

**XANADOO COMPANY AND SUBSIDIARIES**  
**(f.k.a. PEGASUS COMMUNICATIONS CORPORATION)**

**FINANCIAL STATEMENTS**

**For the Years Ended December 31, 2006 and 2005**

Xanadoo Company and Subsidiaries  
(f.k.a. Pegasus Communications Corporation)  
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**Marcum & Kliegman LLP**  
Certified Public Accountants & Consultants  
A Limited Liability Partnership Consisting of Professional Corporations

INDEPENDENT AUDITORS' REPORT

To the Board of Directors of  
Xanadoo Company  
(formerly known as Pegasus Communications Corporation)

We have audited the accompanying consolidated balance sheets of Xanadoo Company (formerly known as Pegasus Communications Corporation) and Subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of operations, stockholders' equity and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated 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 consolidated 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 includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Xanadoo Company (formerly known as Pegasus Communications Corporation) and Subsidiaries as of December 31, 2006 and 2005, and the consolidated results of its operations, stockholders' equity and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

*Marcum & Kliegman LLP*

May 22, 2007

**Xanadoo Company and Subsidiaries**  
**(f.k.a Pegasus Communication Corporation)**  
**Consolidated Balance Sheets**  
(In thousands, except share amounts)  
December 31, 2006 and 2005

	2006	2005
<b>ASSETS:</b>		
Current assets:		
Cash and cash equivalents	\$ 6,830	\$ 29,542
Short-term investments	2,644	5,267
Accounts receivable:		
Trade, less allowance for doubtful accounts of \$48 and \$69, respectively	204	61
Other (including due from affiliates of \$177 and \$69, respectively)	200	286
Inventory	161	392
Prepaid expenses and other current assets	695	928
Total current assets	10,734	36,476
Property and equipment, net	23,020	20,452
Intangible assets, net	119,447	129,725
Assets held for sale, net	501	824
Other noncurrent assets	377	695
Total assets	\$ 154,079	\$ 188,172
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Current portion of long term debt	\$ 224	\$ 214
Accounts payable	1,593	342
Accrued expenses and other current liabilities	3,955	3,571
Total current liabilities	5,772	4,127
Long term debt	7,677	7,901
Other noncurrent liabilities	182	77
Total liabilities	13,631	12,105
Commitments and contingencies		
Minority interest	2,912	2,912
Stockholders' equity:		
Series C convertible preferred stock, \$0.01 par value; 3.0 million shares authorized; shares issued and outstanding: 1,991,147 and 1,991,147, respectively; liquidation preference: \$260.5 million and \$247.5 million, respectively	20	20
Class A common stock, \$0.01 par value; 2.5 million shares authorized; shares issued: 117,299 and 116,341, respectively; shares outstanding: 113,581 and 113,479, respectively	117	116
Class B common stock, \$0.01 par value; 300,000 shares authorized; shares issued: 18,328; shares outstanding: 17,467	18	18
Nonvoting common stock, \$0.01 par value; 2.0 million shares authorized; no shares issued and outstanding	-	-
Additional paid in capital	1,415,328	1,414,524
Investment in and receivable from affiliates	(14,655)	(14,655)
Accumulated deficit	(1,260,453)	(1,224,213)
Class A and B common stock in treasury, at cost; 4,580 and 3,723 shares, respectively	(2,839)	(2,655)
Total stockholders' equity	137,536	173,155
Total liabilities and stockholders' equity	\$ 154,079	\$ 188,172

The accompanying notes are an integral part of these consolidated financial statements.

**Xanadoo Company and Subsidiaries**  
**(f.k.a Pegasus Communications Corporation)**  
**Consolidated Statements of Operations**  
(In thousands, except per share amounts)  
For the Years Ended December 31, 2006 and 2005

	2006	2005
<b>Revenues:</b>		
Wireless high-speed Internet services	\$ 1,673	\$ 859
Equipment and other, net	289	-
	1,962	859
<b>Operating expenses:</b>		
Wireless high-speed Internet services:		
Direct operating expenses	2,943	1,439
Advertising and selling	2,604	2,831
General and administrative	7,812	2,524
Depreciation and amortization	1,759	881
Total wireless high-speed Internet services	15,118	7,675
Corporate and development expenses (net of \$5,689 in 2005 allocated to the Debtors under the Support Services Agreement)	5,448	4,610
Corporate depreciation and amortization (net of \$637 in 2005 allocated to the Debtors under the Support Services Agreement)	14,963	14,693
Other operating expenses (net of \$420 in 2005 allocated to the Debtors under the Support Services Agreement)	3,608	3,136
Total operating expenses	39,137	30,114
Loss from operations	(37,175)	(29,255)
Interest expense	(592)	(675)
Interest income	1,158	1,384
Rental revenue	827	871
Other nonoperating expense, net	(441)	(14)
Loss before income taxes and discontinued operations	(36,223)	(27,689)
Income tax expense	(17)	(30)
Loss before discontinued operations	(36,240)	(27,719)
<b>Discontinued operations:</b>		
Income from discontinued operations (including income from derecognition of negative investment in Pegasus Satellite Communications, Inc. of \$413,125 in 2005)	-	413,125
Net (loss) income	\$ (36,240)	\$ 385,406
<b>Basic and diluted per common share amounts:</b>		
Loss from continuing operations applicable to common shares	\$ (376.77)	\$ (311.59)
Income from discontinued operations	-	3,167.97
Net (loss) income applicable to common shares	\$ (376.77)	\$ 2,856.38
Weighted average number of common shares outstanding:	130,536	130,407

The accompanying notes are an integral part of these consolidated financial statements.

**Xanadoo Company and Subsidiaries**  
**(f.k.a Pegasus Communications Corporation)**  
**Consolidated Statements of Stockholders' Equity**  
(In thousands)

For the Years Ended December 31, 2006 and 2005

	Series C Convertible Preferred Stock		Class A Common Stock		Class B Common Stock		Additional Paid In Capital		Investment in and receivable from Affiliate	Deferred Compensation Expense	Accumulated Deficit	Treasury Stock		Total Stockholders' Equity
	Number of Shares	Par Value	Number of Shares	Par Value	Number of Shares	Par Value	Paid In Capital	Number of Shares				Cost		
January 1, 2005	1,939	\$19	115	\$115	18	\$18	\$1,412,406		\$(14,661)	\$ (812)	\$(1,609,619)	3	\$(2,665)	\$ (215,199)
Net income											385,406			385,406
Common stock issued for:														
Exercise of stock options							360							361
Stock plans and awards							(172)			(84)			141	(115)
Preferred stock issued in satisfaction of liability	52	1					1,387			596				1,388
Stock-based compensation expense prior to adoption of FAS 123R							(300)			300				596
Reclassification of unamortized deferred compensation upon adoption of FAS 123R							730		6					730
Stock-based compensation expense after adoption of FAS 123R														-
Investment in affiliates														730
Class A common stock acquired														-
Class A common stock used to acquire intangible assets												1	(276)	(276)
December 31, 2005	1,991	\$20	116	\$116	18	\$18	\$1,414,524		\$(14,655)	\$ -	\$(1,224,213)	4	\$(2,655)	\$ 173,155
January 1, 2006	1,991	\$20	116	\$116	18	\$18	\$1,414,524		\$(14,655)	\$ -	\$(1,224,213)	4	\$(2,655)	\$ 173,155
Net loss											(36,240)			(36,240)
Common stock issued for:														
Employee plans and awards							219						(16)	204
Class A common stock repurchased												1	(186)	(186)
Stock-based compensation expense							570							570
Common stock used to acquire intangible assets							15						18	33
December 31, 2006	1,991	\$20	117	\$117	18	\$18	\$1,415,328		\$(14,655)	\$ -	\$(1,260,453)	5	\$(2,839)	\$ 137,536

The accompanying notes are an integral part of these consolidated financial statements.

**Xanadoo Company and Subsidiaries**  
**(f.k.a. Pegasus Communications Corporation)**  
**Consolidated Statements of Cash Flows**  
(In thousands)  
For the Years ended December 31, 2006 and 2005

	2006	2005
Cash flows from operating activities:		
Net (loss) income	\$ (36,240)	\$ 385,406
Adjustments to reconcile net (loss) income to net cash used in operating activities:		
Income from derecognition of negative investment in Pegasus Satellite Communications, Inc.	-	(413,125)
Depreciation and amortization	16,721	15,574
Non-cash incentive compensation	774	1,191
Bad debt expense	35	34
Loss on disposal of assets and asset impairments	411	-
Other	24	127
Change in assets and liabilities:		
Accounts receivable	(92)	1,392
Inventory	231	(392)
Prepaid expenses and other current assets	233	(210)
Other noncurrent assets	114	1,177
Accounts payable and accrued expenses	1,635	(3,394)
Other noncurrent liabilities	105	-
Net cash used in operating activities	(16,049)	(12,220)
Cash flows from investing activities:		
Capital expenditures for property and equipment	(4,739)	(4,196)
Purchases of intangible assets	(4,334)	(1,201)
Proceeds from sale of property and equipment	7	-
Short-term investments purchased	(19,218)	(33,828)
Short-term investments sold	21,817	52,049
Other	204	(190)
Net cash (used in) provided by investing activities	(6,263)	12,634
Cash flows from financing activities:		
Borrowings under RUS loan facility	1,889	-
Repayments of RUS loan facility	(1,889)	-
Repayments of long term debt	(214)	(173)
Purchases of common stock	(186)	(276)
Proceeds from exercise of stock options	-	361
Other	-	20
Net cash used in financing activities	(400)	(68)
Net (decrease) increase in cash and cash equivalents	(22,712)	346
Cash and cash equivalents, beginning of year	29,542	29,196
Cash and cash equivalents, end of year	\$ 6,830	\$ 29,542
 Supplemental Cash Flow Disclosures		
Non cash investing and financing activities:		
Common stock issued to acquire intangible assets	\$ 33	\$ 264
Issuance of preferred stock to satisfy liability	\$ -	\$ 1,388
Cash paid for interest	\$ 577	\$ 690

The accompanying notes are an integral part of these consolidated financial statements.

**Xanadoo Company and Subsidiaries**  
**(f.k.a Pegasus Communications Corporation)**  
**Notes to Consolidated Financial Statements**

**1. Nature of Business**

Xanadoo Company (formerly known as Pegasus Communications Corporation) is a Delaware holding corporation, and conducts substantially all of its operations through its direct and indirect subsidiaries. All subsequent references to the "Company" and "Xanadoo" refer to Xanadoo Company, together with its direct and indirect consolidated subsidiaries (see *Note 3 – Basis of Presentation*), and variable interest entities in which the Company is deemed to hold the primary beneficial interest. Other terms used are defined as necessary when they first appear.

The Company's business and assets are concentrated in three areas: (i) the provision of wireless high-speed Internet services to consumers and businesses; (ii) the development of 700 MHz wireless frequencies acquired at auction from the Federal Communications Commission in 2000 and 2001 ("700 MHz Licenses"); and (iii) the realization of value from intellectual property rights licensed to the Company in 2000 ("Personalized Media License") whose claims cover the provision of certain satellite-delivered interactive media services. As of December 31, 2006, the Company offered wireless high-speed Internet service in Texas utilizing licensed frequencies in the 2.5 GHz frequency band (the Company's "Xanadoo<sup>sm</sup>" branded service launched in the first quarter of 2006) and unlicensed frequencies in the 900 MHz, 2.4 GHz and 5 GHz frequency bands ("Pegasus Broadband<sup>sm</sup>" branded service). As of December 31, 2006, the Company served approximately 7,200 subscribers (unaudited) through the Xanadoo and Pegasus Broadband branded services.

As discussed in note 15, on August 14, 2006, Xanadoo's board of directors approved a 1 for 100 reverse stock split of the Company's common stock on the recommendation of a special committee of outside directors. The reverse stock split was approved by stockholders on December 29, 2006 and became effective on January 2, 2007. The effect of this reverse stock split has been retroactively reflected throughout the consolidated financial statements including these notes to the consolidated financial statements.

**2. Management Plans and Liquidity**

As of December 31, 2006, the Company had \$9.5 million of aggregate cash, cash equivalents, and short-term investments. Based on the Company's current operating plan and condition at year-end 2006, external cash resources were required to fund the operating expenses and continued development of its wireless high-speed Internet business. Consequently, the Company completed a financing transaction, as discussed in note 15, through which the Company has raised \$30.0 million through the issuance of Senior Secured Notes by Xanadoo Holdings, Inc. ("XHI"), a wholly-owned subsidiary of the Company. The financing provides sufficient liquidity to meet cash requirements and fund the development of the Company's wireless high-speed Internet business through at least December 31, 2007.

**3. Summary of Significant Accounting Policies**

*Basis of Presentation*

The Company's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America. Except as noted hereinafter for Pegasus Satellite Communications, Inc., the Company's consolidated financial statements include the accounts of Xanadoo, its direct and indirect subsidiaries, and variable interest entities in which the Company is

**Xanadoo Company and Subsidiaries**  
**(f.k.a Pegasus Communications Corporation)**  
**Notes to Consolidated Financial Statements**

**3. Summary of Significant Accounting Policies (continued)**

deemed to hold the primary beneficial interest. All intercompany transactions and balances between consolidated entities have been eliminated. Investments in other entities in which the Company does not have a significant or controlling interest are accounted for using the cost method.

The balance in minority interest at December 31, 2006 and 2005 represents holdings by Pegasus PCS Partners, a variable interest entity that management has determined that the Company is the primary beneficiary of (see *Investment in Affiliate* below).

On June 2, 2004, Pegasus Satellite Communications, Inc. ("Pegasus Satellite") and certain of its subsidiaries (collectively referred to herein as the "Debtors") filed for Chapter 11 bankruptcy protection in the U.S. Bankruptcy Court, District of Maine (the "Bankruptcy Court"). The Chapter 11 filing did not include Xanadoo or its direct subsidiaries other than Pegasus Satellite. As a result of the Chapter 11 filing, the operations of the Debtors became subject to the jurisdiction of the Bankruptcy Court and the Company's access to the cash flows of the Debtors became restricted. Consequently, after June 2, 2004, the Company's negative investment in Pegasus Satellite of \$413 million was presented using the cost method, and the Company no longer consolidates or records earnings or losses from Pegasus Satellite Communications' operations. On May 5, 2005, the Debtors Plan of Reorganization became effective. As such, the Company reversed its negative investment in Pegasus Satellite and recognized income of \$413 million in discontinued operations (see Note 9).

*Use of Estimates*

In preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, management makes estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the consolidated financial statements, as well as the reported amounts of revenue and expenses during the reporting period. Management bases its estimates on historical experience and on various assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Disclosures that are particularly sensitive to estimation include revenue recognition, allowance for doubtful accounts, long lived assets, valuation allowance on deferred tax assets, and management's plans, as disclosed in Note 2. Actual results could differ from those estimates.

*Reclassifications*

Certain accounts in the prior year financial statements have been reclassified for comparative purposes to conform with the presentation in the current year consolidated financial statements. These reclassifications have no effect on previously reported consolidated income.

*Cash and Cash Equivalents*

Cash and cash equivalents include highly liquid investments purchased with an initial maturity of three months or less. The Company has cash balances in excess of the federally insured limits at various banks and investment firms.

*Short-term Investments*

Short-term investments, which may include corporate bonds and government or government agency securities with initial maturities in excess of three months, are available to fund current operations. Short-term investments consist of securities with contractual maturity dates ranging from 2007 to 2012, but are readily converted into cash with minimal market risk. The Company considers these investments to be "available-for-sale" securities as contemplated by Statement of Financial

**Xanadoo Company and Subsidiaries  
(f.k.a Pegasus Communications Corporation)  
Notes to Consolidated Financial Statements**

**3. Summary of Significant Accounting Policies (continued)**

Accounting Standards (No. 115, "Accounting for Certain Investments in Debt and Equity Securities" ("SFAS 115"), and accordingly report them at fair value. The fair value of these instruments approximates cost plus accrued interest. Unrealized gains and losses were not material at December 31, 2006 or 2005.

*Trade Receivables and Related Allowance for Doubtful Accounts*

Trade receivables of the Company's wireless high-speed Internet business are primarily comprised of unpaid subscriber billings and applicable sales taxes net of an estimated provision for uncollectible accounts. Subscription services are generally billed month to month and are billed in advance of services to be rendered for the month. Since subscription services are billed in advance, revenue is deferred until the services are rendered.

The allowance for doubtful accounts reflects management's best estimate of probable losses inherent in the account receivable balance. Management determines the allowance based on known troubled accounts, historical experience, and other currently available evidence. Collections and payments from customers are continuously monitored. Accounts are written off against the allowance in the period in which the balance is deemed uncollectible.

*Inventory*

Inventory primarily consists of finished goods (modems and laptop antennas) and is stated at the lower of cost or net realizable value. Cost is determined under the first-in, first-out inventory method. A periodic review of inventory quantities on hand is performed in order to determine and record a provision for excess and obsolete inventories. Factors related to current inventories such as technological obsolescence and market conditions are analyzed to determine estimated net realizable values. In 2006, the Company recorded inventory impairment charges of \$677 thousand related to the write-down of inventory to its net realizable value, which is equal to the current selling price to subscribers before rebates. The impairment charges are included in direct operating expenses on the consolidated statement of operations. There was no inventory impairment charge in 2005.

*Property and Equipment*

Property and equipment are stated at cost. Depreciation is recorded on a straight-line basis over the estimated useful lives of the related assets. The cost and related accumulated depreciation of assets sold, retired, or otherwise disposed of are removed from the respective accounts and any resulting gains and losses are included in the consolidated results of operations.

Expenditures that extend the useful lives of the related assets are capitalized and depreciated for financial reporting purposes using the straight-line method based upon the estimated useful lives of the assets. Leasehold improvements are amortized using the straight-line method over the lesser of the lease term or life of the related asset to which the improvement was made. Expenditures for repairs and maintenance are charged to expense when incurred.

*Intangible Assets*

Intangible assets are stated at cost. The cost and related accumulated amortization of assets sold, retired, or otherwise disposed of are removed from the respective accounts and any resulting gains and losses are included in the consolidated results of operations. Amortization of intangible assets with finite lives is computed for financial reporting purposes using the straight-line method based upon the estimated useful lives of the assets.

**Xanadoo Company and Subsidiaries  
(f.k.a Pegasus Communications Corporation)  
Notes to Consolidated Financial Statements**

**3. Summary of Significant Accounting Policies (continued)**

The Company's significant intangible assets include the 700 MHz Licenses, the Personalized Media License, and lease and license rights to provide wireless services in the 2.5 GHz spectrum. The Company amortizes its 700 MHz Licenses over their initial term of approximately 14 years ending January 1, 2015. The Company amortizes the Personalized Media license over an approximate 15-year period from its January 13, 2000 grant until December 31, 2014, based on management's estimate of the life of the technology underlying the patent portfolio and the patent applications. The Company amortizes its 2.5 GHz lease rights over their initial lease terms, which management believes to be shorter than their useful lives.

Intangible assets also included a broadcast license that management determined had an indefinite life because under past and existing Federal Communications Commission's regulations the license could be routinely renewed indefinitely with little cost. The Company entered into an agreement to sell the broadcast license in 2006, the sale of which occurred in 2007, as discussed in note 15.

*Impairment of Long-Lived Assets*

In accordance with SFAS No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets", for long-lived assets that are not depreciable or amortizable, an impairment loss is recognized for the excess of carrying amount over fair value. For long-lived assets that are depreciable or amortizable, an impairment loss is recognized when the carrying amount of the asset exceeds its fair value and the carrying amount is not recoverable on an undiscounted basis. Long-lived assets that are not depreciable or amortizable are tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired. Long-lived assets that are depreciable or amortizable are reviewed for impairment whenever events or circumstances suggest the carrying amounts may not be recoverable. The Company recognized an impairment charge of \$151 thousand in 2006 related to the write-down of the broadcast license that was sold in 2007 as discussed in note 15. The Company also recognized an impairment charge of \$144 thousand in 2006 related to the write-down of the Company's ownership interest in the corporate jet that was sold in 2007 also as discussed in note 15. The net realizable value of the broadcast license and the ownership interest in the corporate jet, approximating \$100 thousand and \$401 thousand respectively, are included in assets held for sale as of December 31, 2006. There was no impairment expense recorded for the year ended December 31, 2005.

*Revenues*

Principal revenue of the wireless high-speed Internet business is earned by providing the service on a subscription basis. Monthly subscription charges for broadband service and any subscriber-leased customer premises equipment are recognized over the monthly service period to which the service pertains. Obligations to provide services beyond the close of an accounting period are recorded as unearned revenues. Upfront activation fees for the Pegasus Broadband service are recorded as deferred subscriber fees and recognized as revenue over the twelve month minimum service period committed to by our Pegasus Broadband customers.

In accordance with Emerging Issues Task Force ("EITF") Issue 01-09 "Accounting for Consideration Given by a Vendor to a Customer", the Company recognizes a liability and reduces revenue for mail-in rebates offered. Given the absence of historical experience with similar offers, management does not believe that there is a basis for a reasonable and reliable estimate for the rebates to be redeemed. Therefore, the full amount of the mail-in rebates is recorded as a liability at the time of the modem sale with no reduction for estimated breakage. Breakage is recorded at the expiration of the mail-in rebate time period for any rebates not redeemed.

**Xanadoo Company and Subsidiaries**  
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**Notes to Consolidated Financial Statements**

**3. Summary of Significant Accounting Policies (continued)**

*Allocation of Costs under a Support Services Agreement*

Through August 31, 2005, the Company's consolidated subsidiary, Pegasus Communications Management Company ("PCMC") provided certain support services to the Debtors. The Debtors paid the Company for such services based on a methodology specified in a Support Services Agreement approved by the Bankruptcy Court.

*Advertising*

The Company expenses advertising costs as incurred. Advertising costs from continuing operations were approximately \$0.9 million and \$0.8 million for the years ended December 31, 2006 and 2005, respectively.

*Income Taxes*

The Company accounts for income taxes using the liability method. The liability method requires the determination of deferred tax assets and liabilities based on the differences between the financial statement and income tax basis of assets and liabilities, using enacted tax rates. Additionally, net deferred tax assets are adjusted by a valuation allowance if, based on the weight of available evidence, it is more likely than not that some portion or all of the net deferred tax assets will not be realized. The Company currently has significant deferred tax assets. SFAS No. 109, "Accounting for Income Taxes" ("SFAS 109"), requires a valuation allowance be established when it is more likely than not that all or a portion of deferred tax assets will not be realized. Furthermore, SFAS 109 provides that it is difficult to conclude that a valuation allowance is not needed when there is negative evidence such as cumulative losses in recent years. Therefore, cumulative losses weigh heavily in the overall assessment. Accordingly, the Company recorded a full valuation allowance against its net deferred tax assets. In addition, the Company expects to provide a full valuation allowance on future tax benefits until it can sustain a level of profitability that demonstrates its ability to utilize the assets, or other significant positive evidence arises that suggests its ability to utilize such assets. The future realization of a portion of its reserved deferred tax assets related to tax benefits associated with the exercise of stock options, if and when realized, will not result in a tax benefit in the consolidated statement of operations, but rather will result in an increase in additional paid in capital. The Company will continue to re-assess its reserves on deferred income tax assets in future periods.

In May 2007, the Company entered into a tax sharing agreement with XHI and its subsidiaries. Pursuant to the agreement, the Company and XHI and its subsidiaries will file a consolidated Federal income tax return. The agreement outlines the method for allocating income tax liability. In addition the agreement requires payments be made equal to a Member's share of its allocated portion of the consolidated income tax liability plus the excess, if any, that would result if the Member had filed a separate Federal income tax return.

*Net (Loss) Income Applicable to Common Shares and Computation of Per Common Share Amounts*

Net (loss) income applicable to common shares equals net (loss) income as reported adjusted by certain preferred stock-related activity. The computations of net (loss) income applicable to common shares for 2006 and 2005 were as follows (in thousands):

	2006	2005
Loss before discontinued operations	\$ (36,240)	\$ (27,719)
Preferred stock related adjustments:		
Accumulated and accrued dividends on preferred stock and redeemable preferred stock	(12,942)	(12,914)
Loss from continuing operations applicable to common shares	(49,182)	(40,633)
Income from discontinued operations	-	413,125
Net (loss) income applicable to common shares	\$ (49,182)	\$ 372,492

**Xanadoo Company and Subsidiaries**  
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**Notes to Consolidated Financial Statements**

**3. Summary of Significant Accounting Policies (continued)**

Basic and diluted per share amounts were the same within each period reported because potential common shares had an anti-dilutive effect on loss from continuing operations available to common shares and were excluded from the computation. Potential common shares derived from convertible preferred stocks, warrants, and stock options were 30 thousand and 32 thousand at December 31, 2006 and 2005, respectively. The per share amounts are computed by dividing loss from continuing operations applicable to common shares and income (loss) from discontinued operations, respectively, by the weighted average number of shares of Class A, Class B common stock outstanding during the periods reported.

*Stock Based Compensation*

Effective July 1, 2005, the Company adopted the fair value recognition provisions of Statement of Financial Accounting Standards ("SFAS") No. 123(Revised 2004), "Share-Based Payment", ("SFAS 123(R)"), using the modified-prospective-transition method to account for stock based compensation. Non-employee stock based compensation is accounted for using the provisions of EITF 96-18. As a result, for the year ended December 31, 2006, and the six-month period from July 1, 2005 to December 31, 2005, the Company recorded \$570 thousand and \$730 thousand in stock based compensation expense for the fair value of stock based compensation of which \$539 thousand and \$522 thousand related to stock options granted to employees, and \$31 thousand and \$208 thousand related to restricted stock grants issued in exchange for services. At December 31, 2006, there was \$870 thousand of total unrecognized stock based compensation costs which is expected to be recognized over a weighted average period of 8.5 years.

Prior to July 1, 2005, the Company's stock-based employee compensation plans were accounted for under the recognition and measurement provisions of Accounting Principles Board ("APB") Opinion No. 25 "Accounting for Stock Issued to Employees ("APB 25"), and related Interpretations, as permitted by SFAS 123. The plans under which these were issued are fixed award plans. Compensation expense with respect to stock options was recognized for the excess, if any, of the fair value of the underlying stock at the date of grant of the option over the exercise price of the option. The Company did not recognize stock-based compensation cost in its consolidated statements of operations for periods prior to July 1, 2005 as options granted had an exercise price equal to the market value of the underlying common stock on the date of the grant. The following table illustrates the effect on net loss if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation (in thousands):

	Six Months Ended June 30, 2005
Net income	\$ 385,406
Add: stock-based employee compensation expense, net of income tax, included in net income (loss), as reported .....	597
Deduct: stock-based employee compensation expense, net of income tax, determined under the fair value method .....	(1,096)
Net income, pro forma	\$ 384,907
 Basic and diluted per common share amounts:	
Net income applicable to common shares, as reported	\$ 2,856.38
Net income applicable to common shares, pro forma	\$ 2,852.55

**Xanadoo Company and Subsidiaries**  
**(f.k.a Pegasus Communications Corporation)**  
**Notes to Consolidated Financial Statements**

**3. Summary of Significant Accounting Policies (continued)**

The fair value of stock options granted to employees during the six months ended June 30, 2005 are estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions: (1) expected volatility of 107.3%, (2) dividend rate of 0%, (3) a risk-free interest rate of 3.8% and (4) expected lives of 6.0 years.

*Concentration of Risk*

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash, cash equivalents and short-term investments. The Company maintains cash, cash equivalents and short-term investments with various high credit qualified financial institutions, and apply stringent investment guidelines. Consequently, management believes that any credit risk with respect to cash, cash equivalents and short-term investments is limited. At December 31, 2006, \$4.6 million of the Company's cash, cash equivalents and short-term investments were concentrated in an investment portfolio managed by a large banking institution consisting primarily of money market funds.

The Company has one primary source for its network equipment and all of the customer premise equipment (CPE) that the Company sells in providing Xanadoo branded service in the 2.5 GHz frequency band. The Company expects to continue to rely principally on this vendor for the manufacture of CPE and for a substantial portion of the equipment necessary to construct, enhance and maintain our network. If this vendor fails or refuses to develop and deliver system infrastructure and CPE or enhancements that the Company requires on a timely, cost-effective basis, the Company may not be able to adequately service its existing subscribers or add new subscribers and may not be able to offer competitive services; thereby materially and adversely affecting the Company's results.

As of December 31, 2006, the Company's operations are concentrated in the state of Texas.

*Consolidation of Variable Interest Entities*

Interpretation No. 46, "Consolidation of Variable Interest Entities" was originally issued by the Financial Accounting Standards Board ("FASB") in January 2003 and was revised in December 2003 (as revised, "FIN 46R"). FIN 46R clarifies the application of Accounting Research Bulletin No. 51, "Consolidated Financial Statements" to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support. The Company consolidates Pegasus PCS Partners ("Pegasus PCS Partners") in accordance with FIN 46R (see *Investment in Affiliate* below).

*Investment in Affiliate*

Pegasus Development Corporation ("Pegasus Development"), a consolidated subsidiary, has a limited partnership interest in Pegasus PCS Partners, L.P. Pegasus Development has no control or voice in Pegasus PCS Partners' matters. The general partner of Pegasus PCS Partners is an entity beneficially controlled by the Company's Chairman of the Board and Chief Executive Officer. Presently, Pegasus PCS Partners' activities consist principally of investments in related companies, and its assets consist principally of senior preferred equity interests in Pegasus Capital Holdings, LLC ("PCH LLC"), and 861 Class B Shares of Xanadoo at both December 31, 2006 and 2005. PCH LLC is an entity that is also beneficially controlled by the Chairman of the Board and Chief Executive Officer. At both December 31, 2006 and 2005, PCH LLC's only assets consisted of direct and indirect investments in 16,837 Class B shares of Xanadoo, respectively, as well as an indirect interest in 710 Class A shares of Xanadoo.

**Xanadoo Company and Subsidiaries**  
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**Notes to Consolidated Financial Statements**

**3. Summary of Significant Accounting Policies (continued)**

The Company consolidates Pegasus PCS Partners pursuant to FIN 46R. Pegasus PCS Partners' investment in PCH LLC at December 31, 2006 and 2005 are classified within equity since assets of PCH LLC effectively consist principally of direct and indirect investments in equity of Xanadoo. As a component of equity, these investments are not tested for impairment nor are any gains or losses of the related partnerships recognized by the Company.

*New Accounting Pronouncements*

In November 2005, the FASB issued FASB Staff Position FAS123(R)-3, "Transition Election to Accounting for the Tax Effects of Share Based Payment Awards" ("FSP 123(R)-3"), which provides a practical transition election for purposes of calculating the pool of excess tax benefits available to absorb tax deficiencies recognized subsequent to the adoption of FAS 123(R) (the "APIC pool"). The Company has adopted FSP 123(R)-3 in 2006 using the transition method described in this FSP. Adoption of FSP 123(R)-3 was immaterial to the financial statements as presented as the Company was in a net deferred income tax asset position throughout the 2006 against which a full valuation allowance was applied.

In June 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109". This Interpretation prescribes 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, and provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. This Interpretation is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact of this Interpretation on its consolidated financial statements and has not yet determined such effects.

In June 2006, the EITF reached a consensus on Issue No. 06-3 ("EITF 06-03"), "Disclosure Requirements for Taxes Assessed by a Governmental Authority on Revenue-Producing Transactions." The consensus allows companies to choose between two acceptable alternatives based on their accounting policies for transactions in which the company collects taxes on behalf of a governmental authority, such as sales taxes. Under the gross method, taxes collected are accounted for as a component of sales revenue with an offsetting expense. Conversely, the net method allows a reduction to sales revenue. If such taxes are reported gross and are significant, companies should disclose the amount of those taxes. The guidance should be applied to financial reports through retrospective application for all periods presented, if amounts are significant, for interim and annual reporting beginning after December 15, 2006 with early adoption permitted. The Company currently reports using the net method and does not expect the adoption of EITF 06-03 to have a material effect on its consolidated financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements" (SFAS 157"). SFAS 157 clarifies the principle that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. SFAS 157 requires fair value measurements to be separately disclosed by level within the fair value hierarchy. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently evaluating the impact of adopting SFAS 157 on its future consolidated results of operations and financial condition and has not yet determined such effects.

**Xanadoo Company and Subsidiaries**  
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**Notes to Consolidated Financial Statements**

**3. Summary of Significant Accounting Policies (continued)**

In February 2007, the FASB issued SFAS No. 159 "The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115" ("SFAS No. 159"), which permits entities to choose to measure many financial instruments and certain other items at fair value. The fair value option established by this Statement permits all entities to choose to measure eligible items at fair value at specified election dates. A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. Adoption is required for fiscal years beginning after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply the provisions of SFAS Statement No. 157. The Company is currently evaluating the expected effect of SFAS No. 159 on its consolidated financial statements and is currently not yet in a position to determine such effects.

**4. Property and Equipment**

Property and equipment, along with the applicable estimated useful life of each category, consisted of the following at December 31, 2006 and 2005 (in thousands):

	2006	2005
Towers, antennas, and related equipment (7 to 20 years).....	\$8,366	\$4,433
Equipment, furniture, and fixtures (5 to 10 years).....	5,623	5,923
Building and improvements (up to 40 years) .....	9,702	9,736
Land.....	5,500	5,500
Other (3 to 5 years).....	2,111	2,202
	31,302	27,794
Accumulated depreciation.....	(8,282)	(7,342)
Property and equipment, net.....	\$ 23,020	\$ 20,452

Total depreciation expense from continuing operations was approximately \$2.1 million and \$1.3 million (net of \$0.6 million allocated to the Debtors under the Support Services Agreement) for the years ended December 31, 2006 and 2005, respectively.

**5. Intangible Assets**

Intangible assets for continuing operations, along with the applicable estimated useful life of each category, consisted of the following at December 31, 2006 and 2005 (in thousands):

	2006	2005
Assets subject to amortization:		
Cost:		
Licenses:		
700 MHz Licenses (14 years)	\$ 95,435	\$ 95,435
Intellectual property rights licensed from Personalized Media (15 years)	112,245	112,245
2.5 GHz lease rights (4 to 15 years)	5,831	1,465
Other (30 years)	23	23
(Forward)	\$ 213,534	\$ 209,168

**Xanadoo Company and Subsidiaries**  
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**Notes to Consolidated Financial Statements**

**5. Intangible Assets (continued)**

(Forward)	2006	2005
Accumulated amortization:	\$ 213,534	\$ 209,168
Licenses:		
700 MHz Licenses	41,289	34,520
Intellectual property rights licensed from Personalized Media	52,377	44,895
2.5 GHz lease rights	419	27
Other.....	2	1
	94,087	79,443
Intangible assets, net.....	\$ 119,447	\$ 129,725

Total amortization expense from continuing operations was \$14.7 million and \$14.3 million for the years ended December 31, 2006 and 2005, respectively.

The estimated aggregate amount of amortization expense from continuing operations for intangible assets subject to amortization is \$14.9 million for each of the next five years based on the balance of these assets at December 31, 2006.

**6. Long Term Debt**

Long-term debt consisted of the following at December 31, 2006 and 2005 (in thousands):

	December 31, 2006	December 31, 2005
Mortgage payable due February 2010.....	\$ 7,901	\$ 8,115
Less current maturities.....	224	214
Long term debt.....	\$7,677	\$ 7,901

Scheduled maturities of consolidated long-term debt for each of the four years following December 31, 2006 until maturity are as follows: \$224 thousand in 2007; \$238 thousand in 2008; \$257 thousand in 2009; and \$7,182 thousand in 2010.

*Mortgage payable*

The mortgage payable is secured by the Company's corporate headquarters building and land in Bala Cynwyd, Pennsylvania. The mortgage bears interest at an annual fixed rate of 9.25% through February 25, 2005, a fixed rate of 8% per annum through December 12, 2005, and thereafter a fixed rate of 7% per annum for the balance of the loan. Monthly payments of principal and interest in arrears are based on a twenty-year loan amortization schedule and all principal and unpaid interest is due and payable on or before February 25, 2010.

*Rural Utilities Service Loan*

On June 22, 2005, Pegasus Rural Broadband, LLC ("PRB"), which is an indirect subsidiary of the Company, received confirmation from the Rural Utilities Service ("RUS") of the United States Department of Agriculture that all conditions precedent for loan closing had been completed and that RUS deemed definitive loan documents providing for PRB to borrow up to an aggregate \$13.0 million

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**Notes to Consolidated Financial Statements**

**6. Long Term Debt (continued)**

under the RUS Rural Broadband Access Loan and Loan Guarantee Program (the "Loan Authorization") to be effective as of June 1, 2005. Amounts drawn under the Loan shall become due and payable through June 1, 2015 and bear interest at rates equal to the Treasury Rate of comparable maturity. Amounts drawn and subsequently repaid reduce the aggregate amount that may be borrowed under the loan by the amount previously borrowed and repaid. On September 18, 2006, PRB received \$1.9 million as an initial draw (the "Initial Draw") against the Loan Authorization. This Initial Draw was repaid in full on December 29, 2006, and there was no outstanding balance due as of December 31, 2006 under the Loan Authorization. As of December 31, 2006, the Company had \$11.2 million of unused credit available under the Loan Authorization.

The Loan Authorization is secured by all tangible and intangible assets of PRB, which, at December 31, 2006, consisted primarily of cash of \$2.8 million and property and equipment of \$2.2 million.

In March 2007, PRB gave notice to the RUS terminating the Loan Authorization. In April, 2007, the RUS accepted the Company's notice and consented to the filing of UCC-3 terminations. As a result of the loan termination, any cash that would have been previously classified as restricted became unrestricted.

**7. Stockholders' Equity**

*Common stock*

At December 31, 2006, Xanadoo had three classes of common stock: Class A, Class B, and Nonvoting. Holders of Class A and Class B are entitled to one vote per share and ten votes per share, respectively. The Company's ability to pay dividends on common stock is subject to certain limitations imposed by our preferred stock. No dividends were declared for any of the classes of common stock during the years ended December 31, 2006 or 2005.

Shares included in treasury stock in our consolidated financial statements as of December 31, 2006 include 3,719 Class A shares held by our consolidated subsidiary Pegasus Development Corporation ("Pegasus Development"), and 861 Class B shares held by Pegasus PCS Partners, a consolidated variable interest entity. Shares included in treasury stock in our consolidated financial statements as of December 31, 2005 include 2,855 Class A shares held by Pegasus Development, 861 Class B shares held by Pegasus PCS Partners and 7 of other Class A shares.

During the years ended December 31, 2006 and 2005, the Company's subsidiaries purchased an aggregate of 864 shares and 788 shares, respectively, of the Class A common stock from unaffiliated parties for approximately \$186 thousand and \$276 thousand, respectively, that the Company holds as treasury stock.

Repurchases of our securities have been made under a previously granted standing authorization, which provides that security purchases may be made from time to time, depending on market conditions and other considerations, in open market or in privately negotiated transactions, at prices deemed appropriate by management. There is no set time limit on the purchases, nor any minimum purchase commitment.

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**7. Stockholders' Equity (continued)**

On January 2, 2007, the company completed a reverse stock split in which each 100 outstanding shares of Class A was combined into one share of Class A and each 100 outstanding shares of Class B was combined into one share of Class B. As part of the reverse stock split, a subsidiary of the Company purchased a total of 658 Class A shares representing the fractional interests of shareholders holding less than 100 shares prior to the reverse split, for a total of \$214 thousand. (See Note 15 "Subsequent Events")

*Series C convertible preferred stock*

Each whole share of our Series C convertible preferred stock ("Series C") has a liquidation preference value of \$100 plus accumulated and unpaid dividends, and is convertible at any time at the option of the holder into approximately 0.00314 shares of Xanadoo's Class A common stock. Holders of shares of Series C are entitled to receive, when and if declared by the Board of Directors, quarterly dividends at a rate of 6-1/2%. Dividends may be paid, at the option of Xanadoo, in cash, shares of the Company's Class A common stock, or a combination thereof. Dividends not declared or paid accumulate in arrears until paid, and accumulate without interest.

In the event of liquidation, Series C ranks senior to all classes of the Company's common stock. At its option, the Company may redeem shares of Series C in whole or part at premiums specified in the certificate of designation for this series. Holders of Series C have no voting rights other than those granted by law, except that: 1) holders voting as a class are entitled to elect two directors to the board of directors in the event dividends payable on the series are in arrears for six quarterly periods until such arrearage is paid in full; 2) holders voting as a class are entitled to vote on matters that affect the terms and ranking of the series; and 3) holders voting as a class are entitled to vote on amendments to the Company's charter that may adversely affect their rights.

As permitted by the certificate of designation for the Series C, our board of directors has the discretion to declare or not to declare any scheduled quarterly dividends for this series. Since January 31, 2002, the board of directors only has declared a dividend of \$100 thousand on the series that was paid with shares of our Class A common stock. The total amount of dividends in arrears on Series C at December 31, 2006 was \$61.4 million, or \$31 per share. The Series C dividend of \$3.2 million, subject to declaration on January 31, 2007, was not declared.

At December 31, 2006, Series C consisted of 1,991,147 shares with a liquidation preference of \$260 million including dividends in arrears.

**8. Income Taxes**

Following is a summary of income taxes for the years ended December 31, 2006 and 2005 (in thousands):

	2006	2005
State and local – current expense .....	\$ (17)	\$ (30)
State – deferred benefit (expense):		
Net operating loss carryforwards.....	1,304	1,204
Valuation allowance .....	(1,304)	(1,204)
Total state deferred.....	-	-
Federal – deferred benefit (expense):		
Net operating loss carryforwards.....	15,229	14,060
Valuation allowance .....	(15,229)	(14,060)
Total federal deferred.....	-	-
Net expense attributable to continuing operations .....	(17)	(30)
Total income tax expense recorded .....	\$ (17)	\$ (30)

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**Notes to Consolidated Financial Statements**

**8. Income Taxes (continued)**

Following were the deferred income tax assets and liabilities at December 31, 2006 and 2005 (in thousands):

	2006	2005
Deferred tax assets:		
Current assets and liabilities.....	\$195	\$ 26
Operating loss carryforwards .....	54,565	38,032
Capital loss carryforwards .....	116,214	116,214
Excess of tax basis over book basis:		
Amortizable intangible assets .....	15,779	13,840
Capitalized start-up expenses .....	-	3,496
Impaired assets .....	285	1,311
Other.....	198	156
Total assets.....	187,236	173,075
Deferred tax liabilities:		
Excess of book basis over tax basis:		
Property and equipment .....	(796)	(218)
Total liabilities .....	(796)	(218)
Net deferred tax assets (liabilities) .....	186,440	172,857
Valuation allowance .....	(186,440)	(172,857)
Net deferred tax balance.....	\$ -	\$ -

After considering both continuing and discontinued operations, no deferred income tax expense or benefit was recorded for the years ended December 31, 2006 or 2005 because the Company was in a net deferred income tax asset position throughout the year against which a full valuation allowance was applied. Management has determined that a valuation allowance sufficient to bring the deferred income tax asset balance to zero at December 31, 2006 was necessary because it was more likely than not that the benefits of the net deferred income tax asset will not be realized, based on the Company's history of losses in the absence of unusual or infrequent items.

Following is a reconciliation of the federal statutory income tax rate to the effective income tax rate attributable to continuing operations for the years ended December 31, 2006 and 2005:

	2006	2005
Statutory rate .....	35.00%	35.00%
Effects of:		
Valuation allowance.....	(34.85)	(33.69)
Differences in deductible compensation .....	(0.35)	(0.13)
State taxes .....	(0.05)	(0.11)
Other.....	0.20	(1.18)
Effective tax rate.....	(0.05)%	(0.11)%

At December 31, 2006, the Company has ordinary operating loss carryforwards for income tax purposes of approximately \$144 million that expire beginning 2012 through 2026.

The Company also has a capital loss carryforward of approximately \$306 million that expires in 2010 related to the loss realized on the Company's investment in Pegasus Satellite. Management has determined that a full valuation allowance is required for any tax benefit derived from this deduction.

**Xanadoo Company and Subsidiaries**  
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**8. Income Taxes (continued)**

The Company's ability to use loss carryforwards may be subject to substantial limitation in future periods under certain provisions of the Internal Revenue Code, including but not limited to Section 382 which applies to corporations that undergo an "ownership change". Internal Revenue Code Section 382 rules limit the utilization of net operating losses upon a more than 50% change in ownership of a company (such change refers to a shift in value). The Company believes that it may have undergone one or more ownership changes.

**9. Discontinued Operations**

The Debtors' Plan of Reorganization became effective on May 5, 2005 (see Note 13 - *Proceedings of the Debtors Under Chapter 11 of the Bankruptcy Code*). Consequently, the Company reversed its \$413 million negative investment in Pegasus Satellite in the second quarter of 2005, and recognized income of \$413 million in the Consolidated Statement of Operations within discontinued operations.

**10. Financial Instruments**

The carrying amount and fair value of short-term investments and long-term debt at December 31, 2006 and 2005 were as follows (in thousands):

	2006		2005	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Short-term investments	\$2,644	\$2,644	\$5,267	\$5,267
Long term debt (including current portion).....	7,901	8,041	8,115	8,400

Fair value of our mortgage payable was estimated using average market interest rate for commercial mortgages disclosed by several lenders.

**11. Warrants**

We have issued warrants to purchase shares of Xanadoo's Class A common and nonvoting common stocks. At December 31, 2006, we had a total of 1,585,606 warrants outstanding which, if exercised, could potentially result in the issuance of 15,297 shares of Class A common stock. Information on the Company's warrants outstanding at December 31, 2006 was as follows:

Number Outstanding	Rate of Conversion into Common Stock	Exercise Price	Year of Expiration
25,950	0.00774	\$3,750	2007
9,656	0.010	3,660	2007
1,000,000	0.004	22,500	2010
550,000(a)	0.02	800	2010

(a) Exercisable into shares of nonvoting common stock (the "Warrant Shares"). In the event a holder wishes to sell any issued Warrant Shares, the Company is required, generally at its option, to either purchase the holder's Warrant Shares for cash or exchange such Warrant Shares for the Company's most marketable common stock within the meaning of the warrant agreement relating to these warrants. All other warrants are exercisable into shares of Class A common stock.

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Notes to Consolidated Financial Statements**

**12. Stock Plans**

Xanadoo has stock plans under which shares of Xanadoo's Class A common stock may be issued to eligible plan participants.

*1996 Stock Option Plan*

This plan provided for the granting of nonqualified and qualified options to purchase a maximum of 20,000 shares of Xanadoo's Class A common stock or, as amended in 2003, shares of nonvoting common stock. Participants in the plan are eligible employees and executive officers, both of Xanadoo Company and of the Debtors, and non-employee directors. The plan terminated in September 2006. Options vest and become exercisable in accordance with a schedule determined at the time the option is granted. Exercisable options may be exercised any time up to the expiration or termination of the option. Outstanding options become exercisable immediately in the event of a change in control.

Under the 1996 Stock Option Plan, a disposition of all or substantially all of the assets of Xanadoo constitutes a change in control within the meaning of that plan. Consequently, upon the sale of Pegasus Satellite Communications' satellite television assets on August 27, 2004, all outstanding options under the Stock Option Plan automatically became fully vested and exercisable. However, this acceleration of vesting and exercise terms did not apply to new grants after August 27, 2004. Generally, options issued under the Stock Option Plan remain exercisable until the earlier of the expiration date of the option grant or three months after termination of employment.

156 and 7,103 options were awarded under the Plan in 2006 and 2005, respectively.

*Restricted Stock Plan*

This plan provides for the granting of a maximum of 8,000 shares in the form of restricted stock or, until 2005, options to purchase common stock. Xanadoo Company Class A common stock or, as amended in 2003, nonvoting common stock was issuable under the plan. Participants in the plan are eligible employees and executive officers, both of Xanadoo Company and of the Debtors. The plan terminated in September 2006. Recipients of restricted stock awards do not pay for any portion of the stock received. The Company recognized compensation expense from continuing operations for restricted stock of \$0.8 million during the year ended December 31, 2005. Compensation expense from continuing operations for restricted stock was insignificant during the year ended December 31, 2006. The per-share weighted average grant date fair value of shares issued under the plan was \$595 during the year ended December 31, 2005. There were no restricted shares issued during the year ended December 31, 2006.

*Stock Options Issued under the 1996 Stock Option and Restricted Stock Plans*

The following table summarizes information about the Company's stock options outstanding at December 31, 2006:

**Xanadoo Company and Subsidiaries**  
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**Notes to Consolidated Financial Statements**

**12. Stock Plans (continued)**

Range of Exercise Prices	Outstanding at December 31, 2006	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (years)	Exercisable at December 31, 2006	Weighted Average Exercise Price
\$ 253 – 739	6,886	\$ 559	7.74	4,671	\$ 557
740 – 3,499	2,044	1,145	7.20	1,755	1,208
3,500 – 38,234	16	11,450	3.84	16	11,450
Total	<u>8,946</u>	<u>\$ 712</u>	<u>7.61</u>	<u>6,442</u>	<u>\$ 761</u>

The following table summarizes stock option activity over the past two years:

	Number of Shares	Weighted Average Exercise Price	Total Intrinsic Value (000s)
Outstanding at January 1, 2005 .....	14,761	\$ 4,606	
Granted .....	7,103	596	
Exercised .....	(394)	888	\$ 95
Canceled or expired .....	<u>(11,142)</u>	<u>(5,809)</u>	
Outstanding at December 31, 2005 .....	10,328	708	
Granted .....	156	305	
Exercised .....	-	-	
Canceled or expired .....	<u>(1,538)</u>	<u>(659)</u>	
Outstanding at December 31, 2006 .....	<u>8,946</u>	669	\$ -
Options exercisable at December 31, 2006 .....	6,442	\$ 761	\$ -

The fair value of options was estimated using the Black-Scholes option pricing model with the following weighted average assumptions:

	Year ended December 31, 2006	Year ended December 31, 2005
Risk free interest rate .....	4.62%	3.94%
Dividend yield .....	0.0%	0.0%
Volatility factor .....	109.81%	107.65%
Weighted average expected life (years) .....	6.0	6.0

In August 2005 the Company's officers and outside directors surrendered approximately 4,680 stock options in exchange for the issuance under the 1996 Stock Option Plan of approximately 2,330 new stock options (the "August Modification"). The surrendered options were fully vested as of June 30, 2005 and had exercise prices ranging from \$1,321 to \$20,219 with a weighted average exercise price of approximately \$7,400. For every six options surrendered, the holders received three new options: one option with an exercise price of \$506, one option with an exercise price of \$632, and one option with an exercise price of \$759. Each option granted has a ten year term. The new options were 25% vested on the date of grant with ratable monthly vesting for the remainder through August 2008. Pursuant to FAS 123R, compensation expense of approximately \$0.4 million, representing the incremental grant date fair

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**Notes to Consolidated Financial Statements**

**12. Stock Plans (continued)**

value of the new options over the fair value of the old options immediately prior to their surrender, will be recognized over the vesting period of the new options. These fair values were estimated using the Black-Scholes option pricing model with the following weighted average assumptions: risk free interest rate – 4.1%; dividend yield - 0.0%; volatility factor - 108.2%; expected life - 6 years for the new options, 2.9 years for the surrendered options.

*Employee Stock Purchase Plan*

On August 18, 2005, the board of directors terminated the Employee Stock Purchase Plan effective as of July 1, 2005. Prior to this date, all eligible employees of Xanadoo Company and the Debtors participated in the employee stock purchase plan, which provided for the automatic grant of options to purchase Xanadoo's Class A common stock or, as amended in 2003, nonvoting common stock. The number of shares of Class A common stock issued under this plan was 2,957 during the year ended December 31, 2005.

*401(k) Plan*

Xanadoo maintains a 401(k) plan that covers eligible employees of Xanadoo Company and the Debtors in the United States (see note 13). Substantially all individuals that complete two months of service are eligible to participate. Participants are permitted to make salary deferral contributions, subject to dollar limitations imposed by existing tax laws, of up to 15%.

For 2005 and 2006, the Company matched 100% of plan participant contributions up to 6% of plan participants' before tax salary contributed. For 2005 and 2006, the Company's contributions were made in the form of Class A common stock or in cash used to purchase its Class A common stock. The Company has authorized and reserved for issuance up to 820 shares of Class A common stock in connection with the plan. The Company's contributions to the plan are subject to limitations under applicable laws and regulations. The Company has stopped the matching contribution in 2007.

The expense from continuing operations for these plans was approximately \$0.1 million for each of the years ended December 31, 2006 and 2005, respectively.

*2005 Equity Incentive Plan*

During 2006, the board approved the termination of the 2005 Equity Incentive Plan and replaced it with the 2006 Equity Incentive Plan. No awards were granted under the 2005 Equity Incentive Plan.

*2006 Equity Incentive Plan*

On December 29, 2006, stockholders approved the 2006 Equity Incentive Plan (the "2006 Plan").

The 2006 Plan provides for the granting of: a) incentive stock options ("ISOs") and nonqualified stock options ("NQSOs") to a) purchase shares (except that ISOs may not be granted after August 13, 2016); b) stock appreciation rights, referred to as Exercisable SARs, representing the right to receive, upon exercise an amount in shares measured by the appreciation in share value since the date of grant; c) stock appreciation rights, referred to as Vesting SARs, representing the right to receive, after the right vests, an amount in cash measured by appreciation in share value; d) restricted stock subject to time-based and/or performance-based vesting; e) restricted stock units representing the right to receive an amount measured by the value of a share of stock, subject to time-based or performance-based vesting; f) stock

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Notes to Consolidated Financial Statements**

**12. Stock Plans (continued)**

subject to the attainment of designated performance goals; g) stock subject to the continued provision of service to Xanadoo or its subsidiaries; h) stock awarded as a bonus; and i) dividend equivalent rights representing the right to receive a benefit in lieu of cash dividends on stock. Employees, consultants and non-employee directors of Xanadoo and its consolidated subsidiaries may receive awards under the 2006 Plan, except that ISOs may only be granted to employees of Xanadoo and its consolidated subsidiaries.

The total number of shares that can be delivered under the 2006 Plan is 25,000. No participant may receive awards under the 2006 Plan (including options and stock appreciation rights) covering more than 10,000 shares in any calendar year, or more than 10,000 dividend equivalent rights during any calendar year. All of these limitations, as well as the exercise price of outstanding options and the number of shares issuable after an award is exercised or vests, are subject to future adjustment for stock dividends, stock splits and similar events. Shares available under the 2006 Plan may be authorized but unissued shares or reacquired shares, and may consist of Class A common stock and non-voting common stock.

The exercise price of any stock options granted may not be less than 100% of the fair market value of the underlying shares on the date of grant (110% in the case of an ISO granted to a greater-than-10% stockholder). No option term may exceed 10 years from the date of grant (five years in the case of an ISO granted to a greater-than-10% stockholder).

No awards were granted under the 2006 Plan during the year ended December 31, 2006 (see Note 15).

**13. Commitments and Contingencies**

*Leases*

The Company leases certain buildings, vehicles, various types of equipment and 2.5 GHz licenses through separate operating lease agreements. The operating leases expire at various dates through 2021. Rent expense from continuing operations for all rentals and leases was approximately \$0.9 million and \$0.4 million for the year ended December 31, 2006 and 2005, respectively. At December 31, 2006, minimum lease payments on noncancellable operating leases with terms in excess of one year scheduled for future years are approximately \$1.4 million in 2007, \$1.3 million in 2008, \$1.2 million in 2009, \$1.0 million in 2010, \$0.7 million in 2011, and \$2.2 million thereafter.

*Legal Matters*

*Proceedings of the Debtors Under Chapter 11 of the Bankruptcy Code*

Upon the Debtors' plan of reorganization becoming effective on May 5, 2005, a liquidating trustee (the "Liquidating Trustee") was appointed with responsibility for investigating and prosecuting or settling any claims or causes of action of the Debtors existing on May 5, 2005 (the "Liquidating Trust Claims"). Liquidating Trust Claims include any claims of the Debtors against Xanadoo and its non-Debtor subsidiaries (collectively, the "Non-Debtors"), as well as any claims against the officers and directors of the Non-Debtors and the Debtors, that may have arisen during the bankruptcy proceedings and were not released by the Global Settlement Agreement (the "Global Settlement Agreement") entered into on July 30, 2004 by the Debtors, Xanadoo, DIRECTV Inc., the National Rural Telecommunications Cooperative, and the creditors committee representing the unsecured creditors of the Debtors. Under the Global Settlement Agreement, the Debtors released any and all claims against the non-Debtors and the officers and directors of the Debtors and the non-Debtors arising on or prior to August 27, 2004,

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**13. Commitments and Contingencies (continued)**

excluding claims, if any, arising under the Support Services Agreement. The Global Settlement Agreement did not release any claims of third parties held in their individual capacity and not derivatively.

On October 10, 2006, Xanadoo, Pegasus Satellite Communications, Inc., the Liquidating Trustee and certain of the former directors and officers of the Debtors (the "Claimants") entered into a settlement agreement (the "Settlement Agreement") to resolve all open matters between the Debtors and Liquidating Trustee, on the one hand, and the Non-Debtors and the Claimants, on the other hand. The Settlement Agreement included resolution of all Liquidating Trust Claims against the Non-Debtors and the directors and officers of the Non-Debtors and Debtors, including the Claimants.

The Settlement Agreement provides for the payment of certain medical costs by the Debtors or The PSC Liquidating Trust (the "Trust") of approximately \$177 thousand to PCMC, the release to the Trust of cash reserves held by the Trust relating to medical expenses and director and officer indemnification claims, cooperation by Xanadoo with respect to transferability of shares of Class A Common Stock owned by the Trust, and certain litigation assistance (including the contribution by Xanadoo to the Trust of approximately \$75 thousand toward the settlement of a third party claim). The Settlement Agreement also provides for releases among the parties, including the release of the Liquidating Trust Claims against the Non-Debtors and the Claimants and a waiver of any claims that the Trust and the Non-Debtors may have against each other relating to payments arising from the Support Services Agreement.

The Settlement Agreement was effective on October 10, 2006, subject to an order by the Bankruptcy Court approving the Settlement Agreement which became final and non-appealable on November 21, 2006.

*Patent Infringement Litigation*

On December 4, 2000, Pegasus Development and Personalized Media Communications, LLC ("Personalized Media") filed a patent infringement lawsuit in the United States District Court, District of Delaware against DIRECTV, Inc., Hughes Electronics Corporation ("Hughes"), Thomson Consumer Electronics ("Thomson"), and Philips Electronics North America Corporation ("Philips"). Personalized Media is a company with which Pegasus Development has a licensing arrangement. Pegasus Development and Personalized Media are seeking injunctive relief and monetary damages for the defendants' alleged patent infringement and unauthorized manufacture, use, sale, offer to sell, and importation of products, services, and systems that fall within the scope of Personalized Media's portfolio of patented media and communications technologies, of which Pegasus Development is an exclusive licensee within a field of use. The technologies covered by Pegasus Development's exclusive license include services distributed to consumers using certain Ku band BSS frequencies and Ka band frequencies, including frequencies licensed to affiliates of DIRECTV, Inc.

In this litigation, Pegasus Development and Personalized Media assert infringement of claims from the following patents: U.S. Patent Nos. 4,694,490 ("the '490 patent"); 4,965,825 ("the '825 patent"); 5,109,414 ("the '414 patent"); 5,233,654 ("the '654 patent"); 5,335,277 ("the '277 patent"); and 5,887,243 ("the '243 patent").

In March 2003, a hearing was held before a special master appointed by the Delaware district court to recommend constructions of disputed terms in the patent claims in suit. On March 24, 2003, the special master issued his report, recommending claim constructions largely favorable to the plaintiffs. The report of the special master is subject to review by the district judge.

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**13. Commitments and Contingencies (continued)**

In 2003, the United States Patent and Trademark Office granted petitions filed by defendant Thomson seeking reexamination of the patents in suit in the Delaware litigation. Additional petitions seeking reexamination were filed by Scientific-Atlanta, Inc. In April 2003, the defendants filed a motion in the Delaware district court seeking a stay of the patent litigation pending completion of reexamination proceedings. On May 14, 2003, the Delaware district court granted defendants' motion pending a disposition of the United States Patent and Trademark Office's reexamination of several of the patents in suit, and denied all pending motions without prejudice. The parties may refile those motions following the stay and upon the entry of a new scheduling order. From April 2005 to December 2005, an examiner in the United States Patent and Trademark Office issued office actions finding that the majority of claims in each of the patents are not patentable. Personalized Media responded to the office actions for the '490, '654, and '277 patents, and the United States Patent and Trademark Office thereafter issued final office actions, to which Personalized Media responded and appealed. For the other, non-final, office actions (i.e., for the '243, '414, and '825 patents), Personalized Media has filed responses with the patent examiner. For all of the patents, Personalized Media is entitled to appeal any final adverse action by the patent examiner to the Board of Patent Appeals and Interferences in the Patent and Trademark Office, and may subsequently appeal an adverse decision of the Board to the United States Court of Appeals for the Federal Circuit. Only after such appeals have concluded does the United States Patent and Trademark Office issue a certificate canceling any claims of the patents determined, after appeal, to be unpatentable. This process can take several years. At this time, the Company does not believe these office actions have an impact on the carrying amount of the Personalized Media licenses.

Separately, in 2002, Personalized Media asserted many of the same patent claims against Scientific-Atlanta, Inc. in federal district court in Atlanta, Georgia. Pegasus Development is not a party to that suit. The proceedings in this case are also stayed, pending some developments in the reexaminations discussed above. After allowing some discovery to go forward, the court subsequently stayed proceedings, pending further resolution of the reexamination of the patents in suit. Should the court issue rulings on the merits of Personalized Media's case in Georgia, those rulings are not binding as a matter of law upon those persons not parties to this Georgia litigation (including Pegasus Development). Nonetheless, the Delaware court may be impacted by the Georgia rulings for guidance on common issues of fact or law, especially if the Atlanta litigation has been heard and ruled upon by the U.S. Court of Appeals for the Federal Circuit.

*Securities Litigation*

On May 26, 2005, AIG Global Investments Corp., AIG SunAmerica Asset Management Corp., and the Variable Annuity Life Insurance Company (collectively, the "AIG Plaintiffs"), all of which are members of American International Group, Inc., sued Xanadoo, Xanadoo's Chief Executive Officer, and Xanadoo's then Chief Financial Officer in the Eastern District of Pennsylvania alleging violations of federal and state securities fraud laws, common law fraud and related claims (the "AIG Litigation"). In June 2006, the AIG Plaintiffs and the named defendants agreed to a settlement within the limits of the Company's directors' and officers' liability insurance and filed a stipulation dismissing the case with prejudice. On August 23, 2006, the judge presiding over the AIG Litigation dismissed the case with prejudice.

On November 8, 2005, a putative class action was filed in the United States District Court for the Eastern District of Pennsylvania alleging violations of federal securities fraud laws. The lawsuit named as defendants Xanadoo, its Chief Executive Officer, and two former Chief Financial Officers. In August 2006, the Company entered into a settlement agreement with the class action plaintiffs to resolve this matter. The settlement was within the limits of the Company's directors' and officers' liability insurance. The court approved this settlement on November 21, 2006.

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**13. Commitments and Contingencies (continued)**

Xanadoo's and officers' liability insurance covered costs associated with the AIG lawsuit and the class action lawsuit beyond a \$1 million deductible which was accrued for at December 31, 2005. There was no remaining accrued balance at December 31, 2006.

*Other Legal Matters*

In addition to the matters discussed above, from time to time the company is involved with claims that arise in the normal course of business. The Company believes that the ultimate liability, if any, with respect to these claims will not have a material effect on the Company's consolidated operations, cash flows, or financial position.

*SEC Investigation*

In August 2004, Xanadoo and its subsidiaries received an investigative subpoena from the Securities and Exchange Commission ("SEC") to produce documents related to its and its subsidiaries' practices in reporting the number of subscribers of its direct broadcast satellite business. Subsequent to receipt of the subpoena, the Company sold its direct broadcast satellite business to DIRECTV, Inc. While the Company is cooperating fully with the SEC in its ongoing investigation, management cannot predict the outcome of the SEC's investigation or when the investigation will be resolved. In addition to producing documents, the Company has also advanced expenses to current and/or former directors, officers and employees as permitted by its bylaws. In February 2007, four current and former officers received Wells Notices from the staff of the SEC indicating that the staff will be recommending to the Commissioners of the SEC the filing of civil suits against these individuals. As of December 31, 2006, the Company had incurred \$1.2 million of expenses in connection with the investigation. The Company anticipates incurring additional expenses in connection with the investigation, including primarily the advancement of indemnification expenses to the current and former officers who received the Wells Notices, but those expenses are not estimable at this time. The Company has directors' and officers' liability insurance which should cover certain expenses relating to the investigation beyond a \$1 million deductible. It is unknown which of the expenses paid to date will be credited against the \$1 million deductible, other than reasonable defense costs incurred by the four individuals who received Wells Notices.

*Pegasus Communications Savings Plan*

The Company is the sponsor of a 401(k) plan, the Pegasus Communications Savings Plan (the "401K Plan"). The Internal Revenue Service ("IRS") audited the 401k Plan in 2006, and issued its completed report in April 2007. As a result of the IRS audit, it was determined that the 401K Plan failed discrimination testing for select periods prior to 2005. As part of the settlement with the IRS, the Company made corrective contributions of \$781 thousand in January 2007 in accordance with applicable IRS guidance, which required additional employer contributions to be made to the 401K Plan. Since the 401K Plan is under IRS audit, corrections were made under the IRS' Audit Closing Agreement Program ("Audit CAP") as set forth in the IRS' Revenue Procedure 2003-44. Under this program, the IRS has the ability to impose sanctions in addition to the corrective contributions, excise taxes and penalties. The IRS imposed sanctions of \$275 thousand, which the Company paid in April 2007. In addition to the corrective contributions and IRS imposed sanctions, the Company paid excise taxes totaling \$88 thousand, and paid separate U.S. Department of Labor penalties of \$50 thousand. These amounts totaling approximately \$1.2 million were accrued as of December 31, 2006.

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**13. Commitments and Contingencies (continued)**

*Commitments and other contingencies*

At December 31, 2006, the Company had various purchase commitments for internet connectivity for its wireless Internet services business, for which it expects to make payments of \$285 thousand in 2007, \$41 thousand in 2008, \$35 thousand in 2009, and \$24 thousand in 2010.

In June 2005, the Company negotiated an amendment to a communication services contract that began in 2002 pursuant to which the non-cancellable purchase commitment of \$7.8 million at December 31, 2004 would be eliminated in exchange for a \$1 million payment. The Company made this payment, of which \$770 thousand was reimbursed by the Liquidating Trust, in July 2005.

The Company provides for health insurance claims on a self-insured basis, subject to reinsurance for large claims. At December 31, 2006 and 2005, the consolidated balance sheet reflects accrued liabilities for health claims of \$352 thousand and \$549 thousand, respectively, representing estimated claims incurred but not yet reported.

**14. Related Party Transactions**

As discussed in Note 3, Pegasus Development has a limited partnership interest in Pegasus PCS Partners, the general partner of which is an entity beneficially controlled by the Company's Chairman of the Board and Chief Executive Officer. The Company consolidated Pegasus PCS Partners effective March 31, 2004 pursuant to FIN 46. Pegasus Development granted this individual a ten-year option to purchase its interest in Pegasus PCS Partners for the market value of that interest, payable in cash or by delivery of marketable securities. Such option expires in 2012.

Pegasus Development has a licensing arrangement with Personalized Media. A member of Xanadoo's board of directors, has a controlling interest in Personalized Media. Pegasus Development paid a total of \$112.2 million in a combination of \$14.3 million cash, 800 shares of Xanadoo's Class A common stock, and warrants to purchase 4,000 shares of Class A common stock in 2000 to enter into the arrangement. Pegasus Development's carrying amount of the license it recorded with respect to this arrangement was \$59.9 million and \$67.4 million at December 31, 2006 and 2005, respectively. The license provides Pegasus Development with an exclusive field of use with respect to Personalized Media's patent portfolio concerning the distribution of satellite services from specified orbital locations.

The Company provided accounting and administrative services to companies affiliated with the Company's Chairman of the Board and Chief Executive Officer and paid certain expenses on behalf of the affiliated companies. This arrangement ceased to be effective January 1, 2005. The Company recorded receivables from the affiliated companies for an allocation of accounting and overhead costs related to the services the Company provided and for payments the Company made to third parties for certain legal, accounting and corporate organizational fees. No interest has been charged with respect to amounts outstanding, and the receivables do not have fixed repayment terms. These affiliate receivables, which aggregated \$526 thousand at both December 31, 2006 and 2005, were classified as a component of consolidated equity within "investment in and notes receivable from affiliates".

See Note 3 – *Basis of Presentation* for transactions with the Debtors pursuant to a Support Services Agreement whereby the Company received reimbursement for certain expenditures incurred on behalf of the Debtors.

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**14. Related Party Transactions (continued)**

Pursuant to a management services agreement, employees of Pegasus Development provide services to Pegasus Telecommunications, Inc., Federal Radio Service Corp., and Pegasus Radio Corp. (collectively, the "Radio Affiliates"), entities that are beneficially controlled by the Company's Chairman of the Board and Chief Executive Officer. The Radio Affiliates are charged the actual costs incurred for Pegasus Development's employees based on an allocation formula. The allocation methodology allocates time, based on anticipated responsibilities or value, that these employees are expected to contribute to the Radio Affiliates compared to the Company. For the years ended December 31, 2006 and 2005, the Radio Affiliates incurred \$373,000 and \$372,000, respectively, of allocated expenses. Effective January 1, 2007, these employees ceased to be employed by Pegasus Development. These former employees continue to participate in Xanadoo's Health Benefit and 401k plans which cover affiliated companies. Expenses incurred by Xanadoo in connection with Radio Affiliates employee participation in the Health Benefit and 401k plans are reimbursed by the Radio Affiliates.

**15. Subsequent Events**

*Reverse Stock Split*

On August 14, 2006, Xanadoo's board of directors approved a reverse stock split of the Company's common stock on the recommendation of a special committee of outside directors. The special committee and the board concluded that the transaction was in the best interests of the Company and its stockholders, principally because they believe that the continuing costs and burden of remaining an SEC reporting company are not justified in light of the Company's current size and the relative illiquidity of the Class A. The reverse stock split was approved by stockholders on December 29, 2006 and became effective on January 2, 2007. In the reverse stock split, each 100 outstanding shares of Class A was combined into one share of Class A and each 100 outstanding shares of Class B was combined into one share of Class B. Any holder that would hold a fractional interest in a share of Class A or Class B following the reverse stock split received cash in lieu of any fractional interest in the amount of \$3.25 per pre-reverse split share. As a result, the company paid \$214 thousand to fractional interest shareholders in January 2007 to repurchase.

The reverse stock split reduced the number of record holders of the Class A to fewer than 300. Subsequent to the reverse stock split, the Company suspended its obligation to file periodic reports with the SEC, such as annual and quarterly reports on forms 10-KSB and 10-QSB and current reports on form 8-K, as permitted by the SEC's rules. It also delisted the Class A from the NYSE Arca Exchange. The Class A is currently traded through the Pink Sheets. The Company ceased to be subject to other SEC public-information requirements, such as the proxy rules and the requirement to report securities transactions by directors, officers, and greater-than-10% stockholders, approximately 90 days after the effective date of the reverse stock split.

The effect of this reverse stock split has been retroactively reflected throughout the consolidated financial statements.

*Sale of Assets*

In January 2007, the Company completed the sale of a broadcast license for \$100 thousand. In 2006, the Company recognized an impairment charge of \$151 thousand related to the write-down of the broadcast license to its net realizable value of \$100 thousand. This asset is included with assets held for sale on the consolidated balance sheets with a net carrying value of \$100 thousand and \$251 thousand at December 31, 2006 and 2005, respectively.

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**15. Subsequent Events (continued)**

Also in January 2007, the Company completed the sale of its ownership interest in a corporate jet for \$401 thousand. In 2006, the Company recognized an impairment charge of \$144 thousand related to the write-down of the asset to its net realizable value of \$401 thousand. This asset is included with assets held for sale on the consolidated balance sheets with a net carrying value of \$401 thousand and \$573 thousand at December 31, 2006 and 2005, respectively.

*Refund of FCC Bond*

In August 2001, the FCC awarded Pegasus Development licenses to launch and operate Ka band geostationary satellites at five different orbital locations. In 2004, Pegasus Development accepted an FCC license to launch and operate a Ka band geostationary satellite at the 87(degree) west longitude orbital location. Pursuant to the FCC's satellite licensing rules that took effect in 2003, Pegasus Development posted a \$5.0 million bond to be held by ACE USA for which the FCC had the ability to call for the release of funds. The FCC reduced this bond to \$3 million subsequent to Pegasus Development achieving certain milestones. The remainder was to be forfeited if the Company failed to meet any of the FCC-imposed satellite construction milestones, without adequate justification. In 2004, the Company took a \$3.0 million charge to fully reserve its collateral for the Ka band license performance bond as management believed it was unlikely that the Company would recover any remaining amount of the performance bond.

In October of 2006, the Company received notice that the FCC had given ACE USA the authority to release \$2.25 million of the remaining \$3.0 million surety bond to the FCC due to satisfaction of one of the milestones. In January 2007, Pegasus Development received notification that the conditions of the release of funds were satisfied and the \$750,000 of the bond was returned to Pegasus Development from ACE USA. The Company will account for this transaction as a gain in 2007.

*Corporate Reorganization*

In February 2007, the Company implemented a plan to restructure its workforce which will result in 14 planned job reductions that will occur during the first quarter of 2007. These actions are part of the Company's long-term strategy to reduce operating costs and improve long-term competitiveness. The job cuts are expected to result in a one-time pre-tax restructuring charge of approximately \$0.4 million to be recognized in the first quarter of 2007.

*Sale of Building*

In January 2007, the Company committed to a plan to sell its corporate headquarters building which had a carrying value of \$12.5 million as of December 31, 2006. Management expects to sell the building by December 31, 2007 and may continue to lease space in the building.

*Financing*

In May 2007, the Company closed on a financing transaction with a lender (the "Lender") totaling \$30 million. In accordance with the terms of the financing, Xanadoo Holdings Inc., a consolidated subsidiary of the Company, ("XHI" or the "Issuer") issued \$30 million in Senior Secured Notes (the "Notes") which are collateralized by 100% of the assets of XHI and its subsidiaries. Prior to closing the financing, the Company contributed its member interest in its wholly-owned subsidiary Pegasus Guard Band, LLC ("PGB") to XHI. The assets of PGB, which also collateralize the Notes, consist primarily of 700 MHz licenses which as of December 31, 2006, had a net book value of approximately \$54.1 million. The Company has also provided the Lenders with a non-recourse guaranty of XHI stock held by the Company. Proceeds from the Notes net of fees and expenses were approximately \$29.0 million.

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**15. Subsequent Events (continued)**

The senior secured notes bear interest at 12.5% per annum, payable semi-annually in arrears in cash, that may be paid through the issuance of additional notes with identical terms as Notes at the election of the Issuer. The Notes are to mature four years from issuance, with principal and any interest in arrears due at maturity. The Notes also become due in full at 101% of Par plus accrued interest upon a Liquidity Event, as defined in the agreement as a change in control of the issuer or a sale of a material part of the assets of the issuer. The Issuer also has the election to prepay the Notes in whole plus accrued interest at 106% of Par within 1 year of issuance, at 104% of Par plus accrued interest from 1 to 2 years of issuance, at 102% of Par plus accrued interest from 2 to 3 years from issuance, and at 100% of Par plus accrued interest from 3 years to maturity.

In addition to the Notes, the Lender received warrants to acquire 17% of the fully diluted ownership interests of the Issuer with an exercise price of \$19.7 million. The warrants are detachable from the Notes, and are exercisable over a ten-year period beginning on the issuance date. The warrants also include a one time contractual right to put the warrants to the Issuer for \$7.0 million in cash exercisable at the option of the warrant holder at the earlier of maturity of the Notes or a Liquidity Event.

*Option Grants*

In April 2007, the Company's Board of Directors granted options to purchase 11,700 shares of Class A common stock with an exercise price of \$325 per share to the Company's independent directors, officers, and certain employees under the 2006 Equity Incentive Plan. Twenty-five percent of the options granted vested immediately. The remaining seventy-five percent of the options vest ratably over the 36 months following the grant date. Independent directors, officers, and certain employees received options to purchase 1,000, 7,250, and 3,450 shares respectively.

*Management Fee and Cost Allocation Agreement*

In May 2007, a Management Fee and Cost Allocation Agreement was entered into by the Company and XHI (together with its subsidiaries). This agreement provides for a monthly management fee to be paid by XHI to the Company in the amount of \$104 thousand.

In addition, the agreement provides a methodology for allocating certain shared costs incurred by the Company or XHI on each others behalf.