

GLENAYRE TECHNOLOGIES INC

Form 10-Q

November 09, 2004

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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, 2004**

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

For the transition period from _____ to _____

Commission File Number **0-15761**

GLENAYRE TECHNOLOGIES, INC.

(Exact Name of Registrant as Specified in Its Charter)

DELAWARE

98-0085742

(State or Other Jurisdiction of
Incorporation or Organization)

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

**11360 LAKEFIELD DRIVE, DULUTH,
GEORGIA**

30097

(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 No

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

The number of shares outstanding of the Registrant's common stock, par value \$.02 per share, at October 29, 2004 was 67,349,095 shares.

Glenayre Technologies, Inc. and Subsidiaries

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Part I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Glenayre Technologies, Inc. and Subsidiaries

Report of Independent Registered Public Accounting Firm

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

We have reviewed the condensed consolidated balance sheet of Glenayre Technologies, Inc. and Subsidiaries as of September 30, 2004, and the related condensed consolidated statements of operations for the three month and nine month periods ended September 30, 2004 and 2003, the condensed consolidated statement of stockholders' equity for the nine months ended September 30, 2004, and the condensed consolidated statements of cash flows for the nine months ended September 30, 2004 and 2003. These financial statements are the responsibility of the Company's management.

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

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

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Glenayre Technologies, Inc. and Subsidiaries as of December 31, 2003, 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 18, 2004 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, 2003, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

Atlanta, Georgia
November 4, 2004

Table of Contents**GLENAYRE TECHNOLOGIES, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS**

(In thousands)

	<u>September 30,</u>	<u>December 31,</u>
	<u>2004</u>	<u>2003</u>
	<u>(unaudited)</u>	
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 61,244	\$ 65,853
Short-term investments	29,082	33,007
Restricted cash	258	3,148
Accounts receivable, net	12,613	9,769
Inventories, net	6,451	5,828
Other current asset, discontinued operations		3,374
Prepaid expenses and other current assets	3,019	3,180
	<hr/>	<hr/>
Total Current Assets	112,667	124,159
Property, plant and equipment, net	8,822	8,365
Other assets	781	831
	<hr/>	<hr/>
TOTAL ASSETS	\$ 122,270	\$ 133,355
	<hr/>	<hr/>
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	\$ 2,811	\$ 3,142
Deferred revenue	4,372	4,369
Accrued liabilities	15,239	20,695
Accrued liabilities, discontinued operations	3,681	7,567
	<hr/>	<hr/>
Total Current Liabilities	26,103	35,773
Other liabilities	3,444	4,000
Accrued liabilities, discontinued operations - noncurrent	267	3,350
Stockholders' Equity:		
Preferred stock, \$.01 par value; authorized: 5,000,000 shares, no shares issued and outstanding		
Common stock, \$.02 par value; authorized: 200,000,000 shares, outstanding: 2004 - 66,751,066 shares; 2003 - 66,384,928 shares	1,335	1,327
Contributed capital	362,638	362,273
Accumulated deficit	(271,517)	(273,368)
	<hr/>	<hr/>

Total Stockholders' Equity	92,456	90,232
	<u> </u>	<u> </u>
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 122,270	\$ 133,355
	<u> </u>	<u> </u>

See Notes to Condensed Consolidated Financial Statements.

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

	Three months Ended September 30,	
	2004	2003
REVENUES:		
Product sales	\$ 9,320	\$ 10,199
Service revenues	5,533	4,508
	<hr/>	<hr/>
Total Revenues	14,853	14,707
	<hr/>	<hr/>
COST of REVENUES (exclusive of depreciation shown separately below):		
Cost of sales	4,927	4,684
Cost of services	2,581	2,370
	<hr/>	<hr/>
Total Cost of Revenues	7,508	7,054
	<hr/>	<hr/>
GROSS MARGIN (exclusive of depreciation shown separately below):	7,345	7,653
OPERATING EXPENSES:		
Selling, general and administrative expense	5,456	4,802
Provision for doubtful receivables, net of recoveries	81	(56)
Research and development expense	3,098	4,148
Restructuring expense	10	333
Depreciation expense	470	325
	<hr/>	<hr/>
Total Operating Expenses	9,115	9,552
	<hr/>	<hr/>
OPERATING LOSS	(1,770)	(1,899)
	<hr/>	<hr/>
OTHER INCOME (EXPENSES):		
Interest income	289	282
Interest expense	(6)	(9)
Gain on disposal of assets, net	65	
Other gain (loss), net	59	(36)

Total Other Income	407	237
LOSS FROM OPERATIONS BEFORE INCOME TAXES	(1,363)	(1,662)
Provision (benefit) for income taxes	(121)	11
LOSS FROM CONTINUING OPERATIONS	(1,242)	(1,673)
INCOME FROM DISCONTINUED OPERATIONS (NET OF INCOME TAX PROVISION/BENEFIT)	4,742	2,184
NET INCOME	\$ 3,500	\$ 511
INCOME (LOSS) PER WEIGHTED AVERAGE COMMON SHARE		
(1):		
Loss from continuing operations	\$ (0.02)	\$ (0.03)
Income from discontinued operations	0.07	0.03
Net income per weighted average common share	\$ 0.05	\$ 0.01
INCOME (LOSS) PER COMMON SHARE ASSUMING DILUTION		
(1):		
Loss from continuing operations	\$ (0.02)	\$ (0.03)
Income from discontinued operations	0.07	0.03
Net income per weighted average common share	\$ 0.05	\$ 0.01

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

See Notes to Condensed Consolidated Financial Statements.

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

	Nine months Ended September 30,	
	2004	2003
REVENUES:		
Product sales	\$ 22,358	\$ 30,026
Service revenues	14,915	12,652
	<u>37,273</u>	<u>42,678</u>
Total Revenues	<u>37,273</u>	<u>42,678</u>
COST of REVENUES (exclusive of depreciation shown separately below):		
Cost of sales	13,468	13,993
Cost of services	6,967	7,700
	<u>20,435</u>	<u>21,693</u>
Total Cost of Revenues	<u>20,435</u>	<u>21,693</u>
GROSS MARGIN (exclusive of depreciation shown separately below):	16,838	20,985
OPERATING EXPENSES:		
Selling, general and administrative expense	14,775	18,321
Provision for doubtful receivables, net of recoveries	17	(271)
Research and development expense	9,735	14,131
Restructuring expense	122	2,137
Depreciation expense	1,286	733
	<u>25,935</u>	<u>35,051</u>
Total Operating Expenses	<u>25,935</u>	<u>35,051</u>
OPERATING LOSS	<u>(9,097)</u>	<u>(14,066)</u>
OTHER INCOME (EXPENSES):		
Interest income	813	1,210
Interest expense	(220)	(52)
Gain on disposal of assets, net	59	14
Other gain (loss), net	(7)	60

Total Other Income	645	1,232
LOSS FROM OPERATIONS BEFORE INCOME TAXES	(8,452)	(12,834)
Provision (benefit) for income taxes	(68)	39
LOSS FROM CONTINUING OPERATIONS	(8,384)	(12,873)
INCOME FROM DISCONTINUED OPERATIONS (NET OF INCOME TAX PROVISION/BENEFIT)	10,235	2,386
NET INCOME (LOSS)	\$ 1,851	\$(10,487)
INCOME (LOSS) PER WEIGHTED AVERAGE COMMON SHARE		
(1):		
Loss from continuing operations	\$ (0.13)	\$ (0.20)
Income from discontinued operations	0.15	0.04
Net income (loss) per weighted average common share	\$ 0.03	\$ (0.16)
INCOME (LOSS) PER COMMON SHARE ASSUMING DILUTION		
(1):		
Loss from continuing operations	\$ (0.13)	\$ (0.20)
Income from discontinued operations	0.15	0.04
Net income (loss) per weighted average common share	\$ 0.03	\$ (0.16)

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

See Notes to Condensed Consolidated Financial Statements.

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

	Common Stock		Contributed Capital	Accumulated Deficit	Total Stockholders Equity
	Shares	Amount			
Balances, January 1, 2004	66,385	\$1,327	\$362,273	\$(273,368)	\$90,232
Net Income				1,851	1,851
Shares issued for Employee Stock Purchase Plan and option exercises	366	8	365		373
Balances, September 30, 2004	66,751	\$1,335	\$362,638	\$(271,517)	\$92,456

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,	
	2004	2003
	(In thousands)	
NET CASH USED IN OPERATING ACTIVITIES	\$ (7,223)	\$(14,102)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property, plant and equipment	(1,684)	(3,216)
Maturities of short-term securities, net	3,925	5,317
	2,241	2,101
NET CASH PROVIDED BY INVESTING ACTIVITIES		
CASH FLOWS FROM FINANCING ACTIVITIES:		
Issuance of common stock	373	563
Purchase of treasury stock		(34)
	373	529
NET CASH PROVIDED BY FINANCING ACTIVITIES		
NET DECREASE IN CASH AND CASH EQUIVALENTS	(4,609)	(11,472)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	65,853	64,116
	\$61,244	\$ 52,644
CASH AND CASH EQUIVALENTS AT END OF PERIOD		
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the period for:		
Interest	\$ 197	\$ 52
Income taxes	368	234

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 data)
(Unaudited)**

Summary of Significant Accounting Policies

Description of Business

Glenayre Technologies, Inc. and Subsidiaries (Glenayre or the Company) is an established provider of network-based messaging and communications systems and software. Applications enabled by the Company's products include voice messaging, multimedia messaging and other enhanced telephony services. The Company designs, manufactures, markets and services its products principally under the Glenayre name. The Company's customers are communications service providers (CSPs) including wireless and fixed network carriers, as well as broadband and cable service providers. The Company's products make it possible for CSPs to provide a variety of messaging services including voice mail, one-number services, voice-activated dialing and picture messaging to their customers. Glenayre's executive offices are located in the Atlanta metropolitan area.

The Company's operations also include its Wireless Messaging (Paging) business, which the Company began exiting in May 2001. Consequently, the operating results of the Paging segment are reported as discontinued operations in the accompanying financial statements. See Note 3.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. All significant intercompany accounts and transactions are eliminated in consolidation. Operating results for the three and nine months ended September 30, 2004 are not necessarily indicative of the results that may be expected for the year ending December 31, 2004. Glenayre's financial results in any quarter are highly dependent upon various factors, including the timing and size of customer orders and the shipment of products for large orders. Large orders from customers can account for a significant portion of products shipped in any quarter. Accordingly, the shipment of products in fulfillment of such large orders can dramatically affect the results of operations of any single quarter.

For further information, refer to the consolidated financial statements and footnotes thereto included in the Glenayre Technologies, Inc. Annual Report on Form 10-K for the year ended December 31, 2003.

Use of Estimates

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

Cash Equivalents

The Company considers all highly liquid investments purchased with original maturities of three months or less to be cash equivalents. These investments 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.

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Glenayre Technologies, Inc. and Subsidiaries

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

The Company maintains cash and cash equivalents with various financial institutions. These financial institutions are large diversified entities with operations throughout the U.S. and Company policy is designed to limit exposure to any one institution. The Company performs periodic evaluations of the relative credit standing of those financial institutions that are considered in the Company's investment strategy. Restricted cash at September 30, 2004 consists of cash pledged as collateral to secure letters of credit, substantially all of which expire in less than one year.

Short-Term Investments

Short-term investments consist of highly liquid investments purchased with original maturities of greater than three months and less than twelve months.

Accounts Receivable, Net

The Company maintains allowances for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments. On a quarterly basis, the Company applies a reserve calculation based on the aging of its receivables and either increases or decreases its estimate of doubtful accounts accordingly. If the financial condition of the Company's customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required, which such allowances, if any, would be recorded in the period the impairment is identified.

Inventories

Inventories are valued at the lower of average cost or market. In assessing the ultimate realization of inventories, the Company is required to make judgments as to future demand requirements and compare these with the current or committed inventory levels. The reserve requirements generally increase as projected demand requirements decrease due to market conditions, technological and product life cycle changes, and longer than previously expected usage periods. The Company has experienced changes in required reserves in recent periods due to the introduction or discontinuance of product lines, as well as declining market conditions. As a result, charges for obsolescence and slow-moving inventory were approximately \$123,000 and \$710,000 during the nine month periods ended September 30, 2004 and 2003, respectively. At September 30, 2004 and December 31, 2003, inventories of \$6.5 million and \$5.8 million, respectively, were net of reserves of approximately \$2.6 million and \$3.6 million, respectively. In connection with the introduction of new products and services as well as in an effort to demonstrate its products to new and existing customers, the Company, from time to time, delivers new product test systems for demonstration and test to customer third-party locations. The Company expenses the cost associated with new product test equipment upon shipment from the Company's facilities.

Property, Plant and Equipment

Property, plant and equipment, including internally developed software, are stated at cost less accumulated depreciation. Depreciation is computed principally using the straight-line method based on the estimated useful lives of the related assets (buildings, 20 years; furniture, fixtures and equipment, 3-7 years; internally developed software, 5-10 years).

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Glenayre Technologies, Inc. and Subsidiaries

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

Impairment of Long-Lived Assets

The Company records the impairment or disposal of long-lived assets according to Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. The Company reviews the recoverability of its long-lived assets, including buildings, equipment and internal use software when events or changes in circumstances occur that indicate that the carrying value of the asset may not be recoverable. The assessment of possible impairment is based on the Company's ability to recover the carrying value of the asset from the expected future pre-tax cash flows of the related operations. To the extent that the asset is not recoverable, the Company measures the impairment based on the projected discounted cash flows of the asset over the remaining useful life. The measurement of impairment requires management to make estimates of these cash flows related to long-lived assets, as well as other fair value determinations. No impairment was recorded during the nine months ended September 30, 2004.

Foreign Currency Translation

The accounts of foreign subsidiaries have been translated into U.S. dollars using the current exchange rate in effect at the balance sheet date for monetary assets and liabilities; and for non-monetary items, the exchange rates in effect when acquired. Revenues and expenses are translated into U.S. dollars using average exchange rates, except for depreciation, which is translated at the exchange rate in effect when the related assets were acquired. The resulting gains or losses on currency translations, which are not significant, are included in the unaudited condensed consolidated statements of operations or as a cumulative exchange adjustment in the unaudited condensed consolidated statements of stockholders' equity.

Revenue Recognition

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

The Company allocates revenue on arrangements involving multiple elements to each element based on the relative fair value of each element. The Company's determination of fair value of each element in multiple-element arrangements is based on vendor-specific objective evidence (VSOE). The Company limits its assessment of VSOE for each element to the price charged when the same element is sold separately or to that price set by the Company's

pricing authority for new products. The Company has analyzed all of the elements included in its multiple-element arrangements and determined that it has sufficient VSOE to allocate revenue to each element.

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

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Glenayre Technologies, Inc. and Subsidiaries

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

The Company records estimated reductions to revenue for customer programs and incentive offerings including special pricing agreements and other volume-based incentives. If market conditions were to decline, the Company may take actions to increase customer incentive offerings possibly resulting in an incremental reduction of revenue at the time the incentive is offered.

Significant Customers

During the nine months ended September 30, 2004, Nortel Networks (an OEM partner, as described below), Alltel Communications, Nextel Communications and U.S. Cellular, individually accounted for approximately 17%, 15%, 12%, and 12%, respectively, of the Company's total revenue from continuing operations. During the nine months ended September 30, 2003, Nextel Communications, Nortel Networks (an OEM partner) and U.S. Cellular individually accounted for approximately 28%, 15% and 10%, respectively, of the Company's total revenue from continuing operations. Nortel sells the Company's products to several end user customers, including T-Mobile, whose purchases of Glenayre's products from Nortel represented approximately 9% and 13% of the Company's total revenues during the nine months ended September 30, 2004 and 2003, respectively.

Product Related Software Costs

Product related computer software development costs are expensed as incurred in accordance with SFAS No. 86, *Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed*. Such costs are required to be expensed until the point of technological feasibility is established. Costs, which may otherwise be capitalized after such point, are generally not significant and are therefore expensed as incurred.

Internal Use Software Development Costs

The Company capitalizes the cost associated with the internal development of major business process application software in accordance with Statement of Position 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. The Company expenses preliminary project assessment, research and development, re-engineering and application maintenance costs. No costs were capitalized for the nine months ended September 30, 2004 or 2003.

Estimated Warranty Costs

The Company generally warrants its products for one year after sale and a provision for estimated warranty costs is recorded at the time of sale. Factors that affect the Company's warranty liability include the number of units sold, historical and anticipated rates of warranty claims and cost per claim. On a quarterly basis the Company assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary. Should actual warranty experience differ from previous estimates, additional adjustments may be required.

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

The following is a summary of activity of the Company's continuing operations warranty obligation for the nine months ended September 30, 2004:

Balance at January 1, 2004	\$ 1,257
Provision for and changes in warranty obligations	24
Payments of warranty obligations	(370)
Recoveries of warranty obligations	373
	<hr/>
Balance at March 31, 2004	1,284
Provision for and changes in warranty obligations	(158)
Payments of warranty obligations	(320)
Recoveries of warranty obligations	310
	<hr/>
Balance at June 30, 2004	\$ 1,116
Provision for and changes in warranty obligations	(192)
Payments of warranty obligations	(265)
Recoveries of warranty obligations	215
	<hr/>
Balance at September 30, 2004	<u>\$ 874</u>

The provision for and changes in warranty obligations recorded during the third quarter of 2004 includes a reduction of the estimated warranty costs of \$242,000 as a result of a change in estimate. This change in estimate was due to a reduction in the experience rates for one of the Company's product lines as a result of quality enhancements realized during 2004.

The Company also offers post installation extended warranty and support services, known as Glenayre Care, for its products and services to customers. One year of Glenayre Care is generally included in the price of the Company's product. A portion of the product revenue equal to the fair value of the Glenayre Care is deferred at the time the sale of the product is recorded and recognized ratably over the support period. Once this service period expires, the Company's customers generally enter into Glenayre Care agreements of varying terms, which typically require payment in advance of the performance of the extended warranty service. Revenue derived from the sale of post installation support services is recognized ratably over the contracted support period. Deferred revenue at September 30, 2004 related to support services for new product sales and to the sale of post installation support services was approximately \$2.8 million of the \$4.4 million of deferred revenue.

Stock-Based Compensation

The Company grants stock options and issues shares under option plans and an employee stock purchase plan as described in Note 10. The Company accounts for stock option grants and shares sold under the employee stock purchase plan in accordance with APB Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25); and, accordingly, records compensation expense for options granted and sales made at prices that are less than fair market value at the date of grant or sale. No compensation expense is recognized for options granted to employees with an exercise price equal to the fair value of the shares at the date of grant.

The following table compares the Company's results of continuing operations as reported, in which stock-based compensation expense is recorded under the intrinsic value method per APB 25, as compared to the pro forma results of continuing operations whereby stock-based compensation is computed under the fair value method. For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense on a straight-line basis over the options' vesting period.

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

Pro forma results for each of the three and nine-month periods ended September 30, 2004 and 2003 are as follows:

	Three months Ended September 30,		Nine months Ended September 30,	
	2004	2003	2004	2003
Loss from continuing operations as reported	\$(1,242)	\$(1,673)	\$(8,384)	\$(12,873)
Pro forma stock option expense (1)	(420)	(117)	(967)	(395)
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Loss from continuing operations pro forma	<u>\$ (1,662)</u>	<u>\$ (1,790)</u>	<u>\$ (9,351)</u>	<u>\$ (13,268)</u>
Loss from continuing operations per common share as reported	\$ (0.02)	\$ (0.03)	\$ (0.13)	\$ (0.20)
Pro forma stock option expense	<u> </u>	<u> </u>	(0.01)	(0.01)
Loss from continuing operations per common share pro forma	<u>\$ (0.02)</u>	<u>\$ (0.03)</u>	<u>\$ (0.14)</u>	<u>\$ (0.20)</u>
Loss from continuing operations, assuming dilution as reported	\$ (0.02)	\$ (0.03)	\$ (0.13)	\$ (0.20)
Pro forma stock option expense	<u> </u>	<u> </u>	(0.01)	(0.01)
Loss from continuing operations, assuming dilution pro forma	<u>\$ (0.02)</u>	<u>\$ (0.03)</u>	<u>\$ (0.14)</u>	<u>\$ (0.20)</u>

- (1) As a result of terminations in 2004 and 2003 resulting from restructuring activities and voluntary terminations, a credit to the pro forma stock option expense was included in the September 30, 2004 and 2003 pro forma stock option expense. The credit for the three months was approximately \$10,000 and \$51,000, respectively, or \$0.00 per share for each quarter. The credit for the nine months ended September 30, 2004 and 2003 was approximately \$114,000, or \$0.00 per share, and \$345,000, or \$0.01 per share, respectively. This credit related to the pro forma stock option expense previously recognized for these employees in prior periods.

Income Taxes

Income taxes are accounted for using the liability method in accordance with SFAS No. 109, *Accounting for Income Taxes* (FAS 109). Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Contingencies

A contingency is an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset, the reduction of a liability, a loss or impairment of an asset, or an incurrence of a liability. When loss contingencies exist, including but not limited to, pending or threatened litigation, actual or possible claims and assessments, collectability of receivables or obligations related to product warranties and product defects or statutory obligations, the likelihood of the future event or events occurring generally will confirm the loss or impairment of an asset or the incurrence of a liability. The Company accounts for such contingencies in accordance with the provisions of Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*.

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Fair Value of Financial Instruments

The carrying amount of cash and cash equivalents, trade accounts and notes receivable, and other current and long-term liabilities approximates their respective fair values.

Income (Loss) Per Common Share

The Company computes income (loss) per common share pursuant to SFAS No. 128, *Earnings per Share*. The computation of basic income (loss) per share is based on the weighted average number of common shares outstanding during the period. The computation of diluted income (loss) per share is based on the weighted average number of common shares outstanding plus, when their effect is dilutive, potential common stock consisting of shares subject to stock options. There were no shares of potential common stock included in the calculation of diluted income (loss) per share for the three and nine months ended September 30, 2004 and 2003 as their effect would be antidilutive for those periods. See Note 10.

Impact of Recently Issued Accounting Standards

In response to the December 8, 2003 enactment of the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act), the FASB issued Financial Staff Position (FSP) No. FAS 106-1 and 106-2. The Act introduced a prescription drug benefit under Medicare (Medicare Part D) as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D. FSP No. FAS 106-1 and 106-2 are effective for the Company beginning with the year ended December 31, 2003 and the interim period ended September 30, 2004, respectively. Under FAS 106-1 the Company elected to defer recognition of the effects of the Act on its post retirement benefit plan until authoritative guidance on the accounting for the federal subsidy is issued in accordance with alternatives prescribed by FSP No. FAS 106-1. FSP No. FAS 106-2 is applicable if (i) the prescription drug benefits available under the plan to some or all participants for some or all future years are actuarially equivalent to Medicare Part D and thus qualify for the subsidy under the Act and (ii) the expected subsidy will offset or reduce the employer's share of the cost of the underlying postretirement prescription drug coverage on which the subsidy is based. The measures of the APBO or net periodic postretirement benefit cost do not currently reflect any amount associated with the subsidy, as allowed by FSP No. 106-2, because the Company is unable to conclude whether the benefits provided by the plan are actuarially equivalent to Medicare Part D under the Act. Under FAS 106-2, once the Company determines applicability, the Company has two alternative methods of transition: (i) retroactive application to the date of enactment or (ii) prospective application from the date of adoption.

Reclassifications

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

2. Business Restructuring of Continuing Operations

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

Activities.

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During the first quarter of 2004, the Company recorded a restructuring charge of \$58,000 for severance and outplacement services related to the reduction of the Company's workforce in the first and second quarter of 2003. Additionally, the Company recorded net favorable adjustments to its original estimates associated with the Company's 2003 restructuring activities of \$21,000 primarily related to a reduction in accrued severance benefits.

During the second quarter of 2004, the Company recorded restructuring charges of \$88,000 for severance and outplacement services primarily related to the reduction of the Company's manufacturing workforce in April 2004. Additionally, the Company recorded net favorable adjustments to its original estimates associated with the Company's 2003 restructuring activities of \$13,000 primarily related to a reduction in accrued severance benefits.

During the third quarter of 2004, the Company recorded restructuring charges of \$2,000 for severance and outplacement services primarily related to the reduction of the Company's manufacturing workforce in April 2004. Additionally, the Company recorded net unfavorable adjustments to its original estimates associated with the Company's 2003 restructuring activities of \$8,000 primarily related to an increase in lease cancellation and other costs.

During the first quarter of 2003, the Company recorded a restructuring charge of \$234,000 for severance and outplacement services related to the reduction of the Company's workforce by approximately 19 positions impacting several functional areas within the Company. Additionally, the Company recorded net favorable adjustments to its original estimates associated with the Company's 2002 and 2001 restructuring activities of \$12,000 primarily related to a reduction in accrued severance benefits.

During the second quarter of 2003, the Company recorded a restructuring charge of \$1.4 million for severance and outplacement services related to the reduction of the Company's workforce by approximately 64 positions impacting several functional areas within the Company. In addition to the restructuring charge, a net favorable adjustment of \$41,000 was recorded related to the original estimates associated with the Company's 2003 first quarter restructuring charge for severance. Additionally, the Company recorded a restructuring charge of \$183,000 related to lease cancellation and other exit costs expected to be incurred by the Company through October 2006.

During the third quarter of 2003, the Company recorded a restructuring charge of \$222,000 for severance and relocation related to the October 31, 2003 termination of the Company's president and chief executive officer. In addition, the Company recorded a restructuring charge of \$222,000 related to a reduction of the Company's workforce by approximately 12 positions impacting several functional areas within the Company. The Company also recorded a charge of \$69,000 for other exit costs incurred in the third quarter of 2003. Additionally, the Company recorded net favorable adjustments to its original estimates associated with the Company's 2003 and 2001 restructuring activities of \$180,000 related to severance and facility leases.

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The following is a summary of activity for the nine months ended September 30, 2004 related to the restructuring reserves:

	Severance and Benefits	Lease Cancellation and Other Exit Costs	Total	
Balance at January 1, 2004	\$ 240	\$ 953	\$ 1,193	
Expense accrued	58		58	
Credits and changes in estimates	(11)	(10)	(21)	
Payments	(190)	(176)	(366)	-
	<u> </u>	<u> </u>	<u> </u>	
Balance at March 31, 2004	\$ 97	\$ 767	\$ 864	-
	<u> </u>	<u> </u>	<u> </u>	
Expense accrued	88		88	
Credits and changes in estimates	(13)		(13)	
Payments	(107)	(170)	(277)	-
	<u> </u>	<u> </u>	<u> </u>	
Balance at June 30, 2004	\$ 65	\$ 597	\$ 662	-
	<u> </u>	<u> </u>	<u> </u>	
Expense accrued	2	0	2	
Credits and changes in estimates	0	8	8	
Payments	(36)	(232)	(268)	-
	<u> </u>	<u> </u>	<u> </u>	
Balance at September 30, 2004	\$ 31	\$ 373	\$ 404	-
	<u> </u>	<u> </u>	<u> </u>	<u> </u>

3. Discontinued Operations

In May 2001, the Company began exiting its Paging business and refocusing all of its strategic efforts on the Enhanced Services Messaging business segment based in Atlanta, Georgia. As a result, the Paging segment was reported as a disposal of a segment of business in the second quarter 2001 in accordance with APB Opinion No. 30, *Reporting the Results of Operations Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*. Accordingly, the operating results of the Paging

segment have been classified as a discontinued operation for all periods presented in the Company's unaudited condensed consolidated statements of operations. Additionally, the Company has reported all of the Paging segment assets at their estimated net realizable value in the Company's unaudited condensed consolidated balance sheet as of September 30, 2004. All business transactions related to the Paging segment, with the exception of existing contractual obligations, ceased by May 2002, the end of the transition period.

Results for discontinued operations consist of the following:

	Three Months Ended September 30,		Nine months Ended September 30,	
	2004	2003	2004	2003
Gain on disposal before income taxes	\$4,806	\$2,184	\$ 9,007	\$2,386
Income Tax (Expense) Benefit	(64)	—	1,228	—
Income from discontinued operations	<u>\$4,742</u>	<u>\$2,184</u>	<u>\$10,235</u>	<u>\$2,386</u>

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In the first quarter of 2004, as a result of the Company's review of the estimated liabilities and future commitments related to the discontinued operations, a net decrease in the loss on disposal of \$379,000 was recorded. The adjustments to the original estimates related primarily to better than anticipated recoveries received from paging customers and to asset and inventory liquidations. In addition, the Company recorded a \$1.3 million reduction in its tax liability relating to the discontinued operations primarily due to receiving a favorable assessment for several prior tax years relating to one of the Company's foreign subsidiaries.

During the second quarter of 2004, as a result of the Company's review of the estimated liabilities and future commitments related to the discontinued operations, the Company recorded a net decrease in the loss on disposal of \$3.8 million. \$1.5 million of this decrease was a reduction to the Company's liability for legal and other costs associated with its former Vancouver facility as a result of entering into a favorable settlement agreement with Pilot Pacific Properties Inc. and its associated companies subsequent to June 30, 2004. The remaining \$2.3 million decrease was primarily due to (i) reductions in the liability for costs related to performance obligations the Company has with its various paging customers as third parties have the capability to provide the necessary support, (ii) to the collection of accounts receivable previously reserved for and (iii) to additional inventory liquidations.

During the third quarter of 2004, as a result of the Company's review of the estimated liabilities and future commitments related to the discontinued operations, the Company recorded a net decrease in the loss on disposal of \$4.7 million. \$4.3 million of this decrease related to funds the Company received during the third quarter of 2004 as a result of entering into a favorable settlement agreement with Pilot Pacific Properties Inc. and its associated companies relating to the Company's former Vancouver facility. The remaining \$0.4 million decrease was primarily due to (i) additional inventory liquidation and (ii) the expiration of a sales tax liability guarantee associated with the 1999 sale of the Company's Western Multiplex division.

In the first quarter of 2003, as a result of the Company's review of the estimated asset values and liabilities and future commitments related to the discontinued operations, a net reduction in the loss on disposal of \$1.3 million was recorded. The adjustments to the original estimates made at May 23, 2001 related primarily to collections of accounts receivable previously reserved for, reduction in the original estimate of anticipated headcount related costs to support the on-going obligations and commitments partially offset by additional write-down of the market value of the Singapore facility.

In the second quarter of 2003, as a result of the Company's review of the estimated asset values and liabilities and future commitments related to the discontinued operations, a net increase in the loss on disposal of \$1.1 million was recorded. The adjustments to the original estimates made at May 23, 2001 related mainly to additional write-down of the market value of the Company's Vancouver, British Columbia facility partially offset by collections of accounts receivable previously reserved for and better than expected warranty experience.

In the third quarter of 2003, as a result of the Company's review of the estimated asset values and liabilities and future commitments related to the discontinued operations, a net reduction in the loss on disposal of \$2.2 million was recorded. The adjustments to the original estimates made at May 23, 2001 related mainly to a reduction in the original estimate of headcount related and other operating costs, offset by additional recoveries related to the support of the on-going obligations.

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4. Accounts Receivable

Accounts receivable related to continuing operations consist of:

	September 30, 2004	December 31, 2003
Trade receivables	\$ 12,982	\$ 10,132
Less: allowance for doubtful accounts	(369)	(363)
	<u> </u>	<u> </u>
	\$ 12,613	\$ 9,769
	<u> </u>	<u> </u>

5. Inventories

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

	September 30, 2004	December 31, 2003
Raw materials	\$ 3,420	\$ 3,552
Work-in-process	815	772
Finished goods	2,216	1,504
	<u> </u>	<u> </u>
	\$ 6,451	\$ 5,828
	<u> </u>	<u> </u>

6. Accrued Liabilities

Accrued liabilities at September 30, 2004 and December 31, 2003 consisted of:

September 30,	December 31,
--------------------------	-------------------------

	2004	2003
Accrued income taxes	\$ 5,515	\$ 6,590
Accrued royalty fees	1,406	1,262
Accrued payroll costs	2,767	3,244
Accrued warranty costs	874	1,257
Accrued loss on unfavorable contracts		1,884
Accrued restructuring costs	400	979
Accrued legal fees	303	1,238
Other accruals	3,974	4,241
	<u> </u>	<u> </u>
	\$ 15,239	\$ 20,695
	<u> </u>	<u> </u>

7. Other Liabilities

Other liabilities at September 30, 2004 and December 31, 2003 consist of:

	September 30, 2004	December 31, 2003
Post retirement benefit accrual	\$ 2,234	\$ 2,336
Accrued restructuring costs	4	214
Other	1,206	1,450
	<u> </u>	<u> </u>
	\$ 3,444	\$ 4,000
	<u> </u>	<u> </u>

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8. Income Taxes

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

	Three Months Ended September 30,		Nine months Ended September 30,	
	2004	2003	2004	2003
Income tax benefit federal U.S. statutory rate	\$(477)	\$(582)	\$(2,958)	\$(4,492)
Increase in valuation allowance	465	571	2,924	4,463
Foreign taxes	16	11	69	39
Reduction in foreign valuation allowance	(137)		(137)	
Other non deductibles	12	11	34	29
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Income tax provision	<u>\$ (121)</u>	<u>\$ 11</u>	<u>\$ (68)</u>	<u>\$ 39</u>

The Company accounts for income taxes under the liability method in accordance with FAS 109. At September 30, 2004, the Company's net deferred tax asset was fully reserved by a valuation allowance. Pursuant to FAS 109, a valuation allowance should be recognized to reduce the deferred tax asset to the amount that is more likely than not to be realized as offsets to the Company's future taxable income. The Company assessed whether the net deferred asset at September 30, 2004 was realizable and determined due to significant net operating losses and its inability to project future taxable income that the entire amount should be reserved.

9. Employee Benefit Plans, Postretirement Health Care Benefits

Net postretirement benefit costs consist of the following components:

	Three Months Ended September 30,		Nine months Ended September 30,	
	2004	2003	2004	2003
Service Cost	\$ 9	\$ 6	\$ 36	\$ 94
Interest cost on APBO	28	20	82	142

Amortization of transition obligation		(2)		23
Amortization of prior service costs	(64)	(75)	(191)	(60)
Amortization of actuarial loss	14	20	44	37
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
	\$ (13)	\$ (31)	\$ (29)	\$ 236
	<u> </u>	<u> </u>	<u> </u>	<u> </u>

The plan was amended effective June 1, 2003 reducing the number of participants by changing eligibility provisions. Consequently, the unrecognized prior service cost decreases the postretirement benefit costs as it is amortized. The Company reported in its financial statements for the year ended December 31, 2003, that it expects to contribute \$70,000 to its postretirement health care plan in 2004.

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

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

	Three Months Ended September 30,		Nine months Ended September 30,	
	2004	2003	2004	2003
Numerator:				
Net loss from continuing operations	\$ (1,242)	\$ (1,673)	\$ (8,384)	\$ (12,873)
Denominator:				
Denominator for basic income from continuing operations per share weighted average shares	66,711	65,825	66,593	65,651
Effect of dilutive securities: Stock options	—	—	—	—
Denominator for diluted loss from continuing operations per share	<u>66,711</u>	<u>65,825</u>	<u>66,593</u>	<u>65,651</u>
Loss from continuing operations per weighted average common share	<u>\$ (0.02)</u>	<u>\$ (0.03)</u>	<u>\$ (0.13)</u>	<u>\$ (0.20)</u>
Loss from continuing operations per common share-assuming dilution	<u>\$ (0.02)</u>	<u>\$ (0.03)</u>	<u>\$ (0.13)</u>	<u>\$ (0.20)</u>

There were no shares of potential common stock included in the calculation of diluted loss per share for the three and nine months ended September 30, 2004 and 2003 as their effect would be antidilutive for those periods.

(b) Incentive Stock Plans

The Company maintains two stock option plans (the 1996 Plan and the 1991 Plan) and an employee stock purchase plan that were approved by the stockholders. These plans are administered by the Compensation and Plan Administration Committee of the Board of Directors (the Compensation Committee) and are utilized to promote the long-term financial interests and growth of the Company. The 1996 and 1991 Plans as amended, authorize the grant of

up to 9,650,000 and 11,475,000 shares, respectively, of the Company's common stock for issuance in connection with the grant of stock options, stock appreciation rights, restricted stock and performance shares.

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

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

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The fair value for these options was estimated at the date of grant using the Black-Scholes option-pricing model with the following assumptions:

	September 30, 2004	September 30, 2003
Expected Life in Years	1 to 4	1 to 4
Risk Free Interest Rate	2.1% to 4.1%	1.2% to 4.3%
Volatility	0.78	0.85
Dividend Yield		

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

11. Commitments and Contingencies*Litigation*

Pilot Pacific Properties, Inc. - In August 2001, the Company filed two lawsuits against Pilot Pacific Properties, Inc. (Pilot Pacific), in Vancouver, British Columbia seeking total damages of over \$12.0 million (Canadian) for breach of fiduciary duties and improper charges made to, and paid by, Glenayre in connection with the development and construction of an office building in Vancouver. In response, Pilot Pacific filed counterclaims against the Company for unpaid invoices of \$6.0 million (Canadian) and lost profits of \$60.0 to \$65.0 million (Canadian), as well as seeking to retain approximately \$5.3 million (Canadian) held in trust. On February 10, 2004, the Company commenced an action against E Court V Holdings, Ltd. (E Court), a related company to Pilot Pacific. In this E Court action, the Company alleged that Pilot Pacific improperly contributed to E Court funds that were provided to Pilot Pacific for the designated purpose of constructing the Company's office building in Vancouver (as described above) and which E Court used to purchase a neighboring property. The Company also registered a Certification of Pending Litigation against such property. E Court asserted in a counterclaim that this action was improperly commenced. This E Court action was consolidated with the case against Pilot Pacific in May 2004.

In July 2004 the Company entered into a settlement agreement with Pilot Pacific, and its associated companies including E Court (collectively, Pilot) related to all outstanding matters between the parties. As part of the terms of this settlement, the Company received \$4.3 million (\$5.7 million Canadian) and Pilot placed an additional \$2.0 million (Canadian) in escrow for an agreed-upon investigation period during which the Company is entitled to search for additional recoverable assets. In addition, during the third quarter of 2004 as part of the terms of this settlement agreement, the Company received \$3.2 million (\$4.4 million Canadian) plus interest for monies the Company previously deposited with the court as security for Pilot's claim of lien in connection with the 2003 sale of

the Vancouver facility. At the end of the investigation period, the Company must elect to accept or reject the settlement. If the settlement is accepted, the Company will receive the \$2.0 million (Canadian) from escrow plus the value of additional recoverable assets (if any) discovered during the investigation period, and all current claims by the Company and Pilot against each other will be dismissed. If the Company rejects the settlement, the litigation, including Pilot's claims against the Company, would continue with the trials likely being held in 2005. If the Company elects to continue with the trials, the \$2.0 million (Canadian) currently held in escrow plus the value of any additional recoverable assets discovered during the investigation period would remain in trust or be otherwise secured. The Company anticipates that it will complete its search for additional assets during the fourth quarter of 2004.

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

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

In March 2004, one of the lawsuits was discontinued by the plaintiffs. In April 2004, the Company made an application for grant of summary judgment in an action chosen to be a representative case for this matter, but the plaintiffs in this representative case discontinued their lawsuit in October 2004. The remaining eighteen lawsuits seek approximately \$18.4 million (Canadian) in total damages.

On May 16, 2003, a further action was commenced against the same defendants, including the Company, seeking \$6.0 million (Canadian) on behalf of twenty plaintiffs alleging personal injury as a result of the contamination. None of the statements of claims of these plaintiffs were served on the Company within the statutory period. All of these claims were discontinued, with the exception of one group of plaintiffs, whose claim has now expired because of lack of service of the statement of claim. As a result, all of these claims are at an end.

Infringement of intellectual property rights - In connection with the sale and licensing of the Company's products, the Company typically agrees to defend and indemnify its customers against claims that the Company's products infringe the intellectual property rights of third parties.

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

\$2.7 million judgment plus interest and costs during the second quarter of 2004.

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On May 14, 2004, Jackson filed a motion with the district (trial) court to set trial on remaining issues of contributory infringement and inducement to infringe Jackson's patent. On June 29, 2004, the trial court ruled that there were no issues remaining between the parties and denied Jackson's motion to set trial on remaining issues. Jackson is currently appealing this ruling. The Company believes that it is unlikely that the appellate court will reverse the trial court's ruling of June 29, 2004.

AudioFAX - In July 2003, the Company received a letter and supporting materials from the Intellectual Property Asset Corporation (IPAC), representing AudioFAX IP LLC (AudioFAX), informing the Company that AudioFAX is the owner of certain U.S. and Canadian patents relevant to the fax processing business, and inquiring as to the Company's interest in obtaining a license to use these patents. After thorough review of such patents, the Company communicated to AudioFAX in early 2004 that the Company did not believe that a license of such AudioFAX patents was necessary based on the Company's current product portfolio. AudioFAX disagreed with the Company's analysis and has continued to assert that certain of the Company's products require it to obtain a license of AudioFAX's patents. Included in the Company's accrued liabilities at September 30, 2004 is a \$200,000 accrual related to this matter.

In September 2004, the Company was notified by IPAC that on August 31, 2004 AudioFAX had been issued another patent in the area of enhanced fax / unified messaging that certain of the Company's products may infringe. The Company is in the process of investigating the claims and validity of this most recently issued AudioFAX patent.

The Company believes that if it were determined to be necessary or advisable to license the AudioFAX patent portfolio, the Company could acquire a fully paid-up license to such patent portfolio by paying licensing fees in the range of \$200,000 to \$1,300,000.

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

Other Commitments

In prior years the Company sold its microwave radio business, Western Multiplex Corporation, which merged with Proxim Corporation in March 2002. The Company is contingently liable for Proxim's building lease payments through September 2006. The maximum contingent liability as of September 30, 2004 for this obligation is approximately \$1.1 million.

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

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

Actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors including those set forth under *Risk Factors That May Affect Future Results* below. All forward-looking statements included in this Quarterly Report on Form 10-Q are based on information available to the Company on the date hereof. The Company assumes no obligation to update any forward-looking statements.

Overview

The past three years have been very challenging for the telecommunications industry generally and the wireless segment in particular. Capital spending by Communication Service Providers (CSPs) on network expansions declined as the CSPs focused on improving their return on capital investments through operating efficiencies. Total cost of ownership, including product quality and the ease of implementing technology advancements became significant factors in the CSPs capital spending decisions. Attracting and retaining wireless subscribers continues to be a key focus for CSPs, and has intensified as a result of portability laws that came into effect during 2003. While much of the recent competition between wireless carriers has been focused around pricing plans, the use of features and applications to create differentiation continues to be an important strategy. If the general health of the wireless industry continues to improve, the Company anticipates additional competition between wireless carriers based on technology and applications that will result in increased spending related to such applications.

The Company has responded to this changing environment with significant quality improvements to its legacy products, with product cost reductions that allow it to price its products more competitively, and with a continued focus on customer satisfaction. In addition, despite several restructurings to reduce operating costs, the Company has remained focused on the development of Versera ICE, the Company's next generation messaging platform, and the introduction of several new applications including Multimedia messaging, Missed Call, and MessageMe. During the second and third quarter of 2004 the Company recorded the sales of its first next generation messaging platforms and began generating revenues from the new applications.

Year-to-date revenues through September 30, 2004 declined from the same period last year due to reductions in capital spending by the Company's carrier customers for the Company's products and to price reductions necessitated by increased price competition. The decrease in product revenue was partially offset by an increase in extended warranty and support service revenue from the Company's growing installed base of messaging systems. Gross margins declined during the same period primarily due to a \$2.7 million charge the Company recorded during the first quarter of 2004 as a result of damages awarded to Philip Jackson in a patent infringement suit against Glenayre (see Part II, Item 1. Legal Proceedings) and to price reductions necessitated by increased price competition. Operating expenses declined from the same period last year as a result of restructuring activities the Company implemented during 2003.

During the remainder of 2004, the Company plans to maintain its focus on marketing the new Versera ICE next generation messaging platform, on developing new applications and on obtaining new distribution channels for these products. In addition, the Company will continue to explore opportunities to grow through both complementary and

diversified acquisitions and strategic investments.

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Critical Accounting Policies and Estimates

General. The Company's discussion and analysis of its financial condition and results of operations are based upon the Company's unaudited condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these unaudited condensed consolidated financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. The Company believes the following critical accounting policies affect the more significant judgments and estimates used in the preparation of its unaudited condensed consolidated financial statements.

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

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

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

The Company records estimated reductions to revenue for customer programs and incentive offerings including special pricing agreements and other volume-based incentives. If market conditions were to decline, the Company may take actions to increase customer incentive offerings possibly resulting in an incremental reduction of revenue at the time the incentive is offered.

The Company's revenue recognition policy is significant because its revenue is a key component of the Company's results of operations. In addition, the recognition of revenue determines the timing of certain expenses, such as commissions and royalties. Although the Company follows specific and detailed guidelines in measuring revenue, certain judgments affect the application of its revenue policy. Revenue results are difficult to predict, and any shortfall

in revenue or delay in recognizing revenue could cause the Company's operating results to vary significantly from quarter to quarter and could result in future operating losses.

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Bad Debt. The Company maintains allowances for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments. On a quarterly basis the Company applies a reserve calculation based on the aging of its receivables and either increases or decreases its estimate of doubtful accounts accordingly. If the financial condition of the Company's customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required, and such allowances, if any, would be recorded in the period the impairment is identified.

Estimated Warranty Costs. The Company generally warrants its products for one year after sale and a provision for estimated warranty costs is recorded at the time of sale. Factors that affect the Company's warranty liability include the number of units sold, historical and anticipated rates of warranty claims and cost per claim. At September 30, 2004, the Company's reserve for warranty obligations was \$874,000. On a quarterly basis the Company assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary. Should actual warranty experience differ from previous estimates, additional adjustments may be required.

The Company also offers post installation extended warranty and support services, known as Glenayre Care, for its products and services to customers. One year of Glenayre Care is generally included in the price of the Company's product. A portion of the product revenue equal to the fair value of the Glenayre care is deferred at the time the sale of the product is recorded and recognized ratably over the support period. Once this service period expires, the Company's customers generally enter into Glenayre Care agreements of varying terms, which typically require payment in advance of the performance of the extended warranty service. Revenue derived from post installation support services are recognized ratably over the contracted support period. Deferred revenue at September 30, 2004 related to support services for new product sales and to the sale of post installation support services was approximately \$2.8 million of the total \$4.4 million of deferred revenue.

Inventory. The Company states its inventories at the lower of average cost or market. On a quarterly basis the Company assesses the ultimate realization of inventories by making judgments as to future demand requirements compared to the current or committed inventory levels. The reserve requirements generally increase as projected demand requirements decrease due to market conditions, technological and product life cycle changes, and longer than previously expected usage periods. The Company has experienced changes in required reserves in recent periods due to the introduction or discontinuance of product lines, as well as declining market conditions. As a result, charges for obsolescence and slow-moving inventory were approximately \$123,000 and \$710,000 during the nine months ended September 30, 2004 and 2003, respectively. At September 30, 2004 and December 31, 2003, inventories of \$6.5 million and \$5.8 million, respectively, were net of reserves of approximately \$2.6 million and \$3.6 million, respectively. It is possible that significant changes in required inventory reserves may continue to occur in the future if there is a decline in market conditions or if additional product lines are discontinued. In connection with the introduction of new products and services as well as in an effort to demonstrate its products to new and existing customers, the Company, from time to time, delivers new product test systems for demonstration and test to customer third-party locations. The Company expenses the cost associated with new product test equipment upon shipment from the Company's facilities.

Wind-Down of Discontinued Operations. During 2001, the Company recorded a significant loss from discontinued operations related to the discontinuance of the Paging segment. At September 30, 2004 the Company had current liabilities and non-current liabilities of \$3.7 million and \$0.3 million, respectively, related to the discontinued Paging segment. Approximately \$2.1 million of these liabilities relate to international franchise tax obligations recorded prior to the discontinuance of the segment. Approximately \$1.9 million of these liabilities relate to one time charges recorded in the second quarter of 2001 and consists of (i) lease commitments and (ii) estimated operating costs during the wind down period and other estimated business exit costs related to meeting customer contractual commitments.

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Numerous estimates and assumptions were made in determining the net realizable value related to the discontinued operations' assets and various obligations noted above. These original estimates have been and are subject to further recalculation as a result of future changes in estimates related to the Company's future obligations associated with its pre-existing contractual commitments and actions to finalize the abandonment of the discontinued operations. See *Discontinued Operations* below.

Taxes. Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*, (FAS 109) establishes financial accounting and reporting standards for the effect of income taxes. The objectives of accounting for income taxes are to recognize the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity's financial statements or tax returns. Judgment is required in assessing the future tax consequences of events that have been recognized in the Company's financial statements or tax returns. Fluctuations in the actual outcome of these future tax consequences could materially impact the Company's financial position or its results of operations.

At December 31, 2003, the Company had net deferred tax assets of \$146.5 million. The Company is required to record a valuation allowance to reduce its deferred tax assets to the amount that is more likely than not to be realized. In 2001, the Company assessed whether its net deferred asset was realizable and determined due to the significant net operating losses and management's then current inability to project future taxable income that the entire amount should be reserved. During 2002 and 2003, due to its continued operating losses, the Company maintained a full valuation allowance. Until the Company reaches an appropriate level of profitability, no tax benefits associated with the net deferred tax assets will be recognized. While the Company has considered future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for the valuation allowance, in the event the Company were to determine that it would be able to realize its deferred tax assets in the future an adjustment to the deferred tax asset would increase income in the period such determination was made.

Contingencies. A contingency is an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss, that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability. When loss contingencies exist, including but not limited to, pending or threatened litigation, actual or possible claims and assessments, collectability of receivables or obligations related to product warranties and product defects or statutory obligations, the likelihood of the future event or events occurring generally will confirm the loss or impairment of an asset or the incurrence of a liability. The Company accounts for such contingencies in accordance with the provisions of Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*. The Company records a provision for estimated legal costs associated with the defense of pending or threatened litigation at the time pending or threatened litigation is identified by the Company and such legal costs can be reasonably estimated. The Company records a loss contingency for unfavorable contracts at the time the loss is determined to be probable and the amount of loss can be reasonably estimated.

Discontinued Operations

In May 2001, as a result of the rapid decline in both the paging infrastructure and device market and certain paging carriers' financial health, the Company adopted a plan to exit the Paging business. Wireless messaging products included switches, transmitters, receivers, controllers and related software and two-way messaging devices. As a result, the Paging segment was reported as a disposal of a segment of business in the second quarter of 2001. Accordingly, the operating results of the Paging segment have been classified as a discontinued operation for all periods presented in the Company's unaudited condensed consolidated statements of operations. Additionally, the Company has reported all of the Paging segment assets at their estimated net realizable value in the Company's unaudited condensed consolidated balance sheets as of September 30, 2004 and December 31, 2003 in accordance with APB Opinion No. 30, *Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a*

Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions. See Note 3 to the Company's unaudited condensed consolidated financial statements.

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During 2001, the Company recorded a loss from discontinued operations of approximately \$232.5 million related to the discontinuance of the Paging segment. This loss consisted of (i) operating losses of approximately \$46.8 million incurred in the Paging segment and (ii) an estimated loss on disposal of the segment of approximately \$185.7 million which included charges for the following: (a) the write-off of goodwill and other intangibles, (b) impairment reserves on property, plant and equipment, (c) customer accounts and notes receivable settlement costs, (d) employee termination costs, (e) inventory and non-inventory purchase commitments, (f) anticipated losses from operations during the twelve-month transition period, (g) facility exit and lease termination costs, (h) expenses to be incurred to fulfill existing contractual obligations and (i) a valuation allowance for related deferred tax assets.

The Company believes all business transactions related to the Paging segment, with the exception of existing contractual obligations, were completed by May 2002. As of September 30, 2004, the Company reported current liabilities and non-current liabilities of \$3.7 million and \$0.3 million, respectively related to the discontinued Paging segment. Approximately \$2.1 million of these liabilities relate to international franchise tax obligations arising prior to the discontinuance of the segment. Approximately \$1.9 million of these liabilities relate to one-time charges recorded in the second quarter of 2001 and consist of (i) lease commitment costs and (ii) estimated operating costs during the wind-down period and other estimated business exit costs related to meeting customer contractual commitments.

During the three months ended September 30, 2004, as a result of the Company's review of the estimated liabilities and future commitments related to the discontinued operations, the Company recorded a net decrease in the loss on disposal of \$4.7 million. \$4.3 million of this decrease related to funds the Company received during the third quarter of 2004 as a result of entering into a favorable settlement agreement with Pilot Pacific Properties Inc. and its associated companies relating to the Company's former Vancouver facility. Refer to Part II, Item 1. Legal Proceedings for additional information. The remaining \$0.4 million decrease was primarily due to (i) inventory liquidations and (ii) the expiration of a sales tax liability guarantee associated with the 1999 sale of the Company's Western Multiplex division.

During the three months ended June 30, 2004, as a result of the Company's review of the estimated liabilities and future commitments related to the discontinued operations, the Company recorded a net decrease in the loss on disposal of \$3.8 million. \$1.5 million of this decrease was a reduction to its liability for legal and other costs associated with its former Vancouver facility as a result of entering into a favorable settlement agreement with Pilot Pacific Properties Inc. and its associated companies subsequent to June 30, 2004. Refer to Part II, Item 1. Legal Proceedings for additional information. The remaining \$2.3 million decrease was primarily due to (i) a reduction in the liability for costs related to performance obligations the Company has with its various paging customers as third parties have the capability to provide the necessary support, (ii) better than anticipated recoveries received from paging customers, (iii) the collection of accounts receivable previously reserved for and iv) asset and inventory liquidations.

During the three months ended March 31, 2004, the Company recorded a \$1.3 million reduction in its tax liability relating to the discontinued operations primarily due to receiving a favorable assessment for several prior tax years relating to one of the Company's foreign subsidiaries. As a result of the Company's review of the estimated liabilities and future commitments related to the discontinued operations, a net decrease in the loss on disposal of \$379,000 was also recorded in the first quarter.

During the year ended December 31, 2003, the Company recorded a net reduction in the loss on the disposal of \$16.1 million. These recalculations of the original estimates made in May 2001 were primarily due to better than anticipated revenue during the transition period, lower than anticipated costs to fulfill future contractual obligations, collections of accounts and notes receivable previously reserved for, better than expected warranty experience and reduced income tax liabilities partially offset by additional write-downs of the market values of the Vancouver and Singapore facilities.

The Company estimates that approximately \$0.3 million of the remaining liabilities associated with the discontinued operations will be disbursed during the fourth quarter of 2004 and the remainder in 2005 and beyond.

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Numerous estimates and assumptions were made in determining the net realizable value of the Company's discontinued assets and various obligations noted above. Management will continue to monitor the Company's future obligations associated with its pre-existing contractual commitments in order to assess the current carrying values of the liabilities associated with the discontinued operations. These original estimates have been and are subject to further recalculation as a result of future changes in estimates related to the Company's future obligations associated with its pre-existing contractual commitments. See Note 3 to the Company's unaudited condensed consolidated financial statements.

Results of Continuing Operations

The following table sets forth for the periods indicated the percentage of total revenue represented by certain line items from Glenayre's unaudited condensed consolidated statements of operations from continuing operations:

	Three Months Ended September 30,		Nine months Ended September 30,	
	2004	2003	2004	2003
REVENUE:				
Product sales	63%	69%	60%	70%
Service revenue	37	31	40	30
	<hr/>	<hr/>	<hr/>	<hr/>
Total Revenue	100	100	100	100
	<hr/>	<hr/>	<hr/>	<hr/>
COST of REVENUE (exclusive of depreciation shown separately below)				
Cost of sales	33	32	36	33
Cost of services	18	16	19	18
	<hr/>	<hr/>	<hr/>	<hr/>
Total Cost of Revenue	51	48	55	51
	<hr/>	<hr/>	<hr/>	<hr/>
GROSS MARGIN (exclusive of depreciation shown separately below)	49	52	45	49
OPERATING EXPENSES:				
Selling, general and administrative expense	37	33	40	43
Provision for doubtful receivables, net of recoveries	*	*	*	(1)
Research and development expense	21	28	26	33
Restructuring expense	*	2	*	5
Depreciation expense	3	2	3	2
	<hr/>	<hr/>	<hr/>	<hr/>
Total Operating Expenses	61	65	69	82

	—	—	—	—
OPERATING LOSS	<u>(12)</u>	<u>(13)</u>	<u>(24)</u>	<u>(33)</u>
OTHER INCOME (EXPENSES):				
Interest income, net	2	2	2	3
Gain on disposal of assets, net	*	*	*	*
Other gain (loss), net	*	*	*	*
	—	—	—	—
Total Other Income	<u>3</u>	<u>2</u>	<u>2</u>	<u>3</u>
LOSS FROM OPERATIONS BEFORE INCOME TAXES	<u>(9)</u>	<u>(11)</u>	<u>(23)</u>	<u>(30)</u>
Benefit (Provision) for income taxes	1	—	*	*
	—	—	—	—
LOSS FROM CONTINUING OPERATIONS	<u>(8)%</u>	<u>(11)%</u>	<u>(23)%</u>	<u>(30)%</u>

* less than 0.5%

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Three months Ended September 30, 2004 and 2003

Revenues. Total revenue from continuing operations for the three months ended September 30, 2004 increased approximately 1% to \$14.9 million as compared to \$14.7 million for the three months ended September 30, 2003. Product sales for the three months ended September 30, 2004 decreased 9% to \$9.3 million as compared to \$10.2 million for the three months ended September 30, 2003. Service revenues for the three months ended September 30, 2004 increased 23% to \$5.5 million as compared to \$4.5 million for the three months ended September 30, 2003. International sales increased to \$2.1 million for the three months ended September 30, 2004 as compared to \$1.2 million for the three months ended September 30, 2003 and accounted for 14% and 8% of total net sales for the three months ended September 30, 2004 and 2003, respectively. The decrease in product sales for the three months ended September 30, 2004 was due primarily to reductions in capital spending by the Company's carrier customers for the Company's products and to price reductions necessitated by increasing price competition. The increase in net service revenues was primarily due to increased post installation support revenue resulting from the growth of the installed base of messaging systems.

During the three months ended September 30, 2004, three customers individually accounted for approximately 22%, 12% and 10% of the Company's total revenue from continuing operations. During the three months ended September 30, 2003, three customers individually accounted for 39%, 13% and 11% of the Company's total revenue from continuing operations. There can be no assurance that these significant customers will continue to purchase systems and services from the Company at current levels in the future, and the loss of these significant customers could have a material adverse affect on the Company's business, financial condition or results of operations.

Gross Margins on Product Sales and Services (exclusive of depreciation). Gross margin on products sold, exclusive of depreciation (product margin), was 47% during the three months ended September 30, 2004 compared to 54% during the three months ended September 30, 2003. The decrease in gross margin for the quarter ended September 30, 2004 was due to product mix and to price reductions necessitated by price competition, partially offset by the reduction in estimated warranty costs. Gross margin on services, exclusive of depreciation (service margin), was 53% during the three months ended September 30, 2004 compared to 47% during the three months ended September 30, 2003. Service margins increased during the three months ended September 30, 2004 primarily as a result of an increased volume of extended warranty and support service revenue.

Glenayre's margins may be affected by several factors including, but not limited to: (i) the mix of products sold and services provided, (ii) the price of products sold and services provided and (iii) changes in material costs and other components of cost of sales.

Selling, General and Administrative Expense. Selling, general and administrative expenses increased approximately 14% to \$5.5 million for the three months ended September 30, 2004 from \$4.8 million for the three months ended September 30, 2003. The selling, general and administrative expenses were higher for the three months of 2004 compared to 2003 primarily due to increased selling and marketing costs related to the launch of the Company's new Versera ICE messaging platform and costs associated with the evaluation and testing of the Company's internal controls as required by Section 404 of the Sarbanes-Oxley Act of 2002.

Provision for Doubtful Receivables, net of Recoveries. The provision for doubtful receivables was \$81,000 during the three months ended September 30, 2004 compared to a credit of \$56,000 during the three months ended September 30, 2003. The charge for the three months of 2004 is due to the Company's reserve calculation on the aging of receivables and adjustments to bad debt expense reflecting the Company's assessment of its current credit risk. The credit in the three months of 2003 was primarily due to the collection of older receivables previously reserved as part of the Company's reserve calculation.

Research and Development Expense. Research and development expenses decreased to \$3.1 million during the three months ended September 30, 2004 compared to \$4.1 million during the three months ended September 30, 2003. The decrease of approximately \$1.0 million is primarily attributable to completing the outsourced portions of the core development of the Company's next generation Versera ICE messaging platform product in the fourth quarter of 2003. Research and development costs are expensed as incurred. The Company relies on its research and development programs related to new products and the improvement of existing products for the continued growth in revenues. The Company's ability to continue to develop and effectively bring to market new competitive products is critical to its future success.

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Restructuring Expense. During the third quarter of 2004, the Company recorded restructuring charges of \$2,000 for severance and outplacement services related primarily to the reduction of the Company's manufacturing workforce during the second quarter of 2004. Additionally, the Company recorded net unfavorable adjustments to its original estimates associated with the Company's 2003 restructuring activities of \$8,000 primarily related to an increase in lease cancellation and other costs. During the third quarter of 2003, the Company recorded a restructuring charge of \$222,000 for severance and relocation related to the termination of the Company's president and chief executive officer. In addition the Company recorded a restructuring charge of \$222,000 for severance and outplacement costs related to a reduction of the Company's workforce by approximately 12 positions impacting several functional areas within the Company. The Company also recorded a charge of \$69,000 for other exit costs incurred in the third quarter of 2003. Additionally, a net favorable adjustment of \$180,000 was recorded related primarily to a change in the original estimates associated with the Company's 2003 and 2001 restructuring charges for severance and leased facilities.

Depreciation Expense. Depreciation expense was \$470,000 during the three months ended September 30, 2004 compared to \$325,000 during the three months ended September 30, 2003. The increase in depreciation expense was due to capital equipment purchased during the current and prior periods for use in the development and support of the Company's new Versa ICE messaging platform.

Interest Income. Interest income was \$289,000 and \$282,000 for the three months ended September 30, 2004 and 2003, respectively. Interest earned in the third quarter of 2004 was higher primarily due to higher yields on investment instruments offset by lower cash and short-term investment balances. The Company's weighted average yield on its cash and investments held at September 30, 2004 and 2003 were 1.54% and 1.18% respectively.

Interest Expense. Interest expense was \$6,000 and \$9,000 for the three months ended September 30, 2004 and 2003, respectively.

Gain (Loss) on Disposal of Assets. The Company had a \$65,000 gain on asset disposals for the three months ended September 30, 2004. There were no asset disposals in the third quarter of 2003.

Provision (benefit) for Income Taxes. Due to the Company's operating loss during the third quarter of 2004 and 2003 combined with its significant net operating loss carryforwards, no tax benefit was recognized during either period for domestic operations. In the third quarter of 2004 the Company adjusted its tax liabilities by \$137,000 upon reassessment of certain foreign tax exposures resulting in a related income tax benefit. A provision of approximately \$16,000 and \$11,000 was recorded related to foreign tax on earned income from foreign operations for the three months ended September 30, 2004 and 2003, respectively.

Debt Obligations and Contractual Obligations. In prior years the Company sold its microwave radio business, Western Multiplex Corporation, which merged with Proxim Corporation in March 2002. The Company is contingently liable for Proxim's building lease payments through September 2006. The maximum contingent liability as of September 30, 2004 for this obligation is approximately \$1.1 million.

Nine months Ended September 30, 2004 and 2003

Revenues. Total revenue from continuing operations for the nine months ended September 30, 2004 decreased approximately 13% to \$37.3 million as compared to \$42.7 million for the nine months ended September 30, 2003. Product sales for the nine months ended September 30, 2004 decreased 26% to \$22.4 million as compared to \$30.0 million for the nine months ended September 30, 2003. Service revenues for the nine months ended September 30, 2004 increased 18% to \$14.9 million as compared to \$12.7 million for the nine months ended September 30, 2003. International sales increased to \$6.2 million for the nine months ended September 30, 2004 as

compared to \$4.4 million for the nine months ended September 30, 2003 and accounted for 17% and 10% of total net sales for the nine months ended September 30, 2004 and 2003, respectively. The decrease in product sales for the nine months ended September 30, 2004 was due primarily to reductions in capital spending by the Company's carrier customers for the Company's products and to price reductions necessitated by increasing price competition. The increase in net service revenues was primarily due to increased post installation support revenue resulting from the growth of the installed base of messaging systems.

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During the nine months ended September 30, 2004, four customers individually accounted for approximately 17%, 15%, 12% and 12% of the Company's total revenue from continuing operations. During the nine months ended September 30, 2003, three customers individually accounted for 28%, 15% and 10% of the Company's total revenue from continuing operations. There can be no assurance that these significant customers will continue to purchase systems and services from the Company at current levels in the future, and the loss of these significant customers could have a material adverse affect on the Company's business, financial condition or results of operations.

Gross Margins on Product Sales and Services (exclusive of depreciation). Gross margin on products sold, exclusive of depreciation (product margin), was 40% during the nine months ended September 30, 2004 compared to 53% during the nine months ended September 30, 2003. The decline in the product margin was due to the Company recording a charge of \$2.7 million during the first quarter of 2004 relating to a patent infringement judgment against the Company (see Part II, Item 1. Legal Proceedings) and to unfavorable impact from changes in product mix and price reductions necessitated by increased price competition. This decline was partially offset by the recording of a \$540,000 reduction to the previously recorded reserve for a loss on an unfavorable multi-year contract with one of the Company's major customers that was renegotiated during the second quarter of 2004. Gross margin on services, exclusive of depreciation (service margin), was 53% during the nine months ended September 30, 2004 compared to 39% during the nine months ended September 30, 2003. Service margins increased during the nine months ended September 30, 2004 primarily as a result of cost reductions related to the Company's 2003 restructuring activities and the increased volume of extended warranty and support service revenue.

Glenayre's margins may be affected by several factors including, but not limited to: (i) the mix of products sold and services provided, (ii) the price of products sold and services provided and (iii) changes in material costs and other components of cost of sales.

Selling, General and Administrative Expense. Selling, general and administrative expenses decreased approximately 19% to \$14.8 million for the nine months ended September 30, 2004 from \$18.3 million for the nine months ended September 30, 2003. Selling, general and administrative expenses were lower for the nine months of 2004 compared to 2003 primarily due to reduced employee and facility related costs as a result of the Company's 2003 restructuring activities.

Provision for Doubtful Receivables, net of Recoveries. The provision for doubtful receivables was \$17,000 during the nine months ended September 30, 2004 compared to a credit of \$271,000 during the nine months ended September 30, 2003. The credits in the nine months of 2004 and 2003 were primarily due to the collection of older receivables previously reserved as part of the Company's reserve calculation.

Research and Development Expense. Research and development expenses decreased to \$9.7 million during the nine months ended September 30, 2004 compared to \$14.1 million during the nine months ended September 30, 2003. The decrease of approximately \$4.4 million was primarily attributable to completing the core development of the Company's next generation Versera ICE messaging platform product in 2004. Research and development costs are expensed as incurred. The Company relies on its research and development programs related to new products and the improvement of existing products for the continued growth in revenues. The Company's ability to continue to develop and effectively bring to market new competitive products is critical to its future success.

Restructuring Expense. During the nine months of 2004, the Company recorded a restructuring charge of \$148,000 for severance and outplacement services related to the reduction of the Company's workforce during the first and second quarters of 2003 and the second quarter of 2004. Additionally, the Company recorded net favorable adjustments to its original estimates associated with the Company's 2003 restructuring activities of \$26,000 primarily related to a reduction in accrued severance benefits. During the first nine months of 2003 the Company recorded restructuring charges of \$2.1 million including a restructuring charge of \$222,000 for severance and relocation related to the

termination of the Company's president and chief executive officer. The Company also recorded a restructuring charge of \$1.9 million related to a reduction of the Company's workforce by approximately 96 positions impacting several functional areas within the Company. Additionally, the Company recorded a restructuring charge of \$252,000 for lease cancellation and other exit costs incurred by the Company. In addition to the restructuring charges, a net favorable adjustment of \$233,000 was recorded related primarily to a change in the original sublease recovery estimates associated with the Company's 2001 restructuring charge for leased facilities.

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Depreciation Expense. Depreciation expense was \$1.3 million during the nine months ended September 30, 2004 compared to \$733,000 during the nine months ended September 30, 2003. The increase in depreciation expense was due to capital equipment purchased during the current and prior periods relating to the development and support of the Company's new Versera ICE messaging platform.

Interest Income. Interest income was \$813,000 and \$1.2 million for the nine months ended September 30, 2004 and 2003, respectively. Interest earned in the nine months of 2004 was lower primarily due to lower cash and short-term investments and lower yields on investment instruments. The Company's current weighted average yield on its cash and investments held was 1.54% at September 30, 2004.

Interest Expense. Interest expense was \$220,000 and \$52,000 for the nine months ended September 30, 2004 and 2003, respectively. Interest expense in the first quarter of 2004 included \$200,000 of interest relating to a patent infringement judgment against the Company. See Part II, Item 1. Legal Proceedings.

Gain (Loss) on Disposal of Assets. The Company recorded a \$59,000 gain on disposal of assets for the nine months ended September 30, 2004. No similar gains or losses were recorded for the nine months ended September 30, 2003.

Provision for Income Taxes. Due to the Company's operating loss during the first nine months of 2004 and 2003 combined with its significant net operating loss carryforwards, no tax benefit was recognized during either period for domestic operations. During the third quarter of 2004 the Company adjusted its tax liabilities by \$137,000 upon reassessment of certain foreign tax exposures resulting in a related income tax benefit. A provision of approximately \$69,000 and \$39,000 was recorded related to foreign tax on earned income from foreign operations for the nine months ended September 30, 2004 and 2003, respectively.

Debt Obligations and Contractual Obligations. In prior years the Company sold its microwave radio business, Western Multiplex Corporation, which merged with Proxim Corporation in March 2002. The Company is contingently liable for Proxim's building lease payments through September 2006. The maximum contingent liability as of September 30, 2004 for this obligation is approximately \$1.1 million.

Financial Condition and Liquidity

Overview. At September 30, 2004, the Company had cash and cash equivalents, restricted cash, and short-term investments totaling \$90.6 million. The restricted cash of approximately \$258,000 at September 30, 2004 consisted of cash pledged as collateral to secure letters of credit. At September 30, 2004, Glenayre's principal source of liquidity was its \$61.2 million of cash and cash equivalents and \$29.1 million in short-term investments. The Company's cash generally consists of money market demand deposits and the Company's cash equivalents generally consist of high-grade commercial paper, bank certificates of deposit, treasury bills, notes or agency securities guaranteed by the U.S. government, and repurchase agreements backed by U.S. government securities with original maturities of three months or less. Short-term investments at September 30, 2004 consisted of bank certificates of deposit, and agency securities guaranteed by the U.S. Government with original maturities of greater than three months but less than twelve months. The Company expects to use its cash and cash equivalents and short-term investments for working capital and other general corporate purposes, including the expansion and development of its existing products and markets, liabilities related to discontinued operations, and potential acquisitions.

At September 30, 2004 approximately \$3.9 million in discontinued operations liabilities remain outstanding of which the Company anticipates approximately \$300,000 will be disbursed during the fourth quarter of 2004 and the remainder in 2005 and beyond.

Operating Activities. Due primarily to the operating losses recorded in the nine months ended September 30, 2004 and 2003, cash used in operating activities, including both continuing and discontinued operations, was \$7.2 million and \$14.1 million for the nine months ended September 30, 2004 and 2003, respectively.

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Accounts receivable related to continuing operations increased \$2.8 million to \$12.6 million at September 30, 2004 from \$9.8 million at December 31, 2003. Average days sales outstanding, calculated based on nine months rolling average, increased 2 days to 63 days at September 30, 2004 from 61 days at December 31, 2003. The increase in accounts receivable from continuing operations was due primarily to increased sales for the third quarter of 2004 as compared to the fourth quarter of 2003, and to increased days sales outstanding as a result of a delay in collecting certain past due receivables until subsequent to September 30, 2004.

Inventories related to continuing operations increased \$0.6 million to \$6.4 million at September 30, 2004 from \$5.8 million at December 31, 2003. The increase in inventories was primarily due to deferring the cost, and the related recognition of revenue, on various customer orders for new products shipped to customers during the third quarter where installation that is essential to the functionality of the product was not completed.

Accounts payable decreased \$300,000 to \$2.8 million at September 30, 2004 from \$3.1 million at December 31, 2003 primarily as a result of the timing of inventory purchases. Accrued liabilities related to continuing operations decreased approximately \$5.5 million to \$15.2 million at September 30, 2004 from \$20.7 million at December 31, 2003. The decrease in accrued liabilities was due to charges against and adjustments to the reserve for a loss on an unfavorable multi-year contract, payments of previously accrued restructuring costs, timing of biweekly payroll and related compensation accruals, payment of accrued commissions and reduction in tax liability after receiving a favorable assessment for several prior tax years relating to one of the Company's foreign subsidiaries. See Part I, Item 2, *Discontinued Operations* above for a discussion of the Company's foreign tax assessment. At September 30, 2004, the Company's remaining restructuring obligations were approximately \$404,000 related to employee termination benefits and lease termination costs. The Company anticipates all of the cash payments for its restructuring activities will be made within the next three months with the exception of lease termination costs, which require cash payments through 2005.

Investing Activities. The Company spent \$1.7 million and \$3.2 million during the nine months ended September 30, 2004 and 2003, respectively, on equipment needed in its continuing operations. The Company anticipates that property, plant and equipment purchases related to its continuing operations for the remainder of 2004 will approximate \$700,000.

Financing Activities. During the nine months ended September 30, 2004, and 2003, the Company received proceeds from the sale of Company common stock of \$373,000 and \$563,000 respectively, upon the exercise of stock options and sales of common stock to employees in the Employee Stock Purchase Plan.

In December 2000, the Board of Directors rescinded its 1996 stock repurchase program and authorized the repurchase of up to 3.0 million shares of the Company's common stock. In September 2001, the stock repurchase program was amended to authorize management to repurchase up to 5% of the Company's outstanding common stock, or approximately 3.3 million shares based on shares outstanding as of December 31, 2001. The Company made no purchases during the nine months ended September 30, 2004. For the nine months ended September 30, 2003, the Company repurchased 36,000 shares at a total cost of approximately \$34,000. The Company may commence or suspend purchasing under this program from time to time without notice.

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

At December 31, 2003 the Company has U.S. net operating loss carryforwards (NOLs) aggregating approximately \$254 million, which may be used to offset future taxable income and reduce federal income taxes. These NOLs begin to expire in 2006.

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Summary. The Company believes that its current cash reserves will be sufficient to (i) support the short-term and long-term liquidity requirements for current operations (including annual capital expenditures) and its discontinued operations and (ii) make potential acquisitions and strategic investments. Company management believes that, if needed, it can establish borrowing arrangements with lending institutions.

Outlook

As the telecommunications industry begins to show signs of recovery, timing of Communication Service Provider (CSP) purchasing activity in communications software and messaging products may be somewhat variable. Key growth drivers for the remainder of 2004 and 2005 include:

Replacement of aging legacy systems with next generation platforms;

Continued wireless subscriber growth worldwide;

Increased penetration and acceptance of enhanced services;

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

Deployment of new services across existing network base; and

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

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

The Company also expects that reducing the total cost of ownership of communications systems will remain a primary concern for CSPs. By providing open, standards-based platforms, Glenayre believes it is well positioned to help CSPs offer competitive services with a low total cost of ownership. However, it is possible that macroeconomic conditions may negatively impact this outlook if the industry's economic recovery does not continue.

The Company also intends to continue examining opportunities for growth through both complementary and diversified acquisitions and strategic investments. In January 2004, the Company hired a Chief Acquisition Officer to accelerate its search for potential acquisition and investment candidates. The impact and timing of acquisition and investment decisions on future financial results cannot be predicted.

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

Risk Factors That May Affect Future Results

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

Competition

The majority of the Company's competitors are seasoned communications providers like Glenayre. These companies include Comverse Technologies, Inc., Unisys Corporation, the Octel Messaging division of Lucent Technologies, Inc., InterVoice, LogicaCMG, Tecnomen and Schlumberger-Sema. Like Glenayre, some of these competitors also have the financial stability, aggressive research and development programs and long-term customer relationships required to

compete in the current environment. The competition among these remaining firms continues to be quite fierce and is primarily based on a combination of price, product architecture, features, system capacity, reliability and services and support.

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

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Variability of Quarterly Results and Dependence on Key Customers

The Company's financial results in any single quarter are highly dependent upon the timing and size of customer orders and the shipment of products for large orders. Large orders from customers can account for a significant portion of products shipped in any quarter. During the nine months ended September 30, 2004, Nortel Networks (an OEM partner, as described below), Alltel Communications, Nextel Communications and U.S. Cellular individually accounted for approximately 17%, 15%, 12% and 12%, respectively, of the Company's total revenue from continuing operations. During the nine months ended September 30, 2003, Nextel Communications, Nortel Networks (an OEM partner) and U.S. Cellular individually accounted for approximately 28%, 15% and 10%, respectively, of the Company's total revenue from continuing operations. Nortel sells the Company's products to several end user customers, including T-Mobile, whose purchases of Glenayre's products from Nortel represented approximately 9% and 13% of the Company's total revenue during the nine months ended September 30, 2004 and 2003, respectively. There can be no assurance that these significant customers will continue to purchase systems and services from the Company at current levels in the future, and the loss of one or more of these significant customers could have a material adverse effect on the Company's business, financial condition or results of operations. In the future, the customers with whom the Company does the largest amount of business are expected to vary from quarter to quarter and year to year as a result of the timing for development and expansion of customers' communications networks and systems, the continued expansion into international markets and changes in the proportion of revenues generated by the Company's newly developed products and services. Furthermore, if a customer delays or accelerates its delivery requirements or a product's completion is delayed or accelerated, revenues expected in a given quarter may be deferred or accelerated into subsequent or earlier quarters. Therefore, annual financial results are more indicative of the Company's performance than quarterly results, and results of operations in any quarterly period may not be indicative of results likely to be realized in the subsequent quarterly periods.

Restructuring Activities

The Company continues to assess its business to align resources and achieve its desired cost structure. Past restructuring efforts have been based on certain assumptions regarding the cost structure of the Company's business, which may not be correct. These restructuring efforts may not be sufficient for the Company to achieve profitability and meet the changes in industry and market conditions. The Company will continue to make judgments as to whether further reductions in its workforce may be required. These workforce reductions may impair the Company's ability to achieve its current or future business objectives. Costs incurred in connection with restructuring efforts may be higher than estimated. Any decision by the Company to further limit investment or exit, or dispose of, businesses may result in the recording of additional charges. As a result, the costs actually incurred in connection with the restructuring efforts may be higher than originally planned and may not lead to the anticipated cost savings and a return to profitability.

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

Effective Convergence of Technologies

Glenayre is dependent on the continued growth of its markets as well as the effective and successful convergence of technologies for its systems and related applications and solutions. The markets for these technologies are still developing and market acceptance of some of these services is uncertain. If the commercial market for these services is lower than Glenayre anticipates, or grows more slowly than Glenayre anticipates, it could have a material adverse

effect on the Company's business. There can be no assurance that these technologies will be successfully integrated or that a significant commercial market for the integrated services will develop.

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Potential Market Changes Resulting from Rapid Technological Advances

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

Proprietary Technology

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

Potential Intellectual Property Infringement Claims from Third Parties

Substantial litigation regarding intellectual property rights continues in the technology industry and the Company is subject to certain infringement claims.

In April 2004 the Company lost an appeal of a patent infringement judgment awarded to Phillip Jackson of approximately \$2.7 million in damages, plus interest and costs. While the Company satisfied the judgment obtained by Jackson in May 2004, Jackson has asserted a right to seek additional damages. The trial court ruled that Jackson is not entitled to seek additional damages, but Jackson has appealed this ruling (see Part II, Item 1. Legal Proceedings).

Since July 2003, the Company has been in discussions with the Intellectual Property Asset Corporation (IPAC), representing AudioFAX IP LLC (AudioFAX), regarding whether certain of the Company's products may require it to obtain a license of AudioFAX's patents (see Part II, Item 1. Legal Proceedings).

The Company believes that if it were determined to be necessary or advisable to license the AudioFAX patent portfolio, the Company could acquire a fully paid-up license to such patent portfolio by paying licensing fees in the range of \$200,000 to \$1,200,000. Included in the Company's accrued liabilities at September 30, 2004 is a \$200,000 accrual related to this matter.

The Company expects that its products will continue to be subject to third-party infringement claims. If the Company were to discover that its products violated a third party's valid intellectual property rights and was unable to obtain licenses on terms acceptable to the Company, the Company might not be able to continue offering those products without substantial reengineering. Reengineering efforts might result in substantial costs and product delays, and might not be successful.

Furthermore, any intellectual property infringement claims asserted by a third party against the Company could be time-consuming and costly to defend, divert management's attention and resources, cause product and service delays, and/or require the Company to enter into fee-bearing licensing arrangements. An adverse decision in an infringement claim asserted against the Company could result in the Company being prohibited from using such technology, as licensing arrangements may not be available on commercially reasonable terms. If the Company were unable to license the infringed or similar technology on commercially reasonable terms, this could have a material adverse effect on its business, financial condition and results of operations.

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Potential Changes in Government Regulation

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

International Business Risks

Approximately 17% and 10% of total revenues from continuing operations for the nine months ended September 30, 2004 and 2003, respectively, were generated in markets outside of the United States. International sales are subject to the customary risks associated with international transactions, including political risks, local laws and taxes, the potential imposition of trade or currency exchange restrictions, tariff increases, transportation delays, difficulties or delays in collecting accounts receivable, exchange rate fluctuations and the effects of prolonged currency destabilization in major international markets. Although a substantial portion of the international sales of Glenayre's products and services for the nine months ended September 30, 2004 were negotiated in U.S. dollars, Glenayre may not be able to maintain such a high percentage of U.S. dollar denominated international sales. Should the amount of sales denominated in local currencies of foreign countries increase, the Company may seek to mitigate its currency exchange fluctuation risk by entering into currency hedging transactions. The Company also acts to mitigate certain risks associated with international transactions through the purchase of political risk insurance and the use of letters of credit. However, there can be no assurance that these efforts will successfully limit the risks associated with these international transactions.

Continued Terrorist Attacks, War or Other Civil Disturbances

On September 11, 2001, the United States was the target of terrorist attacks of unprecedented scope. These attacks have caused instability in the global financial markets and contributed to the volatility of the stock prices of many U.S. publicly traded companies over the past three years. In the future, there may be armed hostilities, further acts of terrorism and civil disturbances in the U.S. or elsewhere, which may contribute to economic instability in the U.S. and in the foreign markets served by the Company. Additionally, such disturbances could have a material adverse effect on the Company's business, results of operations or financial condition.

Potential Acquisitions and Strategic Investments

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

The Company has made, and in the future, may continue to make, strategic acquisitions of and investments in other companies. These acquisitions and investments have been made in, and future acquisitions and investments will likely be made in, immature businesses with unproven track records and technologies. Such investments and acquisitions

have a high degree of risk, with the possibility that the Company may lose its entire investment. The Company may not be able to identify suitable acquisition and investment candidates, and, even if it does, the Company may not be able to make those acquisitions and investments on acceptable terms. In addition, even if the Company makes such acquisitions or investments, it may not gain strategic benefits from those acquisitions or investments.

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Continuation and Expansion of Third Party Agreements

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

Volatility of Stock Price

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

Delisting from the Nasdaq National Market

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

Ability to Attract and Retain Key Personnel

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

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Risk Of Non-Compliance With Section 404 Of The Sarbanes-Oxley Act Of 2002.

Beginning with the Company's Annual Report on Form 10-K for the year ended December 31, 2004, Section 404 of the Sarbanes-Oxley Act of 2002 (the Act) will require the Company to include an internal control report of management in its Annual Report on Form 10-K. The internal control report must, among other things, set forth management's assessment of the effectiveness of the Company's internal control over financial reporting as of the end of the Company's most recent fiscal year, including a statement as to whether or not internal control over financial reporting is effective. Additionally, in the Form 10-K, the Company must provide the Company's independent auditors attestation report on management's assessment of internal control over financial reporting in which the Company's independent auditor must clearly state its opinion as to whether management's assessment of the effectiveness of the Company's internal control over financial reporting is fairly stated in all material respects, or include an opinion to the effect that an overall opinion cannot be expressed.

The Company has dedicated internal resources, engaged outside consultants and adopted a detailed work plan to (i) assess and document the adequacy of internal control over financial reporting, (ii) take steps to improve control processes where appropriate, (iii) validate through testing that controls are functioning as documented and (iv) implement a continuous reporting and improvement process for internal control over financial reporting. However, the Company can provide no assurance as to its ability to complete all components of the work plan in a timely manner.

The inability of the Company to timely complete all components of the work plan could (i) prevent the Company's management from completing its assessment of internal control in time so that they can finish the internal control report over financial reporting required in the Company's Annual Report on Form 10-K for the year ended December 31, 2004 in a timely manner or (ii) prevent the Company's management from concluding in the internal control report over financial reporting that they prepare that the Company's internal control over financial reporting is effective. If the Company is not able to timely obtain an internal control report from management, it may not be able to file a complete Form 10-K within the filing deadline.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

Interest Rate Risk

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

Foreign Currency Exchange

The Company operates internationally and is exposed to movements in foreign currency exchange rates primarily as a result of its holding demand deposits denominated in non-functional currencies. At September 30, 2004, approximately U.S. \$1.7 million or 1.8% of the Company's cash and cash equivalent balances were denominated in foreign currencies. In the aggregate, if the value of the dollar against the foreign denominated currency strengthens by 10%, the Company would record an exchange loss of approximately \$166,000. Conversely, if the value of the dollar declines by 10%, the Company would record an exchange gain of approximately \$166,000. The Company seeks to mitigate the risk associated with foreign currency deposits by monitoring and limiting the total cash deposits held at each of its subsidiaries abroad. Additionally, the Company may seek to mitigate the risk by entering into currency hedging transactions. The Company was not a party to any currency hedge transactions as of September 30, 2004.

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ITEM 4. CONTROLS AND PROCEDURES

The Company maintains disclosure controls and procedures designed to ensure that information required to be disclosed in its filings under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. The Company's principal executive and financial officers have evaluated these disclosure controls and procedures as of September 30, 2004 and have determined that such disclosure controls and procedures are effective.

During the quarter ended September 30, 2004, there were no changes in internal controls that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II OTHER INFORMATION

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

ITEM 1. LEGAL PROCEEDINGS

Pilot Pacific Properties, Inc. - In August 2001, the Company filed two lawsuits against Pilot Pacific Properties, Inc. (Pilot Pacific), in Vancouver, British Columbia. These lawsuits, which were consolidated in February 2002 (Pilot Action), seek total damages of over \$12.0 million (Canadian), for the return of \$5 million (Canadian) held in trust, breach of contract, breach of fiduciary duties and improper charges made to, and paid by, the Company in connection with the development and construction of an office building in Vancouver. In response Pilot Pacific filed counterclaims against the Company for unpaid invoices of \$6.0 million (Canadian) and lost profits of \$60.0 to \$65.0 million (Canadian), as well as seeking to retain approximately \$5.3 million (Canadian) held in trust.

On February 10, 2004, the Company commenced an action against E Court V Holdings, Ltd. (E Court), a company related to Pilot Pacific. In this E Court action, the Company alleged that Pilot Pacific improperly contributed to E Court funds that were provided to Pilot Pacific for the designated purpose of constructing the Company's office building in Vancouver (as described above) and which E Court used to purchase a neighboring property. The Company also registered a Certification of Pending Litigation against such property. E Court asserted in a counterclaim that this action was improperly commenced. This E Court action was consolidated with the case against Pilot Pacific in May 2004.

In July 2004 the Company entered into a settlement agreement with Pilot Pacific Holdings Inc. and its associated companies including E Court (collectively, Pilot) related to all outstanding matters between the parties. As part of the terms of this settlement, the Company received \$4.3 million (\$5.7 million Canadian) and Pilot placed an additional \$2.0 million (Canadian) in escrow for an agreed-upon investigation period during which the Company is entitled to search for additional recoverable assets. In addition, during the third quarter of 2004 as part of the terms of this settlement agreement, the Company received \$3.2 million (\$4.4 million Canadian) plus interest for monies the Company previously deposited with the court as security for Pilot's claim of lien in connection with the 2003 sale of the Vancouver facility. At the end of the investigation period, the Company must elect to accept or reject the settlement. If the settlement is accepted, the Company will receive the \$2.0 million (Canadian) from escrow, plus the value of additional recoverable assets (if any) discovered during the investigation period, and all current claims by the Company and Pilot against each other will be dismissed. If the Company rejects the settlement, the litigation, including Pilot's claims against the Company, would continue with the trials likely being held in 2005. If the Company elects to continue with the trials, the \$2.0 million (Canadian) currently held in escrow plus the value of any additional recoverable assets discovered during the investigation period would remain in trust or be otherwise secured. The

Company anticipates that it will complete its search for additional assets during the fourth quarter of 2004.

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

On May 14, 2004, Jackson filed a motion with the district (trial) court to set trial on remaining issues of contributory infringement and inducement to infringe Jackson s patent. On June 29, 2004, the trial court ruled that there were no issues remaining between the parties and denied Jackson s motion to set trial on remaining issues. Jackson is currently appealing this ruling. The Company believes that it is unlikely that the appellate court will reverse the trial court s ruling of June 29, 2004.

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

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

In March 2004, one of the lawsuits was discontinued by one of the plaintiffs. In April 2004, the Company made an application for grant of summary judgment and was chosen to be a representative case for this matter, but the plaintiffs in this representative case discontinued their lawsuit in October 2004. The remaining eighteen lawsuits seek approximately \$18.4 million (Canadian) in total damages.

On May 16, 2003, a further action was commenced against the same defendants, including the Company, seeking \$6.0 million (Canadian) on behalf of twenty plaintiffs alleging personal injury as a result of the contamination. None of the statements of claims of these plaintiffs were served on the Company within the statutory period. All of these claims have been discontinued, with the exception of one group of plaintiffs, whose claim has now expired because of lack of service of the statement of claim. As a result, all of these claims are at an end.

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AudioFAX - In July 2003, the Company received a letter and supporting materials from the Intellectual Property Asset Corporation (IPAC), representing AudioFAX IP LLC (AudioFAX), informing the Company that AudioFAX is the owner of certain U.S. and Canadian patents relevant to the fax processing business, and inquiring as to the Company's interest in obtaining a license to use these patents. After thorough review of such patents, the Company communicated to AudioFAX in early 2004 that the Company did not believe that a license of such AudioFAX patents was necessary based on the Company's current product portfolio. AudioFAX disagreed with the Company's analysis and has continued to assert that certain of the Company's products require it to obtain a license of AudioFAX's patents. Included in the Company's accrued liabilities at September 30, 2004 is a \$200,000 accrual related to this matter.

In September 2004, the Company was notified by IPAC that on August 31, 2004 AudioFAX had been issued another patent in the area of enhanced fax / unified messaging that certain of the Company's products may infringe. The Company is in the process of investigating the claims and validity of this most recently issued AudioFAX patent.

The Company believes that if it were determined to be necessary or advisable to license the AudioFAX patent portfolio, the Company could acquire a fully paid-up license to such patent portfolio by paying licensing fees in the range of \$200,000 to \$1,300,000.

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

ITEM 6. Exhibits

Exhibits

- | | |
|--------------|---|
| Exhibit 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. |
| Exhibit 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. |
| Exhibit 15.1 | Letter regarding unaudited financial information. |
| Exhibit 31.1 | Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer. |
| Exhibit 31.2 | Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer. |
| Exhibit 32.1 | Section 1350 Certification of Chief Executive Officer. |
| Exhibit 32.2 | Section 1350 Certification of Chief Financial Officer. |

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SIGNATURES

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

Glenayre Technologies, Inc.

(Registrant)

/s/ Debra Ziola

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

Date: November 8, 2004

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