

GLENAYRE TECHNOLOGIES INC

Form 10-Q

May 10, 2005

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

**FORM 10-Q**

**þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended **March 31, 2005**

**o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number **0-15761**

**GLENAYRE TECHNOLOGIES, INC.**

(Exact Name of Registrant as Specified in Its Charter)

**DELAWARE**

**98-0085742**

(State or Other Jurisdiction of  
Incorporation or Organization)

(I.R.S. Employer  
Identification No.)

**11360 LAKEFIELD DRIVE, DULUTH, GEORGIA**

**30097**

**(770) 283-1000**

(Registrant's telephone number, including area code)

**NOT APPLICABLE**

(Former name, former address and former fiscal year, if changed since last report)

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

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

The number of shares outstanding of the Registrant's common stock, par value \$.02 per share, at April 29, 2005 was 66,924,506 shares.

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**Glenayre Technologies, Inc. and Subsidiaries**

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**PART I FINANCIAL INFORMATION**

**ITEM 1. Financial Statements**

**Glenayre Technologies, Inc. and Subsidiaries**

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**Report of Independent Registered Public Accounting Firm**

Glenayre Technologies, Inc. Board of Directors and Stockholders  
Atlanta, Georgia

We have reviewed the Condensed Consolidated Balance Sheet of Glenayre Technologies, Inc. and Subsidiaries as of March 31, 2005, and the related Condensed Consolidated Statements of Operations for the three month periods ended March 31, 2005 and 2004, the Condensed Consolidated Statement of Stockholders' Equity for the three months ended March 31, 2005, and the Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2005 and 2004. These financial statements are the responsibility of the Company's management.

We conducted our reviews in accordance with standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures to financial data, and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the Condensed Consolidated Financial Statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the Consolidated Balance Sheet of Glenayre Technologies, Inc. and Subsidiaries as of December 31, 2004, and the related Consolidated Statements of Operations, Stockholders' Equity, and Cash Flows for the year then ended not presented herein, and in our report dated March 7, 2005 we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying Condensed Consolidated Balance Sheet as of December 31, 2004, is fairly stated, in all material respects, in relation to the Consolidated Balance Sheet from which it has been derived.

/s/ Ernst & Young LLP

Atlanta, Georgia  
May 9, 2005

**Table of Contents****GLENAYRE TECHNOLOGIES, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands, except share amounts)**

	<b>March 31, 2005 (unaudited)</b>	<b>December 31, 2004</b>
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 90,927	\$ 82,691
Short-term investments	56	12,180
Restricted cash	106	30
Accounts receivable, net	23,529	7,695
Inventories, net	8,415	6,163
Prepaid expenses and other current assets	2,087	2,863
Total Current Assets	125,120	111,622
Property, plant and equipment, net	8,590	8,812
Other assets	1,676	848
<b>TOTAL ASSETS</b>	<b>\$ 135,386</b>	<b>\$ 121,282</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current Liabilities:		
Accounts payable	\$ 4,993	\$ 3,552
Deferred revenue	12,840	3,754
Accrued liabilities	13,712	11,912
Accrued liabilities, discontinued operations	3,211	3,284
Total Current Liabilities	34,756	22,502
Other liabilities	3,446	3,497
Accrued liabilities, discontinued operations noncurrent	79	98
Total Liabilities	38,281	26,097
Stockholders Equity:		
Preferred stock, \$.01 par value; authorized: 5,000,000 shares, no shares issued and outstanding		
Common stock, \$.02 par value; authorized: 200,000,000 shares, Outstanding: 2005 - 66,924,506 shares; 2004 - 66,820,124 shares	1,338	1,336
Contributed capital	362,826	362,698
Accumulated deficit	(267,059)	(268,849)
Total Stockholders Equity	97,105	95,185
<b>TOTAL LIABILITIES AND STOCKHOLDERS EQUITY</b>	<b>\$ 135,386</b>	<b>\$ 121,282</b>



Table of Contents**GLENAYRE TECHNOLOGIES, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(In thousands, except per share amounts)  
(Unaudited)**

	<b>Three Months Ended March</b>	
	<b>31,</b>	
	<b>2005</b>	<b>2004</b>
<b>REVENUES:</b>		
Product sales	\$ 13,658	\$ 5,837
Service revenues	4,264	4,357
Total Revenues	17,922	10,194
<b>COST of REVENUES:</b>		
Cost of sales	4,155	5,883
Cost of services	2,467	2,180
Total Cost of Revenues	6,622	8,063
<b>GROSS MARGIN</b>	11,300	2,131
<b>OPERATING EXPENSES:</b>		
Selling, general and administrative expense	6,878	4,303
Provision for doubtful receivables, net of recoveries	10	(92)
Research and development expense	2,716	3,421
Restructuring expense	(12)	37
Depreciation expense	429	337
Total Operating Expenses	10,021	8,006
<b>OPERATING INCOME (LOSS)</b>	1,279	(5,875)
<b>OTHER INCOME (EXPENSES):</b>		
Interest income	530	275
Interest expense	(7)	(209)
Loss on disposal of assets, net	(1)	(6)
Other gain (loss), net	8	(52)
Total Other Income	530	8
<b>INCOME (LOSS) FROM OPERATIONS BEFORE INCOME TAXES</b>	1,809	(5,867)
Provision for income taxes	29	34
<b>INCOME (LOSS) FROM CONTINUING OPERATIONS</b>	1,780	(5,901)
<b>INCOME FROM DISCONTINUED OPERATIONS (NET OF INCOME TAX PROVISION/BENEFIT)</b>	10	1,685

<b>NET INCOME (LOSS)</b>	\$	1,790	\$	(4,216)
<b>INCOME (LOSS) PER WEIGHTED AVERAGE COMMON SHARE:</b>				
Income (loss) from continuing operations	\$	0.03	\$	(0.09)
Income from discontinued operations		0.00		0.03
Net income (loss) per weighted average common share	\$	0.03	\$	(0.06)
<b>INCOME (LOSS) PER COMMON SHARE - ASSUMING DILUTION:</b>				
Income (loss) from continuing operations	\$	0.03	\$	(0.09)
Income from discontinued operations		0.00		0.03
Net income (loss) per weighted average common share	\$	0.03	\$	(0.06)

See Notes to Condensed Consolidated Financial Statements.

**Table of Contents****GLENAYRE TECHNOLOGIES, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY****(In thousands)****(Unaudited)**

	<b>Common Stock</b>		<b>Contributed</b>	<b>Accumulated</b>	<b>Total</b>
	<b>Shares</b>	<b>Amount</b>	<b>Capital</b>	<b>Deficit</b>	<b>Stockholders</b>
					<b>Equity</b>
Balances, January 1, 2005	66,820	\$ 1,336	\$ 362,698	\$ (268,849)	\$ 95,185
Net Income				1,790	1,790
Shares issued for Employee Stock Purchase Plan And option exercises	105	2	128		130
Balances, March 31, 2005	66,925	\$ 1,338	\$ 362,826	\$ (267,059)	\$ 97,105

See Notes to Condensed Consolidated Financial Statements.

Table of Contents**GLENAYRE TECHNOLOGIES, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands)****(Unaudited)**

	<b>Three Months Ended March</b>	
	<b>31,</b>	
	<b>2005</b>	<b>2004</b>
<b>NET CASH USED IN OPERATING ACTIVITIES</b>	\$ (3,745)	\$ (4,273)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchases of property, plant and equipment	(273)	(715)
Maturities of (investment in) short-term securities	12,124	(5,502)
<b>NET CASH PROVIDED (USED) BY INVESTING ACTIVITIES</b>	11,851	(6,217)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Issuance of common stock	130	187
<b>NET CASH PROVIDED BY FINANCING ACTIVITIES</b>	130	187
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	8,236	(10,303)
<b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>	82,691	65,853
<b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>	\$ 90,927	\$ 55,550
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:</b>		
Cash paid during the period for:		
Interest	\$ 11	\$ 189
Income taxes		

See Notes to Condensed Consolidated Financial Statements.

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**Glenayre Technologies, Inc. and Subsidiaries**

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Tabular amounts in thousands except per share data)  
(Unaudited)**

**1. Basis of Presentation and Significant Accounting Policies**

***Basis of Presentation***

The accompanying unaudited Condensed Consolidated Financial Statements of the Glenayre Technologies, Inc. and Subsidiaries ( Glenayre or the Company ) have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. All significant intercompany accounts and transactions are eliminated in consolidation. Operating results for the three months ended March 31, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005. Glenayre s financial results in any quarter are highly dependent upon various factors, including the timing and size of customer orders and the shipment of products for large orders. Large orders from customers can account for a significant portion of products shipped in any quarter. Accordingly, the shipment of products in fulfillment of such large orders can dramatically affect the results of operations of any single quarter. For further information, refer to the consolidated financial statements and footnotes thereto included in the Glenayre Technologies, Inc. Annual Report on Form 10-K, as amended, for the year ended December 31, 2004.

***Use of Estimates***

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

***Stock-Based Compensation***

The Company grants stock options and issues shares under option plans and an employee stock purchase plan as described in Note 12. The Company accounts for stock option grants and shares sold under the employee stock purchase plan in accordance with APB Opinion No. 25, *Accounting for Stock Issued to Employees* ( APB 25 ); and, accordingly, records compensation expense for options granted and sales made at prices that are less than fair market value at the date of grant or sale. No compensation expense is recognized for options granted to employees with an exercise price equal to the fair value of the shares at the date of grant.

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)**  
**(Tabular amounts in thousands except per share data)**  
**(Unaudited)**

The following table compares the Company's results of continuing operations as reported to the pro forma results of continuing operations whereby stock-based compensation is computed under the fair value method required by Statement of Financial Accounting Standards No. 123 (Revised 2004). For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense on a straight-line basis over the options' vesting period for each of the three-month periods ended March 31:

	Three months Ended March 31,	
	2005	2004
Income (loss) from continuing operations as reported	\$ 1,780	\$ (5,901)
Pro forma stock option expense (1)	(269)	(240)
Income (loss) from continuing operations pro forma	\$ 1,511	\$ (6,141)
Income (loss) from continuing operations per common share as reported	\$ 0.03	\$ (0.09)
Pro forma stock option expense (2)		
Income (loss) from continuing operations per common share pro forma (2)	\$ 0.02	\$ (0.09)
Income (loss) from continuing operations, assuming dilution as reported	\$ 0.03	\$ (0.09)
Pro forma stock option expense (2)		
Income (loss) from continuing operations, assuming dilution pro forma (2)	\$ 0.02	\$ (0.09)

(1) As a result of terminations during the three month periods ended March 31, 2005 and 2004 resulting primarily from voluntary terminations, a credit to the pro forma stock option expense was included in the March 31, 2005 and 2004 pro forma stock option expense of approximately \$29,000 and \$79,000, respectively, or \$0.00 per share for each quarter. This credit related to the pro forma stock option expense previously recognized for these employees in prior periods.

(2) Income (loss) per weighted average common share amounts are rounded to the nearest \$0.1; therefore, such rounding may impact individual amounts presented.

***Impact of Recently Issued Accounting Standards***

On September 30, 2004, the FASB directed the FASB staff to delay the effective date of the measurement and recognition guidance contained in paragraphs 10 through 20 of EITF Issue No. 03-1, *The Meaning of Other Than-Temporary Impairment and Its Application to Certain Investments* (EITF 03-1). EITF 03-1 provides a

common approach to evaluating other-than-temporary impairment to debt and equity securities within the scope of SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (SFAS 115), and to debt securities not subject to the scope of SFAS 115 and not accounted for under the equity method of accounting. The disclosure provisions were effective for the Company for the year ending December 31, 2003. The requirements of EITF 03-1 did not have a material impact on the disclosure requirements of the Company. The Company does not believe that the measurement and recognition guidance will have a material impact on its financial position.

In response to the December 8, 2003 enactment of the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act), the FASB issued Financial Staff Position ( FSP ) No. FAS 106-1. The Act introduced a prescription drug benefit under Medicare ( Medicare Part D ) as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D. The Company elected to defer recognition of the effects of the Act on its post-retirement benefit plan until authoritative guidance on the accounting for the federal subsidy was issued in accordance with alternatives prescribed by FSP No. FAS 106-1 which was effective for the Company

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)**  
**(Tabular amounts in thousands except per share data)**  
**(Unaudited)**

beginning with the year ended December 31, 2003. FSP No. FAS 106-1 was superseded by FSP No. FAS 106-2 on May 19, 2004 and is effective for the first interim or annual period beginning after June 15, 2004. The Company has two alternative methods of transition: retroactive application to the date of enactment or prospective application from the date of adoption. The Company is unable to determine whether benefits provided by its plan are actuarially equivalent to Medicare Part D and is unable to determine if the Company's plan qualifies for the subsidy under the Act. Consequently, the measure of the Accumulated Post-retirement Benefit Obligation ( APBO ) and net periodic post-retirement benefit cost do not reflect any amount associated with the subsidy. The regulations issued in January of 2005 indicated that the Centers for Medicare and Medicaid Services will provide further guidance on methods required to demonstrate actuarial equivalence.

In November of 2004, FASB issued Statement No. 151, *Inventory Costs*, an amendment of Accounting Research Bulletin No. 43, Chapter 4 ( SFAS 151 ). The amendments made by SFAS 151 clarify that abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current period charges and require the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. The FASB's goal is to promote convergence of accounting standards internationally by adopting language similar to that used in the International Accounting Standard 2, *Inventories* adopted by the International Accounting Standards Board ( IASB ). The Boards noted that the wording of the original standards were similar but were concerned that the differences would lead to inconsistent application of those similar requirements. The guidance is effective for inventory costs incurred during the Company's year beginning January 1, 2006. The Company does not believe that the adoption of the new standard will have a material impact on its financial position.

The FASB issued FSP No. 109-2, *Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004* to provide guidance under FASB issued Statement No. 109, *Accounting for Income Taxes* ( SFAS 109 ) regarding the American Jobs Creation Act of 2004 (the Jobs Act ) enacted on October 22, 2004. The Jobs Act provides for a special one-time dividends received deduction on the repatriation of certain foreign earnings to a US taxpayer. The Company has evaluated the effect of the Jobs Act on its plan for reinvestment and repatriation of foreign earnings and determined that it will not use the one-time deduction due to its net operation loss carryovers that are available to offset income from future dividend payments.

On December 16, 2004, the FASB issued Statement No. 123 (revised 2004), *Share-Based Payment* ( SFAS 123R ), which is a revision of SFAS 123. SFAS 123R supersedes APB 25 and amends FASB Statement No. 95, *Statement of Cash Flows*. SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative. On April 14, 2005 the Securities and Exchange Commission announced the adoption of a new rule that amends the compliance dates for SFAS 123R. Under the new rule public companies will now be required to adopt SFAS 123R by their first fiscal year after June 15, 2005. The Company expects to adopt SFAS 123R on January 1, 2006.

SFAS 123R permits public companies to adopt its requirement using one of two methods:

1. A modified prospective method in which compensation cost is recognized beginning with the effective date
  - (a) based on the requirements of SFAS 123R all share-based payments granted after the effective date and
  - (b) based on the requirements of SFAS 123 for all awards granted to employees prior to the effective date of

SFAS 123R that remain unvested on the effective date.

2. A modified retrospective method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)**  
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**(Unaudited)**

The Company plans to adopt SFAS 123R using the modified-prospective method.

Both SFAS 123 and SFAS 123R require measurement of fair value using an option-pricing model. Although the Company currently uses the Black-Scholes model, the Company may determine that a lattice model provides a better estimate of fair value for its employee stock options. The Company has not determined which model it will use for new awards issued and for awards modified, repurchased or cancelled on or after the effective date, January 1, 2006. All awards granted prior to January 1, 2006 will maintain their grant-date value as calculated under SFAS 123. The future compensation cost for the portion of these awards that are unvested (the service period continues after date of adoption) will be based on their grant-date value adjusted for estimated forfeitures. The Company currently adjusts the pro forma expense for forfeitures only as they occur. The pro forma expense is allocated to the service period based on the accelerated attribution method, and all the awards have graded service vesting. This method will continue for compensation costs recognized for these awards granted prior to the effective date. Under the new standard, the Company may use a straight line or accelerated attribution method and is considering both alternatives for awards issued after the effective date.

**Reclassifications**

Certain items in the prior year consolidated financial statements have been reclassified to conform to the current presentation.

**2. Short-Term Investments**

The following is a summary of held-to-maturity securities:

	Amortized Cost (Net Carrying Amount)	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
March 31, 2005				
Obligation of U.S. government agencies	\$	\$	\$	\$
Other short-term investments	56			56
	\$ 56	\$	\$	\$ 56
December 31, 2004				
Obligation of U.S. government agencies	\$ 5,127	\$	\$	\$ 5,127
Other short-term investments	7,053			7,053
	\$ 12,180	\$	\$	\$ 12,180

All short-term investments mature in one year or less. Short-term investments consist of highly liquid investments purchased with original maturities of greater than three months and less than twelve months when purchased.

### 3. Accounts Receivable

Accounts receivable related to continuing operations consist of:

	March 31, 2005	December 31, 2004
Trade receivables	\$ 23,983	\$ 8,139
Less: allowance for doubtful accounts	(454)	(444)
	\$ 23,529	\$ 7,695

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)**  
**(Tabular amounts in thousands except per share data)**  
**(Unaudited)**

**4. Inventories**

Inventories, net of reserves, related to continuing operations consist of:

	March 31, 2005	December 31, 2004
Raw materials	\$ 2,533	\$ 2,745
Work-in-process	618	586
Finished goods	5,264	2,832
	\$ 8,415	\$ 6,163

At March 31, 2005 and December 31, 2004, reserves were approximately \$2.7 million for both periods. Charges for obsolescence and slow-moving inventory were approximately \$24,000 and \$51,000 during the three month periods ended March 31, 2005 and 2004, respectively.

In connection with the introduction of new products and services as well as in an effort to demonstrate its products to new and existing customers, the Company, from time to time, delivers new product test systems for demonstration and test to customer third-party locations. The Company expenses the cost associated with new product test equipment upon shipment from the Company's facilities.

**5. Estimated Warranty Costs**

The Company generally warrants its products for one year after sale and a provision for estimated warranty costs is recorded at the time of sale. Factors affecting the Company's warranty liability include the number of units sold, historical and anticipated rates of warranty claims and cost per claim. The following is a summary of activity of the Company's continuing operations warranty obligation for the first quarter of 2005.

Balance at January 1, 2005	\$ 573
Provision for warranty obligations	46
Settlements of warranty obligations	(45)
Balance at March 31, 2005	\$ 574

The Company also offers post installation extended warranty and support services, known as Glenayre Care, for its products and services to customers. One year of Glenayre Care is generally included in the price of the Company's product. A portion of the product revenue equal to the fair value of the Glenayre Care is deferred at the time the sale

of the product is recorded and recognized ratably over the support period. Once this service period expires, the Company's customers generally enter into Glenayre Care agreements of varying terms, which typically require payment in advance of the performance of the extended warranty service. Revenue derived from post installation support services is recognized ratably over the contracted support period. Deferred revenue at March 31, 2005 related to product sales and to the sale of post installation support services was approximately \$3.5 million of the \$12.8 million of deferred revenue.

#### **6. Business Restructuring of Continuing Operations**

Effective January 1, 2003, the Company changed its method of accounting for restructuring activities to conform with Statement of Financial Accounting Standard No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*.

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)**  
**(Tabular amounts in thousands except per share data)**  
**(Unaudited)**

During the first quarter of 2005, the Company recorded net favorable adjustments to its original estimates associated with the Company's 2003 restructuring activities of \$12,000 primarily related to a reduction in accrued lease cancellation costs.

During the first quarter of 2004, the Company recorded a restructuring charge of \$58,000 for severance and outplacement services related to the reduction of the Company's workforce in the first and second quarter of 2003. The Company recorded net favorable adjustments to its original estimates associated with the Company's 2001 and 2003 restructuring activities of \$21,000 primarily related to a reduction in accrued severance benefits. The following is a summary of activity for the three months ended March 31, 2005 related to the restructuring reserves:

	Severance and Benefits	Lease Cancellation and Other Exit Costs	Total
Balance at January 1, 2005	\$ 27	\$ 233	\$ 260
Expense accrued			
Credits and changes in estimates		(12)	(12)
Payments		(93)	(93)
Balance at March 31, 2005	\$ 27	\$ 128	\$ 155

**7. Discontinued Operations**

In May 2001, the Company began exiting its Wireless Messaging (Paging) business and refocusing all of its strategic efforts on the Enhanced Services Messaging business segment. As a result, the Paging segment was reported as a disposal of a segment of business in the second quarter 2001 in accordance with APB Opinion No. 30, *Reporting the Results of Operations*. Accordingly, the operating results of the Paging segment have been classified as a discontinued operation for all periods presented in the Company's Consolidated Statements of Operations. Additionally, the Company has reported all of the Paging segment assets at their estimated net realizable value in the Company's unaudited Condensed Consolidated Balance Sheet as of March 31, 2005. All business transactions related to the Paging segment, with the exception of existing contractual obligations, ceased in May 2002, the end of the transition period. Results for discontinued operations consist of the following:

	Three Months Ended March 31,	
	2005	2004
Gain on disposal of segment before income taxes	\$ 63	\$ 379
Income Tax (Expense) Benefit	(53)	1,306

Income from discontinued operations	\$ 10	\$ 1,685
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In the first quarter of 2005, as a result of the Company review of the estimated liabilities and future commitments related to the discontinued operations, a net decrease in the loss on disposal of \$63,000 was recorded. The Company recorded income of \$74,000 primarily due to settlement received from Pilot Pacific Properties, Inc. and its associated companies. This income was offset by the adjustments to the original estimates, related primarily to international office closures, of \$11,000.

In the first quarter of 2004, as a result of the Company's review of the estimated liabilities and future commitments related to the discontinued operations, a net decrease in the loss on disposal of \$379,000 was recorded. The adjustments to the original estimates related primarily to better than anticipated recoveries received from paging customers and to asset and inventory liquidations. In addition, the

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)**  
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Company recorded a \$1.3 million reduction in its tax liability relating to the discontinued operations primarily due to receiving a favorable assessment for several prior tax years relating to one of the Company's foreign subsidiaries.

**8. Accrued Liabilities**

Accrued liabilities at March 31, 2005 and December 31, 2004 consisted of:

	March 31, 2005	December 31, 2004
Accrued income taxes	\$ 5,077	\$ 4,993
Accrued payroll costs	1,841	1,127
Accrued audit, tax and professional services	1,824	857
Accrued vacation	896	644
Accrued contractual obligations to customers	724	708
Other accruals	3,350	3,583
	\$ 13,712	\$ 11,912

**9. Other Liabilities**

Other liabilities at March 31, 2005 and December 31, 2004 consist of:

	March 31, 2005	December 31, 2004
Post-retirement benefit accrual	\$ 2,188	\$ 2,204
Deferred compensation	815	847
Deferred officers compensation	443	446
	\$ 3,446	\$ 3,497

**10. Income Taxes**

The Company's consolidated income tax provision from continuing operations was different from the amount computed using the U.S. federal statutory income tax rate for the following reasons:

	Three Months Ended	
	March 31,	
	2005	2004
Income tax provision (benefit) federal U.S. statutory rate	\$ 633	\$ (2,053)
Increase (decrease) in valuation allowance	(624)	2,267
State income tax benefit, net of federal benefit	(39)	(224)
Foreign taxes, net of federal benefit and related valuation allowance	29	34
Other non deductibles	30	10
Income tax provision	\$ 29	\$ 34

The Company accounts for income taxes under the liability method in accordance with SFAS 109. At March 31, 2005, the Company's net deferred tax asset was fully reserved by a valuation allowance. Pursuant to SFAS 109, a valuation allowance should be recognized to reduce the deferred tax asset to the amount that is more likely than not to be realized as offsets to the Company's future taxable income. The Company assessed whether the net deferred asset at March 31, 2005 was realizable and determined due to significant net operating losses and its inability to project future taxable income that the entire amount should be reserved.

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-(Continued)**  
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**11. Employee Benefit Plans, Postretirement Health Care Benefits**

Net postretirement benefit costs consist of the following components:

	Three Months Ended March 31,	
	2005	2004
Service Cost	\$ 15	\$ 13
Interest cost on APBO	32	27
Amortization of prior service costs	(64)	(63)
Amortization of actuarial loss	22	15
	\$ 5	\$ (8)

The unrecognized prior service cost decreases the postretirement benefit costs due to amortization of the plan amendment effective June 1, 2003 reducing the number of participants by changing eligibility provisions. The Company reported in its financial statements for the year ended December 31, 2004, that it expects to contribute \$82,000 to its postretirement health care plan in 2005.

**12. Stockholders Equity***(a) Income (Loss) from Continuing Operations per Common Share*

The following table sets forth the computation of income (loss) from continuing operations per share:

	Three Months Ended March 31,	
	2005	2004
Numerator:		
Net income (loss) from continuing operations	\$ 1,780	\$ (5,901)
Denominator:		
Denominator for basic income from continuing operations per share - weighted average shares	66,884	66,450
Effect of dilutive securities: Stock options	1,496	
Denominator for diluted income (loss) from continuing operations per share	68,380	66,450
Income (loss) from continuing operations per weighted average common share	\$ 0.03	\$ (0.09)

Income (loss) from continuing operations per common share-assuming dilution	\$ 0.03	\$ (0.09)
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There were no shares of potential common stock included in the calculation of diluted loss per share for the three months ended March 31, 2004, as their effect would be anti-dilutive.

*(b) Incentive Stock Plans*

The Company maintains two stock option plans (the 1996 Plan and the 1991 Plan ) and an employee stock purchase plan that were approved by the stockholders. These plans are administered by the Compensation and Plan Administration Committee of the Board of Directors (the Compensation Committee ) and are utilized to promote the long-term financial interests and growth of the Company. The 1996 and 1991 Plans, as amended, authorize the grant of up to 9,650,000 and 11,475,000 shares, respectively, of the Company's common stock for issuance in connection with the grant of stock options, stock appreciation rights, restricted stock and performance shares.

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Options granted have an option price equal to the fair market value of the Company's common stock on the date of grant. Options under the plans expire no later than ten years from the grant date.

The Company has elected to follow APB 25 and related interpretations in accounting for its employee stock options because, as discussed below, the alternative fair value accounting provided for under FASB Statement No. 123, *Accounting for Stock-Based Compensation*, ( FAS 123 ) requires use of option valuation models that were not developed for use in valuing employee stock options. Under APB 25, because the exercise price of the Company's employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized. Pro forma information regarding net income and earnings per share is required by FAS 123, which also requires that the information be determined as if the Company had accounted for its employee stock options granted subsequent to December 31, 1994 under the fair value method of that statement. See Note 1, *Stock-Based Compensation* for these disclosures. The fair value for these options was estimated at the date of grant using the Black-Scholes option-pricing model with the following assumptions:

	March 31, 2005	March 31, 2004
Expected Life in Years	1 to 4	1 to 4
Risk Free Interest Rate	3.3% to 4.5%	1.2% to 3.8%
Volatility	0.71	0.77
Dividend Yield		

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

**13. Commitments and Contingencies*****Litigation***

In connection with the licensing of the Company's software products, the Company's standard purchase and license agreements typically require the Company to defend and indemnify its customers against claims that the Company's licensed programs infringe or misappropriate the intellectual property rights of third parties. Under these agreements, the Company agrees to indemnify, defend and hold harmless the customer in connection with patent, copyright, trade secret or mask works infringement claims made by third parties with respect to the customer's authorized use of our licensed programs. The indemnity provisions generally provide, subject to various exclusions and conditions, for our control of defense and settlement and cover costs and damages actually finally awarded against the customer. The Company retains the right in its discretion or after issuance of a final adverse judgment to obtain a license for the licensed program in question from the third party, to modify the licensed program so it is no longer infringing, or to terminate the customer's license for the licensed program with a pro-rata refund of license fees paid based on a 5-year

straight-line amortization schedule.

*Phillip Jackson* Beginning in late 2001, Phillip Jackson ( Jackson ) filed lawsuits against several of the Company s customers claiming that products sold by the Company and used by these customers infringed a patent held by Jackson. The Company agreed to indemnify its customers for the claims in these lawsuits and assumed primary responsibility for defending the claims with respect to the Company s

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products. Following completion of the trial and post-trial reduction of damages by the court, the court entered judgment in the total amount of approximately \$2.7 million, plus interest and costs. During the first quarter of 2004, the Company recorded a charge consisting of \$2.7 million royalty fee expense (recorded in cost of revenues) and \$200,000 interest expense, and recorded a reduction of the estimated liability for accrued legal cost associated with this case of \$770,000. The Company paid the \$2.7 million award plus interest and costs during the second quarter of 2004.

On May 14, 2004, Jackson filed a motion with the district ( trial ) court to set trial on remaining issues of contributory infringement and inducement to infringe Jackson's patent. On June 29, 2004, the trial court ruled that there were no issues remaining between the parties and denied Jackson's motion to set trial on remaining issues. Jackson is currently appealing this ruling and the appeal was argued before the United States Court of Appeals for the Federal Circuit on March 11, 2005. As of May 9, 2005, the appellate court has not yet ruled on the appeal. The Company believes that it is unlikely that the appellate court will reverse the trial court's ruling of June 29, 2004.

*Lynnview Ridge, Alberta* In November 2002 and April 2003, a total of twenty lawsuits seeking approximately \$22.3 million (Canadian) in damages were filed in the Court of Queen's Bench, Judicial Centre of Calgary, in Alberta, Canada, against the Company and several other defendants, including Imperial Oil, a major Canadian petroleum company. These lawsuits assert that the defendants, including the Company, are liable for negligence, nuisance, and negligent misrepresentation arising out of the development and sale of homes located in a Calgary, Canada residential development, Lynnview Ridge, that was jointly developed in the early 1980's by a corporate predecessor of the Company and a wholly owned subsidiary of Imperial Oil.

The Company understands that the land on which some of this residential development was located at one time contained a petroleum storage tank farm and is adjacent to land on which Imperial Oil operated a refinery for many years. In June 2001, Alberta Environment, a department of the Government of Alberta, issued an Environmental Protection Order requiring Imperial Oil to remediate significant petroleum-based contamination discovered on Lynnview Ridge. In July 2002, following an appeal to the Environmental Appeal Board, the Alberta Minister of the Environment issued a Ministerial Order confirming this Environmental Protection Order. Imperial Oil initiated a judicial proceeding to reverse this Ministerial Order, which was unsuccessful. The Company is not a party to these proceedings. The Company understands that Imperial Oil has purchased from the homeowners 137 of the 160 homes located in the Lynnview Ridge development. To date, the Company has conducted preliminary investigations and some limited discovery regarding these lawsuits.

In March 2004, one of the lawsuits was discontinued by one of the plaintiffs. In April 2004, the Company made an application for grant of summary judgment in one action that was chosen to be a representative case for this matter, but the plaintiffs in this representative case discontinued their lawsuit in October 2004. In April 2005, the Company was notified that Imperial Oil had filed a notice with the Court that it has settled nine of the lawsuits involving approximately \$11.8 million (Canadian) in total damages and that the releases to be made by the plaintiffs in connection with those settlements will include the Company. However, the Company has not yet received the executed releases and it is possible that some or all of those settlements may fail to be consummated. The remaining nine lawsuits seek approximately \$6.6 million (Canadian) in total damages. A reserve for legal fees associated with this matter of \$333,000 is included in Accrued Liabilities, discontinued operations on the Company's March 31, 2005

unaudited Condensed Consolidated Balance Sheet.

In addition to the legal proceedings discussed above, the Company is from time to time, involved in various disputes and legal actions related to its business operations. While no assurance can be given regarding the

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outcome of the matters discussed above, based on information currently available, the Company believes that the resolution of these matters will not have a material adverse effect on the financial position or results of future operations of the Company. However, because of the nature and inherent uncertainties of litigation, should the outcome of these actions be unfavorable, the Company's business, financial condition, results of operations and cash flows could be materially adversely affected.

***Other Commitments***

Western Multiplex Corporation merged with Proxim Corporation in March 2002. The Company is contingently liable for Proxim's building lease payments through September 2006. The maximum contingent liability as of March 31, 2005 for this obligation is approximately \$789,000.

**14. Subsequent Event**

On May 9, 2005, Entertainment Distribution Company (USA), LLC and Blitz 05-107 GmbH, each of which is an indirect subsidiary of the Company, entered into an Asset Purchase Agreement (the "Asset Purchase Agreement") and a Share Purchase Agreement (the "Share Purchase Agreement" and together with the Asset Purchase Agreement, the "Acquisition Agreements"), respectively, with certain subsidiaries of Universal Music Group ("Universal Music") to acquire Universal Music's North American and central European CD and DVD manufacturing and distribution operations (the "Acquired Business"). The assets to be acquired as part of these agreements include Universal Music's manufacturing and distribution operations in Hanover, Germany, its manufacturing operations in Grover, North Carolina, and its distribution operation in Fishers, Indiana, Reno, Nevada and Wilkes-Barre, Pennsylvania. After the close of this transaction, the Acquired Business will be operated by Entertainment Distribution Company, LLC ("EDC") which will operate as a separate division of the Company. The total purchase price payable for the Acquired Business is approximately \$122.0 million. Included in the assets to be purchased from Universal Music will be approximately \$14.0 million ("11 million") of cash that Universal Music will contribute at closing in order to meet certain German regulatory requirements.

Under the Asset Purchase Agreement, EDC will acquire the assets comprising the United States portion of Universal Music's CD and DVD manufacturing and distribution operations. Under the Share Purchase Agreement, EDC will acquire all of the outstanding shares of Universal Music's Germany subsidiaries that operate the central European portion of Universal Music's CD and DVD manufacturing and distribution operations.

As part of the transaction, at the closing EDC will enter into ten-year manufacturing and distribution agreements with Universal Music under which it will immediately become the exclusive manufacturer and distributor for approximately 80% of Universal Music's CD and DVD requirements for North America and central Europe. Under these contracts, EDC will have the opportunity to assume responsibility for fulfilling the remaining portion of Universal Music's requirements that are currently outsourced as Universal Music's commitments to third party suppliers expire over the next three years.

Under the terms of the Acquisition Agreements, the purchase price payable at closing will be approximately \$81.8 million, of which \$28 million is payable for the U.S. operations, approximately \$47.3 million ("37 million") is

payable for the central European operations and the balance constitutes transaction expenses. The portion of the purchase price payable for the central European operations is payable in Euros and the U.S. dollar value of such amount is subject to change based on currency fluctuations through the closing. Additionally, under the terms of the manufacturing and distribution contracts entered into as part of the transaction, EDC will be obligated to pay to Universal Music fixed rebates with a net present value totaling approximately \$40.2 million. These rebates will be payable as follows: approximately \$5.7 million will be payable on December 31, 2005, approximately \$8.1, \$13.6, \$14.0 and \$1.4 million will be payable on each of June 30, 2006 through 2009, respectively, and approximately \$416,000 will be payable on each of June 30, 2010

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through 2015, respectively. Approximately 47% of the total amount of these rebates and other consideration will be payable in Euros.

The transaction is anticipated to close on or around May 31, 2005 and is subject to customary closing conditions.

Pursuant to the Limited Liability Company Agreement of EDC to be entered into at the closing (the EDC LLC Agreement ), it is anticipated that EDC will be capitalized with \$35.9 million of equity capital, \$35.4 million of which will be provided by the Company and the balance of which will be provided by EDC management. Additionally, under the EDC LLC Agreement certain profits interests will be issued at closing to EDC management, Universal and the Company's financial advisor that will entitle these parties to up to thirty percent of EDC's profits after the Company has received a return of its equity capital contribution and certain internal rate of return hurdles and other conditions have been met.

To fund the balance of the purchase price payable at closing and provide for working capital needs, EDC has entered into a commitment letter with Wachovia Bank, National Association for a senior secured credit facility in an aggregate principal amount of \$56.5 million consisting of a term facility of \$46.5 million repayable over five years, and a revolving credit facility of \$10.0 million. It is anticipated that the Company would collateralize \$16.5 million of the credit facility by depositing cash in the same amount with the lender on the closing date, with \$8.25 million of this deposit being released on June 30, 2006, if EDC meets certain financial milestones, and with the entire deposit being released on June 30, 2007 so long as at such time no event of default exists under the credit agreement.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The Company, from time to time, makes forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements reflect the expectations of management of the Company at the time such statements are made. The reader can identify such forward-looking statements by the use of words such as may, will, should, expects, plans, anticipates, believes, estimates, predicts, intend(s), potential, such terms, or other comparable terminology. Forward-looking statements also include the assumptions underlying or relating to any of the foregoing statements. contin

These forward-looking statements are not guarantees of future performance and involve risks, uncertainties and assumptions that are difficult to predict. Actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors including those set forth under *Risk Factors That May Affect Future Results* below. All forward-looking statements included in this Quarterly Report on Form 10-Q are based on information available to the Company on the date hereof. The Company assumes no obligation to update any forward-looking statements and does not intend to do so.

***Pending Acquisition***

On May 9, 2005, Entertainment Distribution Company (USA), LLC and Blitz 05-107 GmbH, each of which is an indirect subsidiary of the Company, entered into an Asset Purchase Agreement (the Asset Purchase Agreement) and a Share Purchase Agreement (the Share Purchase Agreement) and together with the Asset Purchase Agreement, the Acquisition Agreements), respectively, with certain subsidiaries of Universal Music Group (Universal Music) to acquire Universal Music's North American and central European CD and DVD manufacturing and distribution operations (the Acquired Business). The assets to be acquired as part of these agreements include Universal Music's manufacturing and distribution operations in Hanover, Germany, its manufacturing operations in Grover, North Carolina, and its distribution operations in Fishers, Indiana, Reno, Nevada and Wilkes-Barre, Pennsylvania. After the close of this transaction, the Acquired Business will be operated by Entertainment Distribution Company, LLC (EDC) which will operate as a separate division of the Company. The total purchase price payable for the Acquired Business is approximately \$122.0 million. Included in the assets to be purchased from Universal Music will be approximately \$14.0 million (11 million) of cash that Universal Music will contribute at closing in order to meet certain German regulatory requirements.

Under the Asset Purchase Agreement, EDC will acquire the assets comprising the United States portion of Universal Music's CD and DVD manufacturing and distribution operations. Under the Share Purchase Agreement, EDC will acquire all of the outstanding shares of Universal Music's Germany subsidiaries that operate the central European portion of Universal Music's CD and DVD manufacturing and distribution operations.

As part of the transaction, at the closing EDC will enter into ten-year manufacturing and distribution agreements with Universal Music under which it will immediately become the exclusive manufacturer and distributor for approximately 80% of Universal Music's CD and DVD requirements for North America and central Europe. Under these contracts, EDC will have the opportunity to assume responsibility for fulfilling the remaining portion of Universal Music's requirements that are currently outsourced as Universal Music's commitments to third party suppliers expire over the next three years.

Under the terms of the Acquisition Agreements, the purchase price payable at closing will be approximately \$81.8 million, of which \$28 million is payable for the U.S. operations, approximately \$47.3 million (37 million) is payable for the central European operations and the balance constitutes transaction expenses. The portion of the purchase price payable for the central European operations is payable in Euros and the U.S. dollar value of such

amount is subject to change based on currency fluctuations through the closing. Additionally, under the terms of the manufacturing and distribution contracts entered into as part of the transaction, EDC will be obligated to pay to Universal Music fixed rebates with a net present value totaling approximately \$40.2 million. These rebates will be payable as follows: approximately \$5.7 million will be payable on December 31, 2005, approximately \$8.1, \$13.6, \$14.0 and \$1.4 million will be payable on each of June 30, 2006 through 2009, respectively, and approximately \$416,000 will be payable on each of June 30, 2010

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through 2015, respectively. Approximately 47% of the total amount of these rebates and other consideration will be payable in Euros.

The transaction is anticipated to close on or around May 31, 2005 and is subject to customary closing conditions.

Pursuant to the Limited Liability Company Agreement of EDC to be entered into at the closing (the "EDC LLC Agreement"), it is anticipated that EDC will be capitalized with \$35.9 million of equity capital, \$35.4 million of which will be provided by the Company and the balance of which will be provided by EDC management. Additionally, under the EDC LLC Agreement certain profits interests will be issued at closing to EDC management, Universal and the Company's financial advisor that will entitle these parties to up to thirty percent of EDC's profits after the Company has received a return of its equity capital contribution and certain internal rate of return hurdles and other conditions have been met.

To fund the balance of the purchase price payable at closing and provide for working capital needs, EDC has entered into a commitment letter with Wachovia Bank, National Association for a senior secured credit facility in an aggregate principal amount of \$56.5 million consisting of a term facility of \$46.5 million repayable over five years, and a revolving credit facility of \$10.0 million. It is anticipated that the Company would cash collateralize \$16.5 million of the credit facility by depositing cash in the same amount with the lender on the closing date, with \$8.25 million of this deposit being released on June 30, 2006, if EDC meets certain financial milestones, and with the entire deposit being released on June 30, 2007 so long as at such time no event of default exists under the credit agreement.

***Overview***

A key strategic milestone for the Company was reached during 2004 with the launch of the Versera Intelligent Communications Environment ("Versera ICE"), the Company's next generation messaging solution. Versera ICE is an open standards-based architecture that allows Communications Services Providers ("CSPs") to quickly and easily add new revenue generating applications to their service offering. By the end of 2004, three of the Company's customers in North America had deployed Versera ICE in one or more of their locations. In addition, during 2004 the Company was awarded a \$7.0 million contract to deploy Versera ICE in the network of MTN, a large CSP in South Africa. Approximately \$5.0 million of this contract is for equipment that will be delivered in 2005, and the remainder is for multi-year support services.

During the first quarter of 2005 the Company launched its Versera Video Mail that provides call completion, message recording and mailbox functions for video telephony calls. Versera Video Mail adds a new level of personalization to communication by allowing subscribers to record, send and retrieve messages that now include both an audio and a video component. The Company expects to begin deploying Versera Video Mail mid 2005, and expects to generate revenue from it in the third quarter of 2005.

The Company operates in the enhanced messaging business segment and provides customers with a complete messaging solution. All of the Company's products perform similar functions related to enhanced messaging. The Company's services all relate to the installation or maintenance of the Company's products. These products and services each form a single group that together form one business segment. The Company's new product line allows customers to migrate from existing legacy systems to next-generation systems. Messaging applications available in the product group include voice mail, fax messaging, missed-call notification, multimedia messaging and video mail.

First quarter revenues for 2005 increased over 2004 levels primarily due to an increase in product sales to the Company's North American customers to accommodate their subscriber growth. The Company currently is experiencing a high level of bid activity, driven by the availability of Versera ICE and increased selling and marketing

activities. Gross margins in the first quarter 2005 increased over 2004 levels primarily as a result of \$2.7 million charge recorded in the first quarter of 2004 for a patent infringement judgment that was awarded to Philip Jackson and to strong sales of the Company's higher margin products including software applications in the first quarter of 2005. The Company expects that gross margins in 2005 will be in the low to mid fifty percent range. Research and development spending in the first quarter of 2005 declined over

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2004 levels as a result of the completion of the core development of Versera ICE in the first quarter of 2004. Selling, general and administrative expense increased over 2004 levels primarily due to costs related to an expanded sales force and to costs incurred to comply with Section 404 of the Sarbanes-Oxley Act of 2002.

During the remainder of 2005 the Company plans to continue its focus on aggressively selling and marketing Versera ICE and on developing new applications, including video mail. The Company expects that, on average, quarterly revenue in 2005 will continue to increase, with some variability from quarter to quarter. This is a forward-looking statement and there can be no assurance that the Company's sales levels will remain at, reach or exceed historical levels in any future period.

The Company is continuing its search for potential acquisition targets. During 2004 the Company looked at a significant volume of acquisition opportunities both within and outside of the messaging industry, focusing on those opportunities that could best utilize the Company's accumulated net operating tax losses. As described in Part I, Item 2. *Pending Acquisition*, on May 9, 2005 the Company entered into certain Acquisition Agreements with Universal Music to acquire Universal Music's North American and central European CD and DVD manufacturing and distribution operations.

### ***Critical Accounting Policies and Estimates***

The Company's discussion and analysis of its financial condition and results of operations are based upon the Company's unaudited Condensed Consolidated Financial Statements, which have been prepared in accordance with U.S. generally accepted accounting principles. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

The Company believes that there have been no significant changes during the three months ended March 31, 2005 to the items that were disclosed as critical accounting policies and estimates in Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's Annual Report on Form 10-K, as amended, for the fiscal year ended December 31, 2004.

The following is a clarification of the Company's critical accounting policies for revenue recognition. The Company recognizes revenues in accordance with the guidance of Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements*, as amended by SAB No. 104, *Revenue Recognition*; Emerging Issues Task Force (EITF) Issue No. 00-21: *Revenue Arrangements with Multiple Deliverables*; EITF Issue No. 01-9: *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)*; Statement of Position (SOP) 97-2, *Software Revenue Recognition*; EITF Issue No. 03-5, *Applicability of AICPA Statement of Position 97-2, Software Revenue Recognition, to Non-Software Deliverable in an Arrangement Containing More-Than Incidental Software*; and related interpretations. The Company recognizes revenue for products sold at the time delivery occurs and acceptance is determinable, collection of the resulting receivable is deemed probable, the price is fixed and determinable and evidence of an arrangement exists. Certain products sold by the Company have operating software embedded in the configuration of the system. Existing customers may purchase product enhancements and upgrades after such enhancements or upgrades are developed by the Company based on a standard price list in effect at the time such product enhancements and upgrades are purchased. The Company generally has no significant performance obligations to customers after the date products, product enhancements and upgrades are delivered, except for product warranties.

The Company allocates revenue on arrangements involving multiple elements to each element based on the relative fair value of each element. The Company's determination of fair value of each element in multiple-element arrangements is based on vendor-specific objective evidence (VSOE). The Company limits its assessment of VSOE for each element to the price charged when the same element is sold separately or to that price set by the Company's pricing authority for new products. The Company has analyzed all of the elements included in its multiple-element arrangements and determined that it has sufficient VSOE to allocate revenue to each of the multiple-elements.

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The Company recognizes service revenues from installation and repair services based on a standard price list in effect when such services are provided to customers. In instances where installation is essential to the functionality of the product sold, recognition of the product related revenue is deferred until installation is completed. In instances where installation is not essential to the functionality of the products sold and is inconsequential or perfunctory to the sale of the products, revenue recognition typically occurs at time of delivery. Revenues derived from contractual post installation support services are recognized ratably over the contract support period based on the relative fair value amount to these services.

The Company offers discounts off the established price list as sales incentives to customers during contract negotiations. Once terms are agreed upon, the Company does not provide subsequent sales incentives. The Company accounts for the discounts as reductions to the selling prices of the Company's products and services. Therefore the discounts are recognized in the income statement as a reduction to revenue in accordance with EITF 01-9. If market conditions were to decline, the Company may take actions to increase customer incentive offerings possibly resulting in an incremental reduction of revenue at the time the incentive is offered.

The Company's revenue recognition policy is significant because its revenue is a key component of the Company's results of operations. In addition, the recognition of revenue determines the timing of certain expenses, such as commissions and royalties. Although the Company follows specific and detailed guidelines in measuring revenue, certain judgments, such as determination of VSOE, affect the application of its revenue policy. Revenue results are difficult to predict, and any shortfall in revenue or delay in recognizing revenue could cause the Company's operating results to vary significantly from quarter to quarter and could result in future operating losses.

### ***Recent Accounting Pronouncements***

The FASB issued FASB Staff Position No. 109-2, *Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004* to provide guidance under FASB issued Statement No. 109, *Accounting for Income Taxes* regarding the American Jobs Creation Act of 2004 (the Jobs Act) enacted on October 22, 2004. The Jobs Act provides for a special one-time dividends received deduction on the repatriation of certain foreign earnings to a US taxpayer. The Company has evaluated the effect of the Jobs Act on its plan for reinvestment and repatriation of foreign earnings and determined that it will not use the one-time deduction due to its net operation loss carryovers that are available to offset income from future dividend payments.

See Note 1 of the unaudited Condensed Consolidated Financial Statements for a description of other recent accounting pronouncements, including the expected date of adoption and estimated effects on results of operations and financial condition.

### ***Discontinued Operations***

In May 2001, the Company began exiting its Wireless Messaging (Paging) business and refocusing all of its strategic efforts on the Enhanced Services Messaging business segment. As a result, the Paging segment was reported as a disposal of a segment of business in the second quarter of 2001 in accordance with APB Opinion No. 30, *Reporting the Results of Operations*. Accordingly, the operating results of the Paging segment have been classified as a discontinued operation for all periods presented in the Company's Consolidated Statements of Operations.

Additionally, the Company has reported all of the Paging segment assets at their estimated net realizable values in the Company's unaudited Condensed Consolidated Balance Sheet as of March 31, 2005 and audited Consolidated Balance Sheet as of December 31, 2004. All business transactions related to the Paging segment, with the exception of existing contractual obligations, ceased in May 2002, the end of the transition period. See Note 7 to the Company's unaudited Condensed Consolidated Financial Statements.

During 2001, the Company recorded a loss from discontinued operations of approximately \$232.5 million related to the discontinuance of the Paging segment. This loss consisted of (a) operating losses of approximately \$46.8 million incurred in the Paging segment and (b) an estimated loss on disposal of the segment of approximately \$185.7 million which includes charges for the following: (i) the write-off of

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goodwill and other intangibles, (ii) reserves on property, plant and equipment, (iii) customer accounts and notes receivable settlement costs, (iv) employee termination costs, (v) inventory and non-inventory purchase commitments, (vi) anticipated losses from operations during the twelve month transition period, (vii) facility exit and lease termination costs, (viii) expenses to be incurred to fulfill contractual obligations existing prior to the formal disposal date and (ix) related net tax expense, primarily related to a valuation allowance for related deferred tax assets

The Company believes all business transactions related to the Paging segment, with the exception of existing contractual obligations, were completed by May 2002. As of March 31, 2005, the Company reported current liabilities and non-current liabilities of \$3.2 million and \$79,000, respectively related to the discontinued Paging segment. Approximately \$2.1 million of these liabilities relate to international franchise tax obligations arising prior to the discontinuance of the segment. Approximately \$1.2 million of these liabilities relate to one-time charges recorded in the second quarter of 2001 and consist of (i) lease commitment costs and (ii) estimated operating costs during the wind-down period and other estimated business exit costs related to meeting customer contractual commitments.

In the first quarter of 2005, as a result of the Company's review of the estimated liabilities and future commitments related to the discontinued operations, a net increase in the loss on disposal of \$63,000 was recorded. The adjustments to the original estimates totaling \$11,000 related primarily to international office closures. The Company also recorded income of \$74,000 primarily due to settlement received from Pilot Pacific Properties, Inc. and its associated companies of \$68,000. See Part II, Item 1. Legal Proceedings.

During 2004, the Company recorded income from discontinued operations of \$12.7 million, primarily as a result of entering into a favorable settlement agreement with Pilot Pacific relating to the Company's former Vancouver facility. As part of this settlement, the Company received \$6.0 million and recorded a \$1.5 million reduction to the liability for legal and other costs related to the pending litigation. In addition, the Company liquidated its remaining paging operations inventory for approximately \$714,000 that was previously fully reserved. The Company also recorded income of \$1.6 million primarily due to a reduction to its tax liability after receiving a favorable assessment for several prior tax years relating to one of the Company's foreign subsidiaries. The remaining income from discontinued operations was primarily due to collection of accounts receivable previously reserved for and reductions in the liability for costs related to performance obligations the Company has with its various paging customers as third parties have the capability to provide the necessary support.

Related to the settlement agreement with Pilot Pacific discussed above was the release of \$3.4 million held as security by the court. In order to clear a lien filed against the Vancouver facility related to the Pilot Pacific litigation, the proceeds from the sale in 2003 was placed with the court until the conclusion of the litigation. This \$3.4 million was included in Other Current Assets - discontinued operations on the Company's balance sheet until it was released to the Company in August 2004.

The Company estimates that approximately \$0.9 million of the remaining liabilities associated with the discontinued operations will be disbursed during the remaining three quarters of 2005 and the remainder in 2006 and beyond.

Numerous estimates and assumptions were made in determining the net realizable value of the Company's discontinued assets and various obligations noted above. Management will continue to monitor the Company's future obligations associated with its pre-existing contractual commitments in order to assess the current carrying values of the liabilities associated with the discontinued operations. These original estimates have been and are subject to further recalculation as a result of future changes in estimates related to the Company's future obligations associated with its pre-existing contractual commitments. See Note 7 to the Company's unaudited Condensed Consolidated Financial Statements.



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The following table sets forth for the periods indicated the percentage of total revenue represented by certain line items from Glenayre's unaudited Condensed Consolidated Statements of Operations from continuing operations:

	<b>Three Months Ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
<b>REVENUE:</b>		
Product sales	76%	57%
Service revenue	24	43
Total Revenue	100	100
<b>COST of REVENUE</b>		
Cost of sales	23	58
Cost of services	14	21
Total Cost of Revenue	37	79
<b>GROSS MARGIN</b>	63	21
<b>OPERATING EXPENSES:</b>		
Selling, general and administrative expense	38	42
Provision for doubtful receivables, net of recoveries	*	(1)
Research and development expense	15	34
Restructuring expense	*	*
Depreciation expense	3	4
Total Operating Expenses	56	79
<b>OPERATING INCOME (LOSS)</b>	7	(58)
<b>OTHER INCOME (EXPENSES):</b>		
Interest income	3	3
Interest expense	*	(2)
Loss on disposal of assets, net	*	*
Other income (expenses), net	*	(1)
Total Other Income	3	*
<b>INCOME (LOSS) FROM OPERATIONS BEFORE INCOME TAXES</b>	10	(58)
Provision for income taxes	*	*
<b>INCOME (LOSS) FROM CONTINUING OPERATIONS</b>	10%	(58)%

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\* less than 0.5%

***Three months Ended March 31, 2005 and 2004***

*Revenues.* Total revenue from continuing operations for the three months ended March 31, 2005 increased approximately 76% to \$17.9 million as compared to \$10.2 million for the three months ended March 31, 2004. Product sales for the three months ended March 31, 2005 increased 134% to \$13.6 million as compared to \$5.8 million for the three months ended March 31, 2004. Service revenues for the three months ended March 31, 2005 decreased 2% to \$4.3 million as compared to \$4.4 million for the three months ended March 31, 2004. International sales increased to \$1.9 million for the three months ended March 31, 2005 as compared to \$1.7 million for the three months ended March 31, 2004 and accounted for 11% and 16% of total net sales for the three months ended March 31, 2005 and 2004, respectively. The increase in product sales for the three months ended March 31, 2005 was due primarily to sales to the Company's North American customers to accommodate their subscriber growth. The decrease in net service revenues was primarily due to decreased installations and related service revenue as a result of the timing of the shipment of equipment during the quarter.

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During the three months ended March 31, 2005, three customers individually accounted for approximately 27%, 25% and 12% of the Company's total revenue from continuing operations. During the three months ended March 31, 2004, four customers individually accounted for 22%, 16%, 14% and 13% of the Company's total revenue from continuing operations. There can be no assurance that these significant customers will continue to purchase systems and services from the Company at current levels in the future, and the loss of these significant customers could have a material adverse affect on the Company's business, financial condition or results of operations.

*Gross Margins on Product Sales and Services.* Gross margin on products sold (product margin) was 70% during the three months ended March 31, 2005 compared to (0.8)% during the three months ended March 31, 2004. The increase in gross margin for the quarter ended March 31, 2005 was primarily due to a \$2.7 million charge the Company recorded in the first quarter of 2004 as a result of a patent infringement judgment awarded to Philip Jackson and to sales of higher margin products, including software applications. Gross margin on services (service margin) was 42% during the three months ended March 31, 2005 compared to 50% during the three months ended March 31, 2004. Service margins decreased during the three months ended March 31, 2005 primarily as a result of decreased installation service revenue. The Company's margins may be affected by several factors including, but not limited to: (i) the mix of products sold and services provided, (ii) the price of products sold and services provided and (iii) changes in material costs and other components of cost of sales.

*Selling, General and Administrative Expense.* Selling, general and administrative expenses increased approximately 60% to \$6.9 million for the three months ended March 31, 2005 from \$4.3 million for the three months ended March 31, 2004. The selling, general and administrative expenses were higher for the three months of 2005 compared to 2004 primarily due to increased costs as a result of an expanded sales force and product management team and to costs associated with the evaluation and testing of the Company's internal controls as required by Section 404 of the Sarbanes-Oxley Act of 2002.

*Provision for Doubtful Receivables, net of Recoveries.* The provision for doubtful receivables was \$10,000 during the three months ended March 31, 2005 compared to a credit of \$92,000 during the three months ended March 31, 2004. The charge for the three months of 2005 is due to the Company's reserve calculation on the aging of receivables and adjustments to bad debt expense reflecting the Company's assessment of its current credit risk. The credit in the three months of 2004 was primarily due to the collection of older receivables previously reserved as part of the Company's reserve calculation.

*Research and Development Expense.* Research and development expenses decreased to \$2.7 million during the three months ended March 31, 2005 compared to \$3.4 million during the three months ended March 31, 2004. The decrease of approximately \$0.7 million is primarily attributable to completion of the development of the Company's next generation Versera ICE messaging platform product in the first quarter of 2004. Research and development costs are expensed as incurred. The Company relies on its research and development programs related to new products and the improvement of existing products for the continued growth in revenues. The Company's ability to continue to develop and effectively bring to market new competitive products is critical to its future success.

*Restructuring Expense.* During the three months ended March 31, 2005, the Company recorded net favorable adjustments, totaling \$12,000, to its original estimates associated with the Company's 2003 restructuring activities primarily related to a reduction in lease cancellation costs. During the three months ended March 31, 2004 the Company recorded a restructuring charge of \$58,000 for severance and outplacement services related to a reduction of the Company's workforce during the first and second quarter of 2003. Also in the first quarter ended March 31, 2004, the Company recorded net favorable adjustments to its original estimates associated with the Company's 2003 restructuring activities of \$21,000 primarily related to a reduction in accrued severance benefits.

*Depreciation Expense.* Depreciation expense was \$429,000 during the three months ended March 31, 2005 compared to \$337,000 during the three months ended March 31, 2004. The increase in depreciation expense was due to capital equipment purchased since March 31, 2004.

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*Interest Income.* Interest income was \$530,000 and \$275,000 for the three months ended March 31, 2005 and 2004, respectively. Interest earned in the first quarter of 2005 was higher primarily due to higher yields on investment instruments partially offset by lower cash and short-term investments balances. The Company's weighted average yields on its cash and investments held at March 31, 2005 and 2004 were 2.67% and 1.14% respectively.

*Interest Expense.* Interest expense was \$7,000 and \$209,000 for the three months ended March 31, 2005 and 2004, respectively. Interest expense in the first quarter of 2004 included \$200,000 of interest relating to a patent infringement judgment against the Company. See Part II, Item 1. Legal Proceedings.

*Gain (Loss) on Disposal of Assets.* The Company recorded a \$1,000 loss on asset disposals for the three months ended March 31, 2005 and a \$6,000 loss on asset disposals in the three months ended March 31, 2004.

*Provision (Benefit) for Income Taxes.* In the first quarter of 2005, the Company decreased its valuation allowance by \$663,000 through the utilization of its net operating loss carryforwards. A provision of approximately \$29,000 and \$34,000 was recorded related to foreign tax on earned income from foreign operations for the three months ended March 31, 2005 and 2004, respectively.

## ***Financial Condition and Liquidity***

*Overview.* At March 31, 2005, the Company had cash and cash equivalents, restricted cash, and short-term investments totaling \$91.1 million. The restricted cash of \$106,000 at March 31, 2005 consisted of cash pledged as collateral to secure letters of credit. At March 31, 2005, the Company's principal source of liquidity was its \$90.9 million of cash and cash equivalents. The Company's cash generally consists of money market demand deposits and the Company's cash equivalents generally consist of high-grade commercial paper, bank certificates of deposit, treasury bills, notes or agency securities guaranteed by the U.S. government, and repurchase agreements backed by U.S. government securities with original maturities of three months or less. Short-term investments at March 31, 2005 consisted of bank certificates of deposit with original maturities of greater than three months, but less than twelve months.

The Company expects to use its cash, cash equivalents and short-term investments for working capital and other general corporate purposes, including the expansion and development of its existing products and markets, liabilities related to discontinued operations, and potential acquisitions. As described in Part I, Item 2. *Pending Acquisition*, on May 9, 2005, the Company entered into certain Acquisition Agreements with Universal Music to acquire Universal Music's North American and central European CD and DVD manufacturing and distribution operations. It is anticipated that at the closing, which is scheduled to occur on May 31, 2005, the Company will make a \$35.4 equity capital contribution to EDC which will be used to fund a portion of the purchase price payable at closing. To fund the balance of the purchase price payable at closing and provide for working capital needs, EDC has entered into a commitment letter with Wachovia Bank, National Association for a senior secured credit facility in an aggregate principal amount of \$56.5 million consisting of a term facility of \$46.5 million repayable over five years, and a revolving credit facility of \$10.0 million. It is anticipated that the Company would cash collateralize \$16.5 million of the credit facility by depositing cash in the same amount with the lender on the closing date, with \$8.25 million of this deposit being released on June 30, 2006, if EDC meets certain financial milestones, and with the entire deposit being released on June 30, 2007 so long as at such time no event of default exists under the credit agreement. There can be no assurance, however, that the Company will be able to obtain the financing described in the commitment letter on or prior to the closing or ever, and in the event the Company is not able to obtain such financing on or prior to the closing, the Company would likely need to use its cash to fund the entire purchase price payable at closing.

At March 31, 2005 approximately \$3.3 million in discontinued operations liabilities remain outstanding of which the Company anticipates approximately \$0.9 million will be disbursed during the remaining three quarters of 2005 and the

remainder in 2006 and beyond.

*Operating Activities.* Cash used in operating activities, including both continuing and discontinued operations, was \$3.7 million and \$4.3 million for the three months ended March 31, 2005 and 2004,

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respectively. In the three months ended March 31, 2005, the increase in accounts receivable and inventory were the primary uses of cash offset by income and the increase in deferred revenue recorded. Operating losses for the three months ended March 31, 2004 was the primary use of cash for that period.

Accounts receivable related to continuing operations increased \$15.8 million to \$23.5 million at March 31, 2005 from \$7.7 million at December 31, 2004. Average days sales outstanding, calculated based on a three months rolling average, decreased 4 days to 52 days at March 31, 2005 from 56 days at December 31, 2004. The increase in accounts receivable from continuing operations was due primarily to the delivery of a significant amount of equipment to MTN, a large South African carrier. The revenue related to the delivery of this equipment will not be recognized until the second quarter of 2005 when installation of the equipment is anticipated to be completed. Higher revenues in the first quarter of 2005, as compared to the fourth quarter of 2004, and the timing of shipments during each of the quarters also contributed to the increase in accounts receivable.

Inventories related to continuing operations increased \$2.2 million to \$8.4 million at March 31, 2005 from \$6.2 million at December 31, 2004. The increase in inventories was primarily due to new products shipped to customers during the first quarter of 2005, including MTN as noted in the previous paragraph, where installation that is essential to the functionality of the product was not completed.

Other assets increased \$828,000 to \$1.7 million at March 31, 2005 from \$ 848,000 at December 31, 2004 due to expenditures for direct costs associated with acquisition activity.

Accounts payable increased \$1.4 million to \$5.0 million at March 31, 2005 from \$3.6 million at December 31, 2004 primarily as a result of the timing of inventory purchases.

Total current and non-current accrued liabilities related to continuing operations increased approximately \$10.8 million to \$30.0 million at March 31, 2005 from \$19.2 million at December 31, 2004. The increase in accrued liabilities was due primarily to:

A \$9.0 million increase to deferred revenue primarily related to the delivery of a significant amount of equipment to one customer for which the related revenue is not recognized until installation is complete, as well as to the deferral of revenue for annual extended maintenance contracts that were renewed during the first quarter of 2005.

A \$1.0 million increase to accrued payroll and related compensation costs due to annual incentive bonus accrual, the timing of payment of the bi-weekly payroll, and increased vacation reserve as a result of employees earning more vacation than used during the first quarter of 2005.

A \$0.3 million increase for additional audit fees related to the 2004 audit and costs incurred to comply with Section 404 for the Sarbanes-Oxley Act of 2002.

A \$1.1 million increase in professional fees related to acquisition costs and sales tax liability.

A \$0.5 million decrease for payment of license fees.

In addition, during the first three months of 2005 the Company's liability relating to restructuring costs decreased by \$105,000 primarily due to rental payments. As of March 31, 2005, the Company's remaining restructuring obligations were approximately \$155,000 related to lease termination costs and employee termination benefits. The Company anticipates all of the remaining cash payments for this restructuring charge will be made in 2005.

*Investing Activities.* The Company spent \$273,000 and \$715,000 during the three months ended March 31, 2005 and 2004, respectively, on equipment needed in its continuing operations. The Company anticipates that property, plant and equipment purchases related to its continuing operations for the remainder of 2005 will approximate \$2.5 million.

*Financing Activities.* During the three months ended March 31, 2005, and 2004, the Company issued Company common stock in connection with purchases under the Company's Employee Stock Purchase Plan and as a result of the exercise of options and other awards totaling \$130,000 and \$187,000 respectively.

In December 2000, the Board of Directors rescinded its 1996 stock repurchase program and authorized the repurchase of up to 3.0 million shares of the Company's common stock. In September 2001, the stock

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repurchase program was amended to authorize management the ability to repurchase up to 5% of the Company's outstanding common stock, or approximately 3.3 million shares based on shares outstanding as of December 31, 2001. For the years ended December 31, 2003 and 2001, the Company repurchased 36,000 and 105,900 shares at a total cost of approximately \$34,000 and \$85,000 respectively. The Company made no purchases during 2002 or 2004. As of the date of this filing, the Company has made no purchases during 2005. However, it could commence or suspend purchasing under this program without notice.

*Income Tax Matters.* Glenayre's recent cash outlays for income taxes have been limited primarily to foreign income taxes.

At December 31, 2004, the Company had U.S. net operating loss carryforwards ( NOLs ) aggregating approximately \$306 million, which may be used to offset future taxable income and reduce federal income taxes. These NOLs begin to expire in 2006.

*Summary.* The Company believes that its current cash reserves together with its ability to establish borrowing arrangements will be sufficient to (i) support the short-term and long-term liquidity requirements for current operations (including annual capital expenditures) and its discontinued operations and (ii) make potential acquisitions and strategic investments, including the acquisition of Universal Music's North American and central European CD and DVD manufacturing and distribution operations.

## ***Outlook***

As the telecommunications industry begins to show signs of recovery, timing of Communication Service Provider ( CSP ) purchasing activity in communications software and messaging products may be somewhat variable. Key growth drivers for the remainder of 2005 and 2006 include:

Replacement of aging legacy systems with next generation platforms;

Continued wireless subscriber growth worldwide;

Increased penetration and acceptance of enhanced services;

New market build-outs as CSPs consolidate or increase coverage;

Deployment of new services across existing network base; and

The necessity for CSPs to deploy new revenue generating services that reduce customer churn.

The Company expects that CSPs will continue to seek to differentiate themselves in increasingly competitive markets by offering high-demand solutions. Glenayre continues to invest aggressively in applications and services to help wireless, wireline, cable and broadband operators enhance their competitive positions.

The Company also expects that reducing the total cost of ownership of communications systems will remain a primary concern for CSPs. By providing open, standards-based platforms, Glenayre believes it is well positioned to help CSPs offer competitive services with a low total cost of ownership.

The Company also intends to continue examining opportunities for growth through both complementary and diversified acquisitions and strategic investments. As described above in Part I, Item 2. *Pending Acquisition*, on May 9, 2005, the Company entered into certain Acquisition Agreements with Universal Music to acquire Universal Music's North American and central European CD and DVD manufacturing and distribution operations. The impact

and timing of other acquisition and investment decisions on future financial results cannot be predicted.

This Outlook section contains forward-looking statements that are subject to the risks described under the *Risk Factors That May Affect Future Results* immediately below.

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### ***Risk Factors That May Affect Future Results***

The Company's prospects are subject to certain risks and uncertainties as follows:

#### ***Competition***

The majority of the Company's competitors are seasoned communications providers like Glenayre. These companies include Comverse Technologies, Inc., SS8's Centigram, Unisys Corporation, the Octel Messaging division of Lucent Technologies, Inc., InterVoice, LogicaCMG, Tecnomen and Schlumberger-Sema. Like Glenayre, some of these competitors also have the financial stability, aggressive research and development programs and long-term customer relationships required to compete in the current environment. The competition among these firms is intense and is primarily based on a combination of price, product architecture, features, system capacity, reliability, selection of applications, services and support.

Some of the Company's competitors have substantially greater financial, technical, marketing and distribution resources than Glenayre and Glenayre may be unable to successfully compete with these companies. In addition, competitive pricing pressures exist which may have an adverse effect on the Company's profit margins in the future.

#### ***Variability of Quarterly Results and Dependence on Key Customers***

The Company's financial results in any single quarter are highly dependent upon the timing and size of customer orders and the shipment of products for large orders. Large orders from customers can account for a significant portion of products shipped in any quarter. During the three months ended March 31, 2005, Nextel, Alltel and US Cellular individually accounted for approximately 27%, 25% and 12%, respectively, of the Company's total revenue from continuing operations. During the three months ended March 31, 2004, Alltel, Nortel (an OEM partner, as described below), US Cellular and Nextel individually accounted for approximately 22%, 16%, 14% and 13%, respectively, of the Company's total revenue from continuing operations. Nortel sells the Company's products to several end user customers including T-Mobile whose purchases of Glenayre's products from Nortel represented approximately 9% of the Company's total revenues during the three months ended March 31, 2004. There can be no assurance that these significant customers will continue to purchase systems and services from the Company at current levels in the future, and the loss of one or more of these significant customers could have a material adverse effect on the Company's business, financial condition or results of operations. In the future, the customers with whom the Company does the largest amount of business are expected to vary from quarter to quarter and year to year as a result of the timing for development and expansion of customers' communications networks and systems, the continued expansion into international markets and changes in the proportion of revenues generated by the Company's newly developed products and services. Furthermore, if a customer delays or accelerates its delivery requirements or a product's completion is delayed or accelerated, revenues expected in a given quarter may be deferred or accelerated into subsequent or earlier quarters. The Company has also historically experienced reduced revenues in its fourth quarter resulting from reduced system expansions as many CSPs halt system upgrades during their busiest retail season. Therefore, annual financial results are more indicative of the Company's performance than quarterly results, and results of operations in any quarterly period may not be indicative of results likely to be realized in the subsequent quarterly periods.

#### ***Restructuring Activities***

The Company continues to assess its business to align resources and achieve its desired cost structure. Past restructuring efforts have been based on certain assumptions regarding the cost structure of the Company's business, which may not be correct. These restructuring efforts may not be sufficient for the Company to achieve profitability and meet the changes in industry and market conditions. The Company will continue to make judgments as to whether

further reductions in its workforce may be required. These workforce reductions may impair the Company's ability to achieve its current or future business objectives. Costs incurred in connection with restructuring efforts may be higher than estimated. Any decision by the Company to further limit investment or exit, or dispose of, businesses may result in the recording of additional charges. As a result, the costs actually incurred in connection with the restructuring efforts may be higher than originally planned and may not lead to the anticipated cost savings and a return to profitability.

As part of the Company's review of its restructured business, it must also review long-lived assets for recoverability under FAS 144. Future market conditions may trigger further write downs of these assets due to uncertainties in the estimates and assumptions used in asset valuations, which are based on the Company's

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forecasts of future business performance and accounting estimates relating to the useful life and recoverability of the net book value of these assets.

### ***Effective Convergence of Technologies***

Glenayre is dependent on the continued growth of its markets as well as the effective and successful convergence of technologies for its systems and related applications and solutions. The markets for these technologies are still developing and market acceptance of some of these services is uncertain. If the commercial market for these services is lower than Glenayre anticipates, or grows more slowly than Glenayre anticipates, it could have a material adverse effect on the Company's business. There can be no assurance that these technologies will be successfully integrated or that a significant commercial market for the integrated services will develop.

### ***Potential Market Changes Resulting from Rapid Technological Advances***

Glenayre's business is primarily focused on offering communications solutions to wireless and fixed network carriers, as well as broadband and cable operators worldwide. These industries are characterized by rapid technological change and are likely to experience consolidation in the next 12 to 18 months. Carrier consolidation could result in redeployment of existing capital equipment that could reduce new capital spending and in delays in capital spending decisions. Glenayre has been focused on building next-generation messaging platforms such as its Versera® ICE platforms and communications solutions that leverage speech-driven, multimedia messaging and presence and availability technologies. Demand for these products and services may be affected by changes in technology and the development of substitute products and services by competitors. If changing technology negatively affects demand for Glenayre's Versera solutions, it could have a material adverse effect on Glenayre's business.

Glenayre is dependent on the continued growth of its markets as well as the effective and successful convergence of technologies for its systems and related applications and solutions. The markets for these technologies are still developing and market acceptance of some of these services is uncertain. If the commercial market for these services is lower than Glenayre anticipates, or grows more slowly than Glenayre anticipates, it could have a material adverse effect on the Company's business. There can be no assurance that these technologies will be successfully integrated or that a significant commercial market for the integrated services will develop.

### ***Proprietary Technology***

The Company owns or licenses numerous patents used in its operations. Glenayre believes that while these patents are useful to the Company, they are not critical or valuable on an individual basis. The collective value of the intellectual property of Glenayre is comprised of its patents, blueprints, specifications, technical processes and cumulative employee knowledge. Although Glenayre attempts to protect its proprietary technology through a combination of trade secrets, patent, trademark and copyright law, nondisclosure agreements and technical measures, such protection may not preclude competitors from developing products with features similar to Glenayre's products. The laws of certain foreign countries in which Glenayre sells or may sell its products, including the Republic of Korea, the People's Republic of China, Saudi Arabia, Thailand, India and Brazil, do not protect Glenayre's proprietary rights in its intellectual property to the same extent as do the laws of the United States.

### ***Potential Intellectual Property Infringement Claims from Third Parties***

Substantial litigation regarding intellectual property rights continues in the technology industry.

If the Company were to discover that its products violated a third party's proprietary rights and were unable to obtain licenses on terms acceptable to the Company, the Company might not be able to continue offering those products

without substantial reengineering. Reengineering efforts might result in substantial costs and product delays, and might not be successful.

Furthermore, any intellectual property infringement claims asserted by a third party against the Company could be time-consuming and costly to defend, divert management's attention and resources, cause product

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and service delays, or require the Company to pay damages to or enter into licensing agreements with third party claimants. An adverse decision in an infringement claim asserted against the Company could result in the Company being prohibited from using such technology, as licensing arrangements may not be available on commercially reasonable terms. If the Company were unable to license the infringed or similar technology on commercially reasonable terms, this could have a material adverse effect on its business, financial condition and results of operations.

Although the Company believes its technology does not infringe any third party rights, the Company is currently subject to certain infringement claims. The Company expects that its products may continue to be subject to third-party infringement claims. See Note 13 to the unaudited Condensed Consolidated Financial Statements and Part II, Item 1. Legal Proceedings.

### ***Potential Changes in Government Regulation***

Many of Glenayre's products connect to public telecommunications networks. While many of Glenayre's current products are not directly subject to regulation, national, regional and local governments regulate public telecommunications networks, as well as the operations of telecommunication service providers in most domestic and international markets. As a result, Glenayre must obtain regulatory approvals in connection with the manufacture and sale of certain of its products, and the Company's service provider customers may need regulatory approvals to operate the systems that utilize certain of the Company's products. When introducing a product to a market, there is no assurance that the Company's customers will obtain necessary regulatory approvals. In addition, the enactment by federal, state, local or international governments of new laws or regulations or a change in the interpretation of existing regulations could adversely affect the market for the Company's products.

### ***Litigation***

The Company is party to certain legal proceedings as described in Note 13 to the unaudited Condensed Consolidated Financial Statements and Part II, Item 1. Legal Proceedings. In addition to such legal proceedings, the Company is from time to time, involved in various disputes and legal actions related to its business operations. While no assurance can be given regarding the outcome of such matters, based on information currently available, the Company believes that the resolution of these matters will not have a material adverse effect on the financial position or results of future operations of the Company. However, because of the nature and inherent uncertainties of litigation, should the outcome of such actions be unfavorable, the Company's business, financial condition, results of operations and cash flows could be materially adversely affected.

### ***International Business Risks***

Approximately 11% and 16% of total revenues from continuing operations for the three months ended March 31, 2005 and 2004, respectively, were generated in markets outside of the United States. International sales are subject to the customary risks associated with international transactions, including political risks, local laws and taxes, the potential imposition of trade or currency exchange restrictions, tariff increases, transportation delays, difficulties or delays in collecting accounts receivable, exchange rate fluctuations and the effects of prolonged currency destabilization in major international markets. Although a substantial portion of the international sales of Glenayre's products and services for the three months ended March 31, 2005 were negotiated in U.S. dollars, Glenayre may not be able to maintain such a high percentage of U.S. dollar denominated international sales. Should the amount of sales denominated in local currencies of foreign countries increase, the Company may seek to mitigate its currency exchange fluctuation risk by entering into currency hedging transactions. The Company also acts to mitigate certain risks associated with international transactions through the purchase of political risk insurance and the use of letters of credit. However, there can be no assurance that these efforts will successfully limit the risks associated with these

international transactions.

***Potential Acquisitions and Strategic Investments***

The Company intends to continue to make significant investments in its business, and to examine opportunities for growth through both complementary and diversified acquisitions and strategic investments. These activities may involve significant expenditures and obligations that cannot readily be curtailed or reduced if anticipated demand for the associated products does not materialize or is delayed. The impact of these decisions on future financial results cannot be predicted with certainty, and the Company's commitment to growth may increase its vulnerability to downturns in its markets, technology changes and shifts in competitive conditions.

The Company has made, and in the future, may continue to make, strategic investments in other companies. These investments have been made in, and future investments will likely be made in, immature businesses with unproven track records and technologies. Such investments have a high degree of risk, with the possibility that the Company may lose its entire investment. The Company may not be able to identify suitable investment candidates, and, even if it does, the Company may not be able to make those investments

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on acceptable terms. In addition, even if the Company makes investments, it may not gain strategic benefits from those investments.

### ***Continuation and Expansion of Third Party Agreements***

Glenayre has entered into initiatives with third parties that provide development services, products and channels to market that are used to enhance the Company's business and is continuing to explore additional third party arrangements. Additionally, Glenayre has entered into several Original Equipment Manufacturer agreements with companies that market and distribute Glenayre's products and intends to enter into service reseller arrangements. Glenayre is dependent upon these third parties to augment its research and development efforts as well as to distribute its products and services and increase its product offerings. If these third parties are not successful or the agreements are terminated, a material adverse effect on Glenayre's business could result. Glenayre intends to continue entering into agreements and initiatives with third parties; however, there can be no assurance that additional arrangements with suitable vendors and distributors on acceptable terms will be available. The inability of Glenayre to enter into agreements with third parties on acceptable terms could have a material adverse effect on Glenayre's business.

### ***Volatility of Stock Price***

The market price of the Company's common stock is volatile. The market price of its common stock could be subject to significant fluctuations in response to variations in quarterly operating results and other factors such as announcements of technological developments or new products by the Company, developments in relationships with its customers, strategic alliances and partnerships, potential acquisitions and strategic investments, technological advances by existing and new competitors, general market conditions in the industry and changes in government regulations. In addition, in recent years, conditions in the stock market in general and shares of technology companies in particular have experienced significant price and volume fluctuations that have often been unrelated to the operating performance of these specific companies.

### ***Delisting from the Nasdaq Stock Market***

The Company's common stock currently trades on the Nasdaq Stock Market ( Nasdaq ). The continued listing requirements of Nasdaq require that the closing bid price of the Company's common stock not remain below \$1.00 for more than 30 consecutive trading days. After notice from Nasdaq that the Company's common stock has failed to satisfy this test, Nasdaq may commence suspension and delisting procedures unless within 90 days following receipt of such notice the closing bid price of the Company's common stock is \$1.00 or greater for at least 10 consecutive trading days. There can be no assurance that the trading price of the Company's common stock will meet the minimum bid price requirement and, in the future, the Company's common stock could be subject to delisting. If the Company's common stock were to be delisted from trading on Nasdaq the trading market for the common stock could be materially adversely affected.

### ***Ability to Attract and Retain Key Personnel***

The Company's continued growth and success depends to a significant extent on the continued service of senior management and other key employees, the development of additional management personnel and the hiring of new qualified employees. There can be no assurance that the Company will be successful in continuously recruiting new personnel or in retaining existing personnel. The loss of one or more key or other employees or Glenayre's inability to attract additional qualified employees or retain other employees could have a material adverse effect on Glenayre's business, results of operations or financial condition.

### ***Potential Inability to Close EDC Acquisition or Obtain Financing for EDC; EDC Business Risks***

The closing under the Acquisition Agreements under which the Company would acquire Universal Music's North American and central European CD and DVD manufacturing and distribution operations may not occur due to a failure of one or more closing conditions under the Acquisition Agreements to be satisfied. Additionally, EDC may not be able to close the financing provided for in the Wachovia commitment letter on or prior to the closing of the acquisition or ever, or to obtain similar debt financing to fund EDC. Currency

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fluctuations through the closing could cause the U.S. dollar value of the purchase price payable at closing to increase. The Company's ability to receive the anticipated benefits from the EDC transaction are dependent upon a variety of factors including the Company's ability to achieve manufacturing efficiencies and to add third party business. EDC's revenues and cash flows may be less than anticipated or may be negatively impacted by currency rate fluctuations.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The Company is subject to market risk arising from adverse changes in interest rates, foreign exchange and stock market volatility. The Company does not enter into financial investments for speculation or trading purposes and is not a party to any financial or commodity derivatives.

#### ***Interest Rate Risk***

The Company's exposure to market rate risk for a change in interest rates relates primarily to its investment portfolio. The Company's investment policy requires investment of surplus cash in high-grade commercial paper, bank certificates of deposits, treasury bills, notes or agency securities guaranteed by the U.S. Government and repurchase agreements backed by U.S. Government securities. The Company typically invests its surplus cash in these types of securities for periods of relatively short duration. Although the Company is exposed to market risk related to changes in short-term interest rates on these investments, the Company manages these risks by closely monitoring market interest rates and the duration of its investments. Due to the short-term duration and the limited dollar amounts exposed to market interest rates, management believes that fluctuations in short-term interest rates will not have a material adverse effect on the Company's results of operations.

#### ***Foreign Currency Exchange***

The Company operates internationally and is exposed to movements in foreign currency exchange rates primarily as a result of its holding demand deposits denominated in non-functional currencies. At March 31, 2005, approximately U.S. \$785,000 or 0.9% of the Company's cash and cash equivalent balances were denominated in foreign currencies. In the aggregate, if the value of the dollar against the foreign denominated currency strengthens by 10%, the Company would record an exchange loss of approximately \$79,000. Conversely, if the value of the dollar declines by 10%, the Company would record an exchange gain of approximately \$79,000. The Company seeks to mitigate the risk associated with foreign currency deposits by monitoring and limiting the total cash deposits held at each of its subsidiaries abroad. Additionally, the Company may seek to mitigate the risk by entering into currency hedging transactions. The Company was not a party to any hedge transactions as of March 31, 2005.

Under the terms of the Acquisition Agreements providing for the purchase by the Company of Universal Music's North American and European CD and DVD manufacturing and distribution operations, \$47.3 million ( \$37 million) is payable at closing for the central European operations. This portion of the purchase price is payable in Euros and currency fluctuations through the closing could cause the U.S. dollar value of such portion of the purchase price to increase.

### **ITEM 4. CONTROLS AND PROCEDURES**

As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934 (the Exchange Act)) pursuant to Rule 13a-15 of

the Exchange Act. It should be noted that any system of controls, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system are met. The Company's disclosure controls and procedures were designed to reach a level of reasonable assurance of achieving their objectives and, based on the evaluation described above, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective at reaching that level of reasonable assurance.

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During the quarter ended March 31, 2005, there were no changes in internal controls that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## **PART II OTHER INFORMATION**

**ITEMS 2, 3, 4 and 5 are inapplicable and have been omitted.**

### **ITEM 1. LEGAL PROCEEDINGS**

*Phillip Jackson* Beginning in late 2001, Phillip Jackson ( Jackson ) filed lawsuits against several of the Company's customers claiming that products sold by the Company and used by these customers infringed a patent held by Jackson. The Company agreed to indemnify its customers for the claims in these lawsuits and assumed primary responsibility for defending the claims with respect to the Company's products. Following completion of the trial and post-trial reduction of damages by the court, the court entered judgment in the total amount of approximately \$2.7 million, plus interest and costs. During the first quarter of 2004, the Company recorded a charge consisting of \$2.7 million royalty fee expense (recorded in cost of revenues) and \$200,000 interest expense, and recorded a reduction of the estimated liability for accrued legal cost associated with this case of \$770,000. The Company paid the \$2.7 million award plus interest and costs during the second quarter of 2004.

On May 14, 2004, Jackson filed a motion with the district (trial) court to set trial on remaining issues of contributory infringement and inducement to infringe Jackson's patent. On June 29, 2004, the trial court ruled that there were no issues remaining between the parties and denied Jackson's motion to set trial on remaining issues. Jackson is currently appealing this ruling and the appeal was argued before the United States Court of Appeals for the Federal Circuit on March 11, 2005. As of May 9, 2005, the appellate court has not yet ruled on the appeal. The Company believes that it is unlikely that the appellate court will reverse the trial court's ruling of June 29, 2004.

*Lynnview Ridge, Alberta* - In November 2002 and April 2003, a total of twenty lawsuits seeking approximately \$22.3 million (Canadian) in damages were filed in the Court of Queen's Bench, Judicial Centre of Calgary, in Alberta, Canada, against the Company and several other defendants, including Imperial Oil, a major Canadian petroleum company. These lawsuits assert that the defendants, including the Company, are liable for negligence, nuisance, and negligent misrepresentation arising out of the development and sale of homes located in a Calgary, Canada residential development, Lynnview Ridge that was jointly developed in the early 1980's by a corporate predecessor of the Company and a wholly-owned subsidiary of Imperial Oil.

The Company understands that the land on which some of this residential development was located at one time contained a petroleum storage tank farm and is adjacent to land on which Imperial Oil operated a refinery for many years. In June 2001, Alberta Environment, a department of the Government of Alberta, issued an Environmental Protection Order requiring Imperial Oil to remediate significant petroleum-based contamination discovered on Lynnview Ridge. In July 2002, following an appeal to the Environmental Appeal Board, the Alberta Minister of the Environment issued a Ministerial Order confirming this Environmental Protection Order. Imperial Oil initiated a judicial proceeding to reverse this Ministerial Order, which was unsuccessful. The Company is not a party to these proceedings. The Company understands that Imperial Oil has purchased from the homeowners 137 of the 160 homes located in the Lynnview Ridge development. To date, the Company has conducted preliminary investigations and some limited discovery regarding these lawsuits.

In March 2004, one of the lawsuits was discontinued by one of the plaintiffs. In April 2004, the Company made an application for grant of summary judgment in one action that was chosen to be a representative case for this matter,

but the plaintiffs in this representative case discontinued their lawsuit in October 2004. In April 2005, the Company was notified that Imperial Oil had filed a notice with the Court that it has settled nine of the lawsuits involving approximately \$11.8 million (Canadian) in total damages and that the releases to be made by the plaintiffs in connection with those settlements will include the Company. However, the Company has not yet received the executed releases and it is possible that some or all of those settlements may fail to be consummated. The remaining nine lawsuits seek approximately \$6.6 million (Canadian) in

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total damages. A reserve for legal fees associated with this matter of \$333,000 is included in Accrued Liabilities, discontinued operations on the Company's March 31, 2005 unaudited Condensed Consolidated Balance Sheet.

In addition to the legal proceedings discussed above, the Company is from time to time, involved in various disputes and legal actions related to its business operations. While no assurance can be given regarding the outcome of the above matters, based on information currently available, the Company believes that the resolution of these matters will not have a material adverse effect on the financial position or results of future operations of the Company. However, because of the nature and inherent uncertainties of litigation, should the outcome of the actions be unfavorable, the Company's business, financial condition, results of operations and cash flows could be materially adversely affected.

**ITEM 6. EXHIBITS**

The exhibits listed in the accompanying Exhibit Index are hereby incorporated by reference.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Glenayre Technologies, Inc.

(Registrant)

/s/ Debra Ziola

Debra Ziola  
Senior Vice President and  
Chief Financial Officer  
(Principal Financial Officer)

Date: May 9, 2005

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**GLENAYRE TECHNOLOGIES, INC. AND SUBSIDIARIES**

**EXHIBIT INDEX**

Exhibit Number	Description
3.1	Composite Certificate of Incorporation of Glenayre reflecting the Certificate of Amendment filed December 8, 1995 was filed as Exhibit 3.1 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1995 and is incorporated herein by reference.
3.2	Restated by-laws of Glenayre effective June 7, 1990, as amended September 21, 1994 was filed as Exhibit 3.5 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1994 and is incorporated herein by reference.
15.1	Letter regarding unaudited financial information.
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a), Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a), Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of 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 Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.