

GLENAYRE TECHNOLOGIES INC

Form 10-Q

November 08, 2006

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q**

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

For the quarterly period ended September 30, 2006

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

(State or Other Jurisdiction of
Incorporation or Organization)

98-0085742

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

825 8th Avenue, 23rd Floor, NY, NY

(Address of Principal Executive Offices)

10019

(Zip Code)

(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 No
Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of Exchange Act. (Check one):

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer

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

The number of shares outstanding of the Registrant's common stock, par value \$.02 per share, at October 23, 2006 was 69,103,808 shares.

Glenayre Technologies, Inc. and Subsidiaries

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PART I FINANCIAL INFORMATION

ITEM 1. Financial Statements

Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders

Glenayre Technologies, Inc.

We have reviewed the condensed consolidated balance sheet of Glenayre Technologies, Inc. and subsidiaries as of September 30, 2006, and the related condensed consolidated statements of operations for the three month and nine month periods ended September 30, 2006 and 2005, the condensed consolidated statement of stockholders' equity for the nine month period ended September 30, 2006, and the condensed consolidated statements of cash flows for the nine month periods ended September 30, 2006 and 2005. 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, 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 review, 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, 2005, 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 15, 2006 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, 2005, 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

November 6, 2006

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GLENAYRE TECHNOLOGIES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

| | September 30, 2006 (Unaudited) | December 31, 2005 |
|---|---|----------------------------------|
| | (In thousands, except share and per share amounts) | |
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 64,150 | \$ 78,803 |
| Restricted cash | 2,295 | 10,602 |
| Accounts receivable, net of allowances for doubtful accounts of \$601 and \$489 at September 30, 2006 and December 31, 2005, respectively | 51,884 | 28,056 |
| Current portion of long-term receivable | 2,163 | 6,076 |
| Inventories, net | 18,041 | 15,620 |
| Prepaid expenses and other current assets | 18,764 | 11,099 |
| | | |
| Total Current Assets | 157,297 | 150,256 |
| Restricted cash | 22,248 | 29,727 |
| Property, plant and equipment, net | 66,586 | 62,340 |
| Long-term receivable | 6,754 | 6,560 |
| Goodwill | 2,382 | |
| Intangible assets | 58,874 | 59,642 |
| Deferred income taxes | 2,858 | |
| Other assets | 5,172 | 6,883 |
| | | |
| TOTAL ASSETS | \$ 322,171 | \$ 315,408 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current Liabilities: | | |
| Accounts payable | \$ 35,916 | \$ 28,990 |
| Accrued and other liabilities | 40,026 | 38,001 |
| Income taxes payable | 8,411 | 9,489 |
| Deferred income taxes | 233 | 215 |
| Deferred revenue | 4,038 | 9,003 |
| Loans from employees | 1,127 | 1,132 |
| Current portion of long-term debt | 20,131 | 14,700 |
| Accrued liabilities, discontinued operations | 108 | 2,174 |
| | | |
| Total Current Liabilities | 109,990 | 103,704 |
| Other non-current liabilities | 3,694 | 2,230 |
| Loans from employees | 3,752 | 4,113 |

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| | | |
|---|-------------------|-------------------|
| Long-term debt | 51,938 | 61,868 |
| Pension and other defined benefit obligations | 34,042 | 29,281 |
| Deferred income taxes | 9,805 | 8,462 |
| Accrued liabilities, discontinued operations | | 61 |
| | | |
| Total Liabilities | 213,221 | 209,719 |
| Minority interest in subsidiary company | 871 | 886 |
| Commitments and contingencies | | |
| 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, issued and outstanding: 2006 69,080,297 shares; 2005 68,063,799 shares | 1,382 | 1,361 |
| Contributed capital | 366,940 | 364,376 |
| Profits interests | 4,105 | 1,123 |
| Accumulated deficit | (264,651) | (260,874) |
| Cumulative translation adjustment, net of tax | 303 | (1,183) |
| | | |
| Total Stockholders' Equity | 108,079 | 104,803 |
| | | |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$ 322,171 | \$ 315,408 |

See Notes to Condensed Consolidated Financial Statements.

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GLENAYRE TECHNOLOGIES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

| | Three Months Ended September 30, | |
|---|---|---------------|
| | 2006 | 2005 |
| | (In thousands, except per share amounts) | |
| REVENUES: | | |
| Product sales | \$ 73,412 | \$ 67,720 |
| Service revenues | 23,921 | 29,193 |
| Total Revenues | 97,333 | 96,913 |
| COST OF REVENUES: | | |
| Cost of sales | 58,426 | 51,849 |
| Cost of services | 17,254 | 19,470 |
| Total Cost of Revenues | 75,680 | 71,319 |
| GROSS MARGIN | 21,653 | 25,594 |
| OPERATING EXPENSES: | | |
| Selling, general and administrative expense | 17,723 | 16,646 |
| Research and development expense | 3,375 | 3,462 |
| Amortization of intangible assets | 2,038 | 1,710 |
| Total Operating Expenses | 23,136 | 21,818 |
| OPERATING INCOME (LOSS) | (1,483) | 3,776 |
| OTHER INCOME (EXPENSES): | | |
| Interest income | 1,071 | 729 |
| Interest expense | (1,567) | (1,549) |
| Gain on currency swap, net | 318 | 125 |
| Transaction gain (loss), net | 213 | (109) |
| Other income (expenses) | (94) | 23 |
| Total Other Expenses | (59) | (781) |
| INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE INCOME TAXES, DISCONTINUED OPERATIONS AND EXTRAORDINARY ITEM | (1,542) | 2,995 |
| Provision for income taxes | 1,434 | 404 |
| Minority interests | | |

| | | |
|---|-----------|----------|
| INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE DISCONTINUED OPERATIONS AND EXTRAORDINARY ITEM | (2,976) | 2,591 |
| INCOME (LOSS) FROM DISCONTINUED OPERATIONS, NET OF INCOME TAX | 4,029 | (48) |
| INCOME BEFORE EXTRAORDINARY ITEM | 1,053 | 2,543 |
| Extraordinary gain net of taxes of \$0 | 6,920 | |
| NET INCOME | \$ 7,973 | \$ 2,543 |
| INCOME (LOSS) PER WEIGHTED AVERAGE COMMON SHARE (1): | | |
| Income (loss) from continuing operations | \$ (0.04) | \$ 0.04 |
| Income (loss) from discontinued operations | 0.06 | (0.00) |
| Extraordinary gain | 0.10 | |
| Net income per weighted average common share | \$ 0.12 | \$ 0.04 |
| INCOME (LOSS) PER COMMON SHARE ASSUMING DILUTION (1): | | |
| Income (loss) from continuing operations | \$ (0.04) | \$ 0.04 |
| Income (loss) from discontinued operations | 0.06 | (0.00) |
| Extraordinary gain | 0.10 | |
| Net income per weighted average common share | \$ 0.12 | \$ 0.04 |

(1) Income per weighted average common share amounts are rounded to the nearest \$0.01; therefore, such rounding may impact individual amounts presented.

See Notes to Condensed Consolidated Financial Statements.

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GLENAYRE TECHNOLOGIES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

| | Nine Months Ended September 30, | |
|--|---|----------------|
| | 2006 | 2005 |
| | (In thousands, except per share amounts) | |
| REVENUES: | | |
| Product sales | \$ 199,801 | \$ 111,807 |
| Service revenues | 73,951 | 45,782 |
| Total Revenues | 273,752 | 157,589 |
| COST OF REVENUES: | | |
| Cost of sales | 157,566 | 75,671 |
| Cost of services | 53,459 | 29,794 |
| Total Cost of Revenues | 211,025 | 105,465 |
| GROSS MARGIN | 62,727 | 52,124 |
| OPERATING EXPENSES: | | |
| Selling, general and administrative expense | 53,935 | 35,746 |
| Research and development expense | 12,171 | 10,444 |
| Amortization of intangible assets | 5,818 | 2,276 |
| Total Operating Expenses | 71,924 | 48,466 |
| OPERATING INCOME (LOSS) | (9,197) | 3,658 |
| OTHER INCOME (EXPENSES): | | |
| Interest income | 3,151 | 1,830 |
| Interest expense | (4,541) | (2,061) |
| Gain (loss) on currency swap, net | (2,059) | 387 |
| Transaction gain (loss), net | 1,153 | (1,409) |
| Other income (expense), net | (88) | 55 |
| Total Other Expenses | (2,384) | (1,198) |
| INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE INCOME TAXES, MINORITY INTEREST, DISCONTINUED OPERATIONS AND EXTRAORDINARY ITEM | (11,581) | 2,460 |
| Provision for income taxes | 2,625 | 567 |
| Minority interests | (114) | |
| | (14,092) | 1,893 |

| | | | | |
|--|----|----------|----|-------|
| INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE DISCONTINUED OPERATIONS AND EXTRAORDINARY ITEM INCOME FROM DISCONTINUED OPERATIONS, NET OF INCOME TAX | | 3,395 | | 350 |
| INCOME (LOSS) BEFORE EXTRAORDINARY ITEM | | (10,697) | | 2,243 |
| Extraordinary gain net of taxes of \$0 | | 6,920 | | |
| NET INCOME (LOSS) | \$ | (3,777) | \$ | 2,243 |
| INCOME (LOSS) PER WEIGHTED AVERAGE COMMON SHARE (1): | | | | |
| Income (loss) from continuing operations | \$ | (0.21) | \$ | 0.03 |
| Income from discontinued operations | | 0.05 | | 0.01 |
| Extraordinary gain | | 0.10 | | |
| Income (loss) per weighted average common share | \$ | (0.06) | \$ | 0.03 |
| INCOME (LOSS) PER COMMON SHARE ASSUMING DILUTION (1): | | | | |
| Income (loss) from continuing operations | \$ | (0.21) | \$ | 0.03 |
| Income from discontinued operations | | 0.05 | | 0.01 |
| Extraordinary gain | | 0.10 | | |
| Income (loss) per weighted average common share | \$ | (0.06) | \$ | 0.03 |

(1) Income per weighted average common share amounts are rounded to the nearest \$0.01; therefore, such rounding may impact individual amounts presented.

See Notes to Condensed Consolidated Financial Statements.

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GLENAYRE TECHNOLOGIES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY
(In thousands)
(Unaudited)

| | Common Stock | | Contributed | Profits | | Accumulated | Other | Comprehensive |
|---|---------------------|---------------|--------------------|------------------|----------------|--------------------|----------------------|----------------------|
| | Shares | Amount | Capital | Interests | Deficit | Income | Comprehensive | Income |
| | | | | | | (Loss) | Income | (Loss) |
| Balance, January 1, 2006 | 68,064 | \$ 1,361 | \$ 364,376 | \$ 1,123 | \$ (260,874) | \$ (1,183) | | |
| Net loss | | | | | (3,777) | | | \$ (3,777) |
| Foreign currency translation | | | | | | 1,486 | | 1,486 |
| Shares issued for ESP Plan and option exercises | 1,016 | 21 | 1,463 | | | | | |
| Stock compensation expense | | | 1,101 | | | | | |
| Profits interests | | | | 2,982 | | | | |
| Total comprehensive loss, net of tax | | | | | | | | \$ (2,291) |
| Balances, September 30, 2006 | 69,080 | \$ 1,382 | \$ 366,940 | \$ 4,105 | \$ (264,651) | \$ 303 | | |

See Notes to Condensed Consolidated Financial Statements.

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GLENAYRE TECHNOLOGIES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

| | Nine Months Ended September 30, | |
|--|--|-----------------|
| | 2006 | 2005 |
| | (In thousands) | |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income (loss) | \$ (3,777) | \$ 2,243 |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: | | |
| Extraordinary gain | (6,920) | |
| Depreciation and amortization | 16,367 | 7,903 |
| Stock compensation expense | 1,032 | 42 |
| Compensation expense on profits interests in EDC, LLC | 1,340 | 950 |
| Unrealized loss (gain) on currency swap | 2,059 | (387) |
| Foreign currency transaction (gain) loss | (1,153) | 962 |
| Gain on adjustment to discontinued operations accrual and related tax payable | (3,949) | (302) |
| Minority interest | (114) | |
| Other | 500 | 119 |
| Changes in operating assets and liabilities, net of effects of business dispositions and acquisitions: | | |
| Restricted cash | 913 | (900) |
| Accounts receivable | (4,421) | (20,892) |
| Inventories | 151 | (4,730) |
| Prepays and other current assets | (6,043) | (3,646) |
| Long-term receivable | 4,383 | 7,543 |
| Other assets | (763) | (253) |
| Accounts payable | (36) | 12,179 |
| Deferred revenue | (4,965) | 5,213 |
| Accrued liabilities and income taxes payable | (3,764) | 24,264 |
| Pension and other defined benefit plans | 1,462 | (2,449) |
| NET CASH (USED IN) PROVIDED BY OPERATING ACTIVITIES | (7,698) | 27,859 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of property, plant and equipment | (11,940) | (4,118) |
| Maturities of short-term securities | | 12,180 |
| Asset and share purchase of EDC operations, net of cash acquired | (5,561) | (69,948) |
| Release (increase) in restricted cash | 16,500 | (16,500) |
| NET CASH USED IN INVESTING ACTIVITIES | (1,001) | (78,386) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from long-term borrowing, net of costs | | 45,444 |
| Proceeds from employee loans | 469 | |
| Repayment of long-term borrowing | (8,135) | |

| | | |
|--|------------------|------------------|
| Proceeds from sale of LLC interest in subsidiary | 99 | 772 |
| Repayment of employee loans | (1,156) | |
| Issuance of common stock | 1,483 | 696 |
| NET CASH (USED IN) PROVIDED BY FINANCING ACTIVITIES | (7,240) | 46,912 |
| EFFECT OF EXCHANGE RATE CHANGES ON CASH | 1,286 | (750) |
| NET DECREASE IN CASH AND CASH EQUIVALENTS | (14,653) | (4,365) |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD | 78,803 | 82,691 |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | \$ 64,150 | \$ 78,326 |

Depreciation and amortization included in net cash (used in) provided by operating activities:

| | | |
|--|----------|----------|
| Depreciation included in cost of sales | \$ 8,090 | \$ 3,879 |
| Depreciation included in selling, general and administrative expense | 1,703 | 775 |
| Depreciation included in research and development expense | 756 | 973 |
| Amortization of intangible assets | 5,818 | 2,276 |

SUPPLEMENTAL INFORMATION OF NON-CASH ACTIVITIES:

During the nine months ended September 30, 2006, we purchased a printer under a capital lease for approximately \$1.1 million.

See Notes to Condensed Consolidated Financial Statements.

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GLENAYRE TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Tabular Amounts in Thousands, Except per Share Amounts)
(Unaudited)

1. Business and Basis of Presentation

Glenayre Technologies, Inc. and its wholly owned and controlled majority owned subsidiaries (collectively referred to as we, us, our, Glenayre or the Company) is an international company operating in the entertainment and communications industries. The Company has two reportable business segments: Entertainment Distribution Company, LLC (EDC) and Glenayre Messaging (Messaging). The EDC segment provides pre-recorded products and distribution services to the entertainment industry. The Messaging segment is an established global provider of network-based messaging and communication systems and software that enable applications including voice messaging, multimedia messaging and other enhanced services.

The accompanying unaudited condensed consolidated financial statements are presented in U.S. dollars in conformity 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. We believe all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included.

The results for the interim periods are not necessarily indicative of results for the full year. These interim financial statements should be read in conjunction with the consolidated financial statements of the Company and accompanying notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005. The financial statements include the accounts of Glenayre and its wholly owned as well as controlled majority owned subsidiaries and have been prepared from records maintained by Glenayre and its subsidiaries in their respective countries of operation. The ownership interest of minority investors is recorded as minority interest. All significant intercompany accounts and transactions are eliminated in consolidation. The Company does not have any equity or cost method investments.

Use of Estimates

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

Reclassifications

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

The cost of revenues for the nine months ended September 30, 2006 reflect a reclassification of \$3.0 million from cost of product to cost of services for EDC relating to the period ended June 30, 2006.

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GLENAYRE TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS **Continued**
(Tabular Amounts in Thousands, Except per Share Amounts)
(Unaudited)

2. Recently Adopted Accounting Standards

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued Statement of Accounting Standard (SFAS) No. 123 (revised 2004), *Share-Based Payment* (SFAS 123R), which is a revision of SFAS 123. SFAS 123R supersedes Accounting Principals Board (APB) Opinion No. 25 *Accounting for Stock Issued to Employees* (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. We adopted SFAS 123R on January 1, 2006. Prior to adoption of SFAS 123R, we accounted for share-based payments to employees using APB 25's intrinsic value method and consequently recognized no compensation cost for employee stock options. Had the adoption of SFAS 123R occurred in prior periods, the impact of that standard would have approximated the impact of SFAS 123 as described in the disclosure of pro forma net income and earnings per share in Note 16.

On January 1, 2006 we adopted SFAS No. 151, *Inventory Cost*, an amendment of Accounting Research Bulletin No. 43, Chapter 4 (SFAS 151). SFAS 151 requires abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) to be recognized as current period charges. In addition, SFAS 151 requires the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. The adoption of the new standard did not have a material impact on the Company's financial position or results of operation.

We also adopted on January 1, 2006 SFAS No. 154, *Accounting Changes and Error Corrections* (SFAS 154). SFAS 154 requires retroactive application of a voluntary change in accounting principle to prior period financial statements unless it is impracticable. SFAS 154 replaced APB Opinion No. 20, *Accounting Changes* and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements*. The adoption of the provisions of SFAS 154 did not have a material impact on the Company's results of operations or financial condition.

3. Impact of Recently Issued Accounting Standards

In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, an interpretation of FAS 109, *Accounting for Income Taxes* (FIN 48), to create a single model to address accounting for uncertainty in tax positions. FIN 48 clarifies the accounting for income taxes by prescribing a minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. We will adopt FIN 48 as of January 1, 2007, as required. The cumulative effect of adopting FIN 48 will be recorded in retained earnings and other accounts as applicable. We have not determined the effect the adoption of FIN 48 will have on our financial position and results of operations.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157) which defines fair value, establishes a framework for measuring fair value in accounting principles generally accepted in the United States and expands disclosure about fair value measurements. The statement is effective for us beginning on January 1, 2008. We are still assessing the potential impact of the adoption of SFAS 157.

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GLENAYRE TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS **Continued**
(Tabular Amounts in Thousands, Except per Share Amounts)
(Unaudited)

In September 2006, the FASB also issued SFAS 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R)* (SFAS 158). This statement requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity. This statement also requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions. We will initially recognize the funded status of our defined benefit postretirement plan and provide the required disclosures as of the end of our fiscal year ending December 31, 2006. The requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end statement of financial position is effective for our fiscal year ending December 31, 2009. We have not determined the effect, if any, the adoption of SFAS 158 will have on our financial position and results of operations.

4. Acquisitions

The results of EDC's and Blackburn's operations, discussed below, are included in the condensed consolidated financial statements since their acquisition dates.

(a) EDC Acquisition

On May 31, 2005, we acquired the U.S. and central European CD and DVD manufacturing and distribution operations from Universal Music Group (Universal). The transaction was accounted for under the purchase method of accounting in accordance with SFAS No. 141, *Business Combinations* (SFAS 141). The purchase price of approximately \$129.2 million (as set forth in the table below), using the May 31, 2005 Euro to U.S. dollar exchange rate of 1.2474, consisted of \$81.6 million cash paid at closing, \$39.8 million in deferred payments to Universal and \$7.8 million for various contingent payments and transaction costs. The purchase price was subject to post-closing adjustments associated with the contingent purchase price discussed below. Of the cash purchase price paid at closing, \$30.5 million was for the U.S. operations, 35.5 million (\$44.3 million) was for the central European operations, and the balance constituted transaction expenses. The purchase price was allocated to the related tangible and identifiable intangible assets acquired and liabilities assumed based on their respective estimated fair values on the acquisition date.

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GLENAYRE TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS **Continued**
(Tabular Amounts in Thousands, Except per Share Amounts)
(Unaudited)

Under the purchase method of accounting, the assets and liabilities acquired from Universal were recorded on our balance sheet at their respective fair values as of the date of the acquisition. We have finalized our purchase price allocation and do not expect any further material adjustments to values assigned to the assets acquired and assumed liabilities. The following table summarizes the fair values at acquisition:

| | December 31, 2005 | Adjustment | September 30, 2006 |
|---------------------------------------|----------------------------------|-------------------|-----------------------------------|
| Current assets | \$ 53,406 | \$ | \$ 53,406 |
| Spare parts | 4,569 | (1,532) | 3,037 |
| Property, plant & equipment | 55,549 | 351 | 55,900 |
| Long-term receivable from Universal | 20,667 | | 20,667 |
| Other assets | 1,056 | | 1,056 |
| Customer relationships | 65,383 | 2,484 | 67,867 |
| Goodwill | | 2,382 | 2,382 |
| Accounts payable and accrued expenses | (28,548) | | (28,548) |
| Deferred tax liability | (9,176) | (1,062) | (10,238) |
| Long-term liabilities | (35,933) | (374) | (36,307) |
| Total | \$ 126,973 | \$ 2,249 | \$ 129,222 |

The additional purchase price adjustments recorded during the nine months ended September 30, 2006 included \$1.6 million relating to the fair value of the profits interests awarded to the seller and the investment banker as part of the acquisition, \$1.1 million of additional deferred tax liabilities, \$0.5 million of additional contingent purchase price payable to the seller and \$141,000 of additional transaction costs.

During the first quarter of 2006, in accordance with plans adopted at the EDC acquisition date, we terminated nine employees resulting in estimated severance cost of approximately \$325,000. During the second quarter of 2006 this estimate was increased by \$50,000. The total severance cost of \$375,000 is an adjustment of the purchase price and consequently increased intangible assets in the accompanying unaudited condensed consolidated balance sheet at September 30, 2006. We paid approximately \$298,000 of the severance cost during the nine months ended September 30, 2006. The remaining severance cost is recorded in accrued liabilities in the accompanying unaudited condensed consolidated balance sheet at September 30, 2006.

Universal Contingent Purchase Price

Pursuant to the terms of EDC's acquisition of Universal's central European CD and DVD manufacturing and distribution operations, we must pay Universal a percentage of the profits earned on the revenue derived from two third party distribution services agreements assumed in the acquisition. Profit is defined as earnings before interest and taxes. We reached an agreement with Universal in June 2006 clarifying the terms of this agreement. As clarified, such arrangement extends through December 31, 2007.

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The contingent consideration included in the purchase price totals 4.6 million (\$5.79 million) consisting of 3.4 million (\$4.3 million) for actual consideration from the date of purchase through September 30, 2006 and 1.2 million (\$1.5 million) for estimated consideration due for the remaining 15 months ended December 31, 2007, using the May 31, 2005 Euro to U.S. dollar exchange rate of 1.2474. Additional adjustments to the purchase price will be recorded in future periods when the amounts become probable and determinable. Included in accrued liabilities in the unaudited condensed consolidated balance sheet at September 30, 2006 are approximately 343,000 (\$435,000) for consideration earned but not paid as of September 30, 2006, and 1.2 million (\$1.5 million) for the estimated amount payable for the 15 months ended December 31, 2007, using the September 30, 2006 Euro to U.S. dollar exchange rate of 1.2688.

During the third quarter of 2006, the estimated consideration was adjusted downward by 663,000 (\$841,000) based upon revised projections, using the September 30, 2006 Euro to U.S. dollar exchange rate of 1.2688. In accordance with SFAS 141's guidance on a contingency based on earnings, the adjustment is accounted for as part of the purchase price allocation resulting in the elimination of the goodwill balance associated with central European operations of 514,000 (\$652,000) and reduction in the customer relationships intangible of 149,000 (\$189,000). The estimated consideration will be adjusted quarterly as projections change until the obligation becomes final at December 31, 2007.

EDC Profits Interests

As part of the EDC acquisition, we issued profits interests to certain key employees, Universal, and the Company's financial advisor, that will entitle these parties to up to 30% of EDC's distributed profits after the Company has received a return of its equity capital contribution and certain internal rate of return hurdles and other profitability conditions have been met. No payments were required from these parties to acquire the profits interests. These profits interests do not carry any voting rights.

The estimated fair value of the profits interests at the date of grant represents the present value of estimated future cash flows to those profits interests. The fair value of the profits interests granted to Universal and the financial advisor was included in the acquisition costs of EDC.

The profits interests issued to members of management are accounted for as compensation expense and are included in selling, general and administrative expenses in the unaudited condensed consolidated statements of operations. Compensation expense included in EDC's results for the nine months ended September 30, 2006 and 2005, was \$1.3 million and \$950,000, respectively. Compensation expense is recorded according to a vesting schedule of one-third immediately upon grant and two-thirds ratably in each of the two years after grant.

At September 30, 2006 and December 31, 2005, \$4.1 million and \$1.1 million, respectively, were included in contributed capital in our condensed consolidated balance sheets as follows:

| | September 30, | December 31, |
|----------|----------------------|---------------------|
| | 2006 | 2005 |
| Vested | \$ 3,701 | \$ 710 |
| Unvested | 404 | 413 |
| Total | \$ 4,105 | \$ 1,123 |

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Intangible Assets

Intangible assets are comprised of supply agreements and contractual and non-contractual customer relationships arising from the acquisition of Universal's U.S. and central European manufacturing and distribution operations. The supply agreements and customer relationships include 10-year manufacturing and distribution services supply agreements with Universal, two third party distribution supply agreements with automatic renewal terms and relationships with several central European customers for CD and DVD manufacturing services. The fair value assigned to the agreements was based on the present value of estimated future cash flows. The intangible value of the U.S. and international manufacturing and distribution agreements with Universal is being amortized over the 10-year terms of the agreements. The intangible value of the other international customer agreements and the international third party customer relationships are being amortized over five years.

During the third quarter of 2006, as previously discussed above under Universal Contingent Purchase Price, the gross carrying value of the customer relationship intangibles and goodwill allocated to the central European operations were adjusted 149,000 (\$189,000) and 514,000 (\$652,000), respectively, based upon revised projections of this contingent obligation, which eliminated the goodwill in Germany. Until the final obligation under this contingency is known, there will be quarterly adjustments that could impact intangible assets and goodwill.

As of September 30, 2006, acquired intangible assets and related amortization, using the September 30, 2006 Euro to U.S. dollar exchange rate of 1.2688, are as follows:

| | | September 30, 2006 | | December 31, 2005 | |
|--|-------------------------|--------------------------------------|-------------------------------------|--------------------------------------|-------------------------------------|
| | Useful Lives | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| Intangible assets subject to amortization: | | | | | |
| Customer relationship intangibles | 5-10 years | \$ 68,603 | \$ 9,729 | \$ 63,335 | \$ 3,693 |
| Intangible assets not subject to amortization: | | | | | |
| Goodwill | | \$ 2,382 | \$ | \$ | \$ |

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The weighted average useful life of intangible assets subject to amortization is 9.2 years. The amortization expense for the nine months ended September 30, 2006 and 2005 was \$5.8 million and \$2.3 million, respectively. The estimated amortization expense for the remaining current year and the next five years is as follows:

| | |
|---|---------|
| For the three months ending December 31, 2006 | \$2,030 |
| For the years ending December 31, 2007 | 8,121 |
| 2008 | 8,121 |
| 2009 | 8,121 |
| 2010 | 6,778 |
| 2011 | 5,819 |

Goodwill

In connection with the EDC acquisition, we recorded goodwill in the amount of \$2.4 million. As discussed previously, the goodwill allocated to the central European operations was eliminated during the third quarter of 2006 as part of the purchase price allocation adjustment to the Universal contingent purchase price. No goodwill was recorded at December 31, 2005, because the valuation was preliminary at that time. Goodwill allocated to U.S. operations is expected to be deductible for income tax purposes. There were no indicators of impairment at September 30, 2006. The measurement date for impairment will be October 1 of each fiscal year.

Pro Forma Information

The pro forma financial information for the third quarter and the first nine months of fiscal 2005 includes the business combination accounting effect on historical Glenayre and EDC (but excluding the Blackburn acquisition discussed below) revenues, adjustments to depreciation on acquired property, amortization expense on intangible assets and acquisition costs reflected in Glenayre's and EDC's historical statements of operations for periods prior to the acquisition. The pro forma financial information is presented for informational purposes only and is not indicative of the results of operations that would have been achieved if the acquisition had taken place on the first day of the applicable period presented. In addition, the pro forma amounts are not necessarily indicative of operating results in future periods.

The following unaudited pro forma consolidated results of operations of the Company for three and nine months ended September 30, 2005 assume that the EDC acquisition was completed as of January 1, 2005:

| | Three Months Ended September 30, 2005 | Nine Months Ended September 30, 2005 |
|--|--|---|
| Total revenues | \$ 96,913 | \$ 273,636 |
| Net income (loss) from continuing operations | \$ 2,591 | \$ (126) |
| Net income (loss) from discontinued operations | \$ (48) | \$ 350 |
| Net income | \$ 2,543 | \$ 224 |
| Basic net income per share | \$ 0.04 | \$ 0.00 |

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(b) Blackburn Acquisition

On July 21, 2006, EDC acquired the shares of Deluxe Global Media Services Blackburn Limited (Blackburn), a subsidiary of The Rank Group Plc, for a purchase price of 3.0 million (\$5.6 million) in cash, including closing costs, using the July 21, 2006 British pound to U.S. dollar exchange rate of 1.8465. Blackburn, located in Blackburn, England, is the largest CD replicator in the U.K. Its customer base includes Universal Music Group, its largest customer, as well as Demon Music Group, Sanctuary Records Group and Warner Music Group. As part of EDC's international supply agreement with Universal, Blackburn's Universal volumes were scheduled to revert to EDC in 2007.

This transaction increases our customer base, expands our geographic reach and allows us to further capitalize on our 10-year agreement with our largest client, Universal, by accelerating the reversion of their U.K. volumes. In addition, it allows us to avoid capital expenditures in our Hanover, Germany location that would have been required to accommodate this volume in 2007.

Under the purchase method of accounting, the assets and liabilities acquired were recorded on our balance sheet at their respective fair values as of the date of the acquisition. We have finalized our purchase price allocation and do not expect any further material adjustments to values assigned to the assets acquired and assumed liabilities. The following table summarizes the estimated fair values at the acquisition date, and the subsequent allocation of the excess over the purchase price.

| | Estimated Fair Value** | Allocation | Adjusted Value |
|--|---------------------------------------|-------------------|---------------------------|
| Accounts receivable | \$ 18,457 | \$ | \$ 18,457 |
| Inventory | 2,282 | | 2,282 |
| Prepays and other current assets | 1,035 | | 1,035 |
| Property, plant and equipment ** | 3,937 | (3,937) | |
| Deferred tax asset | 2,926 | | 2,926 |
| Spare parts ** | 961 | (961) | |
| Accounts payable and other accrued liabilities | (11,362) | | (11,362) |
| Long-term liabilities | (857) | | (857) |
| Extraordinary gain | | (6,920) | (6,920) |
| | 17,379 | (11,818) | 5,561 |
| Purchase price | (5,561) | | (5,561) |
| | \$ 11,818 | \$ (11,818) | \$ |

** The fair values for property, plant and equipment and spare parts were not obtained, as

there was not sufficient purchase price to be allocated to these categories. The seller's net book value at the time of acquisition has been used as the estimated fair value for these non-current assets. These net book values may not be representative of the estimated fair values.

In accordance with SFAS 141, the excess was allocated as a pro rata reduction of the amounts assigned with the remaining excess recorded as an extraordinary gain in our condensed consolidated statements of operations for the three months and nine months ended September 30, 2006.

We plan to reorganize the Blackburn operations to integrate them with the existing EDC operations in Europe. In connection therewith, we expect to incur 748,000 (\$1.4 million) in costs over the next several quarters associated with the integration activities. Plans affecting the integration have been completed and approved by management, resulting in adjustments to the purchase price allocation for the acquired assets and assumed liabilities.

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5. Currency Rate Swap

We entered into a cross-currency rate swap agreement with a commercial bank on May 31, 2005. Our objective is to manage foreign currency exposure arising from a U.S. subsidiary loan to its German subsidiary and is therefore for purposes other than trading. The loan is denominated in Euros and repayment is due on demand, or in any event by May 31, 2010. In accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133), as amended, the currency swap does not qualify for hedge accounting. Consequently, we report the foreign currency exchange gains or losses attributable to changes in the US\$/ exchange rate on the currency swap in earnings.

The gain (loss) on the currency rate swap was approximately \$318,000 and (\$2.1) million for the three months and nine months ended September 30, 2006, respectively. The gain on the currency rate swap was approximately \$125,000 and \$387,000 for the three months and nine months ended September 30, 2005, respectively. At September 30, 2006, the currency rate swap was in a net loss position of \$1.3 million and was included as a non-current liability in our condensed consolidated balance sheet.

6. Accounts Receivable

Accounts receivable related to continuing operations consisted of:

| | September 30, 2006 | December 31, 2005 |
|---------------------------------------|-------------------------------|------------------------------|
| Trade receivables | \$ 52,485 | \$ 28,545 |
| Less: allowance for doubtful accounts | (601) | (489) |
| Total | \$ 51,884 | \$ 28,056 |

7. Inventories

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

| | September 30, 2006 | December 31, 2005 |
|-----------------|-------------------------------|------------------------------|
| Raw materials | \$ 12,893 | \$ 10,647 |
| Work in process | 2,319 | 1,390 |
| Finished goods | 2,829 | 3,583 |
| Total | \$ 18,041 | \$ 15,620 |

At September 30, 2006 and December 31, 2005, reserves related to continuing operations were approximately \$3.3 million and \$2.8 million, respectively.

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8. Estimated Warranty Costs and Deferred Revenue

Messaging products generally include a one-year warranty. Consequently, a provision for estimated warranty costs is recorded at the time of sale. Factors affecting the 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 continuing operations warranty obligation for the nine months ended September 30, 2006 and 2005:

| | 2006 | 2005 |
|--|-------------|-------------|
| Balance at January 1 st | \$ 423 | \$ 573 |
| Provision (release) for warranty obligations | 92 | 46 |
| Warranty release | (105) | |
| Settlements of warranty obligation | (8) | (45) |
| | | |
| Balance at March 31 st | \$ 402 | \$ 574 |
| Provision (release) for warranty obligations | (32) | 82 |
| Settlements of warranty obligation | (16) | (74) |
| | | |
| Balance at June 30 th | \$ 354 | \$ 582 |
| Provision (release) for warranty obligations | (41) | 223 |
| Settlements of warranty obligation | (45) | (168) |
| | | |
| Balance at September 30 th | \$ 268 | \$ 637 |

Post installation extended warranty and support services, known as Glenayre Care, are available for Messaging products and services. One year of Glenayre Care is generally included in the price of the product. A portion of the product revenue (an amount equal to the fair value of the Glenayre Care) is deferred when the product is sold and ratably recognized into revenues over the support period. Once this service period expires, 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 related to support services for new product sales and to the sale of post installation support services was approximately \$2.4 million of the \$4.0 million of deferred revenue included in the unaudited condensed consolidated balance sheet at September 30, 2006 and \$2.9 million of the \$9.0 million at December 31, 2005. EDC provides its customers with a fixed credit as compensation for defective products. Revenue for CD and DVD products are recorded net of the fixed credit.

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9. Discontinued Operations

In May 2001, the Company began exiting its Wireless Messaging (Paging) business. As a result, we recorded the Paging segment as a disposal of a segment starting in the second quarter of 2001 in accordance with APB Opinion No. 30, *Reporting the Results of Operations*. The operating results of the Paging segment have been classified as a discontinued operation for all periods presented in the unaudited condensed consolidated statements of operations. Additionally, all of the Paging segment assets are reported at their estimated net realizable value in the unaudited condensed consolidated balance sheet as of September 30, 2006. 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 | | Nine Months Ended | |
|--|---------------------------|---------|--------------------------|--------|
| | September 30, | | September 30, | |
| | 2006 | 2005 | 2006 | 2005 |
| Income (loss) on discontinued operations before income taxes | \$ (55) | \$ | \$ (415) | \$ 491 |
| Income tax benefit (expense) | 4,084 | (48) | 3,810 | (141) |
| Income (loss) from discontinued operations | \$ 4,029 | \$ (48) | \$ 3,395 | \$ 350 |

In the third quarter of 2006, we recorded a net increase in the loss on disposal of approximately \$55,000 related to increased tax contingencies offset by the reduction in customer deposit obligation and estimated contract obligations. The income tax benefit in the third quarter of 2006 reflects the release of a reserve for international business taxes of \$4.1 million due to the receipt of clearance by the applicable foreign country's taxing authority. In the nine months ended September 30, 2006 we recorded a net increase in the loss on disposal of approximately \$415,000 related to foreign currency exchange rate fluctuations offset slightly by liquidation of assets and a reduction in estimated contact obligations. The income tax benefit was primarily related to the release of foreign income tax contingencies as previously discussed.

In the first quarter of 2005, we recorded a net decrease in the loss on disposal of approximately \$63,000. This decrease included income of \$74,000 primarily due to settlement payments received from Pilot Pacific Properties, Inc. and its associated companies. This income was offset by adjustments to the original estimates, related primarily to international office closures, of \$11,000. In the second quarter of 2005, as a result of our review of the estimated liabilities and future commitments related to the discontinued operations, we recorded (1) a net decrease in the loss on disposal of \$428,000 (2) income of \$53,000 primarily due to a settlement and previously reserved accounts receivable receipts and (3) additional reductions of \$375,000 primarily related to the release of a reserve for the Lynnview Ridge litigation (see Note 14). In the third quarter of 2005, no change was recorded in the loss on disposal except for the recurring addition for accretion in contingent tax provisions.

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10. Long-Term Debt

Long-term debt consisted of:

| | September 30, 2006 | December 31, 2005 |
|--------------------------------------|-----------------------------------|----------------------------------|
| Senior Secured Credit Facility | \$ 41,500 | \$ 41,500 |
| Payable to Universal undiscounted | 32,584 | 39,440 |
| Capital Leases | 1,072 | 170 |
| Employee Loans | 4,879 | 5,245 |
| | | |
| Subtotal | 80,035 | 86,355 |
| | | |
| Less: Unamortized Discount | (3,087) | (4,542) |
| | | |
| Total Debt | 76,948 | 81,813 |
| Less: Current Portion | (21,258) | (15,832) |
| | | |
| Total Long-Term Debt | \$ 55,690 | \$ 65,981 |

Total scheduled principal payments for all long-term debt are as follows:

| | |
|-------------------------------|-----------|
| 2006 (Remaining three months) | \$ 6,984 |
| 2007 | 23,334 |
| 2008 | 24,608 |
| 2009 | 11,999 |
| 2010 | 10,325 |
| 2011 | 1,050 |
| Thereafter | 1,735 |
| | |
| Total | \$ 80,035 |

Senior Secured Credit Facility

In May 2005, to fund a portion of the purchase price for the EDC acquisition and provide for working capital needs, EDC obtained a Senior Secured Credit Facility (the "facility") from Wachovia Bank, National Association for an aggregate principal amount of \$56.5 million consisting of a term loan of \$46.5 million, and a revolving credit loan of \$10.0 million. On June 21, 2006, the facility was amended to extend the revolving credit loan for one year, modify the applicable leverage and fixed charge coverage ratios, and move all required principal payment dates from June 30th to December 31st of each year. The term loan expires December 31, 2010, and the revolving credit loan expires May 31, 2007. The amendment also released the \$16.5 million cash collateral that we deposited with the lender on the closing date of the EDC acquisition. Substantially all of EDC's assets are pledged as collateral to secure obligations under this facility. Scheduled principal payments are included in the table above. The weighted average interest rate of

outstanding debt under the facility was 8.62% at September 30, 2006. At September 30, 2006, no drawings were made against the \$10.0 million revolving credit loan.

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11. Income Taxes

The differences in the consolidated income tax provision from continuing operations and the amount computed using the U.S. federal statutory income tax rate is set forth below:

| | Three Months Ended | | Nine Months Ended | |
|--|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2006 | 2005 | 2006 | 2005 |
| Income tax (benefit) federal U.S. statutory rate | \$ (539) | \$ 1,049 | \$ (4,053) | \$ 861 |
| State income tax (benefit) net of federal benefit | (264) | (68) | (832) | (240) |
| Increase (decrease) in valuation allowance | 553 | (1,026) | 4,249 | (1,084) |
| Foreign taxes at rates other than U.S. statutory rates | 1,434 | 477 | 2,625 | 615 |
| Profits interest awards | 181 | 49 | 469 | 331 |
| Deductible amortization | | (99) | | |
| Other non deductibles | 55 | 25 | 145 | 65 |
| Minority interest in earnings of subsidiary | 14 | (3) | 22 | 19 |
| | | | | |
| Income tax provisions | \$ 1,434 | \$ 404 | \$ 2,625 | \$ 567 |

We account for income taxes under the liability method in accordance with SFAS No. 109, *Accounting for Income Taxes* (SFAS 109). At September 30, 2006, the U.S. net deferred tax assets were fully reserved by a valuation allowance. Pursuant to SFAS 109, a valuation allowance should be recognized to reduce the deferred tax assets to the amount that is more likely than not to be realized as offsets to the future taxable income. We assessed whether the net deferred asset at September 30, 2006 was realizable and determined that the entire amount should be reserved due to significant U.S. net operating losses and our inability to project future taxable income. The foreign pretax income (loss) from operations for the three months ended September 30, 2006 and September 30, 2005 was approximately \$7.0 million and \$1.5 million, respectively.

At December 31, 2005, we have realized U.S. federal net operating losses (NOLs) of \$276.9 million and foreign NOLs of \$45.1 million. Of the \$276.9 million realized U.S. NOLs, \$243.5 million will begin to expire in 2019. The remaining \$33.4 million of U.S. NOLs were related to the 1997 acquisitions of Open Development Corporation and Wireless Access, Inc., which start expiring in 2006. Our ability to offset future income with these acquired NOLs is subject to restriction in the United States Internal Revenue Code of 1986, as amended.

Income taxes payable includes \$4.5 million and \$7.5 million at September 30, 2006 and December 31, 2005, respectively, for probable and estimable exposure for tax filing positions in various jurisdictions. At September 30, 2006 and December 31, 2005, the above amounts included \$4.0 million and \$5.5 million respectively, of transfer pricing exposure in various foreign jurisdictions. We received tax clearance from a foreign country's taxing authority for the potential liability of \$4.1 million for international business tax of which \$1.9 million was included in the \$7.5 million December 31, 2005 balance. The remaining \$2.3 million was included in accrued liabilities, discontinued operations on the condensed consolidated balance sheet at December 31, 2005.

An unrecorded tax loss contingency arose in 2005 related to overhead costs incurred in the U.S. that were allocated to certain foreign subsidiaries. It is possible, if such subsidiaries were subjected to an audit, that the tax authorities in these foreign jurisdictions will object to the charges. If we are unsuccessful in defending our position, tax expense could increase by as much as \$1.0 million over the amounts currently accrued. We believe that the chance of disallowance is more than remote, but less than likely.

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12. Employee Benefit Plans

Net pension and post-retirement benefit costs consisted of the following components:

| | Three Months Ended | | Nine Months Ended | |
|-------------------------------------|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2006 | 2005 | 2006 | 2005 |
| Service cost | \$ 240 | \$ 15 | \$ 711 | \$ 44 |
| Interest cost on APBO | 292 | 32 | 869 | 95 |
| Amortization of prior service costs | (64) | (64) | (191) | (191) |
| Amortization of actuarial loss | 8 | 22 | 24 | 67 |
| | \$ 476 | \$ 5 | \$ 1,413 | \$ 15 |

The September 30, 2006 and 2005 amounts include pension benefit costs assumed in May 2005 in connection with the EDC acquisition. The amortization of prior service cost decreases the post-retirement benefit costs due to an amendment of a Messaging plan that reduced the number of participants by changing eligibility provisions.

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13. Stockholders Equity***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 | | Nine Months Ended | |
|--|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2006 | 2005 | 2006 | 2005 |
| Numerator: | | | | |
| Net income (loss) from continuing operations | \$ (2,976) | \$ 2,591 | \$ (14,092) | \$ 1,893 |
| Denominator: | | | | |
| Denominator for basic income (loss) from continuing operations per share weighted average shares | 68,951 | 67,210 | 68,628 | 67,031 |
| Effect of dilutive securities | | 3,044 | | 2,199 |
| Denominator for diluted income (loss) from continuing operations per share | 68,951 | 70,254 | 68,628 | 69,230 |
| Income (loss) from continuing operations per weighted average common share (1) | \$ (0.04) | \$ 0.04 | \$ (0.21) | \$ 0.03 |
| Income (loss) from continuing operations per common share assuming dilution (1) | \$ (0.04) | \$ 0.04 | \$ (0.21) | \$ 0.03 |
| Dilutive securities not included above due to anti-dilutive effect | 778 | | 1,632 | |
| Anti-dilutive securities not included above: | | | | |
| Stock options (2) | 6,387 | 3,094 | 2,933 | 4,943 |

(1) Loss per weighted average common share amounts are rounded to the nearest \$.01; therefore, such rounding may impact individual amounts

presented.

- (2) Increase in anti-dilutive securities is the result of stock options issued in conjunction with the acquisitions of EDC and Blackburn.

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Restricted Stock Units

Restricted stock units (RSU s) issued to directors are non-cash transactions. For the nine months ended September 30, 2006, approximately 39,000 shares were issued to directors upon the vesting of RSU s valued at approximately \$64,000, based on the grant date fair value.

14. Commitments and Contingencies

Litigation

EDC is not currently party to any material legal proceedings. In connection with the licensing of Messaging s software products, our standard purchase and license agreements typically require us to defend and indemnify our customers against claims that our licensed programs infringe or misappropriate the intellectual property rights of third parties. Under these agreements, we agree 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. We retain the right in our 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.

Vladimir Gusinsky On September 11, 2006, we were officially served with a lawsuit filed in the Supreme Court of the State of New York by Vladimir Gusinsky (Gusinsky), a company shareholder, initiating a derivative action against the Company (as nominal defendant) and against certain of our current and former officers and directors as defendants. The complaint, purportedly on behalf of the Company, alleges that the defendants breached their fiduciary duties by improperly backdating the grant of stock options between May 1994 and July 2001, and also contains allegations of related violations of federal securities laws in connection with the dissemination of our financial and proxy statements and violations of generally accepted accounting principles as a result of such allegedly improper grants. The complaint further alleges that the officer defendants were unjustly enriched as a result of their receipt and retention of the subject stock option grants. The plaintiff seeks to obtain, on behalf of the Company, unspecified equitable relief and disgorgement of any improperly granted stock options and related proceeds of any such exercised stock options from the individual officer defendants, as well as an award of attorneys fees and costs. A stipulation has been entered in the case granting the plaintiff 60 days to amend the complaint, and extending the time for the defendants to file an answer. The Company and its Board of Directors have established a Special Litigation Committee of the Board to conduct a full review, with the assistance of outside legal counsel and other experts, of its option grant practice.

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Phillip Jackson Beginning in late 2001, Phillip Jackson (Jackson) filed lawsuits against several of our customers claiming that products sold by us and used by these customers infringed a patent held by Jackson. We agreed to indemnify our customers for the claims in these lawsuits and assumed primary responsibility for defending the claims with respect to our 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, we recorded a charge consisting of \$2.7 million of royalty fee expense (recorded in cost of revenues) and \$200,000 of interest expense, and recorded a reduction of the estimated liability for accrued legal cost associated with this case of \$770,000. We 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 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 filed an appeal with respect to this ruling and the appeal was argued before the United States Court of Appeals for the Federal Circuit on March 11, 2005. On April 11, 2006, the appellate court ruled on the appeal in our favor, affirming the trial court's ruling of June 29, 2004 and dismissing Jackson's claim for a second trial on other issues. On April 25, 2006, Jackson filed a request for rehearing en banc with the appellate court that was subsequently denied. Since that time, Jackson filed a petition for writ of certiorari to the Supreme Court of the United States seeking further appellate review of the decision. We filed a responsive brief in opposition to the Jackson petition on October 10, 2006. A decision regarding whether the Supreme Court will accept the appeal is pending with the Court.

Lynnview Ridge, Alberta In November 2002 and April 2003, a total of twenty lawsuits seeking approximately CDN \$22.3 million in damages were filed in the Court of Queen's Bench, Judicial Centre of Calgary, in Alberta, Canada, against us and several other defendants, including Imperial Oil, a major Canadian petroleum company. These lawsuits asserted that the defendants, including us, are liable for negligence, nuisance, and negligent misrepresentation arising out of the development and sale of homes located in 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.

In March 2004, one of the lawsuits was discontinued by one of the plaintiffs. In April 2004, we 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, we were notified that Imperial Oil had filed a notice with the Court that it has settled nine of the lawsuits involving approximately CDN \$11.8 million in total damages and that the releases to be made by the plaintiffs in connection with those settlements would include us. Since that time consent judgments and dismissals covering us have been entered in eight of the remaining nine lawsuits, which had been requesting approximately CDN \$6.5 million in total damages. In February 2006, the plaintiffs in the last of the lawsuits, seeking approximately CDN \$145,000 in total damages, agreed to discontinue their lawsuit. A dismissal covering us was filed on March 10, 2006, and the case was formally dismissed on that date. Based on the foregoing, all of the original twenty lawsuits have been settled or dismissed and are now closed. We have paid no damages with respect to any of the foregoing settlements or judgments.

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

Letters of Credit and Cash Collateral

Restricted cash includes approximately \$771,000 of customer performance bonds and \$164,000 for letters of credit for leased space. None of these bonds or letters of credit were drawn upon as of September 30, 2006.

Lease Commitments

Due to the acquisition of Blackburn (see Note 4) we incurred additional contractual obligations on leases of office and manufacturing space and machinery and equipment. Total lease commitments resulting from the acquisition total \$7.0 million at September 30, 2006. The facility lease contains a break clause that allows us to cancel the lease without penalty in June 2010.

At September 30, 2006, we had contractual obligations on leases of office and manufacturing space and machinery and equipment as follows:

| | |
|-------------------------------|-----------|
| 2006 (Remaining three months) | \$ 994 |
| 2007 | 3,709 |
| 2008 | 3,630 |
| 2009 | 3,641 |
| 2010 | 3,249 |
| Thereafter | 8,411 |
| Total | \$ 23,634 |

Other

At September 30, 2006, the Company had approximately \$18.6 million of outstanding unconditional purchase commitments, mainly to suppliers of inventories and equipment, primarily related to EDC.

15. Segment Reporting

We have two reportable segments: EDC and Messaging. EDC consists of the CD and DVD manufacturing and distribution operations. Messaging consists of the software development operation, producing network-based messaging and communication systems and software that enable applications including voice messaging, multimedia messaging and other enhanced services. The segments operate in different industries and are managed separately.

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The interim results are not necessarily indicative of estimated results for a full fiscal year. For EDC, the first half of each calendar year is typically the lowest point in the revenue cycle in the entertainment industry. For Messaging, results are variable depending on the capital equipment needs of communication service providers. Additionally, EDC results include four months of operations for the nine months ended September 30, 2005.

| | Three Months Ended September 30, | | | | | |
|---|---|-------------|-------------|-------------|------------------|-------------|
| | Consolidated | | EDC | | Messaging | |
| | 2006 | 2005 | 2006 | 2005 | 2006 | 2005 |
| Revenues | \$97,333 | \$96,913 | \$85,040 | \$75,910 | \$12,293 | \$21,003 |
| Income (loss) from continuing operations before income taxes and extraordinary gain | (1,542) | 2,995 | 1,128 | 1,984 | (2,670) | 1,011 |
| Depreciation & amortization | 5,477 | 5,316 | 5,051 | 4,781 | 426 | 535 |

| | Nine Months Ended September 30, | | | | | |
|---|--|-------------|-------------|-------------|------------------|-------------|
| | Consolidated | | EDC | | Messaging | |
| | 2006 | 2005 | 2006 | 2005 | 2006 | 2005 |
| Revenues | \$273,752 | \$157,589 | \$228,702 | \$95,917 | \$45,050 | \$61,672 |
| Income (loss) from continuing operations before income taxes and extraordinary gain | (11,581) | 2,460 | (5,578) | (2,031) | (6,003) | 4,491 |
| Depreciation & amortization | 16,367 | 7,903 | 14,927 | 6,389 | 1,440 | 1,514 |

16. Stock Compensation Expense

On January 1, 2006, we adopted 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. This pronouncement applies to our incentive stock plan, including stock options and restricted stock units, and our employee stock purchase plan.

We elected the modified prospective method for our transition. Under this method, we recognized compensation cost beginning on January 1, 2006 (a) based on the requirements of SFAS 123R for all share-based payments granted after that date and (b) based on the requirements of SFAS 123 for all awards granted to employees prior to that date that were unvested. No share-based employee compensation cost was recognized in the statement of operations for the year ended December 31, 2005 for options granted because all such options had an exercise price equal to the market value of the underlying common stock on the date of grant. Additionally, no compensation costs were recognized for those periods for the employee stock purchase plan transactions. Compensation expense was recorded for the restricted stock units issued to our directors in the two preceding years because the stock is issued at no cost to the directors.

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As a result of adopting SFAS 123R, our net loss from continuing operations before income taxes and net loss for the nine months ended September 30, 2006 is approximately \$1,032,000 greater than if we had continued to account for share-based compensation under APB 25. Basic and diluted loss per share from continuing operations for the same period are \$0.01 greater than if we had continued to account for share-based compensation under APB 25.

The grant of equity instruments in exchange for services is a non-cash item and, therefore, is reflected as a reconciling item from net income to cash flow from operations, when using the indirect method for presenting the statement of cash flows. Prior to the adoption of SFAS 123R, we presented all tax benefits of deductions resulting from the exercise of stock options as operating cash flows in the statement of cash flows. SFAS 123R requires the cash flows resulting from the tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows. During the nine months ended September 30, 2006, we did not record any excess tax benefits or a corresponding increase to contributed capital because the Company has a net operating loss carry forward, and the tax benefit will not be recognized until the deduction is used to reduce current taxes payable.

We grant stock options and issue new shares under stock incentive plans and an employee stock purchase plan. The following table illustrates the effect on net income and earnings per share if we had applied the fair value recognition provision of SFAS 123R to options granted under the Company's stock option plan in 2005. For purposes of pro forma disclosures, the estimated fair value of the options is estimated using a Black-Scholes-Merton option pricing formula and amortized to expense on a straight-line basis over the options' vesting period. For the three-month and nine-month periods ended September 30, 2005, pro forma option expense was as follows:

| | Three Months Ended September 30, 2005 | Nine Months Ended September 30, 2005 |
|---|--|---|
| Income from continuing operations - as reported | \$ 2,591 | \$ 1,893 |
| Pro forma stock option expense | (401) | (1,186) |
| Income from continuing operations - pro forma | \$ 2,190 | \$ 707 |
| Income from continuing operations per common share - as reported | \$ 0.04 | \$ 0.03 |
| Pro forma stock option expense | (0.01) | (0.02) |
| Income from continuing operations per common share - pro forma | \$ 0.03 | \$ 0.01 |
| Income from continuing operations, assuming dilution per common share - as reported | \$ 0.04 | \$ 0.03 |
| Pro forma stock option expense | (0.01) | (0.02) |
| Income from continuing operations, assuming dilution per common share - pro forma | \$ 0.03 | \$ 0.01 |

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Both SFAS 123 and SFAS 123R require measurement of fair value using an option-pricing model. We use the Black-Scholes-Merton model. All awards granted prior to July 1, 2005 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. Prior to adopting SFAS 123R, we adjusted the pro forma expense for forfeitures only as they occurred. The pro forma expense was allocated to the service period based on the accelerated attribution method, and all the awards have graded service vesting. Under the new standard, we may use a straight-line or accelerated attribution method and elected to use the straight-line method for awards issued after January 1, 2006.

The following table details the compensation expense for options, restricted stock units and the employee stock purchase plan:

| | Three Months Ended | | Nine Months Ended | |
|---|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2006 | 2005 | 2006 | 2005 |
| Employee Stock Purchase Plan | \$ 28 | \$ | \$ 88 | \$ |
| Stock options | 258 | | 907 | |
| Subtotal of expense subsequent to the adoption of FAS123R | 286 | | 995 | |
| Restricted Stock Units | 31 | 15 | 37 | 42 |
| Total stock compensation expense | \$ 317 | \$ 15 | \$ 1,032 | \$ 42 |

No stock compensation expense was capitalized as part of the cost of any asset during the nine months ended September 30, 2006 and 2005.

(a) Incentive Stock Plans

We maintain an incentive stock plan (the 1996 Plan) that is used to promote the long-term financial interests and growth of the Company. The 1996 Plan, as amended, authorizes up to 14,850,000 shares of the Company's common stock for issuance in connection with the grant of stock options, stock appreciation rights, restricted stock and performance shares. Participation under the 1996 Plan is limited to non-officer directors, key employees and other key persons. Options are generally granted with an exercise price equal to the market price of the Company's stock at the date of grant, generally vest based on three years of continuous service and have 10-year contractual terms. Generally, one-third of the options granted vest on each of the first, second and third anniversaries of the grant.

The 1996 Plan also provides for the grant of restricted stock units (RSU's) to non-officer directors on an annual basis. RSU's are intended to align the interest of directors and stockholders in enhancing the value of the Company's common stock and to encourage such directors to remain with and to devote their best efforts to the Company. Beginning in January 2006, each non-officer director receives a number of RSU's equal to \$18,000 divided by the fair market value of the common stock on the last trading day immediately preceding each Annual Meeting. Prior to January 2006, non-officer directors received annual grants of RSU's with a value of \$9,000. One-third of the RSU's vest immediately and the remainder vest on each of the first and second anniversaries of the grant.

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Activity and price information regarding the Company's incentive stock plan are summarized as follows:

| Options | Shares (In 000 s) | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value |
|--|------------------------------|--|--|--|
| Outstanding, December 31, 2005 | 6,067 | \$ 3.28 | | |
| Granted | 330 | 3.70 | | |
| Exercised | (875) | 1.38 | | |
| Forfeited | (284) | 2.71 | | |
| Expired | (89) | 18.87 | | |
| | | | 6.4 | |
| Outstanding, September 30, 2006 | 5,149 | \$ 3.43 | years | \$1,396 |
| Vested or expected to vest at September 30, 2006 | 5,050 | \$ 3.43 | | \$1,394 |
| | | | 5.6 | |
| Exercisable at September 30, 2006 | 3,743 | \$ 3.61 | years | \$1,357 |

The weighted average grant-date fair value of options granted during the nine months ended September 30, 2006 was \$1.85 per share. The total intrinsic value of options exercised during the nine months ended September 30, 2006 was \$2.4 million.

A summary of the status of the Company's RSU's (nonvested shares) as of September 30, 2006 and changes during the nine months ended September 30, 2006 is presented below:

| Nonvested Shares | Shares (000 s) | Weighted-Average Grant-Date Fair Value |
|---------------------------------|---------------------------|---|
| Nonvested at December 31, 2005 | 66 | \$ 1.99 |
| Granted | 50 | 3.05 |
| Vested | (39) | 1.64 |
| Forfeited | | |
| Nonvested at September 30, 2006 | 77 | 2.87 |

As of September 30, 2006, there was \$1.3 million of total unrecognized compensation cost related to all share-based compensation arrangements granted under the 1996 Plan. That cost is expected to be recognized over a weighted-average period of approximately one year. The total fair value of RSU's vested during the nine months ended September 30, 2006 was approximately \$120,000.

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Prior to adopting SFAS 123R on January 1, 2006, we followed APB 25 and related interpretations in accounting for employee stock options. Under APB 25, because the exercise price of our stock options equaled the market price of the underlying stock on the date of grant, no compensation expense was recognized. The weighted average fair value of stock options, calculated using the Black-Scholes-Merton option-pricing model, granted during the year ended December 31, 2005 was \$1.42 per option. The fair value for these options was estimated at the date of grant using the Black-Scholes-Merton option-pricing model with the following assumptions:

| | |
|-------------------------|--------------|
| | 2005 |
| Expected Life in Years | 1 to 4 |
| Risk Free Interest Rate | 4.4 to 4.5 % |
| Volatility | 0.64 |
| Dividend Yield | |

The fair value for each option granted in the nine months ended September 30, 2006 is estimated on the date of grant using the Black-Scholes-Merton option-pricing model using the following assumptions:

| | |
|-------------------------|-------------|
| | 2006 |
| Expected Life in Years | 3.53 |
| Risk Free Interest Rate | 4.35% |
| Volatility | 0.65 |
| Dividend Yield | |

The expected life in years was based on the weighted average of historical grants assuming that outstanding options are exercised at the midpoint of the future remaining term, adjusted for current demographics. The risk free interest rate was the U.S. Treasury five-year spot rate for January 2006. Volatility was determined by using (i) the long-term volatility (mean reversion), (ii) the midpoint of historical rolling 3.53 year volatilities, (iii) the volatility of the most recent 3.53 year time period, (iv) the volatility of the most recent one-year period, (v) the implied volatility as seen in the open market place on January 3, 2006 (beginning of quarter), (vi) the range (min/max) of the implied volatility in the last 52 weeks, and (vii) the Company's selection for volatility in the prior reporting year. We have not paid cash dividends since 1982 and do not anticipate paying cash dividends in the foreseeable future.

(b) Employee Stock Purchase Plan

We use our Employee Stock Purchase Plan (the "ESP Plan") to give employees an opportunity to purchase our common stock through payroll deductions, thereby encouraging employees to share in our economic growth and success. All regular full-time employees are eligible to enter the ESP Plan as of the first day of each six-month period beginning every February 1 and August 1. The calculation of the price for common stock is 85% of the lower of the closing price on the first day of the period (i.e. February 1 or August 1), or the last day of the period (i.e. July 31 or January 31). For the August 1, 2005 to January 31, 2006 period, the discounted stock purchase price was \$3.315. For the February 1, 2006 to July 31, 2006 period, the discounted stock purchase price was \$2.20. For the August 1, 2006 to January 31, 2007 period, the discounted stock price will be the lower of \$2.24 or 85% of the closing market price of the common stock on January 31, 2007.

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17. Subsequent Event

During the third quarter of 2006 we announced that we had retained Jefferies Broadview to assist us with strategic initiatives for our Messaging business. In connection with this, subsequent to September 30, 2006 we entered into advanced discussions with several parties. There can be no assurance that we will be able to consummate a transaction involving the Messaging business on terms favorable to the Company or at all.

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

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

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 in Part II, Item 1A Risk Factors of our quarterly report on Form 10-Q for the fiscal quarter ended March 31, 2006 and Part I, Item 1A Risk Factors of our annual report on Form 10-K for the fiscal year ended December 31, 2005 which factors are specifically incorporated herein by this reference. All forward-looking statements included in this quarterly report on Form 10-Q are based on information available to us on the date hereof. We assume no obligation to update any forward-looking statements and do not intend to do so.

Overview

The nine months ended September 30, 2005 included four months of operations for EDC following the Universal acquisition on May 31, 2005, whereas such operations are included for the full nine months ended September 30, 2006. The three and nine months ended September 30, 2006 included 71 days of results for the Blackburn, U.K. manufacturing operations that were acquired on July 21, 2006. A comparison to EDC's results for such periods may not be indicative of future results.

EDC:

On May 31, 2005, EDC acquired the CD and DVD manufacturing and distribution operations in the United States and central Europe from Universal Music Group ("Universal"). The acquisition was a strategic opportunity for us to become an industry leader in providing pre-recorded products and distribution services to the entertainment industry. As part of the transaction, we entered into 10-year supply agreements with Universal under which we became the exclusive manufacturer and distributor for approximately 80% of Universal's CD and DVD manufacturing requirements and 100% of Universal's distribution requirements for the United States and central Europe. Under these contracts, we have the opportunity to assume responsibility for fulfilling the remaining portion of Universal's requirements in the United States and central Europe that was outsourced as Universal's existing commitments to third party suppliers expire. Approximately 75% of these outsourced volumes have reverted to us as of September 30, 2006, and the remaining 25% is expected to revert to us in 2008.

EDC acquired a CD manufacturing operation in Blackburn, U.K. ("Blackburn") on July 21, 2006. Blackburn is the largest DC replicator in the U.K. Its customer base includes Universal Music Group, its largest customer, as well as Demon Music Group, Sanctuary Records Group and Warner Music Group. As part of EDC's international supply agreement with Universal, Blackburn's Universal volumes were scheduled to revert to EDC in 2007.

EDC's revenues for the nine months ended September 30, 2006 were \$228.7 million compared to \$212.0 million for the nine months ended September 30, 2005 on a pro forma basis assuming the consummation of the EDC acquisition (but excluding the Blackburn acquisition) at the beginning of such period, representing an increase of approximately 7.9%.

In June 2006, our newly installed DVD lines in the U.S. went into full production, providing us with enough capacity to handle all of Universal's current reversionary U.S. DVD business. We continue to add additional customers and manage our costs across our operations. A strong release schedule is anticipated in the peak fourth quarter season, and we expect EDC's cash flow from operations, including Blackburn, will grow 10% compared to 2005 on a pro forma basis.

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Messaging:

Messaging provides communications service providers with a complete messaging solution, consisting of hardware, software, and services that enable a range of related applications that provide significant value in both wireless, wireline and cable networks. Applications available in the product group include voice mail, fax mail, video solutions, short message service, multimedia message service, missed-call notification, and others. Messaging's services relate primarily to the installation and maintenance of our products.

Messaging's revenues for the nine months ended September 30, 2006 were \$45.1 million compared to \$61.7 million for the nine months ended September 30, 2005, representing a 27% decrease. Approximately \$11.6 million, or 70% of the decrease related to domestic sales. Sales to one of our domestic customers, Sprint-Nextel, declined by 73% to approximately \$2.9 million during the nine months ended September 30, 2006 compared to the nine months ended September 30, 2005. During the second quarter of 2006, we were notified by Sprint-Nextel that we would no longer be included in their voicemail vendor selection process. International revenues for the nine months ended September 30, 2006 declined approximately \$5.0 million compared to the nine months ended September 30, 2005. Revenue for the first nine months of 2005 included a significant sale to MTN, a new international customer in 2005. As a result of the continued softness in the domestic market and timing delays in the closing of international business, we implemented a realignment plan in the third quarter to right-size the business while continuing to serve existing clients and secure new business opportunities. This reorganization, which resulted in one-time costs of approximately \$1.3 million in the third quarter of 2006, is expected to generate approximately \$8.0 million of operating cost savings on an annual basis. As a result, we believe Messaging will generate positive cash flow from operations at the new cost level with revenues that exceed the \$12 to \$13 million range. We currently expect forth quarter revenue to fall in a range between our new breakeven level of 25% higher than breakeven. As previously announced, we have retained Jefferies Broadview to assist us with our strategic initiatives for our Messaging business. In connection with these strategic initiatives, we are currently evaluating potential opportunities for the Messaging business and are in advanced discussions with several interested parties. There can be no assurance that we will be able to consummate a transaction for the Messaging business on terms favorable to the Company or at all.

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The following table and discussion present the material changes in the consolidated results of operations of the Company for the periods indicated:

| | Three Months Ended September | | | Nine Months Ended September 30, | | |
|---|------------------------------|-------------|------------|---------------------------------|------------|-------------|
| | 2006 | 30, 2005 | Change | 2006 | 2005 | Change |
| REVENUES | | | | | | |
| EDC Product | \$ 65,913 | \$ 54,504 | \$ 11,409 | \$ 170,567 | \$ 68,692 | \$ 101,875 |
| EDC Services | 19,127 | 21,406 | (2,279) | 58,135 | 27,225 | 30,910 |
| EDC Total | 85,040 | 75,910 | 9,130 | 228,702 | 95,917 | 132,785 |
| Messaging Product | 7,499 | 13,216 | (5,717) | 29,234 | 43,115 | (13,881) |
| Messaging Services | 4,794 | 7,787 | (2,993) | 15,816 | 18,557 | (2,741) |
| Messaging Total | 12,293 | 21,003 | (8,710) | 45,050 | 61,672 | (16,622) |
| Consolidated | \$ 97,333 | \$ 96,913 | \$ 420 | \$ 273,752 | \$ 157,589 | \$ 116,163 |
| GROSS MARGIN | | | | | | |
| EDC Product | \$ 10,813 | \$ 8,794 | \$ 2,019 | \$ 25,572 | \$ 10,152 | \$ 15,420 |
| EDC Services | 4,605 | 5,368 | (763) | 13,420 | 6,739 | 6,681 |
| EDC Total | 15,418 | 14,162 | 1,256 | 38,992 | 16,891 | 22,101 |
| Messaging Product | 4,173 | 7,077 | (2,904) | 16,663 | 25,984 | (9,321) |
| Messaging Services | 2,062 | 4,355 | (2,293) | 7,072 | 9,249 | (2,177) |
| Messaging Total | 6,235 | 11,432 | (5,197) | 23,735 | 35,233 | (11,498) |
| Consolidated | \$ 21,653 | \$ 25,594 | \$ (3,941) | \$ 62,727 | \$ 52,124 | \$ 10,603 |
| OPERATING INCOME (LOSS) | | | | | | |
| EDC | \$ 1,745 | \$ 3,216 | \$ (1,471) | \$ (1,367) | \$ 696 | \$ (2,063) |
| Messaging | (3,228) | 560 | (3,788) | (7,830) | 2,962 | (10,792) |
| Consolidated | \$ (1,483) | \$ 3,776 | \$ (5,259) | \$ (9,197) | \$ 3,658 | \$ (12,855) |
| INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE INCOME TAXES, DISCONTINUED OPERATIONS AND EXTRAORDINARY ITEM | | | | | | |
| EDC | \$ 1,128 | \$ 1,984 | \$ (856) | \$ (5,578) | \$ (2,031) | \$ (3,547) |
| Messaging | (2,670) | 1,011 | (3,681) | (6,003) | 4,491 | (10,494) |

| | | | | | | |
|---|------------|----------|------------|-------------|------------|-------------|
| Consolidated | \$ (1,542) | \$ 2,995 | \$ (4,537) | \$ (11,581) | \$ 2,460 | \$ (14,041) |
| INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE DISCONTINUED OPERATIONS AND EXTRAORDINARY ITEM | | | | | | |
| EDC | \$ (265) | \$ 1,671 | \$ (1,936) | \$ (7,712) | \$ (2,344) | \$ (5,368) |
| Messaging | (2,711) | 920 | (3,631) | (6,380) | 4,237 | (10,617) |
| Consolidated | \$ (2,976) | \$ 2,591 | \$ (5,567) | \$ (14,092) | \$ 1,893 | \$ (15,985) |
| EXTRAORDINARY GAIN | | | | | | |
| EDC | \$ 6,920 | \$ | \$ 6,920 | \$ 6,920 | \$ | \$ 6,920 |
| Messaging | | | | | | |
| Consolidated | \$ 6,920 | \$ | \$ 6,920 | \$ 6,920 | \$ | \$ 6,920 |

Three Months ended September 30, 2006 and 2005

On a consolidated basis, the increase in revenues was primarily due to a 12% increase in EDC's revenue resulting from the acquisition of Blackburn, offset in part by a decrease in Messaging revenue that was primarily caused by decreased product revenue from reduced sales volume due to softness in the domestic markets and timing delays in closing international business. Declining gross margin dollars were primarily due to a \$5.2 million reduction of Messaging's gross margin resulting from reduced sales volume offset by EDC's \$1.3 million increase resulting primarily from the acquisition of Blackburn. Operating income declined primarily due to increased operating expenses from EDC and decreased gross margins from Messaging.

Table of Contents**EDC**

Revenues. The increase in EDC's product sales revenues for the third quarter of 2006 as compared to the third quarter of 2005 was due primarily to revenue generated from the Blackburn operations, that were acquired in July 2006, and to higher central European pricing as a result of an adjustment to the fixed pricing during the second quarter of 2006 offset by reduced costs that are passed through to Universal. The decrease in distribution services revenues for the third quarter of 2006 compared to 2005 was due to lower sales volumes as the industry experienced a soft quarter for new releases. The newly acquired Blackburn operation does not offer distribution services. International revenues comprised 62% of total EDC revenue for the third quarter of 2006 compared to 49% for the same quarter in the prior year. The increase was due primarily to the newly acquired Blackburn operations. Universal individually accounted for approximately 72% and 92% of EDC's revenue for the third quarter of 2006 and 2005, respectively. The second half of each calendar year is typically the highest point in the revenue cycle in this segment of the entertainment industry. We expect revenue growth in the remainder of 2006 to be driven by Universal's forecasted new release schedule, by volume from new customers, and by the newly acquired Blackburn operations.

Gross Margins on Product Sales and Services. Gross margin for the third quarter of 2006 on EDC product revenues was \$10.8 million, or 16% of product revenues compared to \$8.8 million or 16% of revenues for the third quarter of 2005. The margin benefit as a result of the increased pricing described above was offset by lower product margins in Blackburn due to product mix. Gross margin for the third quarter of 2006 on EDC distribution services revenues was \$4.6 million or 24% of service revenues compared to \$5.4 million or 25% of services revenue for the same quarter in the prior year. The decrease was due to lower volumes. EDC's gross margins are impacted by the seasonality of the music business, with lower margins in the first half of the year, and higher margins during the second half of the year due to leverage on fixed costs during the peak season. The 2006 peak season is backend weighted compared to prior years due to the timing of new releases.

Operating Income. Operating income decreased due to increased selling, general and administrative expense including costs related to the establishment of a sales and customer service function to solicit and support new third party business, costs associated with EDC's implementation of internal controls over financial reporting and preparation for the assessment required by Section 404 of the Sarbanes Oxley Act of 2002, reorganization costs, and consulting fees related to transitioning EDC from a divisional manufacturing and distribution operation to an entrepreneurial organization. Operating income includes the amortization of the intangible assets (primarily 10-year manufacturing and distribution services agreements that EDC entered into with Universal as part of the EDC acquisition, and agreements with various central European customers). During the third quarter of 2006 and 2005 we recorded \$517,000 and \$139,000, respectively, of compensation expense relating to the award of profits interests to EDC management.

Income from Continuing Operations before Income Taxes and Extraordinary Item. Income from continuing operations before income taxes and extraordinary item for the third quarter of 2006 and 2005 was reduced by interest expense offset by interest income and unrealized gain on the currency rate swap. EDC interest expense in the third quarter of 2006 and 2005, respectively, included approximately \$0.9 million and \$0.7 million of interest expense related to the term loan with Wachovia Bank and approximately \$0.5 million and \$0.6 million of imputed interest related to the deferred acquisition payments due to Universal. A gain on currency swap of \$318,000 was recorded as a result of changes in forward-looking Euro rate and interest rates at September 30, 2006. Additionally we recorded a \$227,000 and (\$93,000) transaction gain (loss) related primarily to the translation of an inter-company loan with our German subsidiary for the third quarter of 2006 and 2005, respectively. The remaining amounts relate to capital lease implied interest and amortization of debt issue costs.

Income from Continuing Operations. Income from continuing operations for the third quarter of 2006 included income tax expense related to the international operations, principally in Germany and the United Kingdom. EDC's income earned in the U.S. is not subject to income tax due to the utilization of significant tax loss carryforwards.

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Extraordinary Gain. EDC recorded an extraordinary gain of \$6.9 million in the third quarter of 2006 as a result of acquiring net assets in Blackburn with fair values in excess of the purchase price.

Messaging

Revenues. Messaging revenues decreased 41% in the third quarter of 2006 as compared to the third quarter of 2005 due to reduced domestic and international sales volume. Revenues from our domestic customers decreased 53% to \$6.4 million in the third quarter of 2006 as compared to \$13.5 million in the third quarter of 2005. International revenues decreased 21% to \$5.9 million in the third quarter of 2006 as compared to \$7.5 million in the third quarter of 2005. During the third quarter of 2006, two customers individually accounted for approximately 22% and 11% of total revenue from continuing operations. During the third quarter of 2005, five customers individually accounted for 15%, 13%, 12%, 10% and 10% of total revenue from continuing operations.

Gross Margins on Product Sales and Services. The 45% decrease in gross margin dollars of \$5.2 million for the third quarter of 2006 compared to the third quarter of 2005 was due primarily to reduced volume of sales. Gross margin on products sold (product margin) was 56% and 54% for the third quarter of 2006 and 2005, respectively. The gross margin percentage for services (service margin) in the third quarter of 2006 and 2005 was 43% and 56%, respectively. Gross margins for services were primarily impacted by a 38% reduction in revenue while costs were reduced by approximately 20%.

Operating Income (Loss). The operating loss for the third quarter of 2006 was primarily a result of decreased gross margin dollars compared to operating income for 2005. During the third quarter of 2006 we reorganized our operations as a response to reduced domestic sales while maintaining adequate resources to serve growing international opportunities. This reorganization resulted in one-time costs of approximately \$1.3 million in the third quarter of 2006. We expect to generate approximately \$8.0 million of operating cost savings on an annual basis from the reorganization.

Income (Loss) from Continuing Operations before Tax. Income (loss) from continuing operations before tax for the third quarter of 2006 was impacted by the decrease in gross margin and changes in operating expenses discussed above.

Income (Loss) from Continuing Operations. Income (loss) from continuing operations for the third quarter of 2006 was impacted by the changes discussed above and by provisions for income taxes that relate to international operations. Although the segment's U.S. operations were profitable in 2005, no income tax provision was recorded due to net operating loss carryforwards (NOLs) available in the U.S. that we used to offset taxes payable for such period.

Discontinued Operations. Income from discontinued operations for the third quarter of 2006 included \$4.1 million from the release of a reserve for international business taxes as we received clearance for the potential tax liability from the applicable foreign country's taxing authority during the third quarter of 2006.

Nine Months ended September 30, 2006 and 2005

On a consolidated basis, the 74% increase in revenues is primarily due to 2005 revenues from EDC including four months of EDC operations. The 27% decrease in Messaging revenue was primarily due to decreased domestic and international revenue from reduced volume of system sales. The improvement in consolidated gross margin was primarily due to the inclusion of nine months of EDC operations for 2006 compared to four months of operations last year offset by Messaging's decline which resulted primarily from a change in the mix of products sold, with a higher volume of lower margin products. Operating income declined primarily due to the loss from the Messaging business.

Table of Contents**EDC**

Revenues. EDC's product sales revenues for the nine months ended September 30, 2006 were \$170.6 million, and distribution services revenues were \$58.1 million. International revenues comprised 55% and 48% of total EDC revenue for 2006 and 2005, respectively. Universal individually accounted for approximately 81% and 93% of EDC's revenue for 2006 and 2005, respectively. The second half of each calendar year is typically the highest point in the revenue cycle in this segment of the entertainment industry. We expect revenue growth in the remainder of 2006 to be driven by Universal's forecasted new release schedule, by volume from new customers and by the newly acquired Blackburn operations.

Gross Margins on Product Sales and Services. Gross margin for the nine months ended September 30, 2006 on EDC product revenues was \$25.6 million or 15% of product revenues and on EDC distribution services revenues was \$13.4 million or 23% of service revenues. Gross margin for the four months ended September 30, 2005 was 15% of product revenue and 25% on service revenue. EDC's gross margins are impacted by the seasonality of the music business, with lower margins in the first half of the year, and higher margins during the second half of the year due to leverage on fixed costs during the peak season.

Operating Income (Loss). EDC's operating loss for the nine months ended September 30, 2006 compared to operating income for the four months ended September 30, 2005 was impacted by increased selling, general and administration expenses. Increased expenses included costs related to the establishment of a sales and customer service function to solicit and support new third party business, costs associated with EDC's implementation of internal controls over financial reporting and preparation for the assessment required by Section 404 of the Sarbanes Oxley Act of 2002, non-recurring recruiting, relocation, and transition costs related to the restructuring of the operations in the U.S., and acquisition activities expenditures. Operating loss also included amortization of the intangible assets (10-year manufacturing and distribution services agreements that EDC entered into with Universal as part of the EDC acquisition, and agreements with various central European customers). For the nine months ended September 30, 2006 and the four months ended September 30, 2005, we recorded \$1.3 million and \$950,000, respectively, of compensation expense relating to the award of profits interests to EDC management. Operating income for the four months ended September 30, 2005 included approximately \$800,000 of acquisition related charges.

Loss from Continuing Operations before Income Taxes and Extraordinary Item. Loss from continuing operations before income taxes and extraordinary item for the nine months and four months ended September 30, 2006 and 2005, respectively, includes interest expense of approximately \$2.4 million and \$0.9 million related to the term loan with Wachovia Bank and approximately \$1.6 million and \$0.9 million of imputed interest related to the deferred acquisition payments due to Universal. A gain (loss) on currency swap of (\$2.1) million and \$0.4 million was recorded as a result of changes in the forward-looking Euro rate and interest rates at September 30, 2006 and 2005, respectively. A transaction gain (loss) of \$1.3 million and \$(1.4) million related primarily to the translation of an inter-company loan with our German subsidiary was recorded for the nine months and four months ended September 30, 2006 and 2005, respectively. The remaining amounts relate primarily to capital lease implied interest and amortization of debt issue costs.

Loss from Continuing Operations. Loss from continuing operations for the nine and four months ended September 30, 2006 and 2005 included income tax expense related to the international operations, principally in Germany and the United Kingdom. EDC's income earned in the U.S. is not subject to income tax due to the utilization of significant tax loss carryforwards.

Extraordinary Gain. EDC recorded an extraordinary gain of \$6.9 million in the third quarter of 2006 as a result of acquiring net assets in Blackburn with fair values in excess of the purchase price.

Table of Contents**Messaging**

Revenues. Messaging revenues decreased 27% in the nine months ended September 30, 2006 compared to the nine months ended September 30, 2005 due to reduced volume of product sales and a decline in service revenue. Revenues from our domestic customers decreased 28% to \$30.2 million in the first nine months of 2006 as compared to \$41.8 million in the first nine months of 2005. International revenues decreased 25% to \$14.9 million in the first nine months of 2006 as compared to \$19.8 million in the first nine months of 2005, and accounted for 33% and 32% of total net sales in those periods, respectively. During the nine months ended September 30, 2006, three customers individually accounted for approximately 14%, 12%, and 11% of total revenue from continuing operations. During the nine months ended September 30, 2005, four customers individually accounted for 17%, 16%, 15% and 13% of total revenue from continuing operations.

Gross Margins on Product Sales and Services. The 33% decrease in gross margin dollars for the first nine months of 2006 compared to 2005 was due primarily to reduced sales volume. Additionally, a change in the mix of products sold negatively impacted gross margin. Gross margin on products sold (product margin) was 57% for the first nine months of 2006 compared to 60% for the same period last year. The lower margin in the first nine months of 2006 was offset by revenue of \$1.4 million recognized in the first quarter related to undelivered elements of a multi element contract that had been deferred during 2004 and 2005. During the first nine months of 2006, the customer provided confirmation that no additional elements were required, and we were able to recognize this remaining revenue with no associated cost. The gross margin percentage for services (service margin) was 45% and 50% in the first nine months of 2006 and 2005, respectively. Gross margins for services were primarily impacted by a 15% reduction in revenue while costs were reduced by approximately 6%.

Operating Income (Loss). The operating income (loss) for the first nine months of 2006 and 2005 was primarily a result of changes in gross margin dollars. During the third quarter of 2006 we reorganized our operations as a response to reduced domestic sales while maintaining adequate resources to serve growing international opportunities. This reorganization resulted in one-time costs of approximately \$1.3 million in the third quarter of 2006. We expected to generate approximately \$8.0 million of operating cost savings on an annual basis from the reorganization.

Income (Loss) from Continuing Operations before Tax. Income (loss) from continuing operations before tax for the first nine months of 2006 was impacted by the changes in gross margin and operating expenses discussed above.

Income (Loss) from Continuing Operations. Income (loss) from continuing operations for the first nine months of 2006 was impacted by the changes discussed above and by provisions for income taxes that relate to international operations. Although the segment's U.S. operations were profitable in 2005, no income tax provision was recorded due to tax loss carryforwards available in the U.S. that we used to offset taxes payable in such period.

Discontinued Operations. Income from discontinued operations for the first nine months of 2006 included \$4.1 million from the release of a reserve for international business taxes as we received clearance for the potential tax liability from the applicable foreign country's taxing authority during the third quarter of 2006.

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Financial Condition and Liquidity

Overview. At September 30, 2006, we had cash, cash equivalents and restricted cash totaling \$88.7 million. Restricted cash of \$24.5 million at September 30, 2006 consisted primarily of balances held in escrow to fund EDC pension and other debt obligations. Our principal source of liquidity was our \$64.2 million cash and cash equivalents balances. Our cash generally consists of money market demand deposits and our 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.

EDC has a senior credit facility with Wachovia Bank consisting of a five-year term loan with an outstanding balance of \$41.5 million and a \$10.0 million revolving line of credit. At September 30, 2006, no drawings were made against the \$10.0 million line of credit that is available as a source of liquidity, if required. Collateral previously pledged to secure this bank debt in the amount of \$16.5 million was released on June 21, 2006.

On July 21, 2006 we acquired the shares of Deluxe Global Media Services Blackburn Limited for a purchase price of approximately \$5.6 million in cash, including expenses. See detailed information in Note 4 to the Condensed Consolidated Financial Statements.

We expect to use cash and cash equivalents for working capital, investments in capital equipment, and other general corporate purposes, including the expansion and development of our existing products and markets, as well as to fund potential acquisitions.

Operating Activities. Cash used in operating activities was primarily due to changes in operating assets and liabilities offset and cash provided by earnings (net loss adjusted for non-cash items). Significant operating asset and liability activities are described below:

Cash provided by operating activities as of September 30, 2006 included:

- o Cash received from Universal related to the long-term receivable established as part of the EDC acquisition, and
- o Payment of pension and employee savings plan maturities with restricted cash set aside for that purpose.

Cash used in operating activities as of September 30, 2006 included:

- o Increased accounts receivable balances primarily due to increased EDC sales volume due to seasonal production volume, partially offset by Messaging collections and reduced sales volume,
- o Repayment of an advance from Universal for purchase of printed materials,
- o Decreased Messaging deferred revenue resulting from the completion of delivery and installation of prior year invoiced transactions,
- o Payment of the 2005 incentive bonuses, partially offset by an increase in accrued severance costs for messaging employees, and
- o An increase in accrued royalties due to increased production levels for EDC.

Investing Activities. During June 2006, \$16.5 million of restricted cash was released under a long-term borrowing agreement.

The Company used \$5.6 million to fund the Blackburn acquisition during the third quarter of 2006.

During the nine months ended September 30, 2006, we spent \$11.9 million on equipment primarily for EDC's operations. Additionally, a manufacturing printer utilized by EDC was purchased under a capital lease for approximately \$1.1 million. We anticipate that property, plant and equipment purchases related

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to our continuing operations for the remainder of 2006 will approximate \$3.9 million, of which \$3.6 million relates to EDC and \$0.3 million relates to Messaging.

Financing Activities. During the nine months ended September 30, 2006, we paid to Universal \$8.1 million of the deferred purchase price related to the acquisition of EDC. We also remitted payment of pension and employee savings plan maturities using restricted cash set aside for that purpose.

During the nine months ended September 30, 2006, the Company repaid \$1.2 million of employee loans under EDC's German operations government regulated employee savings plan. Proceeds from new loans under the plan were \$469,000.

During July 2006, James Caparro, the president and chief executive officer of EDC, contributed \$99,000 to EDC to partially fund the Blackburn acquisition.

We received approximately \$1.5 million in connection with common stock purchases under the Company's Employee Stock Purchase Plan and as a result of the exercise of options.

Income Tax Matters. Our recent cash outlays for income taxes have been limited primarily to foreign income taxes. At December 31, 2005, of the \$276.9 million realized U.S. NOLs, \$243.5 million will begin to expire in 2019. The remaining \$33.4 million of U.S. NOLs were related to the 1997 acquisitions of Open Development Corporation and Wireless Access, Inc., which start expiring in 2006. However, our ability to offset future income with these acquired NOLs is subject to restriction in the United States Internal Revenue Code of 1986, as amended.

These NOLs begin to expire during 2006 as noted in the table below.

| | Expiration of NOLS (In millions) | | | |
|--------------|---|-------------------|----------------|-----------------|
| | Unrestricted | Restricted | INT L* | TOTAL |
| | U.S | U.S | | |
| 2006 | \$ | \$ 0.2 | \$ | \$ 0.2 |
| 2007 | | 1.8 | | 1.8 |
| 2008 | | 3.3 | | 3.3 |
| 2009 | | 3.8 | 3.7 | 7.5 |
| 2010 | | 5.9 | 41.4 | 47.3 |
| 2011 | | 9.0 | | 9.0 |
| 2012 | | 9.4 | | 9.4 |
| 2019 | 44.3 | | | 44.3 |
| 2020 | 50.6 | | | 50.6 |
| 2021 | 65.0 | | | 65.0 |
| 2022 | 13.4 | | | 13.4 |
| 2023 | 20.7 | | | 20.7 |
| 2024 | 48.4 | | | 48.4 |
| 2025 | 1.1 | | | 1.1 |
| TOTAL | \$ 243.5 | \$ 33.4 | \$ 45.1 | \$ 322.0 |

* International NOLs are primarily related to Canada.

Income taxes payable includes \$4.5 million at September 30, 2006 for probable and estimable exposure for tax filing positions in various jurisdictions. At September 30, 2006 this amount included \$4.0 million of transfer pricing exposure in various foreign jurisdictions related to discontinued operations.

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An unrecorded tax loss contingency arose in 2005 related to overhead costs incurred in the U.S. that were allocated to certain foreign subsidiaries. It is possible if such subsidiaries were subjected to an audit, that the tax authorities in these foreign jurisdictions will object to the charges. If we are unsuccessful in defending our position, tax expense could increase by as much as \$1.0 million over the amounts currently accrued. We believe that the chance of disallowance is more than remote, but less than likely.

Summary. We believe that our current cash reserves together with our 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 discontinued operations and (ii) make potential acquisitions and strategic investments.

Critical Accounting Policies and Estimates

Our discussion and analysis of financial condition and results of operations are based upon our 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 us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. We base our 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.

In Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2005, we discussed the critical accounting policies that affect the more significant judgments and estimates used in the preparation of the Company's consolidated financial statements. Other than the adoption of SFAS 123R, we believe that there have been no significant changes to such critical accounting policies and estimates during the nine months ended September 30, 2006.

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 over the service period for awards expected to vest. The estimation of stock awards that will ultimately vest requires judgment, and to the extent actual results or updated estimates differ from our current estimates, such amounts will be recorded as a cumulative adjustment in the period estimates are revised. We consider many factors when estimating awards expected to vest including type of awards, employee class, and our historical experience. Actual results, and future changes in estimates, may differ substantially from our current estimates.

We use the Black-Scholes-Merton valuation model to determine the fair value of our stock options. Significant judgment is required in determining the inputs to the model including the expected volatility, the expected life, and the risk free interest rate. Changes in the input assumptions, can materially affect the fair value estimate of our stock options.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are subject to market risk arising from adverse changes in interest rates, foreign exchange and stock market volatility. We do not enter into financial investments for speculation or trading purposes. We are not a party to any financial or commodity derivatives except for a cross-currency rate swap. Our exposure to market risk was discussed in the *Quantitative and Qualitative Disclosures About Market Risk* section of our Annual Report on Form 10-K for the year ended December 31, 2005. There have been no material changes to such exposure during the first nine months of 2006.

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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. Based on that evaluation, due to the existence of the material weakness in the Company's internal control over financial reporting discussed below, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were not effective as of September 30, 2006. The Company's Chief Executive Officer and Chief Financial Officer have certified that, to their knowledge, the Company's consolidated financial statements included in this quarterly report on Form 10-Q fairly present in all material respects the financial condition, results of operations and cash flows of the Company for the periods presented.

As discussed in Item 9A of the Company's 2005 annual report on Form 10-K, in assessing the Company's internal control over financial reporting as of December 31, 2005, management determined that the Company did not have effective internal control over financial reporting as of December 31, 2005. The Company concluded that its internal controls were ineffective as a result of an identified material weakness in internal controls over revenue recognition for Messaging. The internal control weakness primarily related to insufficient staffing resources with the knowledge, experience and training in the application of generally accepted accounting principles, as applied to revenue recognition for multi-element contracts, and was attributed primarily to staff turnover and changes in responsibilities.

As discussed below and disclosed in the Company's 2005 Annual Report, the Company has initiated certain corrective actions to remediate this material weakness and continued such efforts during the quarter ended September 30, 2006.

As previously disclosed, during the fourth quarter of 2005 and the first two quarters of 2006, the Company hired personnel trained and experienced in the complex accounting areas of revenue recognition and revenue accounting including a divisional controller and a director of financial analysis, made additional training in this complex area mandatory for finance and other key personnel by having members of financial management attend outside revenue recognition training and by hosting internal revenue recognition training for members of financial and nonfinancial departments and enhanced the Company's revenue recognition policies, procedures and controls. In addition, formal monthly review meetings were established where all revenue arrangements proposed for recognition in that time period were discussed in detail.

During the quarter ended September 30, 2006 there were no changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

In accordance with guidance promulgated by the Office of the Chief Accountant of the Division of Corporate Finance of the Securities and Exchange Commission on June 24, 2004, the Company has excluded EDC from its assessment of changes in internal controls at December 31, 2005, the operations of which consist entirely of the CD and DVD manufacturing and distribution operations acquired from Universal Music Group on May 31, 2005.

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PART II OTHER INFORMATION

ITEM 1A, 2, 3, 4 and 5 are inapplicable and have been omitted.

ITEM 1. LEGAL PROCEEDINGS

See Note 14 to the unaudited condensed consolidated financial statements in Part I, Item 1, which discusses material pending legal proceedings to which the Company is party and is incorporated herein by reference.

ITEM 6. EXHIBITS

The exhibits required to be filed as a part of this quarterly report on Form 10-Q are listed in the accompanying Exhibit Index which is 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
Executive Vice President and Chief
Financial Officer (Principal Financial
Officer)
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Date: November 8, 2006

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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. |