GLENAYRE TECHNOLOGIES INC
Form 10-Q
August 09, 2006

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

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

For the quarterly period ended June 30, 2006

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

For the transition period from __________ to __________

Commission File Number 0-15761
GLENAYRE TECHNOLOGIES, INC.
(Exact Name of Registrant as Specified in Its Charter)

DELAWARE	**98-0085742**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
825 8th Avenue, 23rd Floor, NY, NY	**10019**
(Address of Principal Executive Offices)	(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 þ No o

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 o Accelerated Filer þ Non-Accelerated Filer o

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

The number of shares outstanding of the Registrant s common stock, par value $.02 per share, at July 31, 2006 was 68,819,031 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 June 30, 2006, and the related condensed consolidated statements of operations for the three month and six month periods ended June 30, 2006 and 2005, the consolidated statement of stockholders equity for the six month period ended June 30, 2006, and condensed consolidated statements of cash flows for the six month periods ended June 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
August 7, 2006

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GLENAYRE TECHNOLOGIES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

	June 30, 2006 (Unaudited)	December 31, 2005
	(In thousands, except share and per share amounts)	
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 66,837	$ 78,803
Restricted cash	2,144	10,602
Accounts receivable, net of allowances for doubtful accounts of $375 and $489 at June 30, 2006 and December 31, 2005, respectively	29,229	28,056
Current portion of long-term receivable	1,659	6,076
Inventories, net	14,714	15,620
Prepaid expenses and other current assets	20,418	11,099
Total Current Assets	135,001	150,256
Restricted cash	21,839	29,727
Property, plant and equipment, net	65,168	62,340
Long-term receivable	7,185	6,560
Goodwill	3,027	
Intangible assets	60,674	59,642
Other assets	4,826	6,883
TOTAL ASSETS	$ 297,720	$ 315,408
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 23,678	$ 28,990
Accrued and other liabilities	36,148	38,001
Income taxes payable	10,027	9,489
Deferred income taxes	231	215
Deferred revenue	3,582	9,003
Loans from employees	1,117	1,132
Current portion of long-term debt	19,845	14,700
Accrued liabilities, discontinued operations	2,363	2,174
Total Current Liabilities	96,991	103,704
Other non-current liabilities	7,447	3,353
Loans from employees	3,604	4,113
Long-term debt	51,541	61,868
Pension and other defined benefit obligations	32,541	29,281
Deferred income taxes	9,699	8,462

Accrued liabilities, discontinued operations		61
Total Liabilities	201,823	210,842
Minority interest in subsidiary company	772	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 - 68,815,431 shares; 2005 68,063,799 shares	1,376	1,361
Contributed capital	366,290	364,376
Accumulated deficit	(272,624)	(260,874)
Cumulative translation adjustment, net of tax	83	(1,183)
Total Stockholders Equity	95,125	103,680
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 297,720	$ 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 June 30, 2006	2005
	(In thousands, except per share amounts)	
REVENUES:		
Product sales	$ 66,071	$ 30,429
Service revenues	23,902	12,325
Total Revenues	89,973	42,754
COST OF REVENUES:		
Cost of sales	53,313	19,667
Cost of services	14,740	7,857
Total Cost of Revenues	68,053	27,524
GROSS MARGIN	21,920	15,230
OPERATING EXPENSES:		
Selling, general and administrative expense	17,460	12,113
Research and development expense	4,221	3,948
Amortization of intangible assets	2,025	566
Total Operating Expenses	23,706	16,627
OPERATING LOSS	(1,786)	(1,397)
OTHER INCOME (EXPENSES):		
Interest income	1,032	571
Interest expense	(1,563)	(505)
Gain (loss) on currency swap, net	(1,650)	262
Transaction gain (loss), net	584	(1,300)
Other income	14	25
Total Other Expenses	(1,583)	(947)
LOSS FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	(3,369)	(2,344)
Provision for income taxes	1,187	134
Minority interests	(114)	
LOSS FROM CONTINUING OPERATIONS	(4,442)	(2,478)
	(386)	388

INCOME (LOSS) FROM DISCONTINUED OPERATIONS, NET OF INCOME TAX PROVISION (BENEFIT)				
NET LOSS	$	(4,828)	$	(2,090)
LOSS PER WEIGHTED AVERAGE COMMON SHARE:				
Loss from continuing operations	$	(0.06)	$	(0.04)
Income (loss) from discontinued operations		(0.01)		0.01
Loss per weighted average common share	$	(0.07)	$	(0.03)
LOSS PER COMMON SHARE ASSUMING DILUTION:				
Loss from continuing operations	$	(0.06)	$	(0.04)
Income (loss) from discontinued operations		(0.01)		0.01
Loss per weighted average common share	$	(0.07)	$	(0.03)

See Notes to Condensed Consolidated Financial Statements.

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

	Six Months Ended June 30, 2006	2005
	(In thousands, except per share amounts)	
REVENUES:		
Product sales	$ 126,389	$ 44,087
Service revenues	50,030	16,589
Total Revenues	176,419	60,676
COST OF REVENUES:		
Cost of sales	102,165	23,822
Cost of services	33,180	10,324
Total Cost of Revenues	135,345	34,146
GROSS MARGIN	41,074	26,530
OPERATING EXPENSES:		
Selling, general and administrative expense	36,212	19,100
Research and development expense	8,796	6,982
Amortization of intangible assets	3,780	566
Total Operating Expenses	48,788	26,648
OPERATING LOSS	(7,714)	(118)
OTHER INCOME (EXPENSES):		
Interest income	2,080	1,101
Interest expense	(2,974)	(512)
Gain (loss) on currency swaps, net	(2,377)	262
Transaction gain (loss), net	940	(1,300)
Other income, net	6	32
Total Other Expenses	(2,325)	(417)
LOSS FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	(10,039)	(535)
Provision for income taxes	1,191	163
Minority interests	(114)	

LOSS FROM CONTINUING OPERATIONS		(11, 116)		(698)
INCOME (LOSS) FROM DISCONTINUED OPERATIONS, NET OF INCOME TAX PROVISION (BENEFIT)		(634)		398
NET LOSS	$	(11,750)	$	(300)
LOSS PER WEIGHTED AVERAGE COMMON SHARE:				
Loss from continuing operations	$	(0.16)	$	(0.01)
Income (loss) from discontinued operations		(0.01)		0.01
Loss per weighted average common share	$	(0.17)	$	(0.00)
LOSS PER COMMON SHARE ASSUMING DILUTION:				
Loss from continuing operations	$	(0.16)	$	(0.01)
Income (loss) from discontinued operations		(0.01)		0.01
Loss per weighted average common share	$	(0.17)	$	(0.00)

See Notes to Condensed Consolidated Financial Statements.

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

	Common Stock Shares	Common Stock Amount	Contributed Capital	Deficit	Accumulated Other Comprehensive Loss	Comprehensive Loss
Balances, January 1, 2006	68,064	$ 1,361	$ 364,376	$ (260,874)	$ (1,183)	
Net loss				(11,750)		$ (11,750)
Foreign currency translation					1,266	1,266
Shares issued for ESP Plan and option exercises	751	15	1,129			
Stock compensation expense			785			
Total comprehensive loss, net of tax						$ (10,484)
Balances, June 30, 2006	68,815	$ 1,376	$ 366,290	$ (272,624)	$ 83	

See Notes to Condensed Consolidated Financial Statements.

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

	Six Months Ended June 30, 2006	2005
	(In thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (11,750)	$ (300)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	10,890	2,586
Stock compensation expense	715	26
Profits interest	823	807
Unrealized loss (gain) on currency swap	2,377	(262)
Foreign currency transaction (gain) loss	(1,026)	1,006
Minority interest	(114)	
Other	302	(281)
Changes in operating assets and liabilities, net of effects of business dispositions and acquisitions:		
Restricted cash	1,207	(845)
Accounts receivable	(617)	(25,650)
Inventories	1,129	(2,529)
Prepaids and other current assets	(8,891)	(308)
Long-term receivable	4,359	7,501
Goodwill and intangible assets	(140)	
Other assets	(329)	20
Accounts payable	(6,257)	9,907
Deferred revenue	(5,421)	7,272
Accrued liabilities and income taxes payable	(3,549)	9,541
Pension and other defined benefit plans	1,599	
NET CASH (USED IN) PROVIDED BY OPERATING ACTIVITIES	(14,693)	8,491
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property, plant and equipment	(7,381)	(1,597)
Maturities of short-term securities		12,180
Asset and share purchase of EDC, net of cash acquired		(67,262)
Release (increase) in restricted cash	16,500	(16,500)
NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES	9,119	(73,179)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from long-term borrowing, net of costs		45,444
Proceeds from employee loans	360	
Repayment of long-term borrowing	(8,135)	
Proceeds from sale of LLC interest in subsidiary		772
Repayment of employee loans	(1,156)	
Issuance of common stock	1,144	551

NET CASH (USED IN) PROVIDED BY FINANCING ACTIVITIES	(7,787)	46,767
EFFECT OF EXCHANGE RATE CHANGES ON CASH	1,395	(771)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(11,966)	(18,692)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	78,803	82,691
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 66,837	$ 63,999
Depreciation and amortization included in net cash used in operating activities:		
Depreciation included in cost of sales	$ 5,495	$ 1,036
Depreciation included in selling, general and administrative expense	1,055	341
Depreciation included in research and development expense	560	643
Amortization of intangible assets	3,780	566

SUPPLEMENTAL INFORMATION OF NON-CASH ACTIVITIES:

During the six months ended June 30, 2006, we purchased a printer under a capital lease for approximately $965,000.

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.

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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 15.

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, if any, the adoption of FIN 48 will have on our financial position and results of operations.

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4. 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*. The purchase price of approximately $130.0 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 $7.0 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.

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 acquisition. We have finalized our purchase price allocation and do not expect 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	June 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	2,670	68,053
Goodwill		3,023	3,023
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	$ 3,076	$ 130,049

The additional purchase price adjustments recorded during the six months ended June 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, $1.3 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 acquisition date, we terminated nine employees as part of the EDC acquisition 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 June 30, 2006. We paid approximately $228,000 of the severance cost during the six months ended June 30, 2006. The remaining severance cost is recorded in accrued liabilities in the accompanying unaudited condensed consolidated balance sheet at June 30, 2006.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Continued
(Tabular Amounts in Thousands, Except per Share Amounts)
(Unaudited)

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.

The contingent consideration included in the purchase price totals 5.3 million ($6.6 million) consisting of 3.2 million ($4.0 million) for actual consideration from the date of purchase through June 30, 2006 and 2.1 million ($2.6 million) for estimated consideration due for the remaining 18 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 June 30, 2006 are approximately 94,000 ($117,000) for consideration earned but not paid as of June 30, 2006, and 2.1 million ($2.6 million) for the estimated amount payable for the 18 months ended December 31, 2007, using the June 30, 2006 Euro to U.S. dollar exchange rate of 1.2551.

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 six months ended June 30, 2006 and 2005, respectively was $823,000 and $807,000. 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. The estimated fair value of the profits interests are subject to change in subsequent reporting periods as a result of actual results and revised estimates that differ from our current estimates, and this could result in adjustments to compensation expense related to the management profits interests. At June 30, 2006 and December 31, 2005, $1.9 million and $1.1 million, respectively, were included in other non-current liabilities in our condensed consolidated balance sheets as follows:

	June 30, 2006	December 31, 2005
Vested	$ 1,822	$ 710
Unvested	124	413
Total	$ 1,946	$ 1,123

Volume discount

At March 31, 2006 EDC had a potential unrecorded liability related to a disagreement in the interpretation of the definition of the units that are eligible for the volume discount that is earned by Universal. During the second quarter of 2006 EDC recorded a liability relating to this additional volume discount once we determined that the probability of incurring the liability was more likely than not.

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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)

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.

As of June 30, 2006, acquired intangible assets and related amortization, using the June 30, 2006 Euro to U.S. dollar exchange rate of 1.2551, are as follows:

		June 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	$68,319	$7,645	$63,335	$3,693
Intangible assets not subject to amortization:					
Goodwill		$ 3,027	$	$	$

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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)

The weighted average useful life of intangible assets subject to amortization is 9.2 years. The amortization expense for the six months ended June 30, 2006 and 2005 was $3.8 million and $0.6 million, respectively. The estimated amortization expense for the remaining current year and the next five years is as follows:

For the six months ending December 31, 2006	$4,068
For the years ending December 31,	
2007	8,136
2008	8,136
2009	8,136
2010	6,795
2011	5,837

Goodwill

In connection with the Universal acquisition in our EDC segment, we recorded goodwill in the amount of $3.0 million. 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 June 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 second quarter and the first six months of fiscal 2005 includes the business combination accounting effect on historical Glenayre and EDC 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 six months ended June 30, 2005 assume that the acquisition of the U.S. and central European CD and DVD manufacturing and distribution operations of Universal were completed as of January 1, 2005:

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Total revenues	$ 89,928	$ 172,557
Net loss from continuing operations	$ (5,079)	$ (6,741)
Net income from discontinued operations	$ 388	$ 398
Net loss	$ (4,691)	$ (6,343)
Basic net loss per share	$ (0.07)	$ (0.09)
Diluted net loss per share	$ (0.07)	$ (0.09)

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5. Currency Rate Swap

The Company entered into a cross-currency rate swap agreement with a commercial bank on May 31, 2005. The Company s objective is to manage foreign currency exposure arising from its loan to its German subsidiary, acquired in May 2005, 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, the Company reports the foreign currency exchange gains or losses attributable to changes in the US$/ exchange rate on the currency swap in earnings.

The loss on the currency rate swap was approximately $1.6 million and $2.4 million for the three months and six months ended June 30, 2006, respectively. The gain on the currency rate swap was approximately $262,000 for the three months and six months ended June 30, 2005.

6. Inventories

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

	June 30, 2006	December 31, 2005
Raw materials	$ 10,023	$ 10,647
Work in process	1,892	1,390
Finished goods	2,799	3,583
Total	$ 14,714	$ 15,620

At June 30, 2006 and December 31, 2005, reserves related to continuing operations were approximately $3.0 million and $2.8 million, respectively.

7. 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 six months ended June 30, 2006 and 2005:

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

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

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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 $2.7 million of the $3.6 million of deferred revenue included in the unaudited condensed consolidated balance sheet at June 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.

8. 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 June 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 June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Gain (loss) on disposal of segment before income taxes	$ (405)	$ 428	$ (360)	$ 491
Income tax benefit (expense)	19	(40)	(274)	(93)
Gain (loss) on disposal of discontinued	(386)	388	(634)	398
Income (loss) from discontinued operations	$ (386)	$ 388	$ (634)	$ 398

In the first quarter of 2006, after reviewing the estimated liabilities and future commitments related to the discontinued operations, we recorded a net decrease in the loss on disposal of approximately $45,000. The adjustments to the original estimates related primarily to asset liquidations and a reduction in estimated contract obligations. The income tax benefit (expense) is primarily related to foreign income tax contingencies. In the second quarter of 2006, we recorded a net increase in the loss on disposal of approximately $405,000 related to foreign currency exchange rate fluctuations offset slightly by liquidation of assets.

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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, a net decrease in the loss on disposal of $428,000 was recorded. We recorded income of $53,000 primarily due to a settlement and previously reserved accounts receivable receipts. Additional reductions of $375,000 were recorded primarily related to the release of a reserve for the Lynnview Ridge litigation (see Note 13).

9. Long-Term Debt

Long-term debt consisted of:

	June 30, 2006	December 31, 2005
Senior Secured Credit Facility	$ 41,500	$ 41,500
Payable to Universal undiscounted	32,418	39,440
Capital Leases	1,008	170
Employee Loans	4,721	5,245
Subtotal	79,647	86,355
Less: Unamortized Discount	(3,540)	(4,542)
Total Debt	76,107	81,813
Less: Current Portion	(20,962)	(15,832)
Total Long-Term Debt	$ 55,145	$ 65,981

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

2006 (Remaining six months)	$ 7,056
2007	23,221
2008	24,493
2009	11,945
2010	10,290
2011	1,039
Thereafter	1,603
Total	$ 79,647

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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 Glenayre 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 7.92% at June 30, 2006. At June 30, 2006, no drawings were made against the $10.0 million revolving credit loan.

Capital Leases

Leased equipment includes a DVD reproduction line and a CD printer. Lease terms allow ownership to transfer to EDC at no additional cost. Property, plant and equipment includes $1.3 million for capitalized equipment leases and accumulated depreciation of $74,000**.** Depreciation expense for the three and six months ended June 30, 2006 is $17,000 and $34,000 respectively.

10. 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 June 30,		Six Months Ended June 30,	
	2006	**2005**	**2006**	**2005**
Income tax (benefit) federal U.S. statutory rate	$ (1,179)	$ (821)	$ (3,514)	$ (188)
State income tax (benefit) net of federal benefit	(279)	(133)	(567)	(172)
Increase (decrease) in valuation allowance	1,236	565	3,695	(59)
Foreign taxes at rates other than U.S. statutory rates	1,187	110	1,191	139
Profits interest awards	226	282	288	282
Other non deductibles	7	109	90	139
Minority interest in earnings of subsidiary	(11)	22	8	22
Income tax provisions	$ 1,187	$ 134	$ 1,191	$ 163

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We account for income taxes under the liability method in accordance with SFAS No. 109, *Accounting for Income Taxes* (SFAS 109). At June 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 June 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 June 30, 2006 and June 30, 2005 was approximately $3.0 million and ($122,000), respectively.

We have realized U.S. federal net operating losses (NOLs) of $276.9 million and foreign NOLs of $45.1 million. 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. 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 $8.5 million and $7.5 million at June 30, 2006 and December 31, 2005, respectively, for probable and estimable exposure for tax filing positions in various jurisdictions. At June 30, 2006 and December 31, 2005, the above amounts included $6.3 million and $5.5 million of transfer pricing exposure in various foreign jurisdictions, in addition to reserves for international business taxes. We have approached the foreign country involved for tax clearance in an effort to reach a conclusion on the international business tax.

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.

11. Employee Benefit Plans

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	**2005**	**2006**	**2005**
Service cost	$ 237	$ 14	$ 474	$ 29
Interest cost on APBO	290	31	579	63
Amortization of prior service costs	(64)	(63)	(127)	(127)
Amortization of actuarial loss	8	23	16	45
	$ 471	$ 5	$ 942	$ 10

The June 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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12. Stockholders Equity

Loss from continuing operations per Common Share

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	**2005**	**2006**	**2005**
Numerator:				
Loss from continuing operations	$ (4,442)	$ (2,478)	$ (11,116)	$ (698)
Denominator:				
Denominator for basic Loss from continuing operations per share weighted average shares	68,746	66,997	68,464	67,051
Effect of dilutive securities				
Denominator for diluted Loss from continuing operations per share	68,746	66,997	68,464	67,051
Loss from continuing operations per weighted average common share (1)	$ (0.06)	$ (0.04)	$ (0.16)	$ (0.01)
Loss from continuing operations per common share assuming dilution (1)	$ (0.06)	$ (0.04)	$ (0.16)	$ (0.01)
Dilutive securities not included above due to anti-dilutive effect	2,111	2,051	2,630	1,748
Anti-dilutive securities not included above:				
Stock options	2,199	6,635	2,248	7,378

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

presented.

Restricted Stock Units

Restricted stock units (RSU s) issued to directors are non-cash transactions. For the six months ended June 30, 2006, approximately 39,000 shares were issued to directors for vested RSU s valued at approximately $64,000, based on the grant date fair value.

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13. Commitments and Contingencies

Litigation

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. The following lawsuit relates to these indemnification obligations.

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 Glenayre s 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, no further appeal has been filed by Jackson, and the time for further appeals by Jackson has expired. Accordingly, the Federal Circuit appellate court decision has become final and nonappealable, and the Jackson case is now concluded.

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 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.

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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 the Company. Since that time consent judgments and dismissals covering the Company 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. On March 10, 2006, the case was formally dismissed. 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.

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 the financial position or results of future operations of the Company. However, because of the nature and inherent uncertainties of litigation, should the outcome of these actions be unfavorable, the Company s business, financial condition, results of operations and cash flows could be materially adversely affected.

Letters of Credit and Cash Collateral

Restricted cash includes $771,000 of customer performance bonds and $30,000 for letters of credit for leased space and a tax bond. None of these bonds or letters of credit were drawn upon as of June 30, 2006.

Other

At June 30, 2006, we had approximately $14.9 million of outstanding unconditional purchase commitments, mainly to suppliers of inventories and equipment.

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14. 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. 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 one month of operations for the three and six months ended June 30, 2005.

	Three Months Ended June 30,					
	Consolidated		EDC		Messaging	
	2006	2005	2006	2005	2006	2005
Revenues	$89,973	$42,754	$73,586	$20,007	$16,387	$22,747
Income (loss) from continuing operations before income taxes	(3,369)	(2,344)	(2,334)	(4,015)	(1,035)	1,671
Depreciation & amortization	5,595	2,114	5,133	1,606	462	508

	Six Months Ended June 30,					
	Consolidated		EDC		Messaging	
	2006	2005	2006	2005	2006	2005
Revenues	$176,419	$60,676	$143,662	$20,007	$32,757	$40,669
Income (loss) from continuing operations before income taxes	(10,039)	(535)	(6,706)	(4,015)	(3,333)	3,480
Depreciation & amortization	10,890	2,586	9,877	1,606	1,014	980

15. 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.

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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 the 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.

As a result of adopting SFAS 123R, our net loss from continuing operations before income taxes and net loss for the six months ended June 30, 2006 is approximately $709,000 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 six months ended June 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.

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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 six-month periods ended June 30, 2005, pro forma option expense was as follows:

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Loss from continuing operations as reported	$ (2,478)	$ (698)
Pro forma stock option expense	(477)	(785)
Loss from continuing operations pro forma	$ (2,925)	$ (1,483)

® Index, using a base-weighted aggregate methodology. The daily calculation of each Select Sector Index is computed by dividing the total market value of the companies in the Select Sector Index by a number called the index divisor.

The Index Compilation Agent at any time may determine that a Component Stock which has been assigned to one Select Sector Index has undergone such a transformation in the composition of its business, and should be removed from that Select Sector Index and assigned to a different Select Sector Index. In the event that the Index Compilation Agent notifies S&P Dow Jones Indices that a Component Stock’s Select Sector Index assignment should be changed, S&P Dow Jones Indices will disseminate notice of the change following its standard procedure for announcing index changes and will implement the change in the affected Select Sector Indices on a date no less than one week after the initial dissemination of information on the sector change to the maximum extent practicable. It is not anticipated that Component Stocks will change sectors frequently.

Component Stocks removed from and added to the S&P 500® Index will be deleted from and added to the appropriate Select Sector Index on the same schedule used by S&P Dow Jones Indices for additions and deletions from the S&P 500® Index insofar as practicable.

Issuer Callable Contingent Coupon Barrier
Notes Linked to the Lesser Performing of Two
Equity Indices and One Exchange Traded Fund
Royal Bank of Canada

HISTORICAL INFORMATION

The graphs below set forth the information relating to the historical performance of the Reference Assets. In addition, below the graphs are tables setting forth the intra-day high, intra-day low and period-end closing prices or levels, as applicable, of the Reference Assets. The information provided in these tables is for the period from January 1, 2008 through October 2, 2018.

We obtained the information regarding the historical performance of the Reference Assets in the graphs and tables below from Bloomberg Financial Markets.

We have not independently verified the accuracy or completeness of the information obtained from Bloomberg Financial Markets. The historical performance of any Reference Asset should not be taken as an indication of its future performance, and no assurance can be given as to the prices or levels of the Reference Assets at any time. We cannot give you assurance that the performance of the Reference Assets will not result in the loss of all or part of your investment.

Issuer Callable Contingent Coupon Barrier
Notes Linked to the Lesser Performing of Two
Equity Indices and One Exchange Traded Fund
Royal Bank of Canada

Historical Information for the S&P 500® Index ("SPX")
Below is a table setting forth the intra-day high, intra-day low and period-end closing levels of this Reference Asset. The information provided in the table is for the period from January 1, 2008 through October 2, 2018.

Period-Start Date	Period-End Date	High Intra-Day Level of this Reference Asset	Low Intra-Day Level of this Reference Asset	Period-End Closing Level of this Reference Asset
1/1/2008	3/31/2008	1,471.77	1,256.98	1,322.70
4/1/2008	6/30/2008	1,440.24	1,272.00	1,280.00
7/1/2008	9/30/2008	1,313.15	1,106.39	1,166.36
10/1/2008	12/30/2008	1,167.03	741.02	890.64
1/1/2009	3/31/2009	943.85	666.79	797.87
4/1/2009	6/30/2009	956.23	783.32	919.32
7/1/2009	9/30/2009	1,080.15	869.32	1,057.08
10/1/2009	12/29/2009	1,130.38	1,019.95	1,126.20
1/1/2010	3/31/2010	1,180.69	1,044.50	1,169.43
4/1/2010	6/30/2010	1,219.80	1,028.33	1,030.71
7/1/2010	9/30/2010	1,157.16	1,010.91	1,141.20
10/1/2010	12/30/2010	1,262.60	1,131.87	1,257.88
1/1/2011	3/31/2011	1,344.07	1,249.05	1,325.83
4/1/2011	6/30/2011	1,370.58	1,258.07	1,320.64
7/1/2011	9/30/2011	1,356.48	1,101.54	1,131.42
10/1/2011	12/30/2011	1,292.66	1,074.77	1,257.61
1/1/2012	3/30/2012	1,419.15	1,258.86	1,408.47
4/1/2012	6/29/2012	1,422.38	1,266.74	1,362.16
7/1/2012	9/28/2012	1,474.51	1,325.41	1,440.67
10/1/2012	12/31/2012	1,470.96	1,343.35	1,426.19
1/1/2013	3/28/2013	1,570.28	1,426.19	1,569.19
4/1/2013	6/28/2013	1,687.18	1,536.03	1,606.28
7/1/2013	9/30/2013	1,729.86	1,604.57	1,681.55
10/1/2013	12/31/2013	1,849.44	1,646.47	1,848.36
1/1/2014	3/31/2014	1,883.97	1,737.92	1,872.34
4/1/2014	6/30/2014	1,968.17	1,814.36	1,960.23
7/1/2014	9/30/2014	2,019.26	1,904.78	1,972.29
10/1/2014	12/31/2014	2,093.55	1,820.66	2,058.90
1/1/2015	3/31/2015	2,119.59	1,980.90	2,067.89
4/1/2015	6/30/2015	2,134.72	2,048.38	2,063.11
7/1/2015	9/30/2015	2,132.82	1,867.01	1,920.03
10/1/2015	12/31/2015	2,116.48	1,893.70	2,043.94
1/1/2016	3/31/2016	2,072.21	1,810.10	2,059.74
4/1/2016	6/30/2016	2,120.55	1,991.68	2,098.86
7/1/2016	9/30/2016	2,193.81	2,074.02	2,168.27
10/1/2016	12/30/2016	2,277.53	2,083.79	2,238.83
1/1/2017	3/31/2017	2,400.98	2,245.13	2,362.72
4/1/2017	6/30/2017	2,453.82	2,328.95	2,423.41

7/1/2017	9/29/2017	2,519.44	2,407.70	2,519.36
10/1/2017	12/29/2017	2,694.97	2,520.40	2,673.61
1/1/2018	3/29/2018	2,872.87	2,532.69	2,640.87
4/1/2018	6/29/2018	2,791.47	2,553.80	2,718.37
7/1/2018	9/28/2018	2,940.91	2,698.95	2,913.98
10/1/2018	10/2/2018	2,937.06	2,917.91	2,923.43

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

Issuer Callable Contingent Coupon Barrier
Notes Linked to the Lesser Performing of Two
Equity Indices and One Exchange Traded Fund
Royal Bank of Canada

The graph below illustrates the performance of this Reference Asset from January 1, 2008 to October 2, 2018, reflecting its Initial Level of 2,923.43. The red line represents its Coupon Barrier and Trigger Level of 2,192.57, which is equal to 75% of its Initial Level, rounded to two decimal places.

Issuer Callable Contingent Coupon Barrier
Notes Linked to the Lesser Performing of Two
Equity Indices and One Exchange Traded Fund
Royal Bank of Canada

Historical Information for the Russell 2000® Index (“RTY”)
Below is a table setting forth the intra-day high, intra-day low and period-end closing levels of this Reference Asset.
The information provided in the table is for the period from January 1, 2008 through October 2, 2018.

Period-Start Date	Period-End Date	High Intra-Day Level of this Reference Asset	Low Intra-Day Level of this Reference Asset	Period-End Closing Level of this Reference Asset
1/1/2008	3/31/2008	768.460	643.280	687.967
4/1/2008	6/30/2008	763.270	684.880	689.659
7/1/2008	9/30/2008	764.380	647.370	679.583
10/1/2008	12/30/2008	679.570	371.260	482.770
1/1/2009	3/31/2009	519.180	342.570	422.748
4/1/2009	6/30/2009	535.850	412.770	508.282
7/1/2009	9/30/2009	625.310	473.540	604.278
10/1/2009	12/29/2009	635.990	553.320	633.178
1/1/2010	3/31/2010	693.320	580.490	678.643
4/1/2010	6/30/2010	745.950	607.300	609.486
7/1/2010	9/30/2010	678.900	587.600	676.139
10/1/2010	12/30/2010	793.280	669.430	789.737
1/1/2011	3/31/2011	843.730	771.710	843.548
4/1/2011	6/30/2011	868.570	772.620	827.429
7/1/2011	9/30/2011	860.370	634.710	644.156
10/1/2011	12/30/2011	769.460	601.710	740.916
1/1/2012	3/30/2012	847.920	736.780	830.301
4/1/2012	6/29/2012	841.060	729.750	798.487
7/1/2012	9/28/2012	868.500	765.050	837.450
10/1/2012	12/31/2012	853.570	763.550	849.350
1/1/2013	3/28/2013	954.000	849.330	951.542
4/1/2013	6/28/2013	1,008.230	898.400	977.475
7/1/2013	9/30/2013	1,082.000	981.300	1,073.786
10/1/2013	12/31/2013	1,167.960	1,037.860	1,163.637
1/1/2014	3/31/2014	1,212.823	1,082.717	1,173.038
4/1/2014	6/30/2014	1,193.964	1,082.531	1,192.964
7/1/2014	9/30/2014	1,213.550	1,101.675	1,101.676
10/1/2014	12/31/2014	1,221.442	1,040.472	1,204.696
1/1/2015	3/31/2015	1,268.162	1,151.295	1,252.772
4/1/2015	6/30/2015	1,295.996	1,211.126	1,253.947
7/1/2015	9/30/2015	1,275.899	1,078.633	1,100.688
10/1/2015	12/31/2015	1,205.079	1,080.606	1,135.889
1/1/2016	3/31/2016	1,134.078	943.097	1,114.028
4/1/2016	6/30/2016	1,190.172	1,085.883	1,151.923
7/1/2016	9/30/2016	1,263.460	1,131.713	1,251.646
10/1/2016	12/30/2016	1,392.714	1,156.085	1,357.130
1/1/2017	3/31/2017	1,414.824	1,335.038	1,385.920
4/1/2017	6/30/2017	1,433.790	1,345.244	1,415.359

7/1/2017	9/29/2017	1,493.555	1,349.354	1,490.861
10/1/2017	12/29/2017	1,559.607	1,454.165	1,535.511
1/1/2018	3/29/2018	1,615.517	1,436.427	1,529.427
4/1/2018	6/29/2018	1,708.098	1,482.897	1,643.069
7/1/2018	9/28/2018	1,742.089	1,631.056	1,696.571
10/1/2018	10/2/2018	1,703.809	1,653.343	1,656.042

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

P-24 RBC Capital Markets, LLC

Issuer Callable Contingent Coupon Barrier
Notes Linked to the Lesser Performing of Two
Equity Indices and One Exchange Traded Fund
Royal Bank of Canada

The graph below illustrates the performance of this Reference Asset from January 1, 2008 to October 2, 2018, reflecting its Initial Level of 1,656.042. The red line represents its Coupon Barrier and Trigger Level of 1,242.032, which is equal to 75% of its Initial Level, rounded to three decimal places.

Issuer Callable Contingent Coupon Barrier
Notes Linked to the Lesser Performing of Two
Equity Indices and One Exchange Traded Fund
Royal Bank of Canada

Historical Information for the Consumer Staples Select Sector SPDR® Fund (“XLP”)
Below is a table setting forth the intra-day high, intra-day low and period-end closing price of this Reference Asset. The information provided in the table is for the period from January 1, 2008 through October 2, 2018.

Period-Start Date	Period-End Date	High Intra-Day Price of this Reference Asset ($)	Low Intra-Day Price of this Reference Asset ($)	Period-End Closing Price of this Reference Asset ($)
1/1/2008	3/31/2008	28.91	24.59	27.91
4/1/2008	6/30/2008	28.67	26.36	26.70
7/1/2008	9/30/2008	30.29	26.29	27.46
10/1/2008	12/30/2008	28.70	21.40	23.64
1/1/2009	3/31/2009	24.42	19.28	21.10
4/1/2009	6/30/2009	23.91	20.82	22.99
7/1/2009	9/30/2009	25.67	22.82	25.46
10/1/2009	12/29/2009	27.29	25.11	26.79
1/1/2010	3/31/2010	28.18	25.72	27.91
4/1/2010	6/30/2010	28.20	24.98	25.50
7/1/2010	9/30/2010	28.21	25.30	27.87
10/1/2010	12/30/2010	29.58	27.77	29.30
1/1/2011	3/31/2011	30.04	28.72	29.94
4/1/2011	6/30/2011	32.45	29.99	31.23
7/1/2011	9/30/2011	31.91	28.07	29.70
10/1/2011	12/30/2011	32.71	28.70	32.49
1/1/2012	3/30/2012	34.14	31.85	34.08
4/1/2012	6/29/2012	34.77	33.05	34.77
7/1/2012	9/28/2012	36.40	34.46	35.83
10/1/2012	12/31/2012	36.59	33.97	34.83
1/1/2013	3/28/2013	39.80	35.31	39.76
4/1/2013	6/28/2013	42.20	38.88	39.67
7/1/2013	9/30/2013	41.84	39.06	39.80
10/1/2013	12/31/2013	43.46	39.56	42.98
1/1/2014	3/31/2014	43.10	39.84	43.06
4/1/2014	6/30/2014	45.71	42.70	44.62
7/1/2014	9/30/2014	45.73	42.97	45.11
10/1/2014	12/31/2014	49.63	43.69	48.49
1/1/2015	3/31/2015	50.22	47.69	48.74
4/1/2015	6/30/2015	49.77	47.46	47.60
7/1/2015	9/30/2015	50.95	43.72	47.19
10/1/2015	12/31/2015	51.36	46.69	50.49
1/1/2016	3/31/2016	53.34	47.39	53.05
4/1/2016	6/30/2016	55.15	51.55	55.15
7/1/2016	9/30/2016	56.02	52.48	53.21
10/1/2016	12/30/2016	53.16	49.98	51.71
1/1/2017	3/31/2017	55.50	51.35	54.58
4/1/2017	6/30/2017	57.36	54.41	54.94

7/1/2017	9/29/2017	55.94	53.73	53.98
10/1/2017	12/29/2017	57.30	52.45	56.89
1/1/2018	3/29/2018	58.95	50.82	52.63
4/1/2018	6/29/2018	53.46	48.76	51.53
7/1/2018	9/28/2018	55.33	50.91	53.93
10/1/2018	10/2/2018	54.31	53.74	54.20

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

Issuer Callable Contingent Coupon Barrier
Notes Linked to the Lesser Performing of Two
Equity Indices and One Exchange Traded Fund
Royal Bank of Canada

The graph below illustrates the performance of this Reference Asset from January 1, 2008 to October 2, 2018, reflecting its Initial Level of $54.20. The red line represents its Coupon Barrier and Trigger Level of $40.65, which is equal to 75% of its Initial Level.

Issuer Callable Contingent Coupon Barrier
Notes Linked to the Lesser Performing of Two
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Royal Bank of Canada

USE OF PROCEEDS AND HEDGING

In anticipation of the sale of the Notes, we expect to enter into hedging transactions with one or more of our affiliates, involving purchases of the securities represented by the Reference Assets, shares of the XLP and/or listed and/or over-the-counter derivative instruments related to any of those securities or the Reference Assets prior to or on the Trade Date. From time to time, including around the time of each Observation Date and the Maturity Date, we, RBCCM, and our other affiliates may enter into additional hedging transactions or unwind those that we or they have entered into. In this regard, we, RBCCM, and our other affiliates may:

- acquire or dispose of investments relating to the Reference Assets;
- acquire or dispose of long or short positions in listed or over-the-counter derivative instruments based on the Reference Assets; or
- any combination of the above two.

We, RBCCM and our other affiliates may acquire a long or short position in securities similar to the Notes from time to time and may, in our or their sole discretion, hold or resell those similar securities.

We, RBCCM and our other affiliates may close out our or their hedges on or before any Observation Date. That step may involve sales or purchases of the securities represented by the Reference Assets, shares of the XLP, or over-the-counter derivative instruments linked to the Reference Assets.

SUPPLEMENTAL DISCUSSION OF
U.S. FEDERAL INCOME TAX CONSEQUENCES

The following disclosure supplements, and to the extent inconsistent supersedes, the discussion in the product prospectus supplement dated September 10, 2018 under “Supplemental Discussion of U.S. Federal Income Tax Consequences.”

Under Section 871(m) of the Code, a “dividend equivalent” payment is treated as a dividend from sources within the United States. Such payments generally would be subject to a 30% U.S. withholding tax if paid to a non-U.S. holder. Under U.S. Treasury Department regulations, payments (including deemed payments) with respect to equity-linked instruments (“ELIs”) that are “specified ELIs” may be treated as dividend equivalents if such specified ELIs reference an interest in an “underlying security,” which is generally any interest in an entity taxable as a corporation for U.S. federal income tax purposes if a payment with respect to such interest could give rise to a U.S. source dividend. However, the IRS has issued guidance that states that the U.S. Treasury Department and the IRS intend to amend the effective dates of the U.S. Treasury Department regulations to provide that withholding on dividend equivalent payments will not apply to specified ELIs that are not delta-one instruments and that are issued before January 1, 2021. Based on our determination that the Notes are not delta-one instruments, non-U.S. holders should not be subject to withholding on dividend equivalent payments, if any, under the Notes. However, it is possible that the Notes could be treated as deemed reissued for U.S. federal income tax purposes upon the occurrence of certain events affecting the Reference Assets or the Notes (for example, upon an index rebalancing), and following such occurrence the Notes could be treated as subject to withholding on dividend equivalent payments. Non-U.S. holders that enter, or have entered, into other transactions in respect of the Reference Assets or the Notes should consult their tax advisors as to the application of the dividend equivalent withholding tax in the context of the Notes and their other transactions. If any payments are treated as dividend equivalents subject to withholding, we (or the applicable withholding agent) would be entitled to withhold taxes without being required to pay any additional amounts with respect to amounts so withheld.

SUPPLEMENTAL PLAN OF DISTRIBUTION (CONFLICTS OF INTEREST)

Delivery of the Notes will be made against payment for the Notes on October 5, 2018, which is the third (3rd) business day following the Trade Date (this settlement cycle being referred to as “T+3”). See “Plan of Distribution” in the prospectus dated September 7, 2018. For additional information as to the relationship between us and RBCCM, please see the section “Plan of Distribution—Conflicts of Interest” in the prospectus dated September 7, 2018.

We will deliver the Notes on a date that is greater than two business days following the Trade Date. Under Rule 15c6-1 of the Exchange Act, trades in the secondary market generally are required to settle in two business days, unless the parties to any such trade expressly agree otherwise. Accordingly, purchasers who wish to trade the Notes more than two business days prior to the original Issue Date will be required to specify alternative arrangements to prevent a failed settlement.

The value of the Notes shown on your account statement may be based on RBCCM's estimate of the value of the Notes if RBCCM or another of our affiliates were to make a market in the Notes (which it is not obligated to do). That estimate will be based upon the price that RBCCM may pay for the Notes in light of then prevailing market conditions, our creditworthiness and transaction costs. For a period of approximately three months after the issue date of the Notes, the value of the Notes that may be shown on your account statement may be higher than RBCCM's estimated value of the Notes at that time. This is because the estimated value of the Notes will not include the underwriting discount and our hedging costs and profits; however, the value of the Notes shown on your account statement during that period may initially be a higher amount, reflecting the addition of RBCCM's underwriting discount and our estimated costs and profits from hedging the Notes. This excess is expected to decrease over time until the end of this period. After this period, if RBCCM repurchases your Notes, it expects to do so at prices that reflect their estimated value.

We may use this pricing supplement in the initial sale of the Notes. In addition, RBCCM or another of our affiliates may use this pricing supplement in a market-making transaction in the Notes after their initial sale. Unless we or our agent informs the purchaser otherwise in the confirmation of sale, this pricing supplement is being used in a market-making transaction.

STRUCTURING THE NOTES

The Notes are our debt securities, the return on which is linked to the performance of the Reference Assets. As is the case for all of our debt securities, including our structured notes, the economic terms of the Notes reflect our actual or perceived creditworthiness at the time of pricing. In addition, because structured notes result in increased operational, funding and liability management costs to us, we typically borrow the funds under these Notes at a rate that is more favorable to us than the rate that we might pay for a conventional fixed or floating rate debt security of comparable maturity. Using this relatively lower implied borrowing rate rather than the secondary market rate, is a factor that reduced the initial estimated value of the Notes at the time their terms were set. Unlike the estimated value included in this pricing supplement, any value of the Notes determined for purposes of a secondary market transaction may be based on a different funding rate, which may result in a lower value for the Notes than if our initial internal funding rate were used.

In order to satisfy our payment obligations under the Notes, we may choose to enter into certain hedging arrangements (which may include call options, put options or other derivatives) on the issue date with RBCCM or one of our other subsidiaries. The terms of these hedging arrangements take into account a number of factors, including our creditworthiness, interest rate movements, the volatility of the Reference Assets, and the tenor of the Notes. The economic terms of the Notes and their initial estimated value depend in part on the terms of these hedging arrangements.

The lower implied borrowing rate is a factor that reduced the economic terms of the Notes to you. The initial offering price of the Notes also reflects the underwriting commission and our estimated hedging costs. These factors resulted in the initial estimated value for the Notes on the Trade Date being less than their public offering price. See "Selected Risk Considerations—The Initial Estimated Value of the Notes Is Less than the Price to the Public" above.

Issuer Callable Contingent Coupon Barrier
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Royal Bank of Canada

VALIDITY OF THE NOTES

In the opinion of Norton Rose Fulbright Canada LLP, the issue and sale of the Notes has been duly authorized by all necessary corporate action of the Bank in conformity with the Indenture, and when the Notes have been duly executed, authenticated and issued in accordance with the Indenture and delivered against payment therefor, the Notes will be validly issued and, to the extent validity of the Notes is a matter governed by the laws of the Province of Ontario or Québec, or the laws of Canada applicable therein, and will be valid obligations of the Bank, subject to equitable remedies which may only be granted at the discretion of a court of competent authority, subject to applicable bankruptcy, to rights to indemnity and contribution under the Notes or the Indenture which may be limited by applicable law; to insolvency and other laws of general application affecting creditors' rights, to limitations under applicable limitations statutes, and to limitations as to the currency in which judgments in Canada may be rendered, as prescribed by the Currency Act (Canada). This opinion is given as of the date hereof and is limited to the laws of the Provinces of Ontario and Québec and the federal laws of Canada applicable thereto. In addition, this opinion is subject to customary assumptions about the Trustee's authorization, execution and delivery of the Indenture and the genuineness of signatures and certain factual matters, all as stated in the letter of such counsel dated September 7, 2018, which has been filed as Exhibit 5.1 to Royal Bank's Form 6-K filed with the SEC dated September 7, 2018.

In the opinion of Morrison & Foerster LLP, when the Notes have been duly completed in accordance with the Indenture and issued and sold as contemplated by the prospectus supplement and the prospectus, the Notes will be valid, binding and enforceable obligations of Royal Bank, entitled to the benefits of the Indenture, subject to applicable bankruptcy, insolvency and similar laws affecting creditors' rights generally, concepts of reasonableness and equitable principles of general applicability (including, without limitation, concepts of good faith, fair dealing and the lack of bad faith). This opinion is given as of the date hereof and is limited to the laws of the State of New York. This opinion is subject to customary assumptions about the Trustee's authorization, execution and delivery of the Indenture and the genuineness of signatures and to such counsel's reliance on the Bank and other sources as to certain factual matters, all as stated in the legal opinion dated September 7, 2018, which has been filed as Exhibit 5.2 to the Bank's Form 6-K dated September 7, 2018.