INTER TEL INC
Form PRER14A
May 09, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
SCHEDULE 14A
(Rule 14a-101)
Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934

Filed by the Registrant þ
Filed by a Party other than the Registrant ¨
Check the appropriate box:

þ Preliminary Proxy Statement

¨ Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))

¨ Definitive Proxy Statement

¨ Definitive Additional Materials

¨ Soliciting Material Pursuant to §240.14a-11(c) or §240.14a-12

INTER-TEL, INCORPORATED
(Name of Registrant as Specified in Charter)
(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

þ No fee required.

¨ Fee computed on table below per Exchange Act Rules 14a-6(i)(4) and 0-11.

(1) Title of each class of securities to which transaction applies:

(2) Aggregate number of securities to which transaction applies:

(3) Per unit price or other underling value of transaction computed pursuant to Exchange Act Rule 0-11 (Set forth the amount on which the filing fee is calculated and state how it was determined):

(4) Proposed maximum aggregate value of transaction:

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(1) Amount Previously Paid:

(2) Form, Schedule or Registration Statement No.:

(3) Filing Party:

(4) Date Filed:

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INTER-TEL, INCORPORATED
NOTICE OF ANNUAL MEETING OF SHAREHOLDERS
May 31, 2006

TO THE SHAREHOLDERS:

NOTICE IS HEREBY GIVEN that the Annual Meeting of Shareholders of Inter-Tel, Incorporated (the ***Company***), an Arizona corporation, will be held on May 31, 2006, at 8:00 a.m., local time, at [*] located at [*], Arizona [*], for the following purposes:

1. To elect directors to serve for the ensuing year and until their successors are duly elected and qualified;

2. To approve the reincorporation of the Company into Delaware;

3. To approve a special resolution authorizing the Company s Board of Directors (sometimes referred to below as the Board of Directors, the Board or the Inter-Tel Board) to effect an amendment to the Company s charter documents requiring the approval of a majority of disinterested shareholders to effect certain business combination transactions involving interested parties;

4. To consider and ratify the appointment of Ernst & Young LLP as the Company s independent registered public accounting firm; and

5. To consider and ratify a proposal to adjourn the Annual Meeting, if necessary, to solicit additional votes in favor of Proposals 1 through 4.

We will transact such other business as may properly come before the meeting or any adjournment thereof.

Each of the foregoing items of business is more fully described in the Proxy Statement accompanying this Notice and will be discussed at the Annual Meeting with adequate time allotted for shareholder questions.

Only shareholders of record at the close of business on March 22, 2006 (the ***Record Date***) are entitled to notice of and to vote at the meeting. A copy of the Company s 2005 Annual Report to Shareholders, which includes certified financial statements, will be mailed with this Notice and Proxy Statement on or about May [ ], 2006 to all shareholders of record on the Record Date. YOUR VOTE IS IMPORTANT, NO MATTER HOW MANY OR HOW FEW SHARES YOU OWN. PLEASE SIGN AND DATE THE ENCLOSED PROXY CARD AND RETURN IT IN THE ENCLOSED ENVELOPE PROMPTLY. PROPERLY VOTING THE ENCLOSED PROXY CARD AUTOMATICALLY REVOKES ANY PROXY PREVIOUSLY SIGNED OR RETURNED BY YOU.

All shareholders are cordially invited to attend the meeting in person. However, to assure your representation at the meeting, you are urged to sign, date and return the Proxy Card as promptly as possible in the postage-prepaid envelope provided. Any shareholder attending the meeting may vote in person even if he or she has previously returned a proxy. If you hold your shares through a bank, broker or other custodian, you must present a legal proxy from the record holder of your shares in order to vote at the meeting.

Sincerely,

KURT R. KNEIP, Secretary

Phoenix, Arizona
May [ ], 2006

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INTER-TEL, INCORPORATED
1615 S. 52nd Street
Tempe, Arizona 85281
PROXY STATEMENT
INFORMATION CONCERNING SOLICITATION AND VOTING

General

This Proxy Statement is furnished by Inter-Tel, Incorporated (***Inter-Tel*** or the ***Company***), for use at the Annual Meeting of Shareholders to be held May 31, 2006 at 8:00 a.m., local time or at any postponement or continuation of the meeting, as applicable, or at any adjournment thereof (as applicable, the ***Annual Meeting***), for the purposes set forth herein and in the accompanying Notice of Annual Meeting of Shareholders. The Annual Meeting will be held at [*] located at [*], Arizona [*]. These proxy solicitation materials were mailed on or about May [ ], 2006 to all shareholders entitled to vote at the Annual Meeting.

Record Date and Share Ownership

Only shareholders of record at the close of business on the Record Date, or March 22, 2006, are entitled to notice of and to vote at the Annual Meeting. As of the Record Date, 26,386,651 shares of the Company s Common Stock were issued and outstanding.

Revocability of Proxies

The enclosed proxy is being solicited by the Board of Directors of the Company. Any proxy given pursuant to this solicitation may be revoked by the person giving it at any time before its use by delivering to the Company a written notice of revocation or a duly executed proxy bearing a later date, or by attending the Annual Meeting and voting in person. Attendance at the meeting will not, by itself, revoke a proxy.

Voting and Solicitation

Every shareholder voting at the Annual Meeting for the election of directors may either (i) cumulate such shareholder s votes and give one nominee for director a number of votes equal to (a) the number of directors to be elected (eleven), multiplied by (b) the number of shares of the Company s Common Stock held by such shareholder; or (ii) distribute such shareholder s votes on the same principle among as many nominees for director as the shareholder thinks fit, provided that votes cannot be cast for more than eleven nominees. However, no shareholder will be entitled to cumulate votes for any nominee unless such nominee s name has been placed in nomination in accordance with the Company s bylaws prior to the voting and such shareholder, or another shareholder, has given notice at the Annual Meeting prior to the voting for directors of the intention of such shareholder to cumulate such shareholder s votes.

If you choose to cumulate your votes, you will need to submit a proxy card or a ballot and make an explicit statement of your intent to cumulate your votes, either by so indicating in writing on the proxy card or by indicating in writing on your ballot when voting at the annual meeting. If you hold shares beneficially in street name and wish to cumulate votes, you should contact your broker, trustee or nominee. If you sign your proxy card or voting instruction card with no further instructions, the proxy holders may cumulate and cast your votes in favor of the election of some or all of the applicable nominees in their sole discretion, except that none of your votes will be cast for any nominee as to whom you instruct that your votes be withheld.

Cumulative voting applies only to the election of directors. For all other matters, each share of common stock outstanding as of the close of business on the Record Date is entitled to one vote and one vote may be cast for each share of the Company s Common Stock held by a shareholder.

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A quorum will be present if a majority of the votes entitled to be cast are present in person or by valid proxy. Directors will be elected by a plurality of votes cast; the eleven persons receiving the highest number of votes shall be elected as the directors of the Company.

Proposal Nos. 2 and 3 must be approved by an affirmative vote of a majority of the outstanding shares entitled to vote. Abstentions and broker non-votes resulting from a broker s inability to vote a client s shares on non-discretionary matters will have the same effect as votes against the approval of Proposal Nos. 2, and 3.

Proposal Nos. 4 and 5 must be approved by the affirmative vote of a majority of the shares represented and voting at the Annual Meeting. Consequently, with respect to such proposals, abstentions and Broker non-votes resulting from a broker s inability to vote a client s shares on non-discretionary matters will have no effect on the outcome of the vote on such proposals.

If the enclosed Proxy Card is properly executed and returned to the Company in time to be voted at the Annual Meeting, it will be voted as specified on the proxy, unless it is properly revoked prior thereto. If no instructions are indicated with respect to certain proposals, the proxy will be voted with respect to such proposals as follows: FOR the nominees listed in Proposal 1, with such votes being cumulated at the sole discretion of the proxy holders; and FOR Proposals 2, 3, 4, 5.

It is the intent of the Company s proxy holders to retain discretionary authority to vote on matters presented to the meeting for which the Company did not have adequate notice pursuant to Rule 14a-4(c)(1).

The cost of this proxy solicitation will be borne by the Company, including preparation, assembly, printing and mailing of solicitation materials. We will provide copies of solicitation materials to banks, brokerage houses, fiduciaries and custodians holding shares of our Common Stock beneficially owned by others to forward these materials to the beneficial owners of our Common Stock. In addition, the Company may reimburse brokerage firms and other persons representing beneficial owners of shares of the Company s Common Stock for expenses incurred in forwarding solicitation material to such beneficial owners. Although solicitation of proxies will generally be made by mail, proxies also may be solicited by certain of the Company s directors, officers and regular employees, personally or by telephone or facsimile without additional compensation. We previously retained Innisfree M&A Incorporated as our proxy solicitor; however, in light of recent events, we no longer require their proxy solicitation services.

Deadline for Receipt of Shareholder Proposals

Proposals of shareholders of the Company that are intended to be presented by such shareholders at the annual meeting of the Company for the fiscal year ending December 31, 2006 must be received by the Company no later than January [1], 2007, in order to be included in the proxy statement and form of proxy relating to such meeting.

SEC rules also establish a different deadline for submission of shareholder proposals that are not intended to be included in the Company s proxy statement with respect to discretionary voting. The discretionary vote deadline for the 2006 Annual Meeting was April 8, 2006. If a shareholder gives notice of such a proposal after the discretionary vote deadline, the Company s proxy holders will be allowed to use their discretionary voting authority to vote against the shareholder proposal when and if the proposal is raised at the Company s year 2007 Annual Meeting. [Your Proxy when properly executed will be voted as directed or, if no direction is given, will be voted for each of proposals 1 through 5, and in the discretion of the Company s proxy holders on such other matters as may properly come before the meeting or any adjournments or postponements thereof. The discretionary vote deadline for the 2007 Annual Meeting is [ ], 2007, 45 calendar days prior to the anniversary of the mailing date of this proxy statement.]

Independent Auditors

The independent auditors of the Company for the fiscal year ended December 31, 2005 were Ernst & Young LLP. A representative of Ernst & Young LLP will attend the annual meeting for purposes of responding to appropriate questions.

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Multiple Shareholders Sharing One Address

In some instances, we may deliver to multiple stockholders sharing a common address only one copy of this proxy statement and its attachments. If requested by phone or in writing, we will promptly provide a separate copy of the proxy statement and its attachments to a stockholder sharing an address with another stockholder. Requests by phone should be directed to our Corporate Secretary at (480) 449-8900, and requests in writing should be sent to Inter-Tel, Incorporated, Attention: Corporate Secretary, 1615 S. 52nd Street, Tempe, Arizona 85281. Stockholders sharing an address who currently receive multiple copies and wish to receive only a single copy should contact their broker or send a signed, written request to us at the address above.

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ELECTION OF DIRECTORS

(Proposal No. 1)

Settlement of Proxy Contest

On May 5, 2006, the Company and members of the Company s Board of Directors entered into a settlement agreement (the Settlement Agreement) with Mr. Steven G. Mihaylo (Mr. Mihaylo) and Summit Growth Management LLC, a wholly owned affiliate of Mr. Mihaylo (Summit). Pursuant to the Settlement Agreement, the Company increased the size of the board to eleven members from eight and has elected Mr. Mihaylo, Anil K. Puri and Kenneth L. Urish (the Mihaylo Nominees) as members of the Board of Directors. In addition, the Settlement Agreement provides, among other things, that the Company will nominate, and recommend the election of, the Mihaylo Nominees for election to the Board of Directors at the 2006 Annual Meeting. Mr. Mihaylo will withdraw his proposals and his proxy solicitation for the 2006 Annual Meeting, and vote in favor of the slate of 11 directors nominated by the Company, which slate will include the Mihaylo Nominees, and the other proposals presented by the Company. In accordance with the terms of the Settlement Agreement, the Company will provide Mr. Mihaylo and his advisors and financing sources with access to confidential information regarding the Company, subject to a non-disclosure agreement, in order to facilitate his ability to make an all cash acquisition proposal should he choose to do so. The Company will review and make a determination with regards to any acquisition proposal submitted by Mr. Mihaylo in a timely manner. Prior to December 31, 2006, subject to earlier termination under certain circumstances, Mr. Mihaylo may not make an offer to acquire the Company other than pursuant to an all cash proposal to acquire all the shares of common stock (other than those held by Mr. Mihaylo) which offer he has notified the Company about at least five (5) business days in advance. If the Board of Directors determines that the initial acquisition proposal, if any, submitted by Mr. Mihaylo prior to June 15, 2006, is not in the best interests of shareholders, then, upon the request of Mr. Mihaylo made within the following two weeks, the Company will promptly call a special meeting of shareholders to consider any proposals submitted by Mr. Mihaylo to the Company in his request. In these regards, while the Company may not contest the calling of the special meeting as to a proposal urging the Board to arrange for the prompt sale of the Company to the highest bidder, the Company may contest the calling of the meeting for other purposes and the submission of any other proposal and the Company may oppose any proposal set forth in Mr. Mihaylo s request. Subject to certain limitations discussed in the Settlement Agreement, the Company has agreed not to adopt a bylaw or amend its articles or certificate of incorporation to prevent Mr. Mihaylo from calling any such special meeting. Nothing in the Settlement Agreement prevents Inter-Tel from having discussions, or entering into a definitive acquisition agreement, with third parties. The Settlement Agreement, a related Non-Disclosure Agreement and a press release announcing the settlement were filed by the Company with the Securities & Exchange Commission on Schedule 14A on May 5, 2006.

Nominees.

Eleven (11) directors are to be elected at the Annual Meeting. All eleven nominees named below are currently directors of the Company. In the event that any nominee of the Company becomes unavailable for any reason or if a vacancy should occur before election (which events are not currently anticipated by the Company), the shares represented by the enclosed proxy may be voted for such other person as may be determined by the holders of such proxy. In the event that additional persons are nominated for election as directors, the proxy holders intend to vote all proxies received by them cumulatively, in their discretion, in such a manner as to ensure the election of as many of the nominees listed below as possible. In such event, the specific nominees to be voted for will be determined by the proxy holders in their discretion. The term of office of each person elected as a director will continue until the next annual meeting and until his successor has been duly elected and qualified.

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The names of the nominees and certain biographical information relating to the nominees are set forth below.

Name of Nominee	Age	Current Position	Director Since
Norman Stout	48	Director and Chief Executive Officer	2006
Alexander Cappello	50	Chairman of the Board	2005
J. Robert Anderson	69	Director	1997
Jerry W. Chapman	65	Director	1999
Gary D. Edens	64	Director	1994
Steven E. Karol	51	Director	2006
Robert Rodin	52	Director	2006
Agnieszka Winkler	60	Director	2005
Steven G. Mihaylo	62	Director	2006(1)
Dr. Anil K. Puri	57	Director	2006
Kenneth L. Urish	55	Director	2006

(1) Mr. Mihaylo had served as a director of Inter-Tel from July 1969 to October 1982 and from September 1983 to March 6, 2006 when he voluntarily resigned. Pursuant to the terms of the Settlement Agreement Mr. Mihaylo was appointed to the Board on May 6, 2006.

MR. STOUT was appointed Chief Executive Officer and a member of Inter-Tel s Board of Directors on February 22, 2006. He began his tenure at Inter-Tel in 1994 as a director. Four years later, he resigned from the board and joined Inter-Tel as executive vice president, chief administrative officer and president of Inter-Tel Software and Services. Prior to joining Inter-Tel, Mr. Stout was Chief Operating Officer of Oldcastle Architectural Products and since 1996, Mr. Stout also had served as President of Oldcastle Architectural West. Mr. Stout held previous positions as President of Superlite Block; Chief Financial Officer and Chief Executive Officer (successively) of Boorhem-Fields, Inc. of Dallas, Texas; and as a Certified Public Accountant with Coopers & Lybrand. He currently serves on the board of directors of Hypercom Corporation, a public company headquartered in Phoenix, Arizona. Mr. Stout holds a Bachelor of Business Administration degree in Accounting from Texas A&M and an MBA from the University of Texas.

MR. CAPPELLO was elected as one of our directors in the April, 2005 annual meeting of shareholders, and to Chairman at the July, 2005 Board meeting. Since March 1996, Mr. Cappello has served as the Chairman and Chief Executive Officer of the Cappello Group, Inc., a global boutique merchant bank, which includes Cappello Capital Corp. (member SIPC-NASD). He has over thirty years experience in corporate management & finance, investment banking, merchant banking both in the U.S. and overseas. He is currently or has been a member of the board of directors of several companies and institutions including: University of Southern California (USC) Board of Trustees/ President-Elect of the Board of Governors & Alumni Association, RAND Corporation-Center for Middle East Public Policy, Genius Products, Inc. (NASDAQ:GNPI), CytRx Pharmaceuticals, Inc. (NASDAQ: CYTR), and Swiss American Financial & Euro American Financial (Chairman). Mr. Cappello is a member of the Young Presidents Organization (YPO), where he has served as Chairman of the International Board from 2003-2005. He received a Bachelor of Science degree from the Marshall School of Business at USC in 1977 with honors. He has been a guest lecturer at the USC, UCLA, and Harvard Business Schools and is a contributing author of The New Investor Relations, being published by Bloomberg PRESS.

MR. ANDERSON has served as one of our directors since February 1997 and currently serves as the Chairman of our Compensation Committee. Mr. Anderson held various positions at Ford Motor Company from 1963 to 1983, serving as President of the Ford Motor Land Development Corporation from 1978 to 1983. He served as Senior Vice President, Chief Financial Officer and as a member of the board of directors of The

Firestone Tire and Rubber Company from 1983 to 1989, and as Vice Chairman of Bridgestone/ Firestone, Inc. from 1989 through 1991. He most recently served as Vice Chairman, Chief Financial Officer and as a member of the board of directors of the Grumman Corporation from 1991 to 1994. He currently serves on the boards of GenCorp, Inc. and B-G Corp. Mr. Anderson is currently semi-retired, and he is an active leader in various business, civic and philanthropic organizations.

MR. CHAPMAN was elected as one of our directors in December 1999 and previously served as one of our directors from 1989 to 1992. He currently serves as the Chairman of our Audit Committee. As a Certified Public Accountant, he served with a local accounting firm from 1963 through 1969, at which time he joined Ernst & Ernst, a predecessor entity of Ernst & Young LLP. He became a partner of Ernst & Young in 1977 and, until retiring from the firm in 1989, served as engagement partner on a wide variety of audit, assurance and consulting engagements. Additionally, he managed Ernst & Young s practices in Arizona as well as various offices in the adjoining southwest states from 1980 through 1989. He then operated his own consulting firm through 1992 and joined Arthur Andersen in 1993 as a partner specializing in providing business consulting services. He retired from Arthur Andersen in 1999. Mr. Chapman currently serves on the board of directors of CoBiz Inc., a public company headquartered in Denver, Colorado. Additionally, he provides services for a small number of clients requiring strategic and market-driven services.

MR. EDENS has served as one of our directors since October 1994 and currently serves as the Chairman of our Corporate Governance and Nominating Committee. He was an executive with Southern Broadcasting Company 1968-1982, Harte-Hanks Radio, Inc, chief executive officer, 1982-1984, and Edens Broadcasting, Inc., chairman and chief executive officer 1984-1994. Mr. Edens has served on a number of corporate boards, such as Great Western Bank and Citibank (Arizona), as well as holding leadership positions on the Radio Advertising Board, National Radio Broadcasters Association and Young Presidents Organization. In 1998 he was chairman of the annual international financial seminar for Chief Executives Organization and World Presidents Organization. Since 1994, he has been president of The Hanover Companies, Inc., a private investment firm. He holds a B.S. Degree in Business Administration from the University of North Carolina at Chapel Hill. In 2005 he participated in continuing education for directors at Harvard Business School.

MR. KAROL was elected as one of our directors in February 2006. Mr. Karol is founder, Managing Partner, and Chairman of HMK Enterprises, Inc. and Watermill Group, which consists of Watermill Ventures and Watermill Advisors. He has been an investor, operator, and advisor for almost thirty years. Through HMK and Watermill, he has owned and operated close to 50 companies and has built both into enterprises with over $1 billion in revenue on several occasions. Mr. Karol serves on several corporate boards including: Mooney Aircraft Company (OTC:MNYG.OB) (Chairman), StockerYale (NASDAQ: STKR), and J. Walter Company. He is also on several not-for-profit boards, including the Tufts University Board of Overseers for the School of Engineering (Chairman), the Vermont Academy Board of Trustees (Chairman), and The Brain Tumor Society (Chairman of Strategic Planning). He is a former International President of the Young Presidents Organization where he held many positions throughout his twenty-six year relationship with the organization. He is a former trustee of the Boston Ballet and a former overseer of the Boston Symphony Orchestra. Mr. Karol received his Bachelor of Science degree from Tufts University in 1976. He completed the President s Program of Leadership at the Graduate School of Business Administration at Harvard University in 1997.

MR. RODIN who was elected as one of our directors in February 2006, is currently the Chairman and CEO of RDN Group; strategic advisors focused on corporate transitions, customer interface, sales and marketing, and supply chain management. Previously, Mr. Rodin was Chairman and CEO of eConnections, a provider of extended supply chain intelligence solutions, which he founded in 1999. From 1991 to 1999, he served as the CEO of Marshall Industries (NYSE:MI), a $1.8 billion industrial electronics distributor and supply chain management company. Marshall Industries was recognized as the World s Number One Business to Business Website , by Advertising Age Magazine and Information Week Magazine highlighted Marshall Industries as the World s Number One Company in the Use of Technology , Additionally, CIO Magazine recognized Mr. Rodin as one of the Top 100 Leaders for the New Millennium . Following the sale of Marshall to Avnet (NYSE:AVT) in 1999, Mr. Rodin served as president of global supply chain

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management and electronic commerce solutions and as a member of the Avnet Global Managing Board. Mr. Rodin currently serves as director of Napster (NASDAQ: NAPS), director and Vice Chairman of CommerceNet and director of SM&A (NASDAQ: WINS). Mr. Rodin s best selling book, Free, Perfect and Now: Connecting to the Three Insatiable Customer Demands , chronicles the radical transformation of Marshall Industries. The changes he led have been taught as case studies at Harvard Business School, Columbia, USC, MIT, and Stanford University.

MS. WINKLER was elected as one of our directors in the April 2005 annual meeting of shareholders. Ms. Winkler was the founder, Chairman and CEO of two companies, Winkler Advertising, founded in 1984, and TeamToolz, Inc., founded in 1999, both of which were acquired. She is currently founder and Chairman of The Winkler Group, a management consultancy specializing in marketing efficiency and effectiveness for Fortune 1000 companies. She has served on the board of directors of two NASDAQ companies, SuperCuts and RenoAir, and currently serves on the board of directors of IP Locks, Inc. and the Board of Trustees of Santa Clara University. In addition, she has served on the boards of numerous professional and civic institutions throughout her career and currently sits on the boards of the Committee of 200 Foundation and the Western Folklife Center. Winkler has a BA and an MA and received an MBA from Santa Clara University in 1981. A frequent keynote speaker on the subjects of marketing and branding at industry meetings globally, she is also the author of Warp Speed Branding: The Impact of Technology on Marketing, published by Wiley in the US, China and Turkey.

STEVEN G. MIHAYLO, age 62, is a private investor. Mr. Mihaylo s business address is P.O. Box 19790, Reno, Nevada 89509. He is the founder of Inter-Tel, and served as Chairman of the Board of Directors of Inter-Tel from July 1969 to October 1982 and from September 1983 to July 2005. He served as President of Inter-Tel from 1969 to 1983, from 1984 to December 1994, and from May 1998 to February 2005. He served as Inter-Tel s Chief Executive Officer from the time of the Company s formation in July 1969 to February 22, 2006. Mr. Mihaylo received a bachelor s degree in business administration, with a concentration in Accounting and Finance, from California State University, Fullerton. In 2004, Mr. Mihaylo pledged $3 million to California State University, Fullerton (since increased to $4.5 million), payable over five years, the largest cash pledge in the history of California State University, Fullerton, toward a new College of Business and Economics building that will bear his name. Mr. Mihaylo was initially approached by Dr. Anil K. Puri, Dean of the College of Business and Economics and one of the Mihaylo Nominees, about making a donation to the College of Business and Economics. In 2005, California State University, Fullerton, conferred an honorary doctorate of humane letters upon Mr. Mihaylo in recognition of excellence and extraordinary achievement in significant areas of human endeavor. Mr. Mihaylo has been active in and supported educational charitable endeavors during his career, including Junior Achievement of Arizona, Big Bear Lake California High School, the University of Arizona, Arizona State University, Bishop Manogue Catholic High School, the University of Nevada, Reno, The Arizona Science Center, Juvenile Diabetes Research Foundation, The Goldwater Institute and The Desert Botanical Gardens.

DR. ANIL K. PURI, age 57, has served as the Dean of the College of Business and Economics at California State University, Fullerton from 1998 to present. His business address is 800 North State College Boulevard, California State University, Fullerton, California 92834. California State University, Fullerton is not a parent, subsidiary or other affiliate of the Company. Dr. Puri received bachelors and masters degrees in economics from Panjab University in India and a masters degree and a Ph.D. in economics from the University of Minnesota. Dr. Puri is a member of the American Economic Association, the Western Economic Association, the National Association of Business Economists and the Association of University Bureaus of Economic Research. He is the author of numerous journal articles in the field of economics, and makes numerous presentations every year to business, community, and professional organizations and at university events, and has presented the California State University, Fullerton Annual Economic Forecasts since 1993.

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KENNETH L. URISH, age 55, is managing member of Urish Popeck & Co., LLC, a certified public accounting firm with multi-disciplinary practice units. Mr. Urish s business address is Three Gateway Center, 24th Floor, Pittsburgh, Pennsylvania 15222. He has been a member of Urish Popeck & Co., LLC from its inception in February 1976 to present. Urish Popeck & Co., LLC is not a parent, subsidiary or other affiliate of the Company. Mr. Urish has a bachelors degree in accounting from The Pennsylvania State University. He has served on the Board of Directors, and as a member of the Audit Committee thereof, of Black Rock Liquidity Funds from 1999 to present. Mr. Urish is the co-editor of *Financial Management and Analysis: Methodologies to Manage and Improve Operating Performance*, which was adapted as a business development series. He is a member of the American, Pennsylvania, and Florida Institutes of Certified Public Accountants, President of the Board of Trustees of *The Pittsburgh Catholic*, the official newspaper of the Pittsburgh Diocese, a member of the National Association of Certified Fraud Examiners, a member of the Board of Trustees of Holy Family Foundation, a former Division Chair of the United Way of Allegheny County, the former Chairman and former President of DFK Accountancy Group, and a former member of the Board of Directors of DFK International. Mr. Urish has recently been named The Pennsylvania State University Alumnus of the Year of the Department of Accounting for 2005.

THE BOARD UNANIMOUSLY RECOMMENDS THAT THE SHAREHOLDERS VOTE FOR EACH NOMINEE LISTED ABOVE.

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TO APPROVE THE REINCORPORATION OF THE COMPANY IN DELAWARE

(Proposal No. 2)

The Board has approved a proposal to change the Company s state of incorporation from Arizona to Delaware (the ***Reincorporation***). The Board believes the Reincorporation to be in the best interests of the Company and its shareholders for several reasons, as more fully discussed below.

The Reincorporation will be effected by merging the Company into a newly formed Delaware company (the ***Delaware Company***). Shareholders are urged to read this section of the Proxy Statement carefully, including the related annexes referenced below and attached to this Proxy Statement, before voting on the Reincorporation. The following discussion summarizes material provisions of the Reincorporation. This summary is subject to and qualified in its entirety by the Agreement and Plan of Merger and Reincorporation (the ***Reincorporation Agreement***) that will be entered into by the Company and the Delaware Company in substantially the form attached hereto as Annex A, the Certificate of Incorporation of the Delaware Company (the ***Delaware Certificate***), in substantially the form attached hereto as Annex B, as altered to effect changes approved by the Company s shareholders in Proposal No. 3, if applicable, and the bylaws of the Delaware Company (the ***Delaware Bylaws***), in substantially the form attached hereto as Annex C. Copies of the Articles of Incorporation of the Company filed in Arizona, as amended to date (the ***Arizona Articles***), and the bylaws of the Company, as amended to date (the ***Arizona Bylaws***), are available for inspection at the principal office of the Company and copies will be sent to shareholders free of charge upon written request.

Mechanics of the Reincorporation

The Reincorporation will be effected by the merger of the Company with and into the Delaware Company, a wholly-owned subsidiary of the Company that will be incorporated under the Delaware General Corporation Law ***(Delaware Law)*** for purposes of the Reincorporation. The Company will disappear as a result of the merger, and the Delaware Company will be the surviving corporation and will continue to operate the business of the Company. Assuming approval by the shareholders of the Company (the ***Shareholders***), the Reincorporation will become effective as soon as practicable.

At the effective time of the Reincorporation (the ***Effective Time***), the Company will be governed by the Delaware Certificate, the Delaware Bylaws and Delaware Law. Although the Delaware Certificate and the Delaware Bylaws are patterned after the Arizona Articles and the Arizona Bylaws, they nevertheless include provisions that do not exist in the current Arizona Articles, Arizona Bylaws or under the Arizona Business Corporation Act ***(Arizona Law)***. See Certain Differences in Corporate Governance and Other Differences Between the Corporation Laws of Arizona and Delaware below. It is important to note that, if Proposal No. 3 is adopted and the additional provision described there is included to the Delaware Certificate, the additional provision would be an important difference between the current Arizona Articles and the Delaware Certificate as filed. The description that follows in this Proposal No. 2 refers to the documents and laws governing the Company, without discussing the adoption of or describing the terms of the additional provision described in Proposal No. 3.

In the event the Reincorporation is approved, upon effectiveness of the Reincorporation, (1) each outstanding share of Company Common Stock will automatically be converted into one share of Common Stock of the Delaware Company (the ***Delaware Company Common Stock***). In addition, each outstanding option to purchase shares of Company Common Stock will be converted into an option to purchase the same number of shares of the Delaware Company Common Stock with no other changes in the terms and conditions of such options. The Company s other employee benefit arrangements will be continued by the Delaware Company upon the terms and subject to the conditions then in effect.

CERTIFICATES FOR SHARES IN THE COMPANY WILL AUTOMATICALLY REPRESENT SHARES IN THE DELAWARE COMPANY UPON COMPLETION OF THE MERGER, AND SHAREHOLDERS WILL NOT BE REQUIRED TO EXCHANGE STOCK CERTIFICATES AS A RESULT OF THE REINCORPORATION.

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The Reincorporation will not result in any change in the business, location, management, assets, liabilities or net worth of the Company, nor will it result in any change in location of Company employees, including the Company s management. The consolidated financial condition and results of operations of the Delaware Company immediately after consummation of the Reincorporation will be the same as those of the Company immediately prior to the consummation of the Reincorporation. The capitalization of the Company immediately after consummation of the Reincorporation will be the same as immediately prior to the consummation of the Reincorporation. In addition, upon the effectiveness of the Merger, the Board of the Delaware Company (the ***Delaware Company Board***) will consist of those persons elected to the current Board of the Company and the individuals serving as executive officers of the Company immediately prior to the Reincorporation will continue as executive officers of the Delaware Company. Upon effectiveness of the Reincorporation, the Delaware Company will be the successor in interest to the Company and the Shareholders will become stockholders of the Delaware Company (the ***Stockholders***).

The Reincorporation Agreement provides that the Board may abandon the reincorporation at any time prior to the Effective Time if the Board determines that the Reincorporation is inadvisable for any reason. For example, Delaware Law or Arizona Law may be changed to reduce the benefits that the Company hopes to achieve through the Reincorporation, or the costs of operating as a Delaware corporation may be increased, although the Company does not know of any such changes that are contemplated. The Reincorporation Agreement may be amended at any time prior to the Effective Time, either before or after the shareholders have voted to adopt the proposal subject to applicable law. The Company will re-solicit the shareholders approval of the Reincorporation if the terms of the Reincorporation Agreement are changed in any material respects.

Principal Reasons for the Reincorporation; Recommendation

Predictability, Flexibility and Responsiveness to Corporate Needs. Delaware has adopted comprehensive and flexible corporate laws which are revised regularly to meet changing business circumstances. The Delaware Legislature is particularly sensitive to issues regarding corporate law and is especially responsive to developments in modern corporate law. In addition, Delaware offers a system of specialized chancery courts to deal with corporate law questions. These courts have developed considerable expertise in dealing with corporate issues as well as a substantial and influential body of case law construing Delaware s corporate law. In addition, the Delaware Secretary of State is particularly flexible, expert and responsive in its administration of the filings required for mergers, acquisitions and other corporate transactions. Delaware has become a preferred domicile for most major American corporations and Delaware law and administrative practices have become comparatively well-known and widely understood. As a result of these factors, it is anticipated that Delaware law will provide greater efficiency, predictability and flexibility in the Company s legal affairs than is presently available under Arizona law.

Directors and Officers. The Board believes that reincorporation under Delaware law will enhance the Company s ability to attract and retain qualified directors and officers as well as encourage directors and officers to continue to make independent decisions in good faith on behalf of the Company. The law of Delaware offers greater certainty and stability from the perspective of those who serve as corporate officers and directors. The intense competition that has characterized the communications products and services industry has greatly expanded the challenges and risks facing the directors and officers of companies within the communications products and services industry. To date, the Company has not experienced difficulty in retaining directors or officers. However, as a result of the significant potential liability and relatively small compensation associated with service as a director, the Company believes that the better understood, and comparatively stable corporate environment afforded by Delaware will enable it to compete more effectively with other public companies, most of which are incorporated in Delaware, in the recruitment of talented and experienced directors and officers.

The parameters of director and officer liability are more extensively addressed in Delaware court decisions and are therefore better defined and better understood than under Arizona law. The Board believes that reincorporation in Delaware will enhance the Company s ability to recruit and retain directors and officers in the future, while providing appropriate protection for shareholders from possible abuses by directors and

officers. In this regard, it should be noted that directors personal liability is not, and cannot be, eliminated under Delaware law for intentional misconduct, bad faith conduct or any transaction from which the director derives an improper personal benefit.

Takeover Response. The Company currently has in place a limited number of measures designed to protect shareholder interests in the event of a hostile takeover attempt against the Company. The Company proposes to include similar measures in the charter and bylaws of the Delaware Company. These measures include a requirement that holders of a substantial percentage of voting stock act together to call a special meeting of shareholders, advance notice provisions for shareholder proposals or director nominations at an annual meeting of shareholders, and the requirement that actions by written consent of shareholders be unanimous. Many of these measures have not been as fully tested in the Arizona courts as in the Delaware courts. As a result, Delaware law affords greater certainty that these measures will be interpreted, sustained and applied in accordance with the intentions of the Board. In general, Delaware case law provides a well developed body of law defining the proper duties and decision making process expected of a Board in evaluating potential and proposed corporate takeover offers and business combinations. The Board believes that these measures and related Delaware law will help the Board to protect the Company s corporate strategies, to consider fully any proposed takeover and alternatives, and, if appropriate, to negotiate terms that maximize the benefit to the Company s shareholders.

Other reasons for the Board s recommendation of the Reincorporation include the availability in Delaware of statutory protection for Stockholders against potentially unfair business combinations and a greater ability under Delaware Law for a corporation s Board to exercise influence over the timing of stockholder action. These aspects of Delaware Law are intended both to prevent any potential acquirors of control of the Company from using coercive or abusive takeover-related tactics and to encourage such acquirors to negotiate directly with the Board. The Board believes that the overall effect of the Reincorporation will be to enhance the Board s ability to consider all appropriate courses of action for the benefit of all Shareholders and to negotiate effectively on their behalf in the context of a takeover attempt, thereby maximizing the benefits of any takeover for all Stockholders.

The Company is not seeking through this Proposal No. 2 to change the current charter and bylaw provisions of the Company and, except for those changes resulting from differences between Arizona and Delaware law, this Proposal No. 2 does not seek to alter the rights of the Company s shareholders or the rules by which the Company operates or by which its affairs are governed. The Board recommends that shareholders vote in favor of the Reincorporation.

As described in Proposal No. 3 in this proxy statement, the Board also is recommending that the shareholders approve changes to the Company s charter to impose a requirement of a majority approval of disinterested shareholders of any business combination involving the Company and an interested shareholder. The approval of Proposal No. 3 is to be considered and approved separately from the Reincorporation. You may vote in favor of the Reincorporation whether or not you choose to vote in favor of Proposals No. 3.

Possible Negative Considerations

Notwithstanding the belief of the Board as to the benefits to the Shareholders of the Reincorporation, some Shareholders may find the proposal disadvantageous to the extent it has the effect of discouraging a future attempt to acquire control of the Delaware Company that is not presented to and approved by the Delaware Company Board, but that a substantial number and perhaps even a majority of the Stockholders might believe to be in their best interests or in which Stockholders might receive a substantial premium for their shares over then current market prices. As a result of such effects, Stockholders who might desire to participate in such a transaction may not have an opportunity to do so. In addition, unapproved tender offers and takeover attempts may be made at times and in circumstances that are beneficial to and in the interests of certain Stockholders. Furthermore, a negotiated transaction is not necessarily more advantageous to the Stockholders than a non-negotiated transaction.

In addition, franchise taxes in Delaware will be greater than in Arizona. See below for a comparison of shareholders /stockholders rights and powers of management and under Delaware and Arizona law. Also, the

corporate name Inter-Tel, Incorporated was not available from the Delaware Secretary of State, necessitating that the Company use Inter-Tel (Delaware), Incorporated as its corporate name after the reincorporation and file a dba in order to continue to use Inter-Tel and Inter-Tel, Incorporated as trade names.

The Board has considered the potential disadvantages of the Reincorporation and has concluded that the potential benefits outweigh the possible disadvantages.

Differences Between the Corporation Laws of Arizona and Delaware

In general, the Company s corporate affairs are governed at present by Arizona Law as well as the Arizona Articles and the Arizona Bylaws, which have been adopted pursuant to Arizona law. As noted above, if the Reincorporation is effected, the Company will merge into, and its business will be continued by, the Delaware Company. Following the merger, issues of corporate governance and control would be controlled by Delaware, rather than Arizona Law and by the Arizona Articles and Arizona Bylaws, will, in effect, be replaced by the Delaware Certificate and the Delaware Bylaws. Accordingly, the differences among these documents and between Delaware and Arizona law are relevant to your decision whether to approve the reincorporation proposal.

Provisions of Arizona Law and Delaware Law differ in certain respects, and it is not practical to summarize all differences here. A summary of the material differences that may affect the rights and interests of Stockholders in the Delaware Company, however, is set forth below.

Indemnification and Limitation of Liability. Arizona Law provides that a corporation may indemnify a director or officer of the corporation, or a person who was serving at the corporation s request as a director, officer, partner, trustee, employee or agent of another enterprise or employee benefit plan, provided that the person (a) acted in good faith, (b) reasonably believed, in the case of conduct in his official capacity with the corporation, that the conduct was in the best interest of the corporation and, in all other cases, that his conduct was at least not opposed to the corporation s best interests, and (c) in the case of criminal proceedings, had no reasonable cause to believe the conduct was unlawful. No indemnification of an officer or director may be made in connection with a proceeding (i) by or in the right of the corporation in which the person has been adjudged to be liable to the corporation, or (ii) in connection with any other proceeding in which the person was adjudged liable on the basis that a financial benefit was improperly received by such a person.

Under Arizona Law, to the extent that an officer or director has been successful in the defense of the proceeding, he must be indemnified by the corporation for reasonable expenses incurred in connection with the proceeding. Unless otherwise limited by a company s articles of incorporation or Arizona Law, an outside director must be indemnified against liability, Expenses must be paid in advance of the final disposition of a suit upon receipt of the claimant s written affirmation of good faith belief that he has met the statutory standard of conduct and undertaking to repay such amount if it is ultimately determined that he did not meet the statutory standard of conduct. Special rules apply to outside directors who are neither officers, directors nor 5% stockholders. Unless a court has determined before payment that an outside director failed to meet the statutory standard of conduct, an outside director must be indemnified against liability and his expenses must be paid in advance of a final disposition upon receipt from such outside director of a written affirmation of his good faith belief that he has met the statutory standard of conduct and an undertaking to repay the advance if it is ultimately determined that he did not meet such standard.

Unless mandatory indemnification applies, indemnification may be made under Arizona Law only upon determination that the person has met the statutory standard of conduct. This determination is made by (i) a majority vote of the directors not at the time parties to the proceeding, (ii) special legal counsel selected by majority vote of the disinterested directors, or, if there are no disinterested directors, by majority vote of the board, or (iii) by the shareholders, provided that shares owned by or voted under the control of directors who are at the time parties to the proceeding shall not be voted on the determination. Arizona Law does not limit a corporation s power to further indemnify and advance expenses to employees, agents or officers who are not acting as directors, provided that in the case of such officers, indemnification may not be provided for (x) liability in connection with a proceeding by or in the right of the corporation other than for reasonable expenses incurred in connection with the proceeding and (y) liability arising out of conduct that constitutes

receipt by the officer of a financial benefit to which the officer is not entitled, an intentional infliction of harm on the corporation or shareholders, or an intentional violation of criminal law.

Delaware Law permits a corporation to include a provision in its certificate of incorporation, which is included in the Delaware Certificate, which eliminates or limits the personal liability of a director to the corporation or its shareholders for monetary damages for breach of fiduciary duty. However, no such provision may eliminate or limit director monetary liability for: (a) breaches of the director s duty of loyalty to the corporation or its stockholder; (b) acts or omissions not in good faith or involving intentional misconduct or knowing violations of law; (c) the payment of unlawful dividends or unlawful stock repurchases or redemptions; or (d) transactions in which the director received an improper personal benefit. Under Delaware Law, a corporation has the power to indemnify its directors, officers, employees and agents against judgments, settlements, and expenses in any litigation or other proceeding, except a proceeding by, or in the right of, the corporation, if the person acted in good faith and in a manner he or she reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to a criminal proceeding, had no reasonable cause to believe his or her conduct was unlawful. The indemnification provisions of Delaware Law require indemnification of a present or former director or officer to the extent that he has been successful on the merits or otherwise in defense of any action or claim. Delaware law also permits indemnification of expenses in a suit by, or in the right of, the corporation if the person acted in good faith and in a manner he or she reasonably believed to be in or not opposed to the best interests of the corporation, subject to court approval if the person is adjudged liable. The Delaware Certificate and the Delaware Bylaws generally require the Delaware Company to indemnify and advance litigation expenses to its directors and officers to the extent permitted by Delaware Law.

Cumulative Voting for Directors. Cumulative voting permits the holder of each share of stock entitled to vote in the election of directors to cast that number of votes which equal the number of directors to be elected. The holder may allocate all votes represented by a share to a single candidate or may allocate those votes among as many candidates as he chooses. Thus, a shareholder with a significant minority percentage of the outstanding shares may be able to elect one or more directors if voting is cumulative.

Under Arizona Law cumulative voting in the election of directors is mandatory. Cumulative voting generally is not available under Delaware Law and is only available if so provided in the corporation s certificate of incorporation. In order to establish for Stockholders of the Delaware Company a set of rights approximating as closely as possible the rights of the Company s Shareholders, the Delaware Certificate so provides for cumulative voting.

Number of Directors. Arizona Law requires corporations to have at least one director but allows the number of persons constituting the Board of a corporation to be fixed by the bylaws or the articles of incorporation, and permits the bylaws to provide that the number of directors may vary within a specified range, with the exact number to be determined by the Board.

Delaware Law allows the number of persons constituting the Board of a corporation to be fixed by the certificate of incorporation or the bylaws, or fixed in the manner provided in the bylaws. The Delaware Certificate and Bylaws provide that the number of directors shall be determined from time to time exclusively by resolution of the Board.

The Arizona Bylaws fix the number of directors at nine, or such other number fixed by resolution of the Board. Presently, by virtue of such resolutions, the number of directors is eleven. The Delaware Bylaws fix the number of directors at eight, or such other number fixed by resolution of the Board. Accordingly, despite the technical difference in the Delaware Bylaws, there will be no change in the number of directors if the Delaware Bylaws are adopted pursuant to the approval of this proposal.

Classified Board. Arizona Law and Delaware Law permit, but do not require, the adoption of a classified Board with staggered terms. Neither the Arizona Articles or Bylaws, nor the Delaware Certificate or Delaware Bylaws provide for a classified Board.

Removal of Directors. Under Arizona Law, a director may be removed with or without cause, unless the articles of incorporation provide that they may be removed only for cause, by the affirmative vote of a majority

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of the outstanding shares. A director may not be removed, however, if the number of votes sufficient to elect the director by cumulative voting is voted against removal of the director. The Arizona Articles do not provide that directors may be removed only for cause.

Delaware Law provides that any director or the entire board may be removed, with or without cause, by the holders of a majority of the shares then entitled to vote at an election of directors, except as follows: (i) unless the certificate of incorporation otherwise provides, in the case of a corporation where the board is classified, stockholders may effect such removal only for cause; or (ii) in the case of a corporation having cumulative voting, if less than the entire board is to be removed, no director may be removed without cause if the votes cast against such director s removal would be sufficient to elect such director if then cumulatively voted at an election of the entire Board if there are classes of directors or at an election of the class of directors of which such director is a part.

Neither the Arizona Articles nor the Delaware Certificate provide that directors may be removed only for cause.

Vacancies on the Board of Directors. Under Arizona Law, unless the articles of incorporation provide otherwise, if a vacancy occurs on a board of directors, including a vacancy resulting from an increase in the number of directors, either (i) the shareholders may fill the vacancy, (ii) the board of directors may fill the vacancy, or (iii) if the directors remaining in office constitute fewer than a quorum of the board, they may fill the vacancy by the affirmative vote of a majority of all of the directors remaining in office. If the vacant position was held by a director elected by a voting group of shareholders, only the holders of shares of that voting group are entitled to vote to fill the vacancy if it is filled by the shareholders. If at any time by reason of death or resignation or other cause a corporation has no directors in office, any officer or any shareholder may call a special meeting of shareholders for the purpose of electing directors.

Under Delaware Law, unless otherwise provided in the certificate of incorporation or bylaws, vacancies on the board of directors and newly created directorships resulting from any increase in the authorized number of directors may be filled by the vote of a majority of directors then in office, even though less than a quorum. Delaware Law also provides that where directors are elected by classes or series of stock, vacancies are to be filled by the remaining directors elected by the class or series in whose directorships the vacancy occurs. The Delaware Certificate and Bylaws provide that newly created directorships resulting from any increase in the authorized number of directors or any vacancies in the Delaware Company Board for any other reason may be filled only by a majority vote of the directors then in office, although less than a quorum, or by a sole remaining director. A director elected to fill a vacancy shall be elected to hold office until the next election of directors, subject to the election and qualification of his or her successor and to his or her earlier death, resignation or removal.

Shareholder Power to Call Special Meeting. Under Delaware Law, a special meeting of stockholders may be called by the Board or by any other person(s) authorized to do so in the certificate of incorporation or the bylaws. Under Arizona Law a special meeting of shareholders may be called by the Board or the person or persons authorized to do so by the articles of incorporation or bylaws. Arizona Law further provides that special meetings of the shareholders of issuing public corporations may be called by (i) the president, (ii) the secretary, (iii) two or more directors, (iv) a person authorized in the articles of incorporation or bylaws, or (v) a shareholder or shareholders holding ten percent or more of the voting power of all shares, except that a special meeting for the purpose of considering any action to directly or indirectly facilitate or effect a business combination, including any action to change or otherwise affect the composition of the Board for that purpose, must be called by twenty-five percent or more of the voting power of all shares.

Both the Delaware and the Arizona Bylaws authorize the parties listed in (i) through (v) above to call special meetings of shareholders. Both the Arizona Bylaws and Delaware Bylaws provide that any request for a special meeting shall state the purpose or purposes of the proposed meeting and, if submitted by holder of less than twenty-five percent (25%) in amount of the entire capital stock of the Corporation, shall be accompanied by a declaration under penalty of perjury that the meeting is not being held for the purpose of considering any action to directly or indirectly facilitate a business combination , including any action to change or otherwise affect the composition of the Board for that purpose.

Actions by Written Consent of Shareholders. Under Arizona Law and Delaware Law, shareholders may execute an action by written consent in lieu of a shareholder meeting. Arizona law provides that action by written consent is permitted so long as all of the shares outstanding and entitled to vote on the matter provide consent in writing. Delaware Law permits a corporation to eliminate actions by written consent in its certificate of incorporation.

Both the Arizona Bylaws and Delaware Bylaws provide that written consent is permitted if signed by the holders of all of the shares of outstanding stock entitled to vote with respect to the subject matter of the action.

Advance Notice Requirement for Shareholder Proposals and Director Nominations. There is no specific statutory requirement under either Arizona Law or Delaware Law with regard to advance notice of director nominations and shareholder proposals. However, both the Arizona and the Delaware Bylaws provide that, in order for a shareholder to propose business to be conducted or to nominate directors for election at an annual meeting of shareholders, such shareholder must provide notice to the Company not less than ninety (90) days prior to the anniversary date of the immediately preceding annual meeting; provided, however, that in the event the annual meeting is called for a date that is not within thirty (30) days before or after such anniversary date, notice by the shareholder must be so received not later than the close of business on the tenth (10th) day following the day on which such notice of the date of the meeting was mailed or such public disclosure made, whichever occurs first. Both the Arizona Bylaws and the Delaware Bylaws further provide that, in the year the advance provisions come into effect, if they come into effect less than one hundred (100) days prior to the anniversary date of the immediately preceding annual meeting of shareholders, notice also would be timely if received by the tenth (10th) day following the day on which the advance notice provisions became effective.

These notice requirements help ensure that shareholders are aware of all proposals to be voted on at the meeting and have the opportunity to consider each proposal in advance of the meeting.

In addition to the relevant bylaw provisions, federal securities laws generally provide that shareholder proposals that the proponent wishes to include in the Company s proxy materials must be received not less than 120 days in advance of the date of the proxy statement released in connection with the previous year s annual meeting.

Anti-takeover Measures. Delaware Law has been widely viewed to permit a corporation greater flexibility in governing its internal affairs and its relationships with stockholders and other parties than do the laws of many other states. In particular, Delaware Law permits a corporation to adopt a number of measures designed to reduce a corporation s vulnerability to hostile takeover attempts. Among these measures is the establishment of a stockholder rights plan. While certain types of stockholder rights plans have been upheld by Delaware courts, Arizona courts have yet to decide on the validity of many of such defenses, thus rendering their effectiveness in Arizona less certain. As discussed herein, differences between Arizona and Delaware Law, effective without additional action by the Delaware Company, could have a bearing on unapproved takeover attempts.

As further discussed, some of the anti-takeover provisions of Arizona Law may continue to apply to the Company so long as it is deemed an issuing public corporation under Arizona Law. An issuing public corporation is defined as a public company which is either incorporated in Arizona or has its principal place of business or principal executive office in Arizona and owns or controls assets located within Arizona with a fair market value of at least $1 million and has more than 500 employees residing in Arizona.

Delaware Business Combination Law. Section 203 of the Delaware Law ***(Section 203)*** was adopted by Delaware s legislature to encourage potential acquirors to negotiate with a target company s Board and, in the absence of successful (or any) negotiations, to provide minority stockholders with protections against certain takeover-related abuses.

Section 203 regulates certain transactions incident to or following large accumulations of shares, including those made by tender offers. Section 203 may have the effect of significantly delaying a purchaser s ability to acquire the entire interest sought if such acquisition is not approved by a corporation s Board. In general, Section 203 prevents an Interested Stockholder (defined generally as a person with 15% or more of a corporation s outstanding voting stock), from engaging in a Business Combination, as defined below, with a

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Delaware corporation for three years following the date such person became an Interested Stockholder. For purposes of Section 203, the term Business Combination includes, without limitation: (a) mergers with the Interested Stockholder; (b) sales or other dispositions to the Interested Stockholder (except proportionately with the corporation s other stockholders) of assets of the corporation or a subsidiary having a market value equal to 10% or more of the aggregate market value of the corporation s consolidated assets or its outstanding stock; (c) the issuance or transfer by the corporation or a subsidiary of stock of the corporation or such subsidiary to the Interested Stockholder (except for certain transfers in a conversion or exchange or a pro rata distribution or certain other transactions, none of which increase the Interested Stockholder s proportionate ownership of any class or series of the corporation s or such subsidiary s stock); (d) any transaction involving the corporation or a subsidiary that increases the proportionate share of the stock or convertible security of the corporation or such subsidiary owned by the Interested Stockholder (except as a result of immaterial adjustments or any purchase or redemption of stock not caused by the Interested Stockholder) or (e) receipt by the Interested Stockholder (except proportionately as a stockholder), directly or indirectly, of any loans, advances, guarantees, pledges or other financial benefits provided by or through the corporation or a subsidiary.

The three-year moratorium imposed on Business Combinations with Interested Stockholders by Section 203 does not apply if, among other things: (a) prior to the date on which such stockholder becomes an Interested Stockholder the Board approves either the Business Combination or the transaction that resulted in the person becoming an Interested Stockholder; (b) the Interested Stockholder owns 85% of the corporation s voting stock upon consummation of the transaction that made him or her an Interested Stockholder (excluding from the 85% calculation shares owned by directors who are also officers of the target corporation and shares held by employee stock plans that do not permit employees to decide confidentially (e.g., by giving confidential instructions to a plan s trustee) whether to accept a tender or exchange offer); or (c) on or after the date such person becomes an Interested Stockholder, the Board approves the Business Combination and it is also approved at a stockholder meeting by holders of two-thirds ($66^2/3$ %) of the voting stock not owned by the Interested Stockholder.

Increase in accounts payable and accrued liabilities	
	158,023
	41,978
(Decrease) Increase in customer deposit	
	(102,956)
	179,105
(Decrease) Increase in amount due to shareholder	
	(5,725)

	32,989
(Decrease) Increase in amount due to related parties	
	(4,561)
	27,632
Net cash provided by (used in) operating activities	
	90,046
	(601,314)
Cash flows from investing activities:	

Purchase of property, plant and equipment	
	(6,110)
	(305,357)
Cash flows from financing activities:	
Cash received from the issuance of stock	
	-
	1,148,730

Net increase in cash and cash equivalents	83,936	242,059
Cash and cash equivalents at beginning of year	242,059	-
Cash and cash equivalents at end of year	$ 325,995	$ 242,059

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

GENEX PHARMACEUTICAL, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR THE YEARS ENDED DECEMBER 31, 2004 AND 2003

NOTE 1a) DESCRIPTION OF BUSINESS AND BUSINESS COMBINATION

Tianjin Zhongjin Biology Development Co., Ltd. (TZBD) was founded in the People's Republic of China on February 10, 2003. TZBD is located in the Tianjin Economic and Technological Development Zone in the People's Republic of China. The business license of TZBD was issued by Tianjin Industrial and Commercial Administration on February 10, 2004. The operating period of the business license is from February 10, 2003 to February 9, 2053. TZBD is primarily engaged in production and sales of Reconstituted Bone Xenograft (RBX) in the People's Republic of China. All of the customers are hospitals in People's Republic of China. Marketing is either through distributors or through TZBD's sales offices in various cities in China.

On June 17, 2004, TZBD consummated a share purchase agreement with KS E-Media Holdings, Inc. ("KSE"), a Delaware corporation, under which TZBD shareholders sold 100% undivided interest in TZBD to KSE, in exchange for 3,658,375 shares of KSE. As a part of the agreement, KSE cancelled 2,212,500 shares of its issued and outstanding stock owned by its former president. Within ten (10) days from the Closing Date, KS E-Media effectuated a four-for-one forward split of the KS E-Media Common Shares by way of stock dividend. On June 17, 2004, the KSE was renamed Genex Pharmaceutical, Inc.

KSE was incorporated in the State of Delaware on February 28, 2002. Through June 17, 2004, KSE was considered a development stage company as defined by Statement of Financial Accounting Standard ("SFAS") No. 7, "Accounting and Reporting by Development Stage Enterprises". KSE was a start-up stage Internet based fulfillment Company based in Vancouver, BC, Canada. KSE filed a SB-2 Registration Statement with the United States Securities and Exchange Commission ("SEC") on December 23, 2002 that was declared effective May 7, 2003.

According to the terms of the share exchange agreement, control of the combined companies (the "Company") passed to the former shareholders of TZBD. This type of share exchange has been treated as a capital transaction accompanied by recapitalization of TZBD in substance, rather than a business combination, and is deemed a "reverse acquisition" for accounting purposes. No pro forma financial statements are being presented as the legal acquirer had no significant asset or operations prior to the acquisition.

NOTE 1b) OWNERSHIP OF A PRC SUBSIDIARY

According to the prevailing relevant PRC laws and regulations, a foreign ownership in TZBD is prohibited unless government approvals from the Tianjin offices of the State Administration of Foreign Exchange, the Ministry of Commerce, and the State Administration for Industry and Commerce are obtained. Genex has entered into agreements with the original stockholders of TZBD in respect of the transfer of legal title of the equity interest in TZBD to Genex. However, Genex has not submitted an application for the change of the equity interest of TZBD since the agreements were entered.

Management believes that there should be no legal barriers for the Company to obtain the legal ownership of TZBD. However, in the event that the Company fails to obtain necessary approvals from those offices, there is the risk that the Company may not have equity interest of TZBD and may not enjoy the rights and benefits of being the legal owner of TZBD including repatriation of capital, distribution of profits, etc.

Nevertheless, on May 19, 2006, the Company entered into a trusteeship agreement with Mr. Fuzhi Song and Mr. Deshun Song (the Consigners), the legal shareholders of TZBD. The trusteeship agreement took effect from June 17,

2004 and stipulates that the Consigners are holding all the equity shares in TZBD in trust for the Company and that the Company shall have the exclusive power and authority to exercise any and all shareholder rights with respect to all the equity shares in TZBD as if the Company was the legal, registered owner of such shares in TZBD.

On the same date, the Company entered into a contract for management service with TZBD. The contract for management service took effect from June 17, 2004 and stipulates that the Company shall provide management, administrative and related services to TZBD, and in return, TZBD shall pay to the Company a base annual fee of RMB1,000 and a floating fee equal to TZBD s gross revenues less its gross expenses for each payment period.

NOTE 1c) CHANGE IN REGISTRATION LOCATION:

The Company changed its registration location from Tianjin economic and technological development district to Tianjin Xiqing economic development district. The change in registration took place on March 5, 2004.

NOTE 2. BASIS OF PRESENTATION

The accompanying consolidated financial statements at and for the year ended December 31, 2004 include the accounts of TZBD and its parent company, KSE (legal acquirer) from the date of acquisition. The historical results for the year ended December 31, 2003 include the accounts of TZBD only. All significant inter-company accounts and transactions have been eliminated in consolidation.

NOTE 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Cash and cash equivalents

Cash and cash equivalents include cash on hand, demand and time deposits with banks and liquid investments with an original maturity of three months or less.

Inventories

Inventories are valued at the lower of cost (determined on a weighted average basis) or market. Management compares the cost of inventories with the market value and an allowance is made to write down the inventories to the market value, if market is lower than cost.

Accounts receivable and allowance for doubtful accounts

The Company uses the allowance method to account for uncollectible accounts receivable. The Company periodically adjusts the allowance for doubtful accounts based on management's continuing review of accounts receivable. This analysis by management is based on the composition of accounts receivable, analysis of historical bad debts, customer concentrations, customer credit worthiness, an analysis of current economic and business trends as well as changes in customer payment patterns. Terms of the sales vary from COD through a credit term up to 6 to 9 months.

The Company records a full allowance for accounts receivable that have been determined legally to be uncollectible. For accounts receivable that have been outstanding for over 270 days, the Company determines an appropriate allowance based on individual circumstances.

During the year ended December 2004 and 2003, the Company recorded $22,135 and $19,000 as general allowance for doubtful and long overdue accounts.

Advances from customers

The customers advance payments to the Company for purchases. The advances are interest free and unsecured. The advances from customers amounted to $76,149 at December 31, 2004.

Property and equipment

Property and equipment are stated at cost. Expenditures for maintenance and repairs are charged to earnings as incurred; additions, renewals and betterments are capitalized. When property and equipment are retired or otherwise disposed of, the related cost and accumulated depreciation are removed from the respective accounts, and any gain or loss is included in operations. Depreciation of property and equipment is provided using the straight-line method for substantially all assets with estimated lives ranging from 3 to 7 years.

Impairment of long-lived assets

Effective January 1, 2002, the Company adopted Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS 144"), which addresses financial accounting and reporting for the impairment or disposal of long-lived assets and supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of," and the accounting and reporting provisions of APB Opinion No. 30, "Reporting the Results of Operations for a Disposal of a Segment of a Business." The Company periodically evaluates the carrying value of long-lived assets to be held and used in accordance with SFAS 144. SFAS 144 requires impairment losses to be recorded on long-lived assets used in operations when indicators of impairment are present and the undiscounted cash flows estimated to be generated by those assets are less than the assets' carrying amounts. In that event, a loss is recognized based on the amount by which the carrying amount exceeds the fair market value of the long-lived assets. Loss on long-lived assets to be disposed of is determined in a similar manner, except that fair market values are reduced for the cost of disposal. Based on its review, the Company believes that, as of December 31, 2004, there were no significant impairments of its long-lived assets.

Revenue recognition

The Company's revenue recognition policies are in compliance with Staff accounting bulletin (SAB) 104. Sales revenue is recognized at the date of shipment to customers when a formal arrangement exists, the price is fixed or determinable, the delivery is completed, no other significant obligations of the Company exist and collectibility is reasonably assured. Payments received before all of the relevant criteria for revenue recognition are recorded as unearned revenue.

Advertising costs

The Company expenses the costs of advertising as incurred or, as appropriate, the first time the advertising takes place. Advertising costs for the years ended December 31, 2004 and 2003 were insignificant.

Research and development costs

Research and development costs are expensed as incurred.

Income taxes

The Company accounts for income tax using Statements of Financial Accounting Standards ("SFAS") No. 109 "Accounting for Income Taxes". SFAS No. 109 requires an asset and liability approach for financial accounting and reporting for income taxes and allows recognition and measurement of deferred tax assets based upon the likelihood of realization of tax benefits in future years. Under the asset and liability approach, deferred taxes are provided for the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. A valuation allowance is provided for deferred tax assets if it is more likely than not that these items will either expire before the Company is able to realize their benefits, or that future deductibility is uncertain. No provision for deferred taxation has been made, as there are no temporary differences at the balance sheet date.

According to the Provisional Regulations of the People's Republic of China on Income Tax, the document of Reductions and Exemptions of Income Tax for the Company has been approved by the local tax bureau and the Management Regulation of Tianjin Economic and Technological Development Zone. The Company is exempted from income tax in its first two years of operations.

Stock based compensation

The Company has adopted Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation", which defines a fair-value-based method of accounting for stock based employee compensation and transactions in which an entity issues its equity instruments to acquire goods and services from non-employees. Stock compensation for stock granted to non-employees has been determined in accordance with SFAS No.123 and the Emerging Issues Task Force consensus in Issue No. 96-18, "Accounting for Equity Instruments that are issued to Other than Employees for Acquiring, or in Conjunction with Selling Goods or Services" ("EITF 96-18"), as the fair value of the consideration received or the fair value of equity instruments issued, whichever is more reliably measured.

The Company continues to follow Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees", in accounting for stock options issued to employees (see Note 11) and non-employee directors, and pro forma disclosures of the effect on net income (loss) and net income (loss) per share as if the Company had accounted for such stock options under the fair value method prescribed by SFAS No. 123. The Company did not grant any stock options to its officers and management during the fiscal years ended December 31, 2004 and 2003.

Earning per share

Net income per share is calculated in accordance with the Statement of financial accounting standards No. 128 (SFAS No. 128), "Earnings per share". SFAS No. 128 superseded Accounting Principles Board Opinion No.15 (APB 15). Net income per share for all periods presented has been restated to reflect the adoption of SFAS No. 128. Basic net income per share is based upon the weighted average number of common shares outstanding. Diluted net income per share is based on the assumption that all dilutive convertible shares and stock options were converted or exercised. Dilution is computed by applying the treasury stock method. Under this method, options and warrants are assumed to be exercised at the beginning of the period (or at the time of issuance, if later), and as if funds obtained thereby were used to purchase common stock at the average market price during the period.

Reserve funds

In accordance with the PRC Companies Law, the Company's PRC subsidiary is required to transfer a percentage of its profit after taxation, as determined in accordance with PRC accounting standards and regulations, to the surplus reserve funds upon dividend distribution. The surplus reserve funds are comprised of the statutory surplus reserve fund and the welfare reserve fund. Subject to certain restrictions set out in the PRC Companies Law, the statutory surplus reserve fund may be distributed to stockholders in the form of share bonus and/or cash dividends. The welfare fund is non-distributable and must be used for the benefits of all the staff of the enterprise. During the years ended December 31, 2004 and 2003, no dividend had been declared by Zhongjin, and therefore, no reserve funds were transferred.

Foreign currency translation

Assets and liabilities in foreign currency at the balance sheet date are translated at the exchange rate prevailing at that date. Revenue and expenses are translated at the average exchange rate, which approximate the actual rate prevailing on the date of the transaction. Transaction gains and losses are reflected in the income statement. Gains and losses arising from translation of foreign currency financial statements are reflected as a component of the equity section of the balance sheet. Such items, along with net income, are components of comprehensive income. The functional currency of the Company is the Chinese Renminbi. The unit of Renminbi is in Yuan. Translation gains and losses were insignificant for the year ended December 31, 2004.

This quotation of the exchange rates does not imply free convertibility of RMB to other foreign currencies. All foreign exchange transactions continue to take place either through the Bank of China or other banks authorized to buy and sell foreign currencies at the exchange rate quoted by the People's Bank of China. Approval of foreign currency payments by the Bank of China or other institutions require submitting a payment application form together with invoices, shipping documents and signed contracts.

Fair values of financial instruments

The Company values its financial instruments as required by SFAS No. 107, "Disclosures about Fair Value of Financial Instruments". The Company's financial instruments primarily consist of cash and cash equivalents, accounts receivable, other receivables, prepayments, accounts payable and accruals, short-term loans and amount due to and due from related parties. The carrying values of financial instruments approximate the fair values because of their short-term maturities.

Use of estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the amount of revenues and expenses during the reporting periods. Management makes these estimates using the best information available at the time the estimates are made. However, actual results could differ materially from those results.

Statement of cash flows

In accordance with Statement of Financial Accounting Standards No. 95, "Statement of Cash Flows," cash flows from the Company's operations is calculated based upon the local currencies. As a result, amounts related to assets and liabilities reported on the statement of cash flows will not necessarily agree with changes in the corresponding balances on the balance sheet.

Segment reporting

Statement of Financial Accounting Standards No. 131 ("SFAS 131"), "Disclosure About Segments of an Enterprise and Related Information" requires use of the "management approach" model for segment reporting. The management approach model is based on the way a company's management organizes segments within the company for making operating decisions and assessing performance. Reportable segments are based on products and services, geography, legal structure, management structure, or any other manner in which management disaggregates a company. SFAS 131 has no effect on the Company's consolidated financial statements as the Company consists of one reportable business segment. All revenue is from customers in People's Republic of China. All of the Company's assets are located in People's Republic of China.

Recent accounting pronouncements

In December 2004, the FASB issued FASB Statement No. 123R, "Share-Based Payment, an Amendment of FASB Statement No. 123" ("FAS No. 123R"). FAS No. 123R requires companies to recognize in the statement of operations the grant-date fair value of stock options and other equity-based compensation issued to employees. FAS No. 123R is effective beginning in the Company's second quarter of fiscal 2006. The Company is in process of evaluating the impact of this pronouncement on its financial position.

In December 2004, the FASB issued SFAS Statement No. 153, "Exchanges of Non-monetary Assets." The Statement is an amendment of APB Opinion No. 29 to eliminate the exception for non-monetary exchanges of similar productive assets and replaces it with a general exception for exchanges of non-monetary assets that do not have commercial substance. The Company believes that the adoption of this standard will have no material impact on its financial statements.

In March 2004, the Emerging Issues Task Force ("EITF") reached a consensus on Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments." The EITF reached a consensus about the criteria that should be used to determine when an investment is considered impaired, whether that impairment is other-than-temporary, and the measurement of an impairment loss and how that criteria should be applied to investments accounted for under SFAS No. 115 "Accounting in certain investments in debt and equity securities". EITF 03-01 also included accounting considerations subsequent to the recognition of other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. Additionally, EITF 03-01 includes new disclosure requirements for investments

that are deemed to be temporarily impaired. In September 2004, the Financial Accounting Standards Board (FASB) delayed the accounting provisions of EITF 03-01; however the disclosure requirements remain effective for annual reports ending after June 15, 2004. The Company will evaluate the impact of EITF 03-01 once final guidance is issued.

Reclassifications - Certain prior year amounts in the accompanying financial statements have been reclassified to conform to the current year presentation. These reclassifications had no effect on the results of operations or financial position for any year presented.

NOTE 4. INVENTORIES

		December 31, 2004
Raw and packing materials	$	27,876
Work-in-progress		318,107
Finished goods		176,770
	$	522,753

NOTE 5. DUE FROM / TO RELATED PARTIES

The Company advanced cash to parties related through common shareholders during 2004. Out of total of $1,170,700, $169,286 is interest-free, unsecured and due on demand. The remaining $1,001,414 bears an interest rate of 6% per annum and is also unsecured. Of the $1,001,414, $244,263 and $197,523 are six-month term loans due for repayment on April 30, 2005 and May 31, 2005, respectively, whereas the remaining $559,628 is due on demand. As regards to the term loan of $244,263 already due for repayment on April 30, 2005, the Company has extended the term for 1 year from May 1, 2005 to April 30, 2006 at an interest rate of 6% per annum. Total interest income on the loans for the years ended December 31, 2004 and 2003 amounted to $21,894 and $4,380, respectively.

During the year ended December 31, 2004, the Company borrowed cash from a shareholder and certain parties related to shareholders, amounting to $27,264 and $23,071 respectively. The amounts are interest free, due on demand and unsecured.

NOTE 6. PROPERTY AND EQUIPMENT

		December 31, 2004
Machinery and equipment	$	291,407
Computer equipment		19,356
		310,763
Less: Accumulated depreciation		(79,537)
	$	231,226

Depreciation expense was $58,593 and $21,647 for the years ended December 31, 2004 and 2003, respectively.

NOTE 7. INCOME TAXES

Companies within the Group are subject to income taxes on an entity basis on income arising or derived from the tax jurisdiction in which each entity is domiciled. The Company is a Delaware corporation and is subject to the corporation income taxes of the United State of America at a maximum rate of 34%. For the year ended December 31, 2004 and 2003, there are no income tax (benefit) expenses.

The Company's PRC subsidiary is subject to Enterprise Income Tax in the PRC at a rate of 33% on net profits. However, based on the local tax rules, Zhongjin is entitled to a tax holiday for the first two years of its operations (from June 2003 to May 2005) due to its high technology content of businesses. No provision for taxes on earnings of the PRC subsidiary, calculated based on the prevailing accounting standards in PRC, for the years ended December 31, 2004 and 2003 were made accordingly. No other significant deferred tax assets or liabilities existed at December 31, 2004 and 2003.

The following is a reconciliation of the provision for income taxes at the U.S. federal income tax rate to the income taxes reflected in the Statement of Operations.

	December 31, 2004	December 31, 2003
Tax expense at statutory rate-federal	34%	34%
Foreign tax rate differential	(34)	(34)
Tax expense at actual rate	-	-

NOTE 8. EQUITY-BASED TRANSACTIONS

On June 8, 2004, the Company entered into a Share Purchase Agreement with Tianjin Zhongjin Biology Development Co., Ltd. ("Zhongjin"), a company formed under the laws of the People's Republic of China and the shareholders of Zhongjin. Under the terms of the agreement, the Company acquired 100 percent of Zhongjin's shares in exchange for 3,658,375 restricted shares of the Company's common stock which were issued to the Zhongjin shareholders. On June 17, 2004, the stock purchase made pursuant to the Share Purchase Agreement was consummated. On June 27, 2004, the Company effectuated a four-for-one stock dividend of the Company's common stock.

NOTE 9. DIRECTORS' COMPENSATION IN SHARES AND WARRANTS

The Company currently does not have option, retirement, pension or profit sharing programs for the benefit of the directors, officers or other employees, but the board of directors may recommend adoption of one or more such programs in the future.

During the years ended December 31, 2004 and 2003, there was no warrants granted.

No warrants granted to consultants were exercised during the year ended December 31, 2004.

NOTE 10. EARNINGS (LOSS) PER COMMON SHARE

Basic EPS amounts are determined based on the weighted average number of shares of common stock outstanding. Diluted EPS assumes the conversion, exercise or issuance of all potential common stock instruments such as options, warrants and convertible securities, unless the effect is to reduce a loss or increase earnings per share.

NOTE 11. COMMITMENTS AND CONTINGENCIES

Operating leases

The following are the approximate minimum lease payments that will have to be made in the years as indicated below based on the operating leases in effect as of December 31, 2004:

		Total
2005	$	7,227
2006 - 2009 (4 years)		-
2010 - 2018 (7.25 years)		-
Minimum lease payments	$	7,227

The total rental expense incurred for the years ended December 31, 2004 and 2003 were $17,346 and $32,989, respectively.

Litigation

The Company is not a party to any pending or any threatened legal proceedings. None of the Company's directors, officers or affiliates, or owner of record of more than five percent (5%) of the Company's securities, or any associate of any such director, officer or security holder is a party adverse to the Company or has a material interest adverse to the Company in reference to pending litigation.

NOTE 12. MAJOR CUSTOMERS AND CONCENTRATIONS OF CREDIT RISK

The Company's two main customers are medical device resellers: the Shanghai Yicheng Medical Device Company is Zhongjin's largest customer, representing 15% of total sales in 2004, and the Anhui Hefei Jialian Medical Appliance Company representing 10% of total sales. The aforementioned customers have each signed a three-year letter of intent for RBX deliveries from 2004 through to 2006, amounting to $1,425,000 in sales, although these agreements are not binding. The Company recognizes the importance of the medical device resellers for increasing sales and continues to establish new links with medical device companies throughout China. The Company's medical device customers represent 56% of all sales, and direct sales to hospitals and doctors account for 44% of sales, in 2004.

The Company's financial instruments that are exposed to concentration of credit risk consist primarily of cash and cash equivalents, and accounts receivable from customers. Cash and cash equivalents are mainly maintained with major banks in the PRC. The Company periodically performs credit analysis and monitors that financial condition of its customers at the subsidiary level in order to ensure collections and minimize credit risk.

NOTE 13. CURRENT VULNERABILITY DUE TO CERTAIN CONCENTRATIONS

The Company's primary operations are conducted in the PRC. Accordingly, the Company's business, financial condition and results of operations may be influenced by the political, economic and legal environments in the PRC, and by the general state of the PRC's economy.

The Company's operations in the PRC are subject to special considerations and significant risks not typically associated with companies in North America and Western Europe. These include risks associated with, among others, the political, economic and legal environments and foreign currency exchange. The Company's results may be adversely affected by changes in the political, economic and social conditions in the PRC, and by changes in governmental policies with respect to laws and regulations, anti-inflationary measures, currency conversion and remittance abroad, and rates and methods of taxation, among other things.

The Company's operating assets and primary sources of income and cash flows are its interest in subsidiaries and associated company in the PRC. The PRC economy has, for many years, been a centrally-planned economy, operating on the basis of annual, five-year and ten-year state plans adopted by central PRC governmental authorities, which set out national production and development targets. The PRC government has been pursuing economic reforms since it first adopted its "open-door" policy in 1978. There is no assurance that the PRC government will continue to pursue economic reforms or that there will not be any significant change in its economic or other policies, particularly in the event of any change in the political leadership of, or the political, economic or social conditions in, the PRC. There is also no assurance that the Company will not be adversely affected by any such change in governmental policies or any unfavorable change in the political, economic or social conditions, the laws or regulations, or the rate or method of taxation in the PRC.

As many of the economic reforms which have been or are being implemented by the PRC government are unprecedented or experimental, they may be subject to adjustment or refinement, which may have adverse effects on the Company. Further, through state plans and other economic and fiscal measures, it remains possible for the PRC government to exert significant influence on the PRC economy.

NOTE 14. STATUTORY COMMON WELFARE FUND

As stipulated by the Company Law of the People's Republic of China (PRC), net income after taxation can only be distributed as dividends after appropriation has been made for the following:

(i) Making up cumulative prior years' losses, if any;

(ii) Allocations to the "Statutory surplus reserve" of at least 10% of income after tax, as determined under PRC accounting rules and regulations, until the fund amounts to 50% of the Company's registered capital;

(iii) Allocations of 5-10% of income after tax, as determined under PRC accounting rules and regulations, to the Company's "Statutory common welfare fund", which is established for the purpose of providing employee facilities and other collective benefits to the Company's employees; and

(iv) Allocations to the discretionary surplus reserve, if approved in the shareholders' general meeting.

The Company established a reserve for the annual contribution of 5% of net income to the welfare fund. The amount allocated to the statutory reserve for the years ended December 31, 2004 and 2003 amounted to $50,663 and $22,549, respectively.

NOTE 15. STATUTORY RESERVE

In accordance with the *Chinese Company Law* (note 10), the company has allocated 10% of its annual net income, amounting $101,326 and $45,096 , as statutory reserve on December 31, 2004 and 2003, respectively.

NOTE 16. GMP CERTIFICATION

The management believes that product and the Company are not subject to Good Manufacturing Practices (GMP) certification, as RBX is currently considered to be a part of a treatment with medical equipment. GMP is granted by the State Drug Administration (SDA) of China (China's equivalent to the FDA in the United States of America). GMP guidelines define standards for the pharmaceutical manufacturing process to reduce the possibility of contamination errors and it conforms to the WTO's fundamental principles concerning the medicine production administration. Management believes that the requirement of the GMP certification and license for the Company and RBX will begin by 2005.

EXHIBITS AND REPORTS ON FORM 8-K

(a)

Exhibits.

Exhibit Number	Description of Exhibit
31.1	Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b)

Reports on Form 8-K.

On February 9, 2006, the Company filed a Form 8-K/A to correct certain omissions and misstatements that were contained in its November 16, 2005 Form 8-K regarding the change in the Company s certifying accountant from Kabani & Company, Inc to GC Alliance Limited, Certified Public Accountants. On February 14, 2006, the Company filed another Form 8-K/A which included the letter from Kabani & Company that had not been included as an exhibit to its November 16, 2005 Form 8-K. On March 29, 2006, a Form 8-K was filed to disclose the change in the Company s certifying accountant from GC Alliance Limited, Certified Public Accountants, to Schwartz Levitsky Feldman LLP, Chartered Accountants.

SIGNATURES

In accordance with the requirements of the Exchange Act, the Company caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Genex Pharmaceutical, Inc.

Dated: September 19, 2006

By: /s/ Fuzhi Song

Fuzhi Song,
Chief Executive Officer, President and Director

Dated: September 19, 2006

By: /s/ Shuli Zhang
Shuli Zhang
Chief Financial Officer