HUNGARIAN TELEPHONE & CABLE CORP
Form 10-Q
November 09, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2007

Commission file number 1-11484

HUNGARIAN TELEPHONE AND CABLE CORP.

(Exact name of registrant as specified in its charter)

Delaware	**13-3652685**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

1201 Third Avenue, Suite 3400 Seattle, WA 98101-3034

(Address of principal executive offices)

(206) 654-0204

(Registrant s telephone number, including area code)

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 ninety days. Yes x No ¨

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

Large Accelerated Filer ¨ Accelerated Filer x Non-Accelerated Filer ¨

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock as of the latest possible date:

Common Stock, $.001 par value	16,410,500 Shares
(Class)	(Outstanding at November 8, 2007)

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HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

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Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

Item 1. Financial Statements

Condensed Consolidated Balance Sheets

(In thousands, except share and per share data)

Assets

	September 30, 2007 (unaudited)	December 31, 2006 (unaudited) as restated (1)
Current assets:		
Cash and cash equivalents	$ 24,991	$ 18,794
Restricted cash		11,850
Accounts receivable, net of allowance of $21,596 in 2007 and $5,608 in 2006	81,237	38,336
Current deferred tax asset, net		1,685
Derivative financial instruments	995	1,138
Other current assets	9,351	7,785
Total current assets	116,574	79,588
Property, plant and equipment, net of depreciation of $192,712 in 2007 and $150,864 in 2006	675,696	180,329
Goodwill, net	88,965	9,622
Other intangibles, net of amortization of $29,467 in 2007 and $8,725 in 2006	186,612	49,364
Deferred costs	6,412	5,751
Deferred tax asset, net		3,286
Derivative financial instruments	2,272	1,818
Other assets	772	2,868
Total assets	$ 1,077,303	$ 332,626

(1) See Note 1(b) Restatements in Notes to Condensed Consolidated Financial Statements.

See accompanying notes to condensed consolidated financial statements.

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Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

Condensed Consolidated Balance Sheets

(In thousands, except share and per share data)

Liabilities and Stockholders Equity

	September 30, 2007 (unaudited)	December 31, 2006 (unaudited) as restated (1)
Current liabilities:		
Current installments of long-term debt	$ 34,257	$ 34,749
Short-term debt to related party		24,657
Current obligations under capital leases	560	469
Accounts payable and other accrued liabilities	121,939	43,758
Derivative financial instruments	22,616	
Warrants		13,050
Advance customer payment		2,310
Other current liabilities	4,692	7,573
Due to related parties	1,784	2,881
Total current liabilities	185,848	129,447
Long-term debt, excluding current installments	788,643	115,351
Long-term obligations under capital leases, excluding current portion		399
Derivative financial instruments	26,885	935
Deferred tax liabilities	10,310	
Other non-current liabilities	7,561	7,796
Total liabilities	1,019,247	253,928
Commitments and contingencies		
Minority interest	18	
Stockholders equity:		
Cumulative Convertible Preferred Stock, $.01 par value; $70.00 liquidation value. Authorized 200,000 shares; issued and outstanding 30,000 shares in 2007 and 2006		
Common Stock, $.001 par value. Authorized 25,000,000 shares; issued and outstanding 16,410,500 shares in 2007 and 12,812,665 shares in 2006	15	14
Additional paid-in capital	208,062	140,001
Accumulated deficit	(169,376)	(87,353)
Accumulated other comprehensive income	19,337	26,036
Total stockholders equity	58,038	78,698
Total liabilities and stockholders equity	$ 1,077,303	$ 332,626

(1) See Note 1(b) Restatements in Notes to Condensed Consolidated Financial Statements.

See accompanying notes to condensed consolidated financial statements.

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Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

Condensed Consolidated Statements of Operations and Comprehensive Income (Loss)

For the Three and Nine Month Periods Ended September 30, 2007 and 2006

(In thousands, except share and per share data)

(unaudited)

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2007	**2006 as restated (1)**	**2007**	**2006 as restated (1)**
Revenue	$ 116,139	$ 47,242	$ 258,127	$ 139,936
Cost of Sales	57,455	24,950	124,309	71,772
Gross margin	58,684	22,292	133,818	68,164
Operating expenses				
Selling, general and administrative	19,044	8,232	52,600	27,401
Depreciation and amortization	26,334	6,505	51,757	19,069
Total operating expenses	45,378	14,737	104,357	46,470
Income from operations	13,306	7,555	29,461	21,694
Other income (expenses)				
Foreign exchange gains (losses), net	(8,187)	4,537	(1,688)	(11,198)
Interest expense	(19,170)	(3,281)	(37,323)	(10,399)
Interest income	471	331	953	823
Gains (losses) on derivative financial instruments	6,573	(783)	(59,327)	2,336
Gains (losses) from fair value changes of warrants		(1,550)	(15,075)	1,175
Loss on extinguishment of debt			(2,918)	
Other, net	(16)	(69)	70	469
Income (loss) before income taxes	(7,023)	6,740	(85,847)	4,900
Income tax benefit (expense)				
Current	(2,354)	(927)	(5,868)	(3,142)
Deferred	(1,783)	(1,071)	9,758	(29)
Total income tax benefit (expense)	(4,137)	(1,998)	3,890	(3,171)
Net income (loss) before cumulative effect of change in accounting principle	$ (11,160)	$ 4,742	$ (81,957)	$ 1,729
Cumulative impact of change in accounting principle				(373)
Minority interest	(1)		6	
Net income (loss)	$ (11,161)	$ 4,742	$ (81,951)	$ 1,356
Cumulative convertible preferred stock dividends	(21)	(26)	(72)	(79)
Net income (loss) attributable to common stockholders	(11,182)	4,716	(82,023)	1,277
Foreign currency translation adjustment	4,142	1,300	6,699	662

Total comprehensive income (loss)	(7,040)	6,016	(75,324)	1,939

(1) See Note 1(b) Restatements in Notes to Condensed Consolidated Financial Statements.

See accompanying notes to condensed consolidated financial statements.

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HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

Condensed Consolidated Statements of Operations and Comprehensive Income (Loss)

For the Three and Nine Month Periods Ended September 30, 2007 and 2006

(In thousands, except share and per share data)

(unaudited)

(Continued)

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2007		2006 as restated (1)		2007		2006 as restated (1)	
Basic net income (loss) per common share:								
Prior to cumulative effect of change in accounting principle	$	(0.68)	$	0.37	$	(5.40)	$	0.13
Cumulative effect of change in accounting principle	$		$		$		$	(0.03)
	$	(0.68)	$	0.37	$	(5.40)	$	0.10
Diluted net income (loss) per common share:								
Prior to cumulative effect of change in accounting principle	$	(0.68)	$	0.33	$	(5.40)	$	0.09
Cumulative effect of change in accounting principle	$		$		$		$	(0.03)
	$	(0.68)	$	0.33	$	(5.40)	$	0.06
Weighted average number of common shares outstanding:								
Basic		16,418,244		12,812,372		15,187,502		12,809,577
Diluted		16,418,244		14,195,595		15,187,502		14,299,185

(1) See Note 1(b) Restatements in Notes to Condensed Consolidated Financial Statements.

See accompanying notes to condensed consolidated financial statements.

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Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

Condensed Consolidated Statements of Stockholders Equity

(In thousands, except share data)

(unaudited)

	Shares	Common Stock	Preferred Stock	Additional Paid-in Capital	Accumulated deficit	Accumulated Other Comprehensive Income	Total Stockholders Equity
Balances at December 31, 2006 (unaudited, as restated)	12,812,665	$ 14		140,001	(87,353)	26,036	$ 78,698
Conversion of notes to equity	2,500,000			53,125			53,125
Net settlement of stock option exercise	152,785	1					1
Stock based compensation	6,500			137			137
Cancellation of Directors options				(250)			(250)
Issue of shares in connection with acquisition of subsidiaries	938,550			15,049			15,049
Cumulative convertible preferred stock dividends					(72)		(72)
Net loss					(81,951)		(81,951)
Foreign currency translation adjustment						(6,699)	(6,699)
Balances at September 30, 2007	16,410,500	15		208,062	(169,376)	19,337	$ 58,038

See accompanying notes to condensed consolidated financial statements.

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Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

Condensed Consolidated Statements of Cash Flows

For the Nine Month Periods Ended September 30, 2007 and 2006

(In thousands)

(unaudited)

	2007	2006
Net cash provided by operating activities	$ 52,868	$ 32,221
Cash flows from investing activities:		
Acquisition of telecommunications network equipment and other intangibles	(41,310)	(13,333)
Acquisition of subsidiaries, net of cash acquired	(111,348)	
Settlement of derivative financial instruments	2,696	
Proceeds from sale of assets	2,629	652
Net cash used in investing activities	(147,333)	(12,681)
Cash flows from financing activities:		
Repayments of long-term debt	(166,552)	(12,068)
Proceeds from new long-term borrowings	272,242	
Refinancing costs paid	(18,846)	
Principal payments under capital lease obligations	(360)	(287)
Release of restricted cash	12,251	
Net cash provided by / (used in) financing activities	98,735	(12,355)
Effect of foreign exchange rate changes on cash	1,927	564
Net increase in cash and cash equivalents	6,197	7,749
Cash and cash equivalents at beginning of period	18,794	15,083
Cash and cash equivalents at end of period	$ 24,991	$ 22,832

Summary of material non-cash transactions:

The Company had derivative financial instruments with a negative non-cash effect of $54.4 million for the nine month period ended September 30, 2007.

On March 28, 2007, TDC exercised its warrants for 2.5 million shares by exchanging notes in the principal amount of $25 million, which were issued by the Company and held by TDC (see Note 2 in Notes to the Condensed Consolidated Financial Statements). The Company recorded a non-cash expense of $15.1 million and $0.1 for the first quarter 2007 and 2006, respectively, relating to the change in the fair

market value of the warrants.

On April 27, 2007 in connection with the acquisition of Matel Holdings as described in Note 3, the Company issued 938,550 shares with an assigned value of $15 million (EUR 11 million) and assumed debt of Invitel in the amount of $525 million.

See accompanying notes to condensed consolidated financial statements.

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Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

Notes to the Condensed Consolidated Financial Statements

(1) Summary of Significant Accounting Policies

(a) Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of Hungarian Telephone and Cable Corp. (HTCC) with its consolidated subsidiaries, HTCC Holdco I B.V. (Holdco I), HTCC Holdco II B.V. (Holdco II), Matel Holdings N.V. (Matel Holdings) Magyar Telecom B.V. (Matel), Invitel Tavkozlesi Szolgaltato zRt. (Invitel), V-holding zRt. (V-Holding), Euroweb Internet Szolgaltato zRt. (Euroweb Hungary), Euroweb Romania S.A. (Euroweb Romania), Hungarotel Tavkozlesi zRt. (Hungarotel), PanTel Tavkozlesi es Kommunikacios Kft. (PanTel) and PanTel Technocom Kft. (PanTel Technocom) (together the Company) include all adjustments, consisting mainly of normal recurring accruals, necessary for a fair statement of the results of the interim periods. PanTel owns and consolidates several minor non-Hungarian subsidiaries within the Central and Eastern European region. Results for interim periods are not necessarily indicative of the results for a full year. All inter-company balances and transactions have been eliminated.

Unless the context requires otherwise, references in this report to the Company , we , us and our refer to Hungarian Telephone and Cable Corp. and its consolidated subsidiaries.

Pursuant to the Sale and Purchase Agreement that the Company entered into with Invitel Holdings N.V. on January 8, 2007, the Company completed its acquisition of 100% of the issued ordinary shares of Matel Holdings and thus 99.98% of the outstanding shares of Invitel. The closing of the transaction occurred on April 27, 2007 and the consolidated results of Matel Holdings for the five months ended September 30, 2007 (and the balance sheet as at September 30, 2007) have been consolidated into the financial statements of the Company.

The accompanying unaudited condensed consolidated financial statements are prepared in accordance with generally accepted accounting principles in the U.S. (U.S. GAAP). In preparing financial statements in conformity with U.S. GAAP, management is required to make estimates and assumptions. These estimates and assumptions affect reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements, as well as revenues and expenses during the reporting period. Actual results could differ from those estimates.

During the preparation of its quarterly report on Form 10-Q for the quarterly period ended June 30, 2007, the Company determined that it had made some clerical calculation errors in 2006 related to the application of Statement of Financial Accounting Standards (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, with respect to some embedded derivatives that are contained in certain operating contracts that the Company s subsidiaries entered into which are settled in euros.

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HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

Notes to the Condensed Consolidated Financial Statements

The Company informed its former independent public accounting firm about this matter. Following a thorough review of the matter by the Company s management in consultation with the Company s former independent public accounting firm, the Company s audit committee concluded on August 14, 2007 that it would be necessary to adjust its 2006 financial statements to reflect an additional cumulative, net non-cash corrective charge of approximately $2.0 million. The Company s audit committee determined that it will be necessary to file a second amendment to its 2006 Annual Report on Form 10-K to account for such adjustment. The restatement has no effect on the Company s cash flows or liquidity. The Company expects to file the second amendment to its Annual Report on Form 10-K as soon as reasonably practicable.

The accompanying unaudited condensed consolidated financial statements for the three and nine month periods ended September 30, 2007 have been adjusted to reflect the corrections for the three and nine month periods ended September 30, 2006.

The unaudited condensed consolidated financial statements should be read in conjunction with the (i) restated audited consolidated financial statements of the Company for the year ended December 31, 2006, including the notes thereto, which are filed with the Unites States Securities and Exchange Commission (SEC) and (ii) all subsequent filings with the SEC regarding such financial statements.

(b) Restatements

For its Condensed Consolidated Financial Statements of Operations and Comprehensive Income (Loss) for the three and nine month periods ended September 30, 2006, the Company has restated the presentation of its revenues following the guidance of Emerging Issues Task Force No. 99-19. Historically, the Company presented revenues net of cost of sales but now presents separately its gross revenues, costs of sales and resulting gross margins. This restated accounting presentation has no impact on the gross margin, previously reported as Telephone services revenues, net in the Condensed Consolidated Statements of Operations and Comprehensive Income.

For its Condensed Consolidated Financial Statements of Operations and Comprehensive Income (Loss) for the three and nine month periods ended September 30, 2006, the Company has reclassified its Hungarian local business tax from selling, general and administrative expenses to current income tax in accordance with Statement of Financial Accounting Standard (SFAS) No. 109. For the three and nine month periods ended September 30, 2006, $914,000 and $2,977,000, respectively, was reclassified. This restated accounting presentation has no impact on the net income or earnings per share as reported in the Condensed Consolidated Statements of Operations and Comprehensive Income (Loss).

The Company determined that it misapplied SFAS No. 133 Accounting for Derivative Instruments and Hedging Activities in connection with warrants that the Company issued in 1999 to purchase 2,500,000 shares of HTCC s common stock.

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HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

Notes to the Condensed Consolidated Financial Statements

Historically, the Company did not reflect the changes in the fair market value of the warrants (marking to market) as the fair market value of HTCC s common stock fluctuated. For its Consolidated Financial Statements of Operations and Comprehensive Income (Loss) for the three and nine month periods ended September 30, 2006 disclosed herein, the Company has recorded a loss of $1,550,000 and a gain of $1,175,000, respectively, on the change in the fair market value of the warrants. In connection with this restatement, a non-cash charge of $13,050,000 has been reflected as an adjustment to accumulated deficit as of December 31, 2006 and the creation of a corresponding liability. The warrants were exercised on March 28, 2007.

The Company determined that it misstated its Consolidated Financial Statements for the year ended December 31, 2006 in connection with its accounting for embedded derivatives. The Company determined that it had accounted for a gain of $832,000 net of tax of $166,000 instead of a loss of $935,000 net of tax of $187,000 in its Consolidated Statements of Operations and Comprehensive Income (Loss) for the year ended December 31, 2006. The Company has corrected such amounts in its restated 2006 financial statements disclosed herein.

For its Condensed Consolidated Statements of Operations and Comprehensive Income (Loss) for the three and nine month period ended September 30, 2006, the Company has reclassified the following expenses from selling, general and administrative expenses to cost of sales: (i) sales commissions paid to third party agents; (ii) labor expenses of network labor force and other employees who perform functions directly related to network maintenance; and (iii) expenses relating to the operation and maintenance of our network. For the three and nine month periods ended September 30, 2006, $4,451,000 and $12,798,000, respectively, was reclassified.

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standard (SFAS) No. 123 (revised 2004), Share-Based Payment, (SFAS 123R). SFAS 123R requires the measurement and recognition of compensation expense based on the fair value of the employee stock based awards issued. Management has determined that certain awards previously treated as variable awards under ABP 25 should be classified as liability awards rather than equity awards under FAS 123R. As a result, 2006 amounts disclosed herein have been restated to reflect the revaluation each period of these awards with a corresponding adjustment in earnings. For the three and nine months ended September 30, 2006, the Company recognized adjustments of a loss of $465,000 and a gain of $487,000, respectively, representing reductions in previously recognized compensation expense, as well as a $ 373,000 as January 1, 2006 cumulative transition adjustment.

(c) Earnings Per Share

Basic earnings per share (EPS) is computed by dividing income attributable to common stockholders by the weighted average number of common shares outstanding for the period. The computation of diluted EPS is similar to the computation of basic EPS, except that the weighted average number of common shares outstanding is increased to include

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HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

Notes to the Condensed Consolidated Financial Statements

additional shares from the assumed exercise of stock options and warrants and the conversion of the convertible preferred stock, where dilutive. The number of additional shares is calculated by assuming that preferred securities were converted and that outstanding stock options and warrants were exercised and the proceeds therefrom were used to acquire shares of the Company s common stock at the average market price during the reporting period.

The following is a reconciliation from basic earnings (loss) per share to diluted earnings (loss) per share for the three and nine month periods ended September 30, 2007 and 2006:

($ in thousands, except share data)	3 months ended 2007	3 months ended 2006 (restated)	9 months ended 2007	9 months ended 2006 (restated)
Net income (loss) attributable to Common stockholders before cumulative effect of change in accounting principle after minority interest (A)	$ (11,182)	$ 4,716	$ (82,023)	$ 1,650
Cumulative effect of change in accounting principle (E)	$	$	$	$ (373)
Net income (loss) (B)	$ (11,182)	$ 4,716	$ (82,023)	$ 1,277
plus: preferred stock dividends	21	26	72	79
Net income (loss) attributable to common stockholders	$ (11,161)	$ 4,742	$ (81,951)	$ 1,356
Determination of shares:				
Weighted average common shares outstanding basic (C)	16,418,244	12,812,372	15,187,502	12,809,577
Assumed conversion of dilutive stock options and cumulative convertible preferred stock		1,383,223		1,489,608
Weighted average common shares outstanding diluted (D)	16,418,244	14,195,595	15,187,502	14,299,185
Basic net income (loss) per common share:				
Prior to cumulative effect of change in accounting principle (A/C)	$ (0.68)	$ 0.37	$ (5.40)	$ 0.13
Cumulative effect of change in accounting principle (E/C)	$	$	$	$ (0.03)
	$ (0.68)	$ 0.37	$ (5.40)	$ 0.10
Diluted net income (loss) per common share:				
Prior to cumulative effect of change in accounting principle (B/D)	$ (0.68)	$ 0.33	$ (5.40)	$ 0.09
	$	$	$	$ (0.03)

Cumulative effect of change in accounting principle (E/D)								
	$	(0.68)	$	0.33	$	(5.40)	$	0.06

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Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

Notes to the Condensed Consolidated Financial Statements

For the three and nine month period ended September 30, 2007, common stock equivalents and convertible preferred stock of 1,059,981 and 1,790,538, respectively, were excluded from the computation of diluted loss per share because the effect of their inclusion would be anti-dilutive.

(d) Foreign Currency Translation

The Company uses the Hungarian forint (HUF) as the functional currency for its Hungarian subsidiaries. The Hungarian subsidiaries assets and liabilities are translated into U.S. dollars using the exchange rates in effect at the balance sheet date. Results of operations are translated using the average exchange rates prevailing throughout the period. The effects of exchange rate fluctuations on translating HUF assets and liabilities into U.S. dollars are accumulated as part of other comprehensive income in stockholders equity. Euro denominated debt is re-measured into HUF with a corresponding charge to earnings as exchange gains/(losses).

The Company uses the HUF as the functional currency of PanTel s and Invitel s non-Hungarian subsidiaries. Accordingly, foreign currency assets and liabilities of the non-Hungarian subsidiaries are translated into HUF using the exchange rates in effect at the balance sheet date. Results of operations are translated using the average exchange rates prevailing throughout the period. The effects of exchange rate fluctuations on translating the local currency assets and liabilities of the non-Hungarian subsidiaries into HUF are accumulated as part of foreign exchange gains/(losses) in the consolidated statement of operations.

The translation of the subsidiaries forint denominated balance sheets into U.S. dollars, as of September 30, 2007, has been affected by the strengthening of the Hungarian forint against the U.S. dollar from 191.62 as of December 31, 2006 to 176.84 as of September 30, 2007, an approximate 8% appreciation in value. The average Hungarian forint/U.S. dollar exchange rates used for the translation of the subsidiaries forint denominated statements of operations and statements of cash flows into U.S. dollars, for the three month periods ended September 30, 2007 and 2006, were 183.27 and 216.17, respectively. The average Hungarian forint/U.S. dollar exchange rates used for the translation of the subsidiaries forint denominated statements of operations and statements of cash flows into U.S. dollars, for the nine month periods ended September 30, 2007 and 2006, were 186.73 and 213.31, respectively.

(e) Stock Based Compensation

The Company has three equity compensation plans: the Non-Employee Director Stock Option Plan (the Director Stock Option Plan) which was established by the Company s Board of Directors (the Board) in 1997; the 2002 Incentive Stock Option Plan (the 2002 Stock Option Plan) which amendment and renaming was approved by the Company s stockholders in 2002; and the 2004 Long-Term Incentive Plan (the 2004 Plan) which was approved by the Company s stockholders in 2004.

Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARIES

Notes to the Condensed Consolidated Financial Statements

Upon the approval of the 2004 Plan, the Company agreed not to issue any more options from either the Director Stock Option Plan or the 2002 Stock Option Plan. The 2004 Plan authorized 1,000,000 shares of common stock for awards. In addition to such 1,000,000 shares, the 2004 Plan includes any shares of common stock that remained available for issuance under the 2002 Stock Option Plan and the Director Stock Option Plan as of the date the 2004 Plan was approved by the Company s stockholders. As of the adoption of the 2004 Plan, 424,410 shares of common stock which were then available for issuance under the 2002 Stock Option Plan were rolled over and available for issuance under the 2004 Plan and 88,716 shares of common stock which were then available for issuance under the Director Stock Option Plan were rolled over and available for issuance under the 2004 Plan. In addition, any shares of common stock subject to awards outstanding under the 2002 Stock Option Plan or the Director Stock Option Plan at the time of the adoption of the 2004 Plan which subsequently lapse, expire or otherwise terminate without the issuance of such common stock are also available for awards under the 2004 Plan.

Stock options from the 2004 Plan may be either incentive stock options under Section 422 of the U.S. Internal Revenue Code or options not intended to qualify as incentive stock options (nonqualified options). The term of an option cannot exceed ten years from the date of grant. All options must have an option price that is not less than the fair market value of a share of common stock on the date of grant. Upon exercise of an option, the participant may pay the option price in cash, by delivering shares of common stock to the Company or by having the Company withhold shares otherwise deliverable to the participant upon exercise (net exercise). An option may also be exercised through a cashless exercise procedure involving a broker or dealer. The net exercise feature resulted in variable accounting under the previous accounting rules.

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standard (SFAS) No. 123 (revised 2004), Share-Based Payment, (SFAS 123R). SFAS 123R requires the measurement and recognition of compensation expense based on the fair value of the employee stock based awards issued. Compensation expense for awards and related tax effects are recognized as they vest. The Company has adopted SFAS 123R using the modified prospective transition method. Under this transition method, compensation cost recognized effective January 1, 2006 includes: (1) compensation cost for all share based awards granted prior to, but not yet vested as of, January 1, 2006 based on the original measure of the grant date fair value method under the provisions of SFAS 123 for pro-forma disclosure, and (2) compensation cost for all share-based awards granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. Results for periods prior to the adoption of the new standard were not restated at the time of transition.

In addition, awards previously treated as variable awards are classified as liability awards under the new standard and are subject to revaluation each period, with a corresponding adjustment in earnings for changes in the fair value of outstanding awards.

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For the three and nine month periods ended September 30, 2007, the Company recognized a benefit of $310,000 and an expense of $99,000, respectively, related to stock options granted according to SFAS 123R. For the three and nine month periods ended September 30, 2006, the Company recognized an expense of $465,000 and a benefit of $487,000 related to SFAS 123R.

(f) Recently Issued Accounting Pronouncements

On January 1, 2007, the Company adopted the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109, Accounting for Income Taxes (FIN 48), which clarifies the accounting for uncertainty in income taxes. FIN 48 establishes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 requires that the Company recognize in the financial statements, the impact of a tax position, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. FIN 48 also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods and disclosure. The adoption of FIN 48 has had no significant impact on the Company s consolidated results of operations and financial position or cash flows. As disclosed in the Company 10-K filing as of December 31, 2006, we are engaged in legal proceedings in connection with the payment of local business tax to Hungarian municipalities. Although management does not expect a significant change to our previously recognized tax benefits, it is possible that the result of these proceedings could change within the next 12 months and impact this position.

HTCC files income tax returns in the U.S. while its directly owned subsidiaries file income tax returns in the Netherlands and in Hungary. The Company also files returns in six other Central and Eastern European countries where it has established subsidiaries. We are not aware of any outstanding issue or claim that is likely to be material to our financial position, cash flows or results of operations in any of the jurisdictions in which we operate. The Company currently does not have any provisions for unrecognized tax benefits.

In February 2007, the FASB issued SFAS No. 159 (SFAS 159), The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 which permits entities to choose to measure many financial instruments and certain warranty and insurance contracts at fair value on a contract-by-contract basis. SFAS 159 applies to all reporting entities, including not-for-profit organizations, and contains financial statement presentation and disclosure requirements for assets and liabilities reported at fair value as a consequence of the election. SFAS 159 is effective as of the beginning of an entity s first fiscal year that begins after November 15, 2007. Early adoption is permitted subject to certain conditions; however an early adopter must also adopt SFAS No. 157, Fair Value Measurements , at the same time. The Company is currently evaluating the effect that the adoption of SFAS 159 will have on its consolidated results of operations and financial position or cash flows.

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(2) Related Parties

The net balance of receivables from and payables to related parties totaling a payable in the amount of $772,000 at September 30, 2007, represents cumulative preferred stock dividends in arrears payable to TDC in the amount of $829,000, an accrual of $633,000 for the costs for various individuals employed by TDC who have performed work for the Company and a net $690,000 receivable in connection with the transport of international voice, data and Internet traffic over the Company s and TDC s respective telecommunications networks for each other.

On March 28, 2007, TDC exercised its warrants to purchase 2,500,000 shares of the Company s common stock in exchange for notes issued by the Company and held by TDC in the principal amount of $25 million. As of September 30, 2007, TDC owned 64% of the Company s outstanding common stock and 30,000 shares of preferred stock convertible into 300,000 shares of common stock.

Robert Dogonowski, Jesper Theill Eriksen, Carsten Dyrup Revsbech and Henrik Scheinemann, current directors of the Company, are officers of TDC. Torben V. Holm was an employee of TDC when he served as the Company s President and Chief Executive Officer and as the head of management s executive committee. Alex Wurtz was also an employee of TDC when he served as the Company s head of Corporate Business Development and as a member of management s executive committee.

For Mr. Holm, the Company paid EUR 981,371 (approximately $1.4 million) for his services for the period from May 2005 through April 2007. The Company was also responsible for paying other costs pertaining to Mr. Holm, including lodging in Budapest and for certain of Mr. Holm s travel costs back to his home in Denmark.

For Mr. Wurtz, the Company paid EUR 501,707 (approximately $0.7 million) for his services for the period from June 2005 through April 2007. The Company was also responsible for paying Mr. Wurtz s lodging in Budapest.

In addition to the services of Mr. Holm and Mr. Wurtz, three employees of TDC performed financial controlling services for the Company. The Company reached an agreement with TDC to pay approximately $201,000 for such services. TDC also provided services for the Company in connection with certain strategic projects, including services in connection with the Company s acquisition of Invitel. For such services, the Company has agreed to reimburse TDC approximately $448,000, which was outstanding as of September 30, 2007.

All of the directors of the Company are covered by a directors and officers liability policy taken out by TDC. As of September 30, 2007, the Company had approximately $210,000 in expenses for the Company s portion of the overall premium paid by TDC.

The Company has agreements in place with TDC and its subsidiaries, pursuant to which TDC and the Company transport international voice, data and Internet traffic for each other over their respective telecommunications networks. For the three month periods ended September 30, 2007 and 2006, the Company transported these services for TDC in the amounts of approximately $652,000 and $488,000, respectively, pursuant to such agreements. For the nine month periods ended

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September 30, 2007 and 2006, the Company transported these services for TDC in the amounts of approximately $1,707,000 and $1,324,000 respectively, pursuant to such agreements. For the three month periods ended September 30, 2007 and 2006, the Company agreed to pay TDC an amount of approximately $133,000 and $216,000, respectively, pursuant to such agreements. For the nine month periods ended September 30, 2007 and 2006, the Company agreed to pay TDC an amount of approximately $641,000 and $472,000, respectively, pursuant to such agreements.

(3) Acquisition of Matel Holdings

On April 27, 2007, pursuant to a Sale and Purchase Agreement that the Company entered into with Invitel Holdings N.V. on January 8, 2007, the Company completed its acquisition of 100% of the issued ordinary shares of Matel Holdings and thus 99.98% of the outstanding shares of Invitel (the Invitel Acquisition).

The primary reason for the Invitel Acquisition was that this business combination significantly strengthens our position as the second largest fixed line telecommunications service provider and the number one alternative fixed line operator in Hungary. The Invitel Acquisition provides us with a larger customer base, a more extensive backbone network and enables us to benefit from Invitel s and Hungarotel s combined 14 geographically clustered historical concession areas. The business combination also provides us with a more substantial platform from which to take advantage of key potential service development opportunities and any further market consolidation. The combined business will also benefit from a greater diversity in its sources of revenue, which will make it less susceptible to market pressures in any single market.

The purchase price, including the assumption of net indebtedness, was EUR 470 million. The Company used a discounted cash flow methodology and comparable trading multiples in determining the purchase price.

The purchase price was increased by transaction and other directly related expenses. The total purchase consideration of EUR 479 million included: (i) the payment of cash in the amount of EUR 71 million (approximately $96 million at closing), (ii) 938,550 shares issued by HTCC at a fair value of EUR 11 million (approximately $15 million at closing), (iii) transaction costs and other directly related expenses of EUR 11 million (approximately $15 million at closing) and (iv) net debt assumed of EUR 386 million (approximately $525 million at closing, the Assumed Net Debt). The Assumed Net Debt consists primarily of (a) EUR 133 million in aggregate principal amount and accrued interest of floating rate senior PIK notes due 2013 (the 2006 PIK Notes), (b) EUR 145 million in aggregate principal amount of 10 3/4% Senior Notes due 2012 (the 2004 Notes), and (c) a Facilities Agreement in the amount of EUR 116 million, which was amended and restated in connection with the Invitel Acquisition (the Amended Facilities Agreement) less cash and cash equivalents on closing.

The Invitel Acquisition was financed by: (i) the issuance on April 27, 2007 of Floating Rate Senior Notes, due 2013, for an amount of EUR 200 million (the 2007 Notes), which proceeds were used to pay part of the Invitel Acquisition

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consideration and to refinance the Company s existing credit facility, and (ii) the issuance of 938,550 shares of the Company s common stock to certain members of Invitel s management team. In order to clarify the rights of the creditors under the various debt instruments, Holdco II, Matel Holdings and various creditors and certain other parties also entered into an amended and restated Intercreditor Agreement (the Intercreditor Agreement).

Under the purchase method of accounting, and in accordance with SFAS No. 141 Business Combinations , the Company is required to allocate the cost of an acquired business based on the estimated fair values of the assets acquired and liabilities assumed. The Company engaged a professional valuation firm to determine the estimated fair values of assets acquired and liabilities assumed as of April 27, 2007, the closing date of the Invitel Acquisition. The Company has finalized the purchase price allocation and determined $79 million in goodwill, which represents the excess of the purchase price over the fair value of the net assets acquired.

The following represents the final allocation of the purchase price paid for Matel Holdings based on the fair values of the acquired assets and assumed liabilities as of April 27, 2007:

	April 27, 2007 (in thousands)
Current assets	$ 49,893
Property, plant and equipment	476,146
Intangible assets	132,921
Other non-current assets	2,907
Deferred tax	(25,320)
Current and non-current liabilities	(63,608)
Net assets acquired	$ 572,939
Purchase Price:	
Long-term debt assumed	525,192
Cash	96,483
Shares issued	15,052
Transaction costs and other directly related expenses	14,865
Total purchase price	$ 651,592
Goodwill	**$ 78,653**

The following table presents the fair values of major components of the intangible assets acquired:

	April 27, 2007 (in thousands)	Weighted average amortization period
Customer relationships	$ 62,991	16 years
Trademark	27,038	indefinite

Homezone	2,030	4 years
3.5 GHz license	13,033	9 years
Right of ways	1,921	14 years
Software	16,893	4 years
Other intangible assets	9,015	3 years
Total:	**$ 132,921**	

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The closing of the transaction occurred on April 27, 2007 and the consolidated results of Matel Holdings for the five months ended September 30, 2007 (and the balance sheet as at September 30, 2007) have been consolidated into the financial statements of the Company.

The following table presents unaudited summarized consolidated financial information of the Company and Matel Holdings, on a pro-forma basis, as though the companies had been combined at the beginning of the respective periods:

	Three months ended September 30	Nine months ended September 30
	2007	
	Pro-forma	