100.0 million in cash. The closing of this transaction (the January 2006 Transaction) occurred on January 1, 2006. On December 31, 2005, SkyTerra contributed to HCI the Class A membership interests it acquired in connection with the April 2005 Transaction. As a result, as of January 1, 2006, the Company is a wholly owned subsidiary of HCI. In connection with the closing of the January 2006 Transaction, the parties to the November 2005 Agreement entered into agreements governing the relationship between and among the parties after the closing (see Note 17). On February 21, 2006, SkyTerra distributed shares of HCI stock to each SkyTerra shareholder. As of that date, SkyTerra no longer owns any HCI stock and accordingly no longer has an equity interest in the Company.

HUGHES NETWORK SYSTEMS

NOTES TO THE FINANCIAL STATEMENTS (Continued)

Note 2: Organization

The Company is a Delaware limited liability company. The Limited Liability Company Agreement of Hughes Network Systems, LLC (the LLC Agreement) provides for two classes of membership units. The Class A membership units, which have voting rights, are purchased by investors in the Company. The Class B membership units, which do not have voting rights, are available for grant to employees, officers, directors, and consultants in exchange for the performance of services. HCI serves as the Managing Member of the Company, as defined in the LLC Agreement. As of December 31, 2005, there were 95,000 Class A membership units outstanding and 4,750 Class B membership units outstanding.

Note 3: Description of Business

The Company is a leading provider of network services that utilize VSATs to distribute signals via satellite. The Company s services and products serve a variety of consumer and enterprise customers worldwide. VSAT networks utilize satellite communications as a means of connecting participants in private and shared data networks and are typically used by enterprises with a large number of geographically dispersed locations to provide reliable, scalable, and cost-effective applications such as credit card verification, inventory tracking and control, and video teleconferencing. The Company also operates a satellite-based consumer service that provides broadband Internet access.

The Company also provides hardware and point-to-multipoint networking systems solutions to customers with mobile satellite telephony systems or terrestrial microwave radio transmission systems. These services are generally provided on a contract or project basis and may involve the use of proprietary products engineered by the Company. As with the VSAT systems, the Company also provides ongoing network support services under contracts with its mobile satellite or terrestrial transmission systems customers.

SPACEWAY is a next-generation digital satellite communications system designed to utilize high-capacity Ka-band satellites and spot beam technology to offer site-to-site network connectivity at improved data rates over that of existing Ku-band satellite connections. The system is designed to offer full-mesh, single-hop connectivity between user terminals by means of an end-to-end digital communications system. As further discussed in Note 14, the business plan for SPACEWAY was changed in the third quarter of 2004, a significant provision for impairment of the SPACEWAY assets was recognized, and the remaining net assets of SPACEWAY were adjusted to their fair value. Completion of the revised development plan is expected to result in the launch of the SPACEWAY 3 satellite in early 2007 and commercial service commencement approximately three to six months after the satellite is placed in its orbital slot.

Note 4: Basis of Presentation and Summary of Significant Accounting Policies

Basis of Presentation

The financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States of America and include the assets, liabilities, operating results, and cash flows of the Company, including its domestic and foreign subsidiaries that are more than 50% owned or otherwise controlled by the Company. Pursuant to the December 2004 Agreement, DTV Networks prepared carved-out historical financial statements for the Business and SPACEWAY as if they comprised a separate limited liability company and on the basis of presentation described herein. The 2003 and 2004 financial results and the 2005 financial results for the period January 1, 2005 to April 22, 2005 of DTV Networks included herein are referred to as Predecessor results, and the financial results for the period April 23, 2005 to December 31, 2005 of HNS included herein are referred to as Successor results. Carryover of DTV Networks basis has been used to establish the beginning balances of the Company s accounts. As of January 1, 2006, the Company became a wholly owned subsidiary of HCI, the Company s financial statements will be consolidated by HCI, and

HUGHES NETWORK SYSTEMS

NOTES TO THE FINANCIAL STATEMENTS (Continued)

the basis of the Company s assets and liabilities will be adjusted to their fair values. Management believes the assumptions regarding the financial statements are reasonable. All accounts and transactions among consolidated entities have been eliminated.

DTV Networks participated in DTVG s centralized cash management system. DTVG used concentration accounts to sweep DTV Networks cash receipts to its banks and provided cash to DTV Networks as needed for operating purposes. Accordingly, DTVG had provided funding for the working capital and capital expenditure requirements of DTV Networks in the form of equity capital contributions having no formal repayment terms or interest requirements. The net cash activity associated with DTVG is presented separately as a distribution to or contribution from Parent in the accompanying statements of changes in equity.

DTVG performed certain functions for DTV Networks that are now separately performed by the Company as a stand-alone entity. The functions performed by DTVG that have been replaced by the Company include the treasury, audit, and income tax functions. The Predecessor financial statements reflect the Company s estimate of the costs that were incurred by DTVG on the Company s behalf for these functions. In addition, DTVG performed the Company s risk management function and DTV Networks participated in certain employee benefit programs that were administered by DTVG, and DTVG allocated to DTV Networks its portion of the costs of these functions and programs. Costs for these functions and programs were allocated on a specific identification basis or a methodology consistent with the nature of the service, such as payroll or headcount. Management believes the allocation methodology is reasonable.

Subsequent to the April 2005 Transaction, the Company established its own risk management and employee benefit programs. The costs of the services performed by DTVG for DTV Networks and the allocations of risk management and employee benefit program costs reflected in the financial statements amounted to $11.3 million for the period January 1, 2005 through April 22, 2005, $35.9 million in 2004, and $41.5 million in 2003.

Although management believes that the actual costs the Company incurs on a stand-alone basis are not materially different than the costs reflected in the Predecessor financial statements, the Predecessor financial information included herein may not reflect the financial position, operating results, changes in equity, and cash flow of the Company had it been a separate stand-alone entity during the periods presented.

Market Concentrations and Credit Risk

The Company provides services and extends credit to a number of communications equipment customers, service providers, and a large number of consumers, both in the United States and around the world. The Company monitors its exposure to credit losses and maintains, as necessary, allowances for anticipated losses. No single customer accounted for more than 7% of total annual revenues in any of the periods presented. Financial instruments which potentially subject the Company to a concentration of credit risk consist of cash, cash equivalents, and short-term investments. Although the Company maintains cash balances at financial institutions that exceed federally insured limits, these balances are placed with high credit quality financial institutions.

Use of Estimates in the Preparation of the Financial Statements

The preparation of the financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect amounts reported herein. Management bases its estimates and assumptions on historical experience and on various other factors that are believed to be reasonable under the circumstances. Due to the inherent uncertainty involved in making estimates, actual results reported in future periods may be affected by changes in those estimates.

HUGHES NETWORK SYSTEMS

NOTES TO THE FINANCIAL STATEMENTS (Continued)

Revenue Recognition

Service revenues and hardware sales, excluding lease revenues described below, are recognized as services are rendered or products are installed or shipped to third-party installers and as title passes to those customers**.** In situations where customer offerings represent a bundled arrangement for both services and hardware, revenue elements are separated into their relevant components (services or hardware) for revenue recognition purposes. The Company offers a rebate to qualifying new consumer subscribers and records a reduction in revenue in the same period the related sale occurs based on an estimate of the number of rebates that will be redeemed. This estimate is based on historical experience and actual sales during the promotion.

Hardware sales totaling $36.2 million, $19.2 million, $58.0 million, and $55.8 million in the period April 23, 2005 through December 31, 2005, the period January 1, 2005 through April 22, 2005, and the years ended December 31, 2004 and 2003, respectively, represent annual revenues under VSAT hardware operating leases with customers which are funded by third-party financial institutions and for which the Company has retained a financial obligation to the financial institution. At the inception of the operating lease, the Company receives cash from the financial institution for a substantial portion of the aggregate lease rentals and, for those transactions in which the Company has retained a continuing obligation to the financing institution to indemnify it from losses it may incur (up to the original value of the hardware), recognizes a corresponding liability to the financial institution for those transactions.

Hardware lease revenues are recognized over the term of the operating lease. The Company capitalizes the book value of the installed equipment used to provide services to the customer as VSAT operating lease hardware and depreciates these costs over the term of the customer lease agreement. For transactions in which the Company has not retained a continuing obligation to the financing institution, hardware revenues are recognized at the inception of the transaction.

Revenues are also earned from long-term contracts for the sale of mobile satellite communications systems. Sales under these long-term contracts are recognized using the percentage-of-completion (cost-to-cost) method of accounting. Under this method, sales are recorded equivalent to costs incurred plus a portion of the profit expected to be realized, determined based on the ratio of costs incurred to estimated total costs at completion. Profits expected to be realized on long-term contracts are based on estimates of total sales value and costs at completion. These estimates are reviewed and revised periodically throughout the lives of the contracts, and adjustments to profits resulting from such revisions are recorded in the accounting period in which the revisions are made. Estimated losses on contracts are recorded in the period in which they are identified.

Income Taxes

HNS is a limited liability company, and as such, U.S. Federal and domestic state income taxes (in the states which tax limited liability companies as partnerships) are the direct responsibility of its members. DTV Networks participates in the filing of consolidated U.S. Federal and domestic state income tax returns with DTVG, and DTV Networks incurred operating losses in each of the last seven years. Under the terms of the December 2004 Agreement, DTVG retained the tax benefits from these net operating losses and has responsibility for all of the pre-closing domestic and international income tax liabilities of DTV Networks. Foreign income taxes for HNS consolidated foreign subsidiaries are reflected in the financial statements in other income (expense), net.

Cash and Cash Equivalents

The Company considers all highly liquid investments with original maturities of ninety days or less to be cash equivalents. While a component of DTVG, DTV Networks participated in the centralized cash management system of DTVG, wherein cash receipts were transferred to and cash disbursements were funded by DTVG on a

HUGHES NETWORK SYSTEMS

NOTES TO THE FINANCIAL STATEMENTS (Continued)

daily basis. The amount of cash and cash equivalents presented on the Predecessor balance sheet represents amounts held outside of the DTVG cash management system.

Short-term Investments

The Company considers all debt securities with original maturities of more than ninety days but less than one year as short-term investments and determines the appropriate classification of such securities in accordance with Statement of Financial Accounting Standards No. 115, Accounting for Certain Investments in Debt and Equity Securities. All short-term investments at December 31, 2005 have been classified as available-for-sale. Available-for-sale securities are stated at fair value with the related unrealized gains and losses reported as a component of accumulated other comprehensive income (loss). At December 31, 2005, the cost basis and fair value of available-for-sale securities was $13.5 million. The Company had no short-term investments at December 31, 2004.

Restricted Cash

Restricted cash deposits expiring within one year are included in prepaid expenses and other, and deposits expiring beyond one year are included in other assets in the accompanying balance sheets. At December 31, 2005, the Company had $4.9 million of restricted cash which secures certain letters of credit. All of the underlying letters of credit expire in 2006. Restrictions on the cash will be removed as the letters of credit expire. In connection with the April 2005 Transaction, restricted cash held at April 22, 2005 was distributed to DTV Networks. At December 31, 2004, restricted cash of $10.5 million represented cash deposited to secure certain letters of credit and obligations of DTV Networks and DTV Networks majority-owned foreign subsidiaries.

Receivables, Net

Receivables, net include contracts in process that are stated at costs incurred plus estimated profit, less amounts billed to customers and advances and progress payments applied. Advances and progress billings are offset against contract-related receivables, as appropriate.

Inventories

Inventories are stated at the lower of cost or market, principally using standard costs adjusted to reflect actual based on variance analyses performed throughout the year. Cost of sales for services are based on actual costs incurred for service cost elements.

Prepaid Expenses and Other

Prepaid expenses and other includes subscriber acquisition costs (SAC) incurred to acquire new consumer subscribers. SAC consists of dealer and customer service representative commissions on new installations, and, in certain cases, the cost of hardware and installation provided to customers at the inception of service. SAC is deferred when a customer commits to a 12- to 15-month service agreement, and amounts deferred are amortized to expense over the commitment period as the related service revenue is earned. Customers who receive hardware and installation under these service agreements have a higher monthly service rate than is charged to customers who purchase their equipment outright at the inception of service. The Company monitors the recoverability of subscriber acquisition costs and is entitled to an early termination fee (secured by customer credit card information obtained up-front) if the subscriber cancels service prior to the end of the commitment period. The recoverability of deferred subscriber acquisition costs is reasonably assured through the increased monthly service fee charged to customers, the ability to recover the equipment, or the ability to charge an early termination fee.

HUGHES NETWORK SYSTEMS

NOTES TO THE FINANCIAL STATEMENTS (Continued)

Property and Depreciation

Property is carried at cost, which includes construction costs and capitalized interest for qualifying projects. Depreciation is computed generally using the straight-line method over the estimated useful lives of the assets. Leasehold improvements are amortized over the lesser of the life of the asset or term of the lease. See Note 1 regarding an allocation to property of the Asset Impairment Provision in December 2004.

Goodwill and Other Intangible Assets

Goodwill is recognized in accordance with Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets . Goodwill resulting from business acquisitions represents the excess of the purchase price over the net assets of the acquired businesses. Goodwill is not amortized but is subject to write-down, as needed, based upon an impairment analysis that occurs at least annually, or sooner if an event occurs or circumstances change that would more likely than not result in an impairment loss. HNS performs its annual impairment analysis in the fourth quarter of each year. If an impairment loss results from the annual impairment test, the loss will be recorded as a charge to operations. There was no goodwill balance as of December 31, 2004 and 2005 as goodwill was written-off as a result of allocating a portion of the Asset Impairment Provision at December 31, 2004, described in Note 1.

Debt issuance costs are amortized based upon the lives of the associated debt obligations. Debt issuance cost amortization is included in interest expense. Debt issuance costs at December 31, 2005, net of accumulated amortization of $1.0 million, relate to costs incurred in connection with the term indebtedness issued in connection with the April 2005 Transaction and are included in other assets. There were no deferred debt issuance costs at December 31, 2004.

Software Development Costs

Software development costs are capitalized in accordance with SFAS No. 86, Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed. Capitalized software development costs are amortized using the straight-line method over their estimated useful lives, not in excess of five years. Software program reviews are conducted at least annually to ensure that capitalized software development costs are not impaired and that costs associated with programs that do not generate revenues are expensed. Accumulated amortization of software development costs was $0.1 million at December 31, 2005. There was no accumulated amortization at December 31, 2004, as software development costs as of that date were written off as a result of the Asset Impairment Provision and the SPACEWAY impairment provision described in Notes 1 and 14, respectively.

Valuation of Long-Lived Assets

The Company evaluates the carrying value of long-lived assets to be held and used, other than goodwill, when events and circumstances warrant such a review. The carrying value of a long-lived asset is considered impaired when the carrying value of the asset exceeds the aggregate amount of its separately identifiable undiscounted future cash flows. In that event, a loss is recognized based on the amount by which the carrying value exceeds the fair value of the long-lived asset. Fair value is determined primarily using the estimated future cash flows associated with the asset under review, discounted at a rate commensurate with the risk involved and other valuation techniques. Losses on long-lived assets to be disposed of are determined in a similar manner, except that fair values are reduced for the cost of disposal. Changes in estimates of future cash flows could result in a write-down of the asset in a future period. See Note 1 regarding the Asset Impairment Provision recognized at December 31, 2004.

HUGHES NETWORK SYSTEMS

NOTES TO THE FINANCIAL STATEMENTS (Continued)

Foreign Currency

Some of HNS foreign operations have determined the local currency to be their functional currency. Accordingly, these foreign entities translate assets and liabilities from their local currencies to U.S. dollars using year-end exchange rates while income and expense accounts are translated at the average rates in effect during the year. The resulting translation adjustment is recorded as part of accumulated other comprehensive income (loss) (OCI), a separate component of equity. Translation adjustments for foreign currency denominated equity investments are not material and are recorded as part of OCI.

The Company also has foreign operations where the U.S. dollar has been determined as the functional currency. Gains and losses resulting from remeasurement of the foreign currency denominated assets, liabilities, and transactions into the U.S. dollar are recognized currently in the statements of operations and were not material in each of the periods presented herein.

Investments and Financial Instruments

The Company maintains investments in equity securities of unaffiliated companies, and such investments are included in other assets in the balance sheets. Nonmarketable equity securities are carried at cost. Marketable equity securities are considered available-for-sale and carried at current fair value based on quoted market prices with unrealized gains or losses (excluding other-than-temporary losses), reported as part of OCI. The Company continually reviews its investments to determine whether a decline in fair value below the cost basis is other-than-temporary. The Company considers, among other factors: the magnitude and duration of the decline; the financial health and business outlook of the investee, including industry and sector performance, changes in technology, and operational and financing cash flow factors; and HNS intent and ability to hold the investment. If the decline in fair value is judged to be other-than-temporary, the cost basis of the security is written down to fair value, and the amount is recognized in the statements of operations as part of Other income (expense), net and recorded as a reclassification adjustment from OCI.

Investments in which HNS owns at least 20% of the voting securities or has significant influence are accounted for under the equity method of accounting. Equity method investments are recorded at cost and adjusted for the appropriate share of the net earnings or losses of the investee. The carrying value of investments may include a component of goodwill if the cost of HNS investment exceeds the fair value of the investment, and any such goodwill is subject to an evaluation for impairment pursuant to Accounting Principles Board Opinion (APB) No. 18 The Equity Method of Accounting for Investments in Common Stock. Investee losses are recorded up to the amount of the investment plus advances and loans made to the investee, and financial guarantees made on behalf of the investee. In certain instances, this can result in HNS recognizing investee earnings or losses in excess of its ownership percentage.

The carrying value of cash and cash equivalents; short-term investments; receivables, net; other assets; accounts payable; and amounts included in accrued liabilities and other liabilities meeting the definition of a financial instrument and debt approximated fair value at December 31, 2005 and 2004.

The Company carries all derivative financial instruments in the balance sheets at fair value based on quoted market prices. The Company uses derivative contracts to minimize the financial impact of changes in the fair value of recognized assets, liabilities, and unrecognized firm commitments, or the variability of cash flows associated with forecasted transactions in accordance with internal risk management policies. Changes in fair value of designated, qualified, and effective fair value hedges are recognized in earnings as offsets to the changes in fair value of the related hedged items. Changes in fair value of designated, qualified, and effective cash flow hedges are deferred and recorded as a component of OCI until the hedged transactions occur and are recognized in earnings. Changes related to amounts excluded from the effectiveness assessment of a hedging derivative s

135

HUGHES NETWORK SYSTEMS

NOTES TO THE FINANCIAL STATEMENTS (Continued)

change in fair value and the ineffective portion of a hedge are immediately recognized in the statements of operations. Both at the inception of the hedge and on an on-going basis, HNS assesses whether the derivatives are highly effective. Hedge accounting is prospectively discontinued when hedge instruments are no longer highly effective. During each of the periods presented herein there were no material hedge transactions.

The Company s cash flows and earnings are subject to fluctuations resulting from changes in foreign currency exchange rates, interest rates, and changes in the market value of its equity investments. HNS manages its exposure to these market risks through internally established policies and procedures and, when deemed appropriate, through the use of derivative financial instruments. HNS enters into derivative instruments only to the extent considered necessary to meet its risk management objectives and does not enter into derivative contracts for speculative purposes.

The Company generally conducts its business in U.S. dollars with some business conducted in a variety of foreign currencies and therefore is exposed to fluctuations in foreign currency exchange rates. HNS objective in managing its exposure to foreign currency changes is to reduce earnings and cash flow volatility associated with foreign exchange rate fluctuations. Accordingly, HNS enters into foreign exchange contracts to mitigate risks associated with foreign currency denominated assets, liabilities, commitments, and anticipated foreign currency transactions. The gains and losses on derivative foreign exchange contracts offset changes in value of the related exposures. As of December 31, 2005, the Company had purchased foreign exchange contracts totaling $5.2 million to mitigate foreign currency fluctuation risks associated with short-term U.S. dollar denominated obligations. The differences between the face amount of the foreign exchange contracts and their estimated fair values were not material at December 31, 2005. All of the forward exchange contracts expire by June 30, 2006.

The Company is exposed to credit risk in the event of non-performance by the counterparties to its derivative financial instrument contracts. While the Company believes this risk is remote, credit risk is managed through the periodic monitoring and approval of financially sound counterparties.

Stock-Based Compensation

On January 1, 2003, the Company adopted the fair value based method of accounting for stock-based employee compensation of SFAS No. 123, Accounting for Stock-Based Compensation as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure an Amendment of SFAS No. 123 (SFAS No. 123). Under this method, compensation expense equal to the fair value of the stock-based award at grant is recognized over the course of its vesting period. When SFAS No. 123 was initially adopted, the Company elected to follow the prospective method of adoption, which resulted in the recognition of fair value based compensation cost in the statements of operations for stock options and other stock-based awards granted to employees or modified on or after January 1, 2003. Subsequently, in connection with the News Corporation transaction described in Note 17, vesting for substantially all unvested stock options outstanding at December 22, 2003 was accelerated. All stock-based awards are accounted for under the fair value method subsequent to the completion of the News Corporation transaction as a result of the modification of all stock-based compensation awards in connection therewith.

HUGHES NETWORK SYSTEMS

NOTES TO THE FINANCIAL STATEMENTS (Continued)

The following table presents the effect on earnings of recognizing compensation cost as if the fair value based method had been applied to all outstanding and unvested stock options and other stock-based awards for the periods shown:

	Successor	Predecessor		
	April 23, 2005 December 31, 2005	January 1, 2005 April 22, 2005	Years ended December 31, 2004	2003
	(Dollars in thousands)			
Reported income (loss)	$ 46,571	$ (22,523)	$ (1,433,484)	$ (157,026)
Add: Stock compensation cost, included above				3,020
Deduct: Total stock compensation cost, under the fair value based method				(47,944)
Pro Forma Net Income (Loss)	$ 46,571	$ (22,523)	$ (1,433,484)	$ (201,950)

The pro forma amounts for compensation cost are not necessarily indicative of the amounts that will be reported in future periods.

New Accounting Pronouncements

In January 2003, the Financial Accounting Standards Board (FASB) issued Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities an interpretation of ARB No. 51 (FIN 46R). FIN 46R requires the consolidation of a variable interest entity (VIE) where a holder of variable interests achieves a controlling financial interest through arrangements other than voting interests, and it is determined that the investor will absorb a majority of the expected losses and/or receive the majority of residual returns of the VIE. FIN 46R became effective for the Company on January 1, 2005. The adoption of this standard had no impact on HNS results of operations or financial position.

In March 2005, the FASB issued Interpretation No. 47 Accounting for Conditional Asset Retirement Obligations, an interpretation of FASB Statement No. 143, (FIN 47) which clarifies the term conditional asset retirement obligation as used in SFAS No. 143 Accounting for Asset Retirement Obligations. Specifically, FIN 47 provides that an asset retirement obligation is conditional when the timing and/or method of settling the obligation is conditioned on a future event. Accordingly, an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. Uncertainty about the timing and/or method of settlement of a conditional asset retirement obligation should be factored into the measurement of the liability when sufficient information exists. This interpretation also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. FIN 47 became effective for the Company on January 1, 2005. The adoption of this standard had no impact on HNS results of operations or financial position.

In November 2002, the Emerging Issues Task Force (EITF) reached a consensus on Issue No. 00-21, Accounting for Revenue Arrangements with Multiple Deliverables. EITF Issue No. 00-21 requires the allocation of revenues into separate units of accounting for transactions that involve more than one deliverable and contain more than one unit of accounting. HNS elected to apply the accounting required by EITF Issue No. 00-21 prospectively to transactions entered into after June 30, 2003. The adoption of this standard did not have a significant impact on HNS results of operations or financial position.

In November 2004, the FASB issued SFAS No. 151, Inventory Costs an Amendment of Accounting Research Bulletin No. 43 (ARB 43), Chapter 4 , (SFAS No. 151). SFAS No. 151 amends ARB 43, Chapter 4 to clarify the accounting for idle facility expense, freight, handling costs, and wasted material. SFAS No. 151

HUGHES NETWORK SYSTEMS

NOTES TO THE FINANCIAL STATEMENTS (Continued)

requires that these types of costs be recognized as current period expenses when incurred. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of this standard is not expected to have a significant impact on HNS results of operations or financial position.

HNS adopted SFAS No. 153 Exchanges of Nonmonetary Assets an amendment of APB Opinion No. 29 on July 1, 2005 (SFAS No. 153). SFAS No. 153 eliminates the exception for nonmonetary exchanges of similar productive assets of APB Opinion No. 29 and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. The adoption of this standard had no impact on HNS results of operations or financial position.

In December 2004, the FASB issued SFAS No. 123R, Share Based Payment , a revision of SFAS No. 123, (SFAS No. 123R). SFAS No. 123R requires entities to recognize compensation expense for all shared-based payments to employees, including stock options, based on the estimated fair value of the instrument on the date it is granted. The expense will be recognized over the vesting period of the award. SFAS No. 123R is effective for HNS for fiscal years beginning after December 15, 2005 and provides entities two transition methods. Under the modified prospective method, compensation expense is recognized beginning with the effective date for all awards granted to employees prior to the effective date that are unvested on the effective date. The modified retrospective method is a variation of the modified prospective method, except entities can restate all prior periods presented or prior interim periods in the year of adoption using the amounts previously presented in the pro forma disclosure required by SFAS No. 123. As HNS currently accounts for share-based payments using the fair value method under SFAS No. 123, HNS does not expect the adoption of SFAS No. 123R to have a material impact on its results of operations or financial position.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections , a replacement of APB Opinion No. 20, Accounting Changes and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements (SFAS No. 154). SFAS No. 154 applies to all voluntary changes in accounting principle and changes the requirements for accounting for and reporting a change in accounting principle. SFAS No. 154 requires the retrospective application to prior periods financial statements of the direct effect of a voluntary change in accounting principle unless it is impracticable to determine either the period-specific effects or the cumulative effective of the change. SFAS No. 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005, however the statement does not change the transition provisions of any existing accounting pronouncements. HNS does not expect the adoption of SFAS No. 154 to have a material impact on its results of operations or financial position.

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140 (SFAS No. 155), an amendment to FASB Statements No. 133, *Accounting for Derivative Instruments and Hedging Activities,* and No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* SFAS No. 155 permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement 133, establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and amends Statement 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity s first fiscal year that begins after September 15, 2006. HNS does not expect the adoption of SFAS No. 155 to have a material impact on its results of operations or financial position.

HUGHES NETWORK SYSTEMS

NOTES TO THE FINANCIAL STATEMENTS (Continued)

Reclassifications

Certain reclassifications have been made to the prior periods financial statements to conform to the current year s presentation.

Note 5: Receivables, Net

The following table sets forth the amounts recorded for receivables as of the dates shown:

	Successor	Predecessor
	At December 31,	
	2005	2004
	(Dollars in thousands)	
Trade receivables	$ 181,585	$ 155,698
Contracts in process, net of advances and progress billings	29,086	34,516
Other receivables	2,845	2,652
Total	213,516	192,866
Less allowance for doubtful accounts	(12,534)	(19,853)
Total Receivables, Net	$ 200,982	$ 173,013

There were no advances or progress billings offset against contracts in process at December 31, 2005. Advances and progress billings offset against contracts in process amounted to $3.4 million at December 31, 2004. The Company expects to collect the $29.1 million recorded at December 31, 2005 as contracts in process in the next twelve months except for $5.3 million, $4.4 million, $2.6 million and $1.9 million due in the years ending December 31, 2007, 2008, 2009 and 2010, respectively.

Amounts due from affiliates totaling $0.7 million and $0.3 million at December 31, 2005 and 2004, respectively, are included in trade receivables.

At December 31, 2005, amounts due from customers under long-term VSAT operating lease agreements totaled $97.3 million, of which $43.4 million, $26.2 million, $16.5 million, $7.7 million, and $3.5 million are due in the years ending December 31, 2006, 2007, 2008, 2009, and 2010 and thereafter, respectively. Revenues and receivables from these customer contracts are not recorded until they are earned on a month-to-month basis.

Note 6: Inventories

The following table sets forth the amounts recorded for inventories as of the dates shown:

	Successor	Predecessor
	At December 31,	
	2005	2004
	(Dollars in thousands)	
Productive material and supplies	$ 17,467	$ 19,808
Work in process	9,926	30,785
Finished goods	54,763	66,369
Total	82,156	116,962

Less provision for excess or obsolete inventories	(8,630)	(17,070)
Total Inventories	$ 73,526	$ 99,892

139

HUGHES NETWORK SYSTEMS

NOTES TO THE FINANCIAL STATEMENTS (Continued)

Provisions for excess or obsolete inventories are provided using management s best estimates of future use or recovery of inventory. In making its assessment of future use or recovery, management considers the aging and composition of inventory balances, the effects of technological and/or design changes, forecasted future product demand based on firm or near-firm customer orders, and alternative means of disposition of excess or obsolete items.

Note 7: Prepaid Expenses and Other

The following table sets forth the amounts recorded for prepaid expenses and other as of the dates shown:

	Successor	Predecessor
	At December 31,	
	2005	2004
	(Dollars in thousands)	
Subscriber Acquisition Costs (SAC)	$ 18,927	$ 20,209
Prepaid expenses	9,015	8,173
Prepaid taxes	13,878	9,678
Restricted cash	4,860	1,979
Deposits and other	1,992	2,153
Total Prepaid Expenses and Other	$ 48,672	$ 42,192

Note 8: Property, Net

The following table sets forth the amounts recorded for net property as of the dates shown:

	Estimated Useful Lives (years)	Successor	Predecessor
		At December 31,	
		2005	2004
		(Dollars in thousands)	
Land and improvements	10-30	$ 11,809	$ 11,823
Buildings and leasehold improvements	1-40	44,587	42,942
Machinery and equipment	3-23	57,261	6,776
Furniture, fixtures, and office machines	3-15	842	
VSAT operating lease hardware	2-5	149,853	287,184
Construction in progress SPACEWAY		124,878	85,000
Other		10,762	15,710
Total		399,992	449,435
Less accumulated depreciation		(140,414)	(222,691)
Total Property, Net		$ 259,578	$ 226,744

VSAT operating lease hardware represents VSAT equipment installed at customer facilities that is subject to an operating lease with the customer and against which HNS has borrowed funds from third-party financial institutions. Title to the equipment has passed to the financial institutions, and they will own the equipment at the end of the term of the customer contract; however, for the majority of the contracts HNS has retained certain ongoing obligations relating to the equipment as described in Note 4. For those contracts, deferred VSAT operating lease hardware costs are depreciated and such depreciation is recorded in cost of hardware products sold over the term of the operating lease.

HUGHES NETWORK SYSTEMS

NOTES TO THE FINANCIAL STATEMENTS (Continued)

Depreciation expense for property amounted to $27.1 million for the period April 23, 2005 through December 31, 2005, $13.7 million for the period January 1, 2005 through April 22, 2005, $80.9 million in 2004, and $80.0 million in 2003. In December 2004, $76.9 million of the Asset Impairment Provision was allocated to property and the carrying value of the property was written down, on a pro rata basis, by the amount of the Asset Impairment Provision, except for i) certain real estate assets with an appreciated market value, ii) VSAT operating lease assets that are recoverable from customer leases, and iii) the remaining assets of SPACEWAY (carried in construction in progress).

Interest has been capitalized during the construction of the SPACEWAY 3 satellite on costs incurred subsequent to April 22, 2005, the date on which the Company issued $325.0 million of term indebtedness as described in Note 11. Capitalized interest totaled $0.5 million for the period April 23, 2005 through December 31, 2005.

Note 9: Other Assets

The following table sets forth the amounts recorded for other assets as of the dates shown:

	Successor	Predecessor
	At December 31,	
	2005	2004
	(Dollars in thousands)	
Investments accounted for under the equity method	$ 8,795	$ 8,779
Investments classified as available-for-sale	9,450	9,804
Debt issuance costs, net	9,452	
Restricted cash		8,496
Other	2,627	3,157
Total Other Assets	$ 30,324	$ 30,236

Note 10: Accrued Liabilities

The following table sets forth the amounts recorded for accrued liabilities as of the dates shown:

	Successor	Predecessor
	At December 31,	
	2005	2004
	(Dollars in thousands)	
Accrued and other liabilities	$ 53,195	$ 38,750
Payroll and other compensation	29,151	32,254
Progress billings to customers	31,687	30,827
Taxes other than income taxes	7,089	4,780
Foreign income taxes	5,425	6,753
Employee severance costs		10,993
Provision for warranties	4,054	3,833
Total Accrued Liabilities	$ 130,601	$ 128,190

In connection with entering into the December 2004 Agreement, the Company announced a staff reduction of 164 personnel, or 9% of its staff effective as of February 1, 2005. All staff reduction activities were completed in 2005. See Note 15.

HUGHES NETWORK SYSTEMS

NOTES TO THE FINANCIAL STATEMENTS (Continued)

Note 11: Short-Term Borrowings and Long-Term Debt

Short-Term Borrowings and Current Portion of Long-Term Debt

	Interest Rates at	Successor	Predecessor	
		At December 31,		
	December 31, 2005	2005	2004	2003
		(Dollars in thousands)		
Revolving bank borrowings	6.75% -16.0%	$ 3,693	$ 6,439	$ 14,198
Term loans payable to banks, current portion	8.5%	752	1,943	2,282
VSAT hardware financing, current portion	4.0%-9.0%	25,171	44,375	52,152
Total Short Term Borrowings and Current Portion of Long-Term Debt		$ 29,616	$ 52,757	$ 68,632

Outstanding revolving bank borrowings at December 31, 2005 consist of borrowings by a subsidiary in India under revolving lines of credit with local banks. Borrowings at the Indian subsidiary are with several banks, and there is no requirement for compensating balances. $1.8 million of the outstanding revolving borrowings are at variable rates tied to the Mumbai Inter Bank Offer Rate, and are adjusted monthly. The balance of outstanding revolving borrowings are at fixed rates. The total available for borrowing by the Indian subsidiary under the revolving lines of credit is $4.4 million.

Long-Term Debt

	Interest Rates at	Successor	Predecessor	
		At December 31,		
	December 31, 2005	2005	2004	2003
		(Dollars in thousands)		
Term loans payable to banks	8.19%-12.44%	$ 325,360	$ 1,153	$ 3,145
VSAT hardware financing	4.0%-9.0%	17,046	36,312	63,355
Total Long-Term Debt		$ 342,406	$ 37,465	$ 66,500

The April 2005 Transaction was financed with (i) a $250.0 million first lien term loan and a $50.0 million first lien revolving credit facility and (ii) a $75.0 million second lien term loan. In June 2005, the above two facilities were syndicated with a larger number of financial institutions, at which time the first lien loan was increased to $275.0 million and the second lien loan was reduced to $50.0 million. At the election of the Company, which can be made monthly, the term indebtedness bears interest at either the ABR Rate as defined in the credit agreement (the ABR Rate) plus 2.75% for the first lien credit facility and the ABR Rate plus 7.0% for the second lien credit facility or for Eurocurrency borrowings at the London Interbank Offered Rate (LIBOR) plus 3.75% for the first lien credit facility and LIBOR plus 8.0% for the second lien credit facility. At December 31, 2005, the Company had elected the LIBOR (4.44% on December 31, 2005) option. As a result, outstanding borrowings under the first lien credit facility are at 8.19% as of December 31, 2005 and outstanding borrowings under the second lien facility are at 12.44% as of December 31, 2005. Principal repayment for both credit facilities starts on June 30, 2007, and the final payment is due on April 22, 2012 for the first lien credit facility and April 22, 2013 for the second lien credit facility. With respect to Eurocurrency LIBOR loans, the Company elects interest periods of one, two, three, or six months and interest is payable in arrears at the end of each interest period, and, in any event, at least every three months. The $50.0 million revolving credit facility is available under the first lien credit agreement for borrowings and for issuance of letters of credit. At December 31, 2005, the Company had issued letters of credit totaling $12.1 million under the revolving credit

HUGHES NETWORK SYSTEMS

NOTES TO THE FINANCIAL STATEMENTS (Continued)

facility. As a result, the available borrowing capacity under the revolving credit facility at December 31, 2005 was $37.9 million. The interest rate for borrowings, if any, under the revolving credit facility is, at the Company s option, either the ABR Rate plus 2% or LIBOR plus 3%. For outstanding letters of credit issued under the revolving credit facility, the Company pays a commission fee of 3% per annum and an issuance fee of 0.25% per annum. In addition, the Company is charged a commitment fee of 0.5% per annum for any unused portion of the revolving credit facility. HCI has pledged its equity interests in the Company to secure the obligations of the Company under the term indebtedness and revolving credit facility. The indebtedness is otherwise non-recourse to HCI.

The agreements governing the term indebtedness and revolving credit facility require the Company to comply with certain affirmative and negative covenants, for as long as there is any debt balance outstanding and the credit agreements are in effect. Negative covenants include limitations on additional indebtedness, liens, sale and lease back transactions, investments and loans and advances, mergers, consolidations, sale of assets and acquisitions, payment of dividends and distributions, certain transactions with affiliates, and other covenants customary to credit agreements. In addition, the Company is required to comply with certain financial covenants including leverage ratios (first lien leverage ratio and debt to adjusted EBITDA, as defined in the agreements), interest coverage ratios (adjusted EBITDA to interest) and certain limits on capital expenditure for the four quarter period up to an including the fiscal quarter being reported. HNS has been in compliance with all of its debt covenants since the placement of the term indebtedness and through December 31, 2005.

In connection with certain commercial VSAT sales, the Company enters into long-term operating leases (generally three to five years) for the use of the VSAT hardware installed at a customer s facilities. HNS has an arrangement with two financial institutions to borrow against the future operating lease revenues at the inception of the operating lease. When amounts are funded under these arrangements, customer credit risk for the operating lease passes to the financial institution. The financial institution receives title to the equipment and obtains the residual rights to the equipment after the operating lease with the customer has expired. For the majority of the transactions with the financial institutions, the Company has retained a continuing obligation to the financing institution to indemnify it from losses it may incur (up to the original value of the hardware) from non-performance of the HNS system (a Non-Performance Event). Since the inception of the borrowing program in 1997, the Company has not been required to make any indemnification payments for a Non-Performance Event; however, the Company did incur nominal costs in a period prior to 2002 to re-establish service for a group of customers who were impacted by the failure of a third-party satellite. The Company has not provided a reserve for a Non-Performance Event because it believes that the possibility of an occurrence of a Non-Performance Event due to a service outage is remote, given the ability to quickly re-establish customer service at relatively nominal costs.

The following table sets forth scheduled principal payments on long-term debt:

	Total	**2007**	**2008**	**2009**	**2010**	**Thereafter**
			(Dollars in Thousands)			
First lien credit facility	$ 275,000	$ 2,063	$ 2,750	$ 2,750	$ 2,750	$ 264,687
Second lien credit facility	50,000	375	500	500	500	48,125
Other term loans	360	360				
Total term loans payable to banks	325,360	2,798	3,250	3,250	3,250	312,812
VSAT hardware financing	17,046	4,727	8,099	3,141	1,079	
Total Long-Term Debt	$ 342,406	$ 7,525	$ 11,349	$ 6,391	$ 4,329	$ 312,812

HUGHES NETWORK SYSTEMS

NOTES TO THE FINANCIAL STATEMENTS (Continued)

Note 12: Retirement Programs and Other Post-Retirement Benefits

Prior to the April 2005 Transaction, HNS employees participated in contributory and noncontributory defined benefit retirement plans maintained by DTVG. These plans were available to substantially all domestic full-time employees. Benefits were based on years of service and compensation earned during a specified period of time before retirement. The accumulated benefit obligation and net assets available for benefits for employees were not separately determined and are not included in the Predecessor balance sheet. In addition to pension benefits, DTVG charged HNS for the cost of certain other post-retirement benefits. The accumulated post-retirement benefit obligation related to employees was not separately determined and was not included in the accompanying balance sheets. HNS portion of the cost of these benefit plans, allocated from DTVG, amounted to $2.4 million, $13.6 million, and $13.0 million for the period January 1, 2005 through April 22, 2005, and the years ended December 31, 2004 and 2003, respectively. The costs allocated from DTVG did not include pension curtailment and termination benefit charges recorded by DTVG as a result of the fact that HNS employees no longer earned benefits in the DTVG plan subsequent to the completion of the April 2005 Transaction. HNS employees also participated in the DTV 401(k) Retirement Savings Plan (the DTVG 401(k) Plan) and in other post-retirement health and welfare plans administered by DTVG for which HNS was billed directly by the provider. Subsequent to the April 2005 Transaction, HNS implemented the HNS LLC 401(k) Plan (the HNS 401(k) Plan) for qualified employees in the United States. Eligible employees may contribute up to 20% of their eligible earnings, and the Company will match 100% of employee contributions on up to 3% of eligible earnings and 50% of employee contributions on up to an additional 6% of eligible earnings. Employer contributions to the HNS 401(k) Plan and to the DTVG 401(k) Plan were $3.6 million, $1.7 million, $6.2 million, and $6.7 million for the periods April 23, 2005 though December 31, 2005 and January 1, 2005 through April 22, 2005 and the years ended December 31, 2004 and 2003, respectively.

Note 13: Stock-Based Compensation

Prior to the April 2005 Transaction, HNS participated in the Hughes Incentive Plan (the Plan) together with other DTVG business units. Under the Plan, shares, rights, or options to acquire DTVG s common stock were authorized for grant subject to the approval of the Compensation Committee of the DTVG Board of Directors. In connection with the News Corporation transactions on December 22, 2003 (see Note 17), 30.4 million outstanding options of DTVG s former parent company held by HNS employees were converted into options to acquire shares of DTVG stock. The exercise price of the options granted under the Plan was equal to 100% of the fair market value of the underlying common stock on the date the options were granted. These nonqualified options generally vested over two to five years, vested immediately in the event of certain transactions, expired 10 years from date of grant, and were subject to earlier termination under certain conditions. DTVG allocated compensation expense to HNS for its covered employees under the fair value method as described in Note 4.

DTVG s Compensation Committee also granted restricted stock units under the Plan that vested over two to three years. During the year ended December 31, 2003, 1.2 million restricted stock units were granted with a weighted average grant-date fair value of approximately $11.53 per share. Compensation expense charged to general and administrative expenses in the combined consolidated statement of operations related to restricted stock unit awards amounted to $3.0 million in 2003. No restricted stock units were granted subsequent to December 31, 2003.

Following the completion of the April 2005 Transaction, HNS employees no longer receive stock option or restricted stock unit grants from DTVG, and DTVG remains responsible for all of the outstanding DTVG options for HNS employees.

HUGHES NETWORK SYSTEMS

NOTES TO THE FINANCIAL STATEMENTS (Continued)

In the second quarter of 2005, Class B equity interests were issued to certain members of HNS senior management and SkyTerra s Chief Executive Officer and President. The holders of the Class B equity interests are entitled to receive their pro rata share of any distributions made by the Company after the holders of Class A equity interests have received distributions equaling their capital contributions. However, holders of the Class B equity interests are not entitled to distributions resulting from appreciation of the Company s assets or income earned by the Company prior to the issuance of the Class B equity interests. As of December 31, 2005, the Class B equity interests represented approximately 4.8% of the combined outstanding Class A and Class B equity interests. These Class B equity interests are subject to certain vesting requirements, with 50% of the Class B equity interests subject to time vesting over five years and the other 50% vesting based upon certain performance milestones. One-half of the Class B equity interests subject to performance milestones will vest if, following the earlier of April 22, 2010 or a change of control of HNS, HCI has received a cumulative total return of at least 3.0 times on its investment in HNS. All Class B equity interests subject to performance milestones will vest if, following the earlier of April 22, 2010 or a change of control of HNS, HCI has received a cumulative total return of at least 5.0 times on its investment in HNS. In each such case, vesting of Class B equity interests subject to performance milestones requires continued employment of the Class B equity holder through the earlier of April 22, 2010 or a change in control of HNS. On January 1, 2007, at the holders election, vested Class B equity interests may be exchanged for common stock of HCI. The number of shares of HCI common stock to be issued upon such exchange will be based upon the fair market value of such vested Class B membership interest divided by the value of HCI common stock at the time of such exchange. Pursuant to SFAS No. 123, the Company determined that the Class B equity interests had nominal value at the date of grant, and, accordingly, no compensation expense was recorded in connection with the issuance of the Class B equity interests.

In July 2005, the Company adopted an incentive plan (the Bonus Unit Plan) pursuant to which 4.4 million bonus units representing approximately 4% of the increase in the value of the Company, as defined in the Bonus Unit Plan, were granted to its employees. The bonus units provide for time vesting over five years subject to a participant s continued employment with the Company. Pursuant to the Bonus Unit Plan, as a result of the January 2006 Transaction, if a participant in the Bonus Unit Plan is still employed by the Company on April 22, 2008, then at such time, the participant s vested bonus units would be exchanged for HCI common stock. A second exchange will take place on April 22, 2010 for participants in the Bonus Unit Plan still employed by the Company at such time. The number of shares of HCI common stock to be issued upon each such exchange would be based upon the fair market value of such vested bonus unit divided by the value of HCI common stock at the time of the exchange. Pursuant to SFAS No. 123, the Company determined that the fair value of the bonus units on the grant date was approximately $1.2 million. This amount is being amortized over the five year vesting period beginning on the date of grant. The Company recognized compensation expense of $0.1 million in the period April 23, 2005 through December 31, 2005.

Note 14: SPACEWAY Impairment Provision

The Company historically managed the Business and SPACEWAY as separate products. The Business includes established services and product lines with their own distinct revenues and operating costs, whereas SPACEWAY is a system that is under construction and for which the Company has not received or recognized any significant revenues. Prior to September 30, 2004, certain hardware costs relating to the construction of three satellites and a network operating center and development costs relating to network infrastructure for the SPACEWAY program had been capitalized as construction in progress over the period of construction through September 30, 2004.

During 2004, DTVG decided that it would offer the Business for sale, and it commenced a process for seeking buyers for this business. In the third quarter of 2004, DTVG determined that it would no longer continue to pursue the business plan of the SPACEWAY program as it was originally contemplated and that it would

HUGHES NETWORK SYSTEMS

NOTES TO THE FINANCIAL STATEMENTS (Continued)

transfer two of the SPACEWAY satellites (SW1 and SW2) and certain support equipment to DIRECTV Holdings LLC, an affiliated company, for use in its direct-to-home satellite broadcasting business. DTVG also determined that it would include the remaining SPACEWAY assets as a component of the Business offered for sale. These decisions by DTVG triggered the need to perform an asset impairment analysis on the Company s investment in SPACEWAY since the ultimate disposition of this investment differed from its original intended purpose. As of September 30, 2004, DTV Networks had a capitalized value of $1,552.7 million for SPACEWAY of which $11.2 million represented capitalized software development costs, and the remainder was included in property as construction in progress. Based upon an independent valuation and analysis, DTVG determined that the fair value of the satellites, support equipment, and other satellite related costs to be transferred to DIRECTV was $308.0 million. DTVG determined that the fair value of the remaining SPACEWAY assets, including the third SPACEWAY satellite (SW3), was $85.0 million, based upon an analysis of the alternative disposition opportunities available to DTVG. Previously capitalized costs in excess of these fair value amounts totaling $1,217.7 million were recognized as a SPACEWAY impairment provision in the third quarter of 2004. DTVG also determined that, given the uncertainty of recovery of any additional capitalized costs relating to SPACEWAY in a potential sale or other disposition, all subsequent spending on the SPACEWAY program would be expensed as incurred, other than costs directly related to the construction and launch of SW3. DTVG also assumed responsibility for the satellite manufacturing contract with Boeing covering all three of the satellites. The portion of the satellite manufacturing contract relating to SW3, including Boeing s obligation to complete construction of SW3 for an additional $49.0 million, was assigned to HNS upon the closing of the April 2005 Transaction. Of this $49.0 million, $17.0 million was paid during the year ended December 31, 2005, and the Company expects to pay $22.0 of the balance in 2006 and the remainder in 2007. Additionally the Company has entered into commitments with two companies totaling $73.7 million related to launch and launch operations services. Of this amount $22.2 million was paid in 2005 and based on the expected launch of SPACEWAY 3 in early 2007, the Company expects to pay $47.5 million in 2006 and $4.0 million in 2007.

Note 15: Restructuring Costs

In the periods April 23, 2005 through December 31, 2005 and January 1, 2005 through April 22, 2005, and the years ended December 31, 2004 and 2003, HNS recognized restructuring costs of $1.4 million, $1.6 million, $11.0 million, and $4.1 million, respectively, principally attributable to employee headcount reductions; and in 2005, the decision to close one of the Company s network operations centers related to SPACEWAY which resulted in charges for the cancellation of equipment leases. Restructuring costs recognized related principally to HNS domestic operations and affected approximately 1%, 9%, and 7% of the then existing headcount in each of the period January 1, 2005 through April 22, 2005 and the years ended December 31, 2004 and 2003, respectively. Severance costs per employee were greater in 2004 due to enhanced severance benefit programs resulting from the News Corporation transaction described in Note 17. These restructuring activities were primarily taken as cost reduction and downsizing actions intended to respond to market conditions in the principal markets served by the Company. Additionally, in 2004, the realignment of the SPACEWAY program in the third quarter of 2004 contributed to the need for additional downsizing adjustments. In connection with the April 2005 Transaction, the Company relocated certain employees and operations in order to vacate certain leased facilities and the lease obligations on those facilities remained with DTVG following the closing of the April 2005 Transaction. Restructuring costs of $1.4 million in the period April 23, 2005 through December 31, 2005 $1.6 million in the period January 1, 2005 through April 22, 2005, $7.8 million in 2004, and $1.6 million in 2003 were charged to the VSAT Business segment, and the remainder, $3.2 million in 2004 and $2.5 million in 2003, were charged to the Telecom Systems segment described in Note 18.

HUGHES NETWORK SYSTEMS

NOTES TO THE FINANCIAL STATEMENTS (Continued)

Note 16: Other Income (Expense), Net

Other income (expense), net consisted of the following:

	Successor	Predecessor		
	April 23, 2005 December 31, 2005	January 1, 2005 April 22, 2005	Years ended December 31, 2004	2003
		(Dollars in thousands)		
Equity in earnings (losses) of affiliates	$ 23	$ 34	$	$ (1,298)
Minority interests share of subsidiary losses (earnings)	366	231	(64)	(678)
Interest income	2,813	102	772	1,000
Gain on sale of real estate			5,805	
Foreign income tax expense	(693)	(180)	(32)	(2,199)
Other	198			
Total Other Income (Expense), Net	$ 2,707	$ 187	$ 6,481	$ (3,175)

Note 17: Transactions with Related-Parties

In the ordinary course of its operations, the Company enters into transactions with related parties to purchase and/or sell telecommunications services, advertising, equipment, and inventory. In addition, as further described below, the Company purchased certain management services from SkyTerra. Related parties include News Corporation, who become a related party on December 23, 2003 when it purchased a minority interest in DTVG from General Motors Corporation (GM) and its affiliates; DTVG and its affiliates; and subsequent to the April 2005 Transaction, SkyTerra, Apollo Management, L.P. (an affiliate of SkyTerra and HCI), and their affiliates. In addition, related parties include GM, which through December 22, 2003, was the 100% owner of DTVG. In connection with the January 2006 Transaction, News Corporation and its affiliates, including DTVG and its affiliates, cease to be related parties.

HUGHES NETWORK SYSTEMS

NOTES TO THE FINANCIAL STATEMENTS (Continued)

As discussed in Note 4, DTV Networks participated in the cash management program of DTVG prior to the April 2005 Transaction. As such, DTVG was responsible for funding the working capital and capital expenditures of DTV Networks, as well as providing certain corporate services for which there were no analogous functions performed at DTV Networks. DTVG also administered and maintained certain employee retirement and stock option programs in which DTV Networks employees participated and for which DTV Networks was charged its allocable share of the related costs. Upon the closing of the April 2005 Transaction, the Company s participation in the programs administered by DTVG ceased and the Company established its own cash management program, employee benefits program, and service organizations to provide for the functions that DTVG provided prior to the closing. Amounts due to DTVG for providing the preceding services, including funding HNS working capital and capital expenditures, were recorded as contributions within equity. The balances included in equity had no formal repayment terms or interest requirements. Other net cash contributions from parent shown in the table below represent the net funding for working capital and operational needs of the Company. It is not practical for the Company to calculate the average net cumulative cash contributions from DTVG as a result of the daily nature of the transfers to and from DTVG under the cash management program. The following represents an analysis of changes in Predecessor equity:

	Predecessor		
	January 1, 2005 April 22, 2005	Years ended December 31, 2004	2003
	(Dollars in thousands)		
Equity, beginning of period	$ 267,044	$ 1,956,099	$ 1,913,619
Net loss before allocation of costs from parent	(11,225)	(1,397,619)	(115,559)
Allocation of costs from parent	(11,298)	(35,865)	(41,467)
Property transferred to parent		(308,000)	
Cash paid for intercompany purchases	(15,740)	(81,944)	(99,970)
Cash received for intercompany revenues	1,198	3,611	6,408
Other net cash (distributions to) contributions from parent	(94,326)	130,762	293,068
Equity, end of period	$ 135,653	$ 267,044	$ 1,956,099

Transactions between the Company and DTVG other than those related to HNS participation in the centralized cash management system of DTVG as well as to DTVG s provision of certain corporate services to HNS are included in the amount due to related parties in the table below. As of December 31, 2005 and 2004, the balance due to DTVG of $25.0 million and $20.3 million, respectively, consisted of amounts due to DTVG for restricted cash of HNS funded by DTVG which HNS must repay to DTVG, HNS investment in common stock of an unconsolidated affiliate (see Note 19), and purchases of advertising sales from DTVG, partially offset by amounts due to HNS by DTVG for services performed by HNS for DTVG.

Under the terms of the December 2004 Agreement, DTVG retained the responsibility for all pre-closing tax obligations of DTV Networks and HNS, as well as obligations related to certain pending litigation and facilities leases for property that the Company had vacated. DTVG also liquidated all capital lease debt and all foreign indebtedness outstanding at such time and remained liable for its indemnities to third parties relating to the VSAT hardware financing borrowings. The Company has indemnified DTVG for any losses relating to the VSAT hardware financings.

Pursuant to the LLC Agreement, during the three year period subsequent to the April 2005 Transaction, the Company will pay SkyTerra or its successor a quarterly management fee of $0.3 million for services to be rendered by SkyTerra or its successor in its capacity as the Managing Member.

HUGHES NETWORK SYSTEMS

NOTES TO THE FINANCIAL STATEMENTS (Continued)

In connection with the closing of the January 2006 Transaction, the parties to the November 2005 Agreement entered into agreements governing certain relationships between and among the parties after the closing. Such agreements include the modification and/or termination of certain prior agreements between and among the parties, including:

- amending certain provisions of the December 2004 Agreement to accelerate the expiration of certain representations and warranties made by DTV Networks in connection with that agreement;

- terminating an investor rights agreement in connection with the December 2004 Agreement pursuant to which, among other covenants, SkyTerra and DTV Networks agreed to limit the transferability of the Class A membership interests and HNS granted SkyTerra and DTV Networks public offering registration rights; and

- amending the Advertising and Marketing Support Agreement, pursuant to which affiliates of DTV Networks provided HNS with discounted advertising costs.

The following table summarizes sales and purchase transactions with related parties, including the allocation of the cost of employee benefits from DTVG and its subsidiaries or affiliates:

	Successor	Predecessor		
			Years Ended	
	April 23, 2005 December 31, 2005	January 1, 2005 April 22, 2005	December 31, 2004	2003
		(Dollars in Thousands)		
Sales				
DTVG and affiliates	$ 10,669	$ 1,198	$ 3,611	$ 5,936
SkyTerra, HCI, and affiliates	1,795			
Total	$ 12,464	$ 1,198	$ 3,611	$ 5,936
Purchases				
DTVG and affiliates	$ 6,135	$ 16,049	$ 78,826	$ 103,485
SkyTerra, HCI, and affiliates	15,451			
Total	$ 21,586	$ 16,049	$ 78,826	$ 103,485

The following table sets forth the amount of assets and liabilities resulting from transactions with related parties:

	Successor	Predecessor
	At December 31,	
	2005	2004
	(Dollars in Thousands)	
Due from related parties		
DTVG and affiliates	$ 206	$ 255
SkyTerra, HCI, and affiliates	508	

Total	$ 714	$ 255
Due to related parties		
DTVG and affiliates	$ 25,179	$ 20,562
SkyTerra, HCI, and affiliates	2,748	
Total	$ 27,927	$ 20,562

HUGHES NETWORK SYSTEMS

NOTES TO THE FINANCIAL STATEMENTS (Continued)

Note 18: Segment and Geographical Data

HNS operates in two business segments consisting of the VSAT segment (including SPACEWAY), which provides satellite-based private business networks and broadband Internet access to consumers, and the Telecom Systems segment consisting of the Company s mobile satellite communications business unit, its terrestrial carrier network services business unit, and the HNS corporate office.

Selected financial information for HNS operating segments follows:

	VSAT Business	Telecom Systems	Total
		(Dollars in Thousands)	
April 23, 2005 December 31, 2005 Successor			
Revenues	$ 538,622	$ 44,846	$ 583,468
Segment operating income	56,815	9,793	66,608
Depreciation and amortization	27,078	131	27,209
Segment assets	590,192	166,332	756,524
Capital expenditures	64,228	2,337	66,565
January 1, 2005 April 22, 2005 Predecessor			
Revenues	$ 199,698	$ 23,743	$ 223,441
Segment operating (loss) income	(23,526)	2,447	(21,079)
Depreciation and amortization	13,703	31	13,734
Segment assets	516,670	185,974	702,644
Capital expenditures	25,339	846	26,185
2004 Predecessor			
Revenues	$ 696,693	$ 92,657	$ 789,350
Segment operating (loss) income	(1,407,574)	(24,925)	(1,432,499)
Depreciation and amortization	91,027	5,946	96,973
Segment assets	486,266	100,618	586,884
Capital expenditures	131,834	6,997	138,831
2003 Predecessor			
Revenues	$ 665,623	$ 85,525	$ 751,148
Segment operating (loss) income	(123,189)	(18,465)	(141,654)
Depreciation and amortization	88,130	6,709	94,839
Segment assets	2,150,252	166,688	2,316,940
Capital expenditures	204,220	11,309	215,529

HUGHES NETWORK SYSTEMS

NOTES TO THE FINANCIAL STATEMENTS (Continued)

Revenues by geographic area are summarized below based upon the location of the customer:

	Successor	Predecessor		
		January 1, 2005	Years ended December 31,	
	April 23, 2005 December 31, 2005	April 22, 2005	2004	2003
	(Dollars in thousands)			
North America	$ 411,406	$ 163,953	$ 538,822	$ 506,823
Europe	78,731	17,212	106,577	89,503
South America and the Caribbean	14,239	4,133	16,052	16,354
Africa, Asia, and the Middle East	79,092	38,143	127,899	138,468
Total Revenues	$ 583,468	$ 223,441	$ 789,350	$ 751,148

Individual countries with significant revenues are as follows:

	Successor	Predecessor		
	April 23, 2005	January 1, 2005	Years ended December 31,	
	December 31, 2005	April 22, 2005	2004	2003
	(Dollars in thousands)			
United States	$ 385,706	$ 161,805	$ 526,054	$ 501,390
India	35,499	12,483	31,955	40,151

Net property grouped by physical locations is as follows:

	Successor	Predecessor
	At December 31,	
	2005	2004
	(Dollars in thousands)	
North America		
United States	$ 245,412	$ 212,992
Canada and Mexico	10	
Total North America	245,422	212,992
Europe	5,448	8,048
South America and the Caribbean	490	
Africa, Asia, and the Middle East	8,218	5,704
Total Net Property	$ 259,578	$ 226,744

Note 19: Commitments and Contingencies

Litigation

Litigation is subject to uncertainties, and the outcome of individual litigated matters is not predictable with assurance. Various legal actions, claims, and proceedings, including disputes with customers, are pending against HNS arising in the ordinary course of business. HNS has a policy of establishing loss provisions for matters in which losses are probable and can be reasonably estimated. Some of the matters may involve compensatory, punitive, or treble damage claims, or sanctions, that if granted, could require HNS to pay damages or make other expenditures in amounts that could not be estimated at December 31, 2005.

HUGHES NETWORK SYSTEMS

NOTES TO THE FINANCIAL STATEMENTS (Continued)

In 2002, the Department of Revenue Intelligence, or DRI, in India initiated an action against a former affiliate and customer of the Company, Hughes Tele.com (India) Ltd., or HTIL, relating to alleged underpayment of customs duty and misclassification of import codes. The DRI action was also directed against the Company and other HTIL suppliers whose shipments are the focus of that action. HTIL, renamed Tata Teleservices (Maharashtra) Ltd., or TTML, after the Tata Group purchased HNS equity interest in December 2003, is the principal party of interest in this action. The Company, together with the other named suppliers, are potentially liable for penalties in an amount of up to five times the underpayment of duty if HNS is found to have aided HTIL in avoiding duty. In connection with HNS sale to the Tata Group, the Company did not indemnify TTML in relation to its own potential liability in this matter. Currently, the parties have filed replies to the DRI s allegations and are engaged in a series of hearings to resolve the matter before a forum known as the Settlement Commission.

Following a voluntary disclosure by DTVG and DTV Networks in June 2004, DTVG and DTV Networks entered into a consent agreement (the Consent Agreement) with the US Department of State in January 2005 regarding alleged violations of the International Traffic in Arms regulations involving exports of technology related to the VSAT business primarily to China. As part of the Consent Agreement, which applies to the Company, one of the Company s subsidiaries was debarred from conducting certain international business. The Company is now eligible to seek reinstatement and intends to do so in the near future. In addition, the Company is required to enhance its export compliance program to avoid future infractions. As a result of its voluntary disclosure and the Consent Agreement, the Company is currently unable to perform its obligations under certain contracts with certain customers in China and Korea addressed by the Consent Agreement, and if ultimately unable to perform, the Company may be liable for certain damages of up to $5.0 million as a result of its non-performance. In November 2005, the Company received notice that one of these customers in China had filed a demand for arbitration with the International Center for Dispute Resolution, a division of the American Arbitration Association. The arbitration is currently stayed pending non-binding mediation, which is expected to be concluded in the first half of 2006.

On April 19, 2005, the Company settled a lawsuit with Helius, Inc. in which Helius had alleged patent infringement. As a result of the settlement, the Company recognized a charge of $1.8 million in the period January 1, 2005 to April 22, 2005 and was granted a license under the allegedly infringed patents. In addition, Helius released the Company from all claims relating thereto.

After discussion with counsel representing the Company in the actions described above, it is the opinion of management that such litigation is not expected to have a material adverse effect on the Company s results of operations, financial position, or cash flows.

Product Warranties

The Company warrants its hardware products for up to fifteen months following the date of installation. A large portion of its enterprise customers enter into maintenance agreements under which the company recognizes revenue for providing maintenance services that prolong the life and effectiveness of the installed hardware, thus minimizing the potential for warranty claims or repairs. Warranty reserves are determined based on historical warranty repair experience and an assessment of the number of units remaining under warranty coverage. Long-term contracts for the sale of wireless communications systems may include contractual provisions relating to warranty coverage for fixed terms generally not exceeding five years. Warranty provisions for these contracts are included in the determination of overall contract costs and earnings, based on management s estimates of the cost of the related coverage. Accrued contract warranty costs are reviewed and adjusted, as appropriate, over the term of the contractual warranty period.

HUGHES NETWORK SYSTEMS

NOTES TO THE FINANCIAL STATEMENTS (Continued)

Changes in the accrued warranty costs were as follows:

	Successor	Predecessor	
	April 23, 2005 December 31, 2005	January 1, 2005 April 22, 2005	Year ended December 31, 2004
		(Dollars in thousands)	
Balance at beginning of period	$ 4,501	$ 3,833	$ 3,607
Warranty cost accrual	2,069	1,887	3,865
Warranty costs incurred	(2,516)	(1,219)	(3,639)
Balance at end of period	$ 4,054	$ 4,501	$ 3,833

Leases

The Company has noncancelable operating leases having lease terms in excess of one year, primarily for real property. Future minimum payments under such leases consisted of the following at December 31, 2005 (in thousands):

Year Ending December 31,	
2006	$ 5,560
2007	2,395
2008	1,725
2009	1,159
2010	560
Thereafter	566
Total Minimum Lease Payments	$ 11,965

Rental expenses under operating leases, net of sublease income, were $10.3 million for the period April 23, 2005 through December 31, 2005, $6.2 million for the period January 1, 2005 through April 22, 2005, $33.5 million in 2004, and $38.8 million in 2003.

The Company has noncancelable vendor obligations for acquisition of space segment. Future minimum payments under such leases consisted of the following at December 31, 2005 (in thousands):

Year Ending December 31,	
2006	$ 136,598
2007	93,814
2008	63,173
2009	35,896
2010	25,402
Thereafter	54,320
Total Minimum Lease Payments	$ 409,203

Rental expenses under operating leases for space segment were $94.0 million for the period April 23, 2005 through December 31, 2005, $42.0 million for the period January 1, 2005 through April 22, 2005, $133.3 million in 2004, and $122.0 million in 2003.

Other

The Company is contingently liable under standby letters of credit and bonds in the aggregate amount of $26.9 million that were undrawn at December 31, 2005. Of this amount, $12.1 million were issued under the $50.0 million revolving credit facility (see Note 11), $4.9 million were secured by restricted cash (see Note 4), and the balance was secured by letters of credit issued under credit arrangements available to the Company s

153

HUGHES NETWORK SYSTEMS

NOTES TO THE FINANCIAL STATEMENTS (Continued)

Indian subsidiaries. Certain of the letters of credit issued by the Company s Indian subsidiaries are secured by those entities assets. These obligations expire as follows: $10.5 million in 2006, $2.0 million in 2007, $1.6 million in 2008, $6.6 million in 2009, and $6.2 million thereafter.

In connection with the prior disposition by DTV Networks of a subsidiary that was an affiliate of the Company, the Company entered into a services contract under which it agreed to procure a minimum amount of services from the former subsidiary over a two year period ending March 31, 2007. The minimum total amount to be procured under the agreement is $23.8 million, of which $9.8 million has been incurred as of December 31, 2005 and $14.0 million remains to be procured as of that date. The Company has determined that it will not purchase the level of services contractually required and as of December 31, 2005 has recorded a liability of $2.8 million to satisfy this purchase commitment.

Pursuant to the terms of the December 2004 Agreement, HNS has limited rights with respect to its investment in common stock of an unconsolidated affiliate carried in other assets in the balance sheets. Among other things, HNS may not pledge or otherwise encumber these shares, and while it may sell the shares to an unaffiliated third party, it must deliver the net proceeds from such sale to DTVG. The shares must be returned to DTVG within three years of the closing of the April 2005 Transaction unless a qualifying disposition of the shares has occurred. Accordingly, at December 31, 2005, HNS has recorded a liability in due to affiliates long-term in the balance sheet for the amount of $8.9 million for this investment.

* *

SIGNATURES

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

SKYTERRA COMMUNICATIONS, INC.

Date: March 29, 2006

By: /s/ JEFFREY A. LEDDY
Name: Jeffrey A. Leddy

Title: Chief Executive Officer and President

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

Signature	Title	Date
/s/ JEFFREY A. LEDDY Jeffrey A. Leddy	Chief Executive Officer and President (Principal Executive Officer and Principal Financial Officer)	March 29, 2006
/s/ CRAIG J. KAUFMANN Craig J. Kaufmann	Controller and Treasurer (Principal Accounting Officer)	March 29, 2006
/s/ ANDREW D. AFRICK Andrew D. Africk	Director	March 29, 2006
/s/ JEFFREY M. KILLEEN Jeffrey M. Killeen	Director	March 29, 2006
/s/ WILLIAM F. STASIOR William F. Stasior	Director	March 29, 2006
/s/ AARON J. STONE Aaron J. Stone	Director	March 29, 2006
/s/ MICHAEL D. WEINER Michael D. Weiner	Director	March 29, 2006