

BALLANTYNE OF OMAHA INC  
Form 10-Q  
November 14, 2006

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549**

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended September 30, 2006

OR

**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: 1-13906

**BALLANTYNE OF OMAHA, INC.**

(Exact Name of Registrant as Specified in Its Charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**47-0587703**

(IRS Employer  
Identification No.)

**4350 McKinley Street, Omaha, Nebraska**

(Address of Principal Executive Offices)

**68112**

Zip Code

**(402) 453-4444**

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act (check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

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Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date:

<b>Class</b>	<b>Outstanding as of November 10, 2006</b>
Common Stock, \$.01, par value	13,710,934 shares

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## Part I. Financial Information

**Item 1. Financial Statements**

**Ballantyne of Omaha, Inc. and Subsidiaries**  
**Consolidated Balance Sheets**  
**September 30, 2006 and December 31, 2005**

	September 30, 2006 (Unaudited)	December 31, 2005
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 20,746,692	\$ 19,628,348
Restricted cash	602,984	
Accounts receivable (less allowance for doubtful accounts of \$485,196 in 2006 and \$420,223 in 2005)	7,729,413	7,821,085
Inventories, net	8,958,692	9,942,065
Deferred income taxes	1,431,440	1,247,609
Other current assets	1,102,023	430,411
Total current assets	40,571,244	39,069,518
Deferred income taxes	222,010	
Property, plant and equipment, net	5,078,381	5,379,933
Goodwill, net	2,927,960	2,467,219
Other intangible assets, net	503,670	
Other assets	19,257	19,257
Total assets	\$ 49,322,522	\$ 46,935,927
<b>Liabilities and Stockholders Equity</b>		
Current liabilities:		
Current portion of long-term debt	\$ 21,727	\$ 27,761
Accounts payable	2,621,489	2,212,056
Warranty reserves	660,370	680,017
Accrued group health insurance claims	242,287	275,468
Accrued bonuses	68,250	983,235
Other accrued expenses	2,162,943	1,663,708
Customer deposits	160,142	536,724
Income tax payable	212,244	63,217
Total current liabilities	6,149,452	6,442,186
Long-term debt, net of current portion		14,609
Deferred income taxes		156,912
Other accrued expenses, net of current portion	430,020	324,715
Total liabilities	6,579,472	6,938,422
Commitments and contingencies		
Stockholders equity:		
Preferred stock, par value \$.01 per share; Authorized 1,000,000 shares, none outstanding		
Common stock, par value \$.01 per share; Authorized 25,000,000 shares; issued 15,808,739 shares in 2006 and 15,495,336 shares in 2005	158,087	154,953
Additional paid-in capital	34,136,528	33,411,013
Retained earnings	23,763,889	21,746,993
	58,058,504	55,312,959
Less 2,097,805 common shares in treasury, at cost	(15,315,454)	(15,315,454)
Total stockholders equity	42,743,050	39,997,505

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Total liabilities and stockholders equity	\$	49,322,522	\$	46,935,927
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See accompanying notes to consolidated financial statements.

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**Ballantyne of Omaha, Inc. and Subsidiaries**  
**Consolidated Statements of Operations**  
**Three and Nine Months Ended September 30, 2006 and 2005**  
**(Unaudited)**

	Three Months Ended September 30, 2006		2005		Nine Months Ended September 30, 2006		2005	
Net revenues	\$	13,069,673	\$	14,260,237	\$	37,357,779	\$	39,813,700
Cost of revenues		10,875,149		10,203,994		29,100,160		28,675,874
Gross profit		2,194,524		4,056,243		8,257,619		11,137,826
Selling and administrative expenses:								
Selling		718,213		699,485		2,157,917		2,055,394
Administrative		1,226,067		1,479,973		3,680,785		4,107,509
Total selling and administrative expenses		1,944,280		2,179,458		5,838,702		6,162,903
Gain (loss) on disposal of assets		(3,457)	)	(1,296)	)	37,546		8,704
Income from operations		246,787		1,875,489		2,456,463		4,983,627
Interest income		203,292		105,440		572,306		272,974
Interest expense		(11,676)	)	(8,433)	)	(40,118)	)	(25,913)
Other income (expense), net		11,775		18,847		(28,432)	)	(20,059)
Income before income taxes		450,178		1,991,343		2,960,219		5,210,629
Income tax expense		(75,465)	)	(762,298)	)	(943,323)	)	(1,978,409)
Net income	\$	374,713	\$	1,229,045	\$	2,016,896	\$	3,232,220
Basic earnings per share	\$	0.03	\$	0.09	\$	0.15	\$	0.24
Diluted earnings per share	\$	0.03	\$	0.09	\$	0.14	\$	0.23
Weighted average shares outstanding:								
Basic		13,635,064		13,355,955		13,540,737		13,209,580
Diluted		14,029,604		13,955,817		14,007,988		13,903,081

See accompanying notes to consolidated financial statements.

**Ballantyne of Omaha, Inc. and Subsidiaries**  
**Consolidated Statements of Cash Flows**  
**Nine Months Ended September 30, 2006 and 2005**  
**(Unaudited)**

	2006	2005
<b>Cash flows from operating activities:</b>		
Net income	\$ 2,016,896	\$ 3,232,220
Adjustments to reconcile net income to net cash provided by operating activities.		
Provision for doubtful accounts	86,288	(9,301 )
Provision for inventory reserves	515,806	432,481
Depreciation of assets	807,902	834,850
Other amortization	23,557	23,488
Gain on sale of assets	(37,546 )	(8,704 )
Deferred income taxes	(562,753 )	(27,246 )
Share-based compensation	75,414	
Excess tax benefits from stock options exercised	(371,350 )	
Changes in assets and liabilities, net of effect of business acquisition:		
Accounts receivable	573,967	(3,374,616 )
Inventories	582,860	112,836
Other current assets	(661,327 )	(66,495 )
Accounts payable	208,209	782,174
Warranty reserves	(19,647 )	25,557
Accrued group health insurance claims	(33,181 )	(55,579 )
Accrued bonuses	(914,985 )	274,791
Other accrued expenses	437,454	232,952
Customer deposits	(376,582 )	67,009
Current income taxes	520,377	796,320
Other assets		4,500
Net cash provided by operating activities	2,871,359	3,277,237
<b>Cash flows from investing activities:</b>		
Acquisition, net of cash acquired	(1,391,258 )	
Increase in restricted cash	(602,984 )	
Proceeds from sale of assets	265,401	19,334
Capital expenditures	(470,394 )	(730,346 )
Net cash used in investing activities	(2,199,235 )	(711,012 )
<b>Cash flows from financing activities:</b>		
Payments on notes payable	(206,504 )	
Payments on long-term debt	(20,643 )	(19,286 )
Proceeds from exercise of stock options	302,017	832,907
Excess tax benefits from stock options exercised	371,350	
Net cash provided by financing activities	446,220	813,621
Net increase in cash and cash equivalents	1,118,344	3,379,846
Cash and cash equivalents at beginning of period	19,628,348	14,031,984
Cash and cash equivalents at end of period	\$ 20,746,692	\$ 17,411,830

See accompanying notes to consolidated financial statements.

**Ballantyne of Omaha, Inc. and Subsidiaries**  
**Notes to Consolidated Financial Statements**  
**Three and Nine Months Ended September 30, 2006 and 2005**  
**(Unaudited)**

**1. Company**

Ballantyne of Omaha, Inc., a Delaware corporation ( Ballantyne or the Company ), and its wholly-owned subsidiaries Strong Westrex, Inc., Design & Manufacturing, Inc. and Strong Technical Services, Inc., design, develop, manufacture, service and distribute theatre equipment and lighting systems and distribute restaurant products. The Company's products are distributed to movie exhibition companies, sports arenas, auditoriums, amusement parks, special venues, and the food service industry. Refer to the Business Segment Section (note 14) for further information.

**2. Summary of Significant Accounting Policies**

The principal accounting policies upon which the accompanying consolidated financial statements are based are summarized as follows:

a. Basis of Presentation and Principles of Consolidation

The consolidated financial statements included herein are presented in accordance with the requirements of Form 10-Q and consequently do not include all of the disclosures normally required by accounting principles generally accepted in the United States of America for annual reporting purposes or those made in the Company's annual Form 10-K filing. These consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Form 10-K for fiscal 2005.

In the opinion of management, the unaudited consolidated financial statements of the Company reflect all adjustments of a normal recurring nature necessary to present a fair statement of the financial position and the results of operations and cash flows for the respective interim periods. The results for interim periods are not necessarily indicative of trends or results expected for a full year.

b. Use of Estimates

The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results and changes in facts and circumstances may alter such estimates and affect results of operations and financial position in future periods.

c. Allowance for Doubtful Accounts

Accounts receivable are presented net of allowance for doubtful accounts of \$485,196 and \$420,223 at September 30, 2006 and December 31, 2005, respectively. This allowance is developed based on several factors including overall customer credit quality, historical write-off experience and a specific analysis that projects the ultimate collectibility of the account. As such, these factors may change over time causing the reserve level to adjust accordingly.



d. Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market and include appropriate elements of material, labor and manufacturing overhead. Inventory balances are net of reserves of slow moving or obsolete inventory estimated based on management's review of inventories on hand compared to estimated future usage and sales.

e. Goodwill and Other Intangible Assets

Goodwill represents the excess of cost over the fair value of assets of businesses acquired through purchase business combinations in accordance with the provisions of Statement of Financial Accounting Standards ( SFAS ) No. 142, *Goodwill and Other Intangible Assets*. Goodwill and intangible assets that are determined to have an indefinite useful life are not amortized but instead tested for impairment at least annually. An impairment loss is recognized to the extent that the carrying amount exceeds the asset's estimated fair value. Intangible assets with estimatable useful lives are amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment in accordance with SFAS No. 144, *Accounting for Impairment or Disposal of Long-Lived Assets*.

f. Property, Plant and Equipment

Significant expenditures for the replacement or expansion of property, plant and equipment are capitalized. Depreciation of property, plant and equipment is provided over the estimated useful lives of the respective assets using the straight-line method. For financial reporting purposes, assets are depreciated over the estimated useful lives of 20 years for buildings and improvements, 3 to 10 years for machinery and equipment, 7 years for furniture and fixtures and 3 years for computers and accessories. The Company generally uses accelerated methods of depreciation for income tax purposes.

g. Income Taxes

Income taxes are accounted for under the asset and liability method. The Company uses an estimate of its annual effective rate at each interim period based on the facts and circumstances at the time while the actual effective rate is calculated at year-end. 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 carry forwards. 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. In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized.

h. Revenue Recognition

The Company recognizes revenue from product sales upon shipment to the customer when collectibility is reasonably assured. Revenues related to services are recognized as earned over the terms of the contracts or delivery of the service to the customer.

The Company enters into transactions that represent multiple element arrangements, which may include a combination of services and asset sales. Under EITF 00-21, *Revenue Arrangements with Multiple Deliverables*, multiple element arrangements are assessed to determine whether they can be separated into more than one unit of accounting. A multiple element arrangement is separated into more than one unit of accounting if all of the following criteria are met.

- The delivered item(s) has value on a standalone basis;
- There is objective and reliable evidence of the fair value of the undelivered item(s);
- If the arrangement includes a general right of return relative to the delivered item(s), delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the Company.

If these criteria are not met, then revenue is deferred until such criteria are met or until the period(s) over which the last undelivered element is delivered. If there is objective and reliable evidence of fair value for all units of accounting in an arrangement, the arrangement consideration is allocated to the separate units of accounting based on each unit's relative fair value. There may be cases, however, in which there is objective and reliable evidence of fair value of the undelivered item(s) but no such evidence for the delivered item(s). In those cases, the residual method is used to allocate the arrangement consideration. Under the residual method, the amount of consideration allocated to the delivered item(s) equals the total arrangement consideration less the aggregate fair value of the undelivered item.

i. Fair Value of Financial Instruments

The fair value of a financial instrument is the amount at which the instruments could be exchanged in a current transaction between willing parties. All financial instruments reported in the consolidated balance sheets equal or approximate their fair values.

j. Cash and Cash Equivalents

All highly liquid financial instruments with maturities of three months or less from date of purchase are classified as cash equivalents in the consolidated balance sheets and statements of cash flows.

k. Restricted Cash

The Company had restricted cash in the amount of \$602,984 at September 30, 2006 pertaining to the acquisition of National Cinema Service Corp. (NCSC) that was placed in escrow for potential contingent payments to the seller. See Note 3 to the Consolidated Financial Statements for further detail regarding the acquisition of NCSC.

## I. Earnings Per Common Share

The Company computes and presents earnings per share in accordance with SFAS No. 128, *Earnings Per Share*. Basic earnings per share have been computed on the basis of the weighted average number of shares of common stock outstanding. Diluted earnings per share has been computed on the basis of the weighted average number of shares of common stock outstanding after giving effect to potential common shares from dilutive stock options. The following table provides a reconciliation between basic and diluted earnings per share:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Basic earnings per share:				
Income applicable to common stock	\$ 374,713	\$ 1,229,045	\$ 2,016,896	\$ 3,232,220
Weighted average common shares outstanding	13,635,064	13,355,955	13,540,737	13,209,580
Basic earnings per share	\$ 0.03	\$ 0.09	\$ 0.15	\$ 0.24
Diluted earnings per share:				
Income applicable to common stock	\$ 374,713	\$ 1,229,045	\$ 2,016,896	\$ 3,232,220
Weighted average common shares outstanding	13,635,064	13,355,955	13,540,737	13,209,580
Assuming conversion of options outstanding	394,540	599,862	467,251	693,501
Weighted average common shares outstanding, as adjusted	14,029,604	13,955,817	14,007,988	13,903,081
Diluted earnings per share	\$ 0.03	\$ 0.09	\$ 0.14	\$ 0.23

At September 30, 2006 and 2005, options to purchase 268,800 shares of common stock at a weighted average price of \$8.43 per share were outstanding, but were not included in the computation of diluted earnings per share for the three and nine months ended September 30, 2006 and 2005 as the options' exercise price was greater than the average market price of the common shares. These options expire between January 2007 and May 2010.

## m. Share-Based Payments

Effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards No. 123R ( SFAS 123R ), Share-Based Payments, which requires the measurement and recognition of compensation expense for all share-based payment awards to employees and directors based on estimated fair values. SFAS 123R supersedes the Company's previous accounting methodology using the intrinsic value method under Accounting Principles Board Opinion No. 25 ( APB 25 ), Accounting for Stock Issued to Employees. Under the intrinsic value method, no share-based compensation expense related to stock option awards granted to employees had been recognized in the Company's consolidated statements of operations, as all stock option awards granted under the plans had an exercise price equal to the market value of the common stock on the date of the grant.

The Company adopted SFAS 123R using the modified prospective transition method. Under this transition method, compensation expense recognized during the three and nine months ended September 30, 2006 include: (a) compensation expense for all share-based awards granted prior to, but not yet vested, as of December 31, 2005, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, and (b) compensation expense for all share-based awards granted subsequent to December 31, 2005, based on the grant date fair value estimated in accordance with the provisions of SFAS 123R. In accordance with the modified prospective transition method, the Company's consolidated financial statements for prior periods have not been restated to reflect the impact of SFAS 123R.

On November 10, 2005 the Financial Accounting Standards Board ( FASB ) issued FASB Staff Position No. 123R-3, Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards. The Company has elected to adopt the alternative transition method provided in the FASB Staff Position for calculating the tax effects of share-based compensation pursuant to SFAS 123R. The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in capital pool ( APIC Pool ) related to the tax effects of employee share-based compensation, and to determine the subsequent impact on the APIC Pool and consolidated statements of cash flows of the tax effects of employee and director share-based awards that are outstanding upon adoption of SFAS 123R.

*Options*

The Company currently maintains a 2001 Non-Employee Directors Stock Option Plan ( 2001 Directors Plan ) and a 2005 Outside Directors Stock Option Plan ( 2005 Outside Directors Plan ) which have been approved by the Company's stockholders. The Company also maintained a 1995 Employee Stock Option Plan and a 1995 Directors Stock Option Plan which both expired in 2005, however, there are outstanding stock options remaining under these two expired plans.

All past and future grants under the Company's stock option plans were granted at prices based on the fair market value of the Company's common stock on the date of grant. The outstanding options generally vest over periods ranging from zero to three years from the grant date and expire between 5 and 10 years after the grant date.

All options granted under the 2001 Directors Plan and the 1995 Employee Stock Option Plan were fully vested, based on their original terms, prior to January 1, 2006. As such, no compensation expense related to those options has been recognized under SFAS 123R. The 1995 Outside Directors Stock Plan had 47,250 shares outstanding not yet vested at January 1, 2006 and were subject to the recognition of compensation expense.

A total of 1,105,690 shares of common stock have been reserved for issuance pursuant to the Company's stock option plans for directors at September 30, 2006.

The Company records compensation expense for stock options based on the estimated fair value of the options on the date of grant using the Black-Scholes option-pricing model. The Company uses historical data among other factors to estimate the expected price volatility, the expected option life and the expected forfeiture rate. The risk-free rate is based on the U.S. Treasury yield in effect at the time of grant for the estimated life of the option. The Company has not and is not expected to pay cash dividends in the future. The Company granted 47,250 and 70,875 stock options under the 2005 and 1995 Outside Directors plans during the nine months ended September 30, 2006 and 2005, respectively. All stock options granted during 2006 and 2005 were granted during the second quarter of the particular year.

The fair value of option grants during the nine months ended September 30, 2006 and 2005 was estimated using the following weighted average assumptions:

	2006	2005
Expected dividend yield	0.0 %	0.0 %
Risk-free interest rate	4.97 %	3.82 %
Expected volatility	48.9 %	37.6 %
Expected life (in years)	4	5

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The following table summarizes the Company's activities with respect to its stock options for the nine months ended September 30, 2006 as follows:

	Number of Shares	Weighted Average Exercise Price Per Share	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at January 1, 2006	987,078	\$ 2.86		
Granted	47,250	\$ 4.25		
Exercised	(313,403)	\$ 0.96		
Forfeited		\$		
Outstanding at September 30, 2006	720,925	\$ 3.77	3.55	\$ 1,474,683
Exercisable at September 30, 2006	665,800	\$ 3.72	3.49	\$ 1,474,053

The aggregate intrinsic value in the table above represents the total that would have been received by the option holders if all in-the-money options had been exercised on September 30, 2006. The total intrinsic value for options exercised during the three and nine months ended September 30, 2006 was \$626,100 and \$1,062,417, respectively. The total intrinsic value for options exercised during the three and nine months ended September 30, 2005 was \$131,890 and \$907,420, respectively. The weighted average grant date fair value of options granted in the nine months ended September 30, 2006 and 2005 was \$1.86 and \$2.29, respectively.

Cash received from option exercises under all plans for the nine months ended September 30, 2006 and 2005 was \$302,017 and \$832,907, respectively. The actual tax benefit realized for the tax deductions from option exercises under all plans totaled \$371,350 and \$291,438 for nine months ended September 30, 2006 and 2005, respectively.

The following table summarizes information about stock options outstanding and exercisable at September 30, 2006:

Range of option exercise price	Options Outstanding at September 30, 2006			Options Exercisable at September 30, 2006		
	Number of options	Weighted average remaining contractual life	Weighted average exercise price per option	Number of options	Weighted average remaining contractual life	Weighted average exercise price per option
\$ 0.36 to 1.19	404,875	4.64	\$ 0.63	404,875	4.64	\$ 0.63
4.25 to 4.75	118,125	4.07	4.55	63,000	3.92	4.63
7.30 to 11.43	197,925	1.01	9.74	197,925	1.01	9.74
\$ 0.36 to 11.43	720,925	3.55	\$ 3.77	665,800	3.49	\$ 3.72

As of September 30, 2006, the total unrecognized compensation cost related to stock option awards was \$109,266 and is expected to be recognized over a weighted average period of approximately 13 months.

The following table summarizes information regarding non-vested stock options granted for the nine months ended September 30, 2006.

	Shares Outstanding	Weighted Average Grant Date Fair Value per Share
Non-vested at January 1, 2006	47,250	\$ 2.29
Granted	47,250	\$ 1.86
Vested	(39,375 )	\$ 2.12
Forfeited		
Non-vested at September 30, 2006	55,125	\$ 2.04

The weighted-average grant date fair value of non-vested stock options granted during the nine months ended September 30, 2006 and 2005, was \$1.86 and \$2.29, respectively. There were no options granted during the three months ended September 30, 2006 and 2005. As of September 30, 2006, the total unrecognized compensation cost related to non-vested stock option awards was approximately \$60,796 and is expected to be recognized over a weighted average period of 15 months.

#### *Restricted Stock Plan*

During 2005, the Company adopted and the stockholders approved, the 2005 Restricted Stock Plan. Under terms of the plan, the compensation committee of the Board of Directors selects which employees of the Company are to receive restricted stock awards and the terms of such awards. The total number of shares reserved for issuance under the plan is 250,000 shares. There have been no shares issued under the plan since inception. The plan expires in September 2010.

#### *Employee Stock Purchase Plan*

The Company's Employee Stock Purchase Plan, approved by the stockholders, provides for the purchase of shares of Ballantyne common stock by eligible employees at a per share purchase price equal to 85% of the fair market value of a share of Ballantyne common stock at either the beginning or end of the offering period, as defined, whichever is lower. Purchases are made through payroll deductions of up to 10% of each participating employee's salary. The number of shares that can be purchased by participants in any offering period is 2,000 shares. Additionally, the Plan has set certain limits, as defined, in regard to the number of shares that may be purchased by all eligible employees during an offering period. At September 30, 2006, 150,000 shares of common stock remained available for issuance under the Plan. The Plan expires in September 2010. The total estimated grant date fair value of purchase rights outstanding under the Employee Stock Purchase Plan was \$1.79 using the Black-Scholes option-pricing model made with the following weighted average assumptions: risk-free interest rate - 4.91%, dividend yield - 0%, expected volatility - 36.3% and expected life in years - 1. At September 30, 2006, the total unrecognized estimated compensation cost was \$2,237 which is expected to be recognized over a period of 1 month.

*Share-Based Compensation Expense*

The table below shows the amounts recognized in the financial statements for the three and nine months ended September 30, 2006 for share-based compensation related to employees and directors.

	<b>Three Months Ended September 30, 2006</b>	<b>Nine Months Ended September 30, 2006</b>
Total cost of share-based compensation included in selling and administrative expenses, before income tax	\$ 27,470	\$ 75,414
Amount of income tax benefit recognized	(10,322	) (23,306 )
Amount charged against net income	\$ 17,148	\$ 52,108
<b>Impact on earnings per share:</b>		
Basic	\$ (0.00	) \$ (0.00 )
Diluted	\$ (0.00	) \$ (0.00 )

There were no amounts relating to share-based compensation capitalized in inventory during the three and nine months ended September 30, 2006.

*Pro Forma Share-Based Compensation Expense*

Prior to December 31, 2005, the Company accounted for share-based compensation arrangements in accordance with the provisions and related interpretations of APB 25. Had compensation cost for share-based awards been determined consistent with SFAS No. 123R, the net income and earnings per share would have been adjusted to the following pro forma amounts:

	<b>Three Months Ended September 30, 2005</b>	<b>Nine Months Ended September 30, 2005</b>
Net income, as reported	\$ 1,229,045	\$ 3,232,220
Deduct: Total share-based compensation expense determined under fair value based method for all awards, net of related tax effects	(10,236	) (47,237 )
Pro forma net income	\$ 1,218,809	\$ 3,184,983
<b>Earnings per share:</b>		
Basic-as reported	\$ 0.09	\$ 0.24
Basic-pro forma	\$ 0.09	\$ 0.24
Diluted-as reported	\$ 0.09	\$ 0.23
Diluted-pro forma	\$ 0.09	\$ 0.23

## n. Impairment of Long-Lived Assets

The Company reviews long-lived assets, exclusive of goodwill, for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds their fair value. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

The Company's most significant long-lived assets subject to these periodic assessments of recoverability are property, plant and equipment, which have a net book value of \$5.1 million at September 30, 2006. Because the recoverability of property, plant and equipment is based on estimates of future undiscounted cash flows, these estimates may vary due to a number of factors, some of which may be outside of management's control. To the extent that the Company is unable to achieve management's forecasts of future income, it may become necessary to record impairment losses for any excess of the net book value of property, plant and equipment over its fair value.

## o. Warranty Reserves

The Company generally grants a warranty to its customers for a one-year period following the sale of all new equipment, and on selected repaired equipment for a one-year period following the repair. The warranty period is extended under certain circumstances and for certain products. The Company accrues for these costs at the time of sale or repair, or when events dictate that additional accruals are necessary.

The following table summarizes warranty activity for the periods indicated below:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Balance at beginning of period	\$ 705,247	\$ 596,043	\$ 680,017	\$ 668,268
Charged to expense	33,217	121,694	148,719	207,421
Amounts written off, net of recoveries	(78,094)	(23,912)	(168,366)	(181,864)
Balance at end of period	\$ 660,370	\$ 693,825	\$ 660,370	\$ 693,825

## p. Comprehensive Income

The Company's comprehensive income consists solely of net income. All other items were not material to the consolidated financial statements.

## q. Litigation

During March 2006, Ballantyne settled an asbestos case entitled *Bercu v. BICC Cables Corporation, et al.*, originally filed June 27, 2003 in the Supreme Court of the State of New York. The settlement amount was not material to the Company's results of operations, financial position or cash flows.



Ballantyne is a party to various other legal actions which are ordinary routine litigation matters incidental to the Company's business, such as products liability. Based on currently available information, management believes that the ultimate outcome of these matters individually and in the aggregate, will not have a material adverse effect on the Company's results of operations, financial position or cash flows.

r. Reclassifications

Certain amounts in the accompanying consolidated financial statements have been reclassified to conform to the 2006 presentation.

s. Environmental

The Company is subject to various federal, state and local laws and regulations pertaining to environmental protection and the discharge of material into the environment. During 2001, Ballantyne was informed by a neighboring company of likely contaminated soil on certain parcels of land adjacent to Ballantyne's main manufacturing facility in Omaha, Nebraska. The Environmental Protection Agency and the Nebraska Health and Human Services System subsequently determined that certain parcels of Ballantyne property had various levels of contaminated soil relating to a former pesticide company which previously owned the property and that burned down in the 1960's. During October 2004, Ballantyne agreed to enter into an Administrative Order on Consent (AOC) to resolve the matter. The AOC holds Ballantyne and two other parties jointly and severally responsible for the cleanup. In this regard, the three parties have also entered into a Site Allocation Agreement by which they will divide past, current and future costs of the EPA, the costs of remediation and the cost of long term maintenance. In connection with the AOC, the Company has paid its share of the costs. At September 30, 2006, the Company has provided for management's estimate of any future payments relating to this matter which is not material to the consolidated financial statements.

t. Concentrations

The Company's top ten customers accounted for approximately 45% of 2006 consolidated net revenues. Trade accounts receivable from these customers represented approximately 54% of net consolidated receivables at September 30, 2006. Sales to AMC Theatres, Inc. represented over 10% of consolidated revenues. In addition, receivables from Regal Cinemas represented over 10% of net consolidated receivables at September 30, 2006. While the Company believes its relationships with such customers are stable, most arrangements are made by purchase order and are terminable at will by either party. A significant decrease or interruption in business from the Company's significant customers could have a material adverse effect on the Company's business, financial condition and results of operations. The Company could also be adversely affected by such factors as changes in foreign currency rates and weak economic and political conditions in each of the countries in which the Company sells its products.

u. Adoption of New Accounting Pronouncements

During 2005, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 153, Exchanges of Nonmonetary Assets which eliminates the exception to the fair-value principle for exchanges of similar productive assets, which had been accounted for based on the book value of the asset surrendered with no gain recognition. Nonmonetary exchanges have to be accounted for at fair-value, recognizing any gain or loss, if the transactions meet the commercial-substance criterion and fair-value determinable. The Statement reduces the differences between U.S. and international accounting standards. This Statement is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The Company adopted this Statement in the first quarter of fiscal 2006 and the pronouncement did not have a material impact on the Company's consolidated financial position, results of operations or cash flows.

During 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections* (SFAS 154). SFAS 154 is a replacement of Accounting Principles Board No. 20, *Accounting Changes* and FASB Statement No. 3 *Reporting Accounting Changes in Interim Financial Statement*. SFAS 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes retrospective application as the required method for reporting a change in accounting principle. SFAS 154 provides guidance for determining whether retrospective application of a change in accounting principle is impracticable and for reporting a change when retrospective application is impracticable. The reporting of a correction of an error by restating previously issued financial statements is also addressed by SFAS 154. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 31, 2005. The Company adopted this pronouncement in the first quarter of 2006.

The FASB has adopted SFAS No. 151, *Inventory Costs* an Amendment of ARB No. 43, Chapter 4. The provisions of SFAS 151 are intended to eliminate narrow differences between the existing accounting standards of the FASB and the International Accounting Standards Board (IASB) related to inventory costs, in particular, the treatment of abnormal idle facility expense, freight, handling costs and spoilage. SFAS 151 requires that these costs be recognized as current period charges regardless of the extent to which they are considered abnormal. The provisions of SFAS 151 are effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of SFAS 151 did not have a significant impact on the Company's results of operations, financial position or cash flows.

In December 2004, the FASB issued FASB Staff Position No. FAS 109-1 ( *FSP FAS 109-1* ), *Application of FASB Statement No. 109, Accounting for Income Taxes, to the Tax Deduction on Qualified Production Activities provided by the American Jobs Creation Act of 2004*. FSP FAS 109-1 clarifies that the deduction will be treated as a special deduction as described in SFAS 109, *Accounting for Income Taxes*. As such, the special deduction has no effect on deferred tax assets and liabilities existing at the date of enactment. The impact of the deduction will be reported in the period in which the deduction is claimed. The incentive for U.S. qualified production activities included in the Act is effective as of December 21, 2004.

In March 2005, the FASB issued Financial Interpretation No. ( *FIN* ) 47, *Accounting for Conditional Asset Retirement Obligations*, as an interpretation of SFAS No. 143, *Accounting for Asset Retirement Obligations* . This interpretation clarifies that the term conditional asset retirement obligation as used in SFAS No. 143, refers to a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. The obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and/or method of settlement. Accordingly, an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. This interpretation also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. FIN 47 was effective no later than the end of fiscal years ending after December 15, 2005. The Company adopted FIN 47 during the first quarter of 2006 and such adoption did not impact the Company's consolidated results of operations or financial position.

v. Recently Issued Accounting Pronouncements

On July 13, 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109* ( FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods and disclosure. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is in the process of evaluating the impact FIN 48 will have on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* . SFAS No. 157 establishes a framework for measuring fair value in generally accepted accounting principles ( GAAP ), and expands disclosures about fair value measurements. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company has not yet completed its evaluation of the impact of adopting SFAS No. 157.

In September 2006, the SEC issued SAB No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current year Financial Statements* ( SAB No. 108 ). SAB 108 establishes a single quantification framework wherein the significance measurement is based on the effects of the misstatements on each of the financial statements as well as the related financial statement disclosures. If a company's existing methods for assessing the materiality of misstatements are not in compliance with the provisions of SAB 108, the initial application of the provisions may be adopted by restating prior period financial statements under certain circumstances or otherwise by recording the cumulative effect of initially applying the provisions of SAB 108 as adjustments to the carrying values of assets and liabilities as of January 1, 2006 with an offsetting adjustment recorded to the opening balance of retained earnings. SAB No. 108 is effective for the first annual period ending after November 15, 2006. The Company does not expect that the adoption of SAB 108 will have a material effect on its results of operations or financial position.

In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans – an amendment of FASB Statements No. 87, 88, 106 and 132(R)* (SFAS No. 158). SFAS No. 158 requires an employer that sponsors one or more single-employer defined benefit plans to (a) recognize the overfunded or underfunded status of a benefit plan in its statement of financial position, (b) recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost pursuant to SFAS No. 87, *Employers' Accounting for Pensions* , or SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* , (c) measure defined benefit plan assets and obligations as of the date of the employer's fiscal year-end, and (d) disclose in the notes to financial statements additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation. SFAS No. 158 is effective for the Company's fiscal year ending December 31, 2006. The Company is in the process of evaluating SFAS No. 158.

### 3. Acquisition of National Cinema Service Corp.

On May 31, 2006, the Company acquired certain assets and assumed certain liabilities of National Cinema Service Corp. (NCSC). The results of NCSC's operations have been included in the consolidated financial statements from the acquisition date through the reporting period ending September 30, 2006. NCSC is a national provider of cinema services including film and digital projector maintenance, repair, equipment installations, site surveys and other theatre services and has a reputation for quality work, responsiveness and an experienced technical team. As a result of the acquisition, Strong Technical Services, Inc., a wholly-owned subsidiary of Ballantyne, will form a core business established to service the digital and film cinema marketplace.

The total purchase price of NCSC was \$1.7 million including cash acquired. The Company has entered into an agreement to pay the former owner of NCSC, \$150,000 in consideration over a five year period from the date of closing of which \$25,000 was paid at closing with the remaining \$125,000 being placed in escrow. The payments are contingent upon the satisfaction of the requirement to not compete with the Company in the cinema service business over a five-year period. The purchase price excludes an additional \$0.5 million of restricted funds that were placed in escrow for contingent payments. These contingencies relate to certain aged accounts receivable, inventories deemed to have a heightened risk of becoming obsolete and certain contingent sales tax liabilities. These funds will become due and payable to the seller upon satisfaction of terms as identified in the purchase agreement.

Funds for the purchase were provided by internally generated cash flows. Direct transaction costs were not material to the transaction.

The assets acquired and liabilities assumed were recorded at estimated fair values as determined by Company's management based on information currently available, assumptions as to future operations and preliminary independent appraisals. Based on the preliminary analysis, \$135,962 was assigned to a non-compete agreement entered into with the former owner of NCSC and will be amortized over the five-year life of the agreement. The remaining \$391,265 of acquired intangible assets is subject to amortization using an estimated useful life not exceeding 9 years. The allocation of the purchase price is subject to revision, which is not expected to be material, based on the final determination of appraised and other fair values. The following table summarizes the estimated fair value of the assets acquired and liabilities assumed at the date of acquisition.

Cash acquired	\$ 313,941
Other current assets	694,161
Property and equipment	263,811
Amortizable intangible assets	527,227
Goodwill	460,741
Total assets acquired	2,259,881
Current liabilities	(465,954 )
Non-current liabilities	(88,728 )
Total liabilities assumed	(554,682 )
Net assets acquired	\$ 1,705,199

Goodwill represents the excess of the purchase price over the fair value of the net tangible and intangible assets acquired and is expected to be deductible for tax purposes.

The following tables summarize the unaudited pro forma results of operations for the three months and nine months ended September 30, 2006 as if NCSC had been combined as of the beginning of the year. In addition, the tables summarize the unaudited results of operations for comparable periods ended September 30, 2005 as if NCSC has been combined at the beginning of that period.

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The pro forma results include estimates and assumptions which management believes are reasonable. However, the pro forma results are not necessarily indicative of the results which would have occurred if the business combination had been in effect on the dates indicated, or which may result in the future.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Net sales	\$ 13,069,673	\$ 15,992,760	\$ 39,864,554	\$ 44,934,408
Earnings before taxes	450,178	2,010,434	3,211,887	5,284,892
Net income	374,713	1,240,438	2,180,871	3,277,151
Basic earnings per common share	0.03	0.09	0.16	0.25
Diluted earnings per common share assuming dilution	0.03	0.09	0.16	0.24

#### 4. Goodwill

The changes in the carrying value of goodwill for the nine months ended September 30, 2006 are as follows:

	Cost	Accumulated Amortization	Net Book Value
Balance as of January 1, 2006	\$ 3,720,743	(1,253,524 )	2,467,219
Acquisition of National Cinema Service Corp.	460,741		460,741
Balance as of September 30, 2006	\$ 4,181,484	(1,253,524 )	2,927,960

#### 5. Intangible Assets

Amortizable intangible assets consist of the following:

	Cost	Accumulated Amortization	Net Book Value
Customer relationships	\$ 391,265	(14,492 )	376,773
Non-competition agreement	135,962	(9,065 )	126,897
	\$ 527,227	\$ (23,557 )	503,670

The intangible assets were recorded pursuant to the purchase of National Cinema Service Corp. during June of 2006.

The Company recorded amortization expense related to identifiable intangible assets of \$23,557 for the three and nine months ended September 30, 2006, respectively, as compared to \$3,354 and \$23,488 for the three and nine months ended September 30, 2005, respectively.

**6. Note Receivable**

During July 2006, the Company entered into a note receivable arrangement with Digital Link LLC (Digital Link) pertaining to the sale and installation of digital projectors. The sale amounted to \$780,000 of which 25% was due upon installation and was collected. The remaining amounts are due over a 5-year period at an 8% interest rate. At September 30, 2006, \$568,909 is due from Digital Link. Only the down payment of \$195,000 and \$16,091 of payments received on the note receivable during the third quarter were recorded as revenue during the nine months ended September 30, 2006 with the remaining amounts to be recognized as revenue in future periods when the cash is received from Digital Link as described in the note receivable arrangement or when collections from Digital Link can be reasonably assured. The costs incurred with the sale of projectors to Digital Link were expensed during the nine months ended September 30, 2006 with no future associated costs to be incurred.

**7. Inventories**

Inventories consist of the following:

	September 30, 2006	December 31, 2005
Raw materials and components	\$ 6,418,043	\$ 7,008,791
Work in process	1,069,362	1,339,323
Finished goods	1,471,287	1,593,951
	\$ 8,958,692	\$ 9,942,065

The inventory balances are net of reserves for slow moving or obsolete inventory of approximately \$1,181,000 and \$1,138,000 as of September 30, 2006 and December 31, 2005, respectively.

**8. Property, Plant and Equipment**

Property, plant and equipment include the following:

	September 30, 2006	December 31, 2005
Land	\$ 343,500	\$ 343,500
Buildings and improvements	4,699,981	4,699,981
Machinery and equipment	9,121,532	9,511,671
Office furniture and fixtures	2,411,931	2,251,428
	16,576,944	16,806,580
Less accumulated depreciation	11,498,563	11,426,647
Net property, plant and equipment	\$ 5,078,381	\$ 5,379,933

Depreciation expense amounted to \$257,506 and \$807,902 for the three and nine months ended September 30, 2006, respectively, as compared to \$271,379 and \$834,850 for the three and nine months ended September 30, 2005, respectively.

**9. Debt**

The Company is a party to a revolving credit facility with First National Bank of Omaha expiring August 27, 2007. The Company expects to renew the credit facility in the ordinary course of business. The credit facility provides for borrowings up to the lesser of \$4.0 million or amounts determined by an asset based lending formula, as defined. Borrowings available under the credit facility amounted to \$4.0 million at September 30, 2006. No amounts are currently outstanding. The Company would pay interest on outstanding amounts equal to the Prime Rate plus 0.25% (8.5% at September 30, 2006) and pays a fee of 0.125% on the unused portion. The credit facility contains certain restrictive covenants primarily related to maintaining certain earnings, as defined, and restrictions on acquisitions and dividends. All of the Company's personal property and stock in its subsidiaries secure this credit facility.

In connection with the acquisition of National Cinema Service Corp., the Company assumed notes payable in the amount of \$206,504 pertaining to certain acquired automobiles. The notes have various interest rates and terms and were paid off in July 2006.

Long-term debt at September 30, 2006 consisted of installment payments relating to the purchase of certain intangible assets. Future maturities of long-term debt for the remainder of fiscal 2006 and the remaining years are as follows: 2006: \$7,119 and 2007: \$14,608.

**10. Supplemental Cash Flow Information**

Supplemental disclosures to the consolidated statements of cash flows are as follows:

	<b>Nine Months September 30,</b>	
	<b>2006</b>	<b>2005</b>
Interest paid	\$ 10,467	\$ 7,325
Income taxes paid	\$ 985,699	\$ 1,209,335
Income tax benefit related to stock option plans	\$ 371,350	\$ 291,438
Share-based compensation expense related to liability classified awards	\$ 20,132	\$
Share-based compensation expense related to equity classified awards	\$ 55,282	\$

**11. Stockholder Rights Plan**

On May 26, 2000, the Board of Directors of the Company adopted a Stockholder Rights Plan (the Rights Plan). Under terms of the Rights Plan, which expires June 9, 2010, the Company declared a distribution of one right for each outstanding share of common stock. The rights become exercisable only if a person or group (other than certain exempt persons, as defined) acquires 15 percent or more of Ballantyne common stock or announces a tender offer for 15 percent or more of Ballantyne's common stock. Under certain circumstances, the Rights Plan allows stockholders, other than the acquiring person or group, to purchase the Company's common stock at an exercise price of half the market price.

**12. Postretirement Health Care**

The Company sponsors a postretirement health care plan (the Plan) for certain current and former executives and their spouses. The Company's policy is to fund the cost of the Plan as expenses are incurred. The costs of the postretirement benefits are accrued over the employees' service lives.

In accordance with SFAS No. 132, *Disclosures About Pensions and Other Postretirement Benefits*, the following table sets forth the components of the net period benefit cost for the three and nine months ended September 30, 2006 and 2005:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Service cost	\$ 3,116	\$ 3,051	\$ 9,348	\$ 9,153
Interest cost	6,083	6,196	18,249	18,588
Amortization of prior-service cost	6,717	6,718	20,153	20,154
Amortization of loss		934		2,802
Net periodic benefit cost	\$ 15,916	\$ 16,899	\$ 47,750	\$ 50,697

The Company expects to pay \$6,045 under the plan in 2006. As of September 30, 2006, benefits of \$2,287 have been paid.

In December 2003, the United States enacted into law the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act). The Act established a prescription drug benefit under Medicare, known as Medicare Part D and a federal subsidy to sponsors of retired healthcare benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D. On May 19, 2004, the FASB issued Staff Position No. FAS-106-2, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003* (FSP-106-2), which requires measures of the accumulated postretirement benefit obligation and net periodic postretirement benefit costs to reflect the effects of the Act in the first interim or annual period beginning after June 15, 2004. On January 21, 2005, final regulations under the Act were issued. The effects of the Act did not have a material impact on the consolidated financial statements of the Company.

**13. Self-Insurance**

The Company is self-insured up to certain loss limits for group health insurance. Accruals for claims incurred but not paid as of September 30, 2006 and December 31, 2005 are included in accrued group health insurance claims in the accompanying consolidated balance sheets. The Company's policy is to accrue the employee health benefit accruals based on historical information along with certain assumptions about future events.



#### **14. Business Segment Information**

The presentation of segment information reflects the manner in which management organizes segments for making operating decisions and assessing performance.

As of September 30, 2006, the Company's operations were conducted principally through three business segments: Theatre, Lighting and Restaurant. Theatre operations include the design, manufacture, assembly, sale and service of motion picture projectors, xenon lamphouses and power supplies, sound systems, film handling equipment and the sale and service of xenon lamps, lenses and digital projection equipment. The lighting segment operations include the design, manufacture, assembly and sale of follow spotlights, stationary searchlights and computer operated lighting systems for the motion picture production, television, live entertainment, theme parks and architectural industries. The restaurant segment includes the manufacture and sale of replacement parts and the sale of seasonings, marinades and barbeque sauces. The Company allocates resources to business segments and evaluates the performance of these segments based upon reported segment gross profit. However, certain key operations of a particular segment are tracked on the basis of operating profit. There are no significant intersegment sales. All intersegment transfers are recorded at historical cost.

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## Summary by Business Segments

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Net revenue				
Theatre	\$ 12,246,608	\$ 13,228,282	\$ 34,310,747	\$ 36,806,106
Lighting	634,817	822,404	2,493,761	2,359,449
Restaurant	188,248	209,551	553,271	648,145
Total net revenue	\$ 13,069,673	\$ 14,260,237	\$ 37,357,779	\$ 39,813,700
Gross profit				
Theatre	\$ 1,923,885	\$ 3,695,022	\$ 7,272,046	\$ 10,082,395
Lighting	188,288	270,161	748,956	760,531
Restaurant	82,351	91,060	236,617	294,900
Total gross profit	2,194,524	4,056,243	8,257,619	11,137,826
Selling and administrative expenses	(1,944,280 )	(2,179,458 )	(5,838,702 )	(6,162,903 )
Gain (loss) on sale of assets	(3,457 )	(1,296 )	37,546	8,704
Operating income	246,787	1,875,489	2,456,463	4,983,627
Net interest income	191,616	97,007	532,188	247,061
Other income (expense), net	11,775	18,847	(28,432 )	(20,059 )
Income before income taxes	\$ 450,178	\$ 1,991,343	\$ 2,960,219	\$ 5,210,629
Expenditures on capital equipment				
Theatre	\$ 180,214	\$ 184,614	\$ 456,180	\$ 695,744
Lighting	2,039	7,615	14,214	34,602
Total	\$ 182,253	\$ 192,229	\$ 470,394	\$ 730,346
Depreciation and amortization				
Theatre	\$ 275,755	\$ 270,088	\$ 785,035	\$ 821,750
Lighting	5,308	4,645	46,424	36,588
Total	\$ 281,063	\$ 274,733	\$ 831,459	\$ 858,338
Gain on sale of assets				
Theatre	\$ (3,457 )	\$ (1,992 )	\$ 35,746	\$ 8,008
Lighting		696	1,800	696
Total	\$ (3,457 )	\$ (1,296 )	\$ 37,546	\$ 8,704

	At September 30, 2006	At December 31, 2005
Identifiable assets		
Theatre	\$ 44,859,920	\$ 42,866,118
Lighting	3,752,587	3,382,738
Restaurant	710,015	687,071
Total	\$ 49,322,522	\$ 46,935,927

## Summary by Geographical Area

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Net revenue				
United States	\$ 9,086,921	\$ 11,185,760	\$ 27,312,098	29,416,083
Canada	159,842	171,584	578,812	531,913
Asia	2,499,440	1,465,628	5,558,366	4,734,112
Mexico and South America	665,998	1,206,656	2,597,075	3,954,120
Europe	656,536	226,812	1,256,854	1,124,699
Other	936	3,797	54,574	52,773
Total	\$ 13,069,673	\$ 14,260,237	\$ 37,357,779	\$ 39,813,700

	At September 30, 2006	At December 31, 2005
Identifiable assets		
United States	\$ 47,639,589	\$ 44,910,526
Asia	1,682,933	2,025,401
Total	\$ 49,322,522	\$ 46,935,927

Net revenues by business segment are to unaffiliated customers. Net sales by geographical area are based on destination of sales. Identifiable assets by geographical area are based on location of facilities.

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion and analysis should be read in conjunction with the consolidated financial statements and notes thereto appearing elsewhere in this report. Management's discussion and analysis contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 and Section 21E of the Securities Exchange Act of 1934 that involve risks and uncertainties, including but not limited to: quarterly fluctuations in results; customer demand for the Company's products; the development of new technology for alternate means of motion picture presentation; domestic and international economic conditions; the achievement of lower costs and expenses; the continued availability of financing in the amounts and on the terms required to support the Company's future business; credit concerns in the theatre exhibition industry; and other risks detailed from time to time in the Company's other Securities and Exchange Commission filings. Actual results may differ materially from management's expectations. The risks included here are not exhaustive. Other sections of this report may include additional factors which could adversely affect the Company's business and financial performance. Moreover, the Company operates in a very competitive and rapidly changing environment. New risk factors emerge from time to time and it is not possible for management to predict all such risk factors, nor can it assess the impact of all such risk factors on the Company's business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements. Given these risks and uncertainties, investors should not place undue reliance on forward-looking statements as a prediction of actual results.

Investors should also be aware that while the Company does communicate with securities analysts from time to time, it is against its policy to disclose to them any material non-public information or other confidential information. Accordingly, investors should not assume that the Company agrees with any statement or report issued by any analyst irrespective of the content of the statement or report. Furthermore, the Company currently has a policy against issuing or confirming financial forecast or projections issued by others. Therefore, to the extent that reports issued by securities analysts contain any projections, forecasts or opinions, such reports are not the responsibility of the Company.

### **Overview**

The Company designs, develops, manufactures and distributes commercial motion picture equipment and lighting systems and also distributes restaurant products. The Company business was founded in 1932.

The Company has three reportable core operating segments: theatre, lighting and restaurant. Approximately 92% of year-to-date 2006 revenues were theatre products, 7% were lighting products and 1% were restaurant products.

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

#### **General**

Management's Discussion and Analysis of Financial Condition and Results of Operations is based upon the consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses, and the related disclosure of contingent assets and liabilities. Management bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Senior management has discussed the development, selection and disclosure of these estimates with the Audit Committee of the Board of Directors. Actual results may differ from these estimates under different assumptions or conditions.

An accounting policy is deemed to be critical if it requires an accounting estimate to be made based on

assumptions about matters that are uncertain at the time the estimate is made, and if different estimates that reasonably could have been used, or changes in the accounting estimates that are reasonably likely to occur periodically, could materially impact the consolidated financial statements.

The Company's accounting policies are discussed in note 2 to the consolidated financial statements in this report. Management believes the following critical accounting policies reflect its more significant estimates and assumptions used in the preparation of the consolidated financial statements.

### **Revenue Recognition**

The Company normally recognizes revenue upon shipment of goods or delivery of the service to customers when collectibility is reasonably assured. In certain circumstances revenue is not recognized until the goods are received by the customer or upon installation and customer acceptance based on the terms of the sale agreement. During 2003, the Company adopted the provisions of EITF 00-21, *Revenue Arrangements With Multiple Deliverables* (EITF 00-21). EITF 00-21 addresses certain aspects of revenue recognition on contracts with multiple deliverable elements.

### **Allowance for Doubtful Accounts**

The Company makes judgments about the credit worthiness of both current and prospective customers based on ongoing credit evaluations performed by the Company's credit department. These evaluations include, but are not limited to, reviewing customers' prior payment history, analyzing credit applications, monitoring the aging of receivables from current customers and reviewing financial statements, if applicable. The allowance for doubtful accounts is developed based on several factors including overall customer credit quality, historical write-off experience and a specific account analysis that project the ultimate collectibility of the accounts. As such, these factors may change over time causing the reserve level to adjust accordingly. When it is determined that a customer is unlikely to pay, a charge is recorded to bad debt expense in the consolidated statements of operations and the allowance for doubtful accounts is increased. When it becomes certain the customer cannot pay, the receivable is written off by removing the accounts receivable amount and reducing the allowance for doubtful accounts accordingly.

At September 30, 2006, there were approximately \$8.2 million in gross outstanding accounts receivable and \$0.5 million recorded in the allowance for doubtful accounts. At December 31, 2005, there were approximately \$8.2 million in gross outstanding accounts receivable and \$0.4 million recorded in the allowance for doubtful accounts to cover potential future customer non-payments. If economic conditions deteriorate significantly or if one of the Company's large customers were to declare bankruptcy, a larger allowance for doubtful accounts might be necessary.

### **Inventory Valuation**

Inventories are stated at the lower of cost (first-in, first-out) or market and include appropriate elements of material, labor and overhead. The Company's policy is to evaluate all inventory quantities for amounts on-hand that are potentially in excess of estimated usage requirements, and to write down any excess quantities to estimated net realizable value. Inherent in the estimates of net realizable values are management's estimates related to the Company's future manufacturing schedules, customer demand and the development of digital technology, which could make the Company's theatre products obsolete, among other items. Management has managed these risks in the past and believes that it can manage them in the future, however, operating margins may suffer if they are unable to effectively manage these risks. At September 30, 2006 the Company had recorded gross inventory of approximately \$10.2 million and \$1.2 million of inventory reserves. This compared to \$11.0 million and \$1.1 million, respectively, at December 31, 2005.

### **Warranty**

The Company's products must meet certain product quality and performance criteria. In addition to known claims or warranty issues, the Company estimates future claims on recent sales. The Company

relies on historical product claims data to estimate the cost of product warranties at the time revenue is recognized. In determining the accrual for the estimated cost of warranty claims, the Company considers experience with: 1) costs for replacement parts; 2) costs of scrapping defective products; 3) the number of product units subject to warranty claims and 4) other direct costs associated with warranty claims. If the cost to repair a product or the number of products subject to warranty claims is greater than originally estimated, the Company's accrued cost for warranty claims would increase.

At September 30, 2006, the warranty accrual amounted to \$0.7 million and the amount charged to expense for the three and nine months ending September 30, 2006 was approximately \$33,000 and \$149,000, respectively. At September 30, 2005, the warranty accrual amounted to \$0.7 million and the amount charged to expense for the three and nine months ending September 30, 2005 was approximately \$122,000 and \$207,000, respectively.

### **Long-Lived Assets**

The Company reviews long-lived assets, exclusive of goodwill, for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the assets exceeds their fair value. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

The Company's most significant long-lived assets subject to these periodic assessments of recoverability are property, plant and equipment, which have a net book value of \$5.1 million at September 30, 2006. Because the recoverability of property, plant and equipment is based on estimates of future undiscounted cash flows, these estimates may vary due to a number of factors, some of which may be outside of management's control. To the extent that the Company is unable to achieve management's forecasts of future income, it may become necessary to record impairment losses for any excess of the net book value of property, plant and equipment over its fair value.

### **Goodwill and Other Intangible Assets**

Goodwill represents the excess of cost over the fair value of assets of businesses acquired through purchase business combinations in accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets*. Goodwill and intangible assets that are determined to have an indefinite useful life are not amortized but instead tested for impairment at least annually. An impairment loss is recognized to the extent that the carrying amount exceeds the asset's estimated fair value. Intangible assets with estimatable useful lives are amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment in accordance with SFAS No. 144, *Accounting for Impairment or Disposal of Long-Lived Assets*.

In accordance with SFAS No. 142, the Company evaluates its goodwill for impairment on an annual basis based on values at the end of the fourth quarter or whenever indicators of impairment exist. The Company has evaluated its goodwill for impairment in the fourth quarter of fiscal 2005 and determined that the fair value of the reporting units exceeded their carrying value, so no impairment of goodwill was recognized. Goodwill of approximately \$2.9 and \$2.5 million is included in the consolidated balance sheets at September 30, 2006 and December 31, 2005, respectively. Management's assumptions about future cash flows for the reporting units require significant judgment and actual cash flows in the future may differ significantly from those forecasted today.

### **Deferred Income Taxes**

Income taxes are accounted for under the asset and liability method. The Company uses an estimate of its annual effective rate at each interim period based on the facts and circumstances known at the time, while the actual effective rate is calculated at year-end. 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 carry forwards. 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.

### **Self-Insurance Reserves**

The Company is partially self-insured for certain employee health benefits. The related liabilities are included in the accompanying consolidated financial statements. The Company's policy is to accrue the liabilities based on historical information along with certain assumptions about future events.

### **Share-Based Compensation**

Effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards No. 123R ( SFAS 123R ), Share-Based Payments, which requires the measurement and recognition of compensation expense for all share-based payment awards to employees and directors based on estimated fair values. SFAS 123R supersedes the Company's previous accounting methodology using the intrinsic value method under Accounting Principles Board Opinion No. 25 ( APB 25 ), Accounting for Stock Issued to Employees. Under the intrinsic value method, no share-based compensation expense related to stock option awards granted had been recognized in the Company's consolidated statements of operations, as all stock option awards granted under the plans had an exercise price equal to the market value of the common stock on the date of the grant.

The Company adopted SFAS 123R using the modified prospective transition method. Under this transition method, compensation expense recognized during the nine months ended September 30, 2006 included: (a) compensation expense for all share-based awards granted prior to, but not yet vested, as of December 31, 2005, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, and (b) compensation expense for all share-based awards granted subsequent to December 31, 2005, based on the grant date fair value estimated in accordance with the provisions of SFAS 123R. In accordance with the modified prospective transition method, the Company's consolidated financial statements for prior periods have not been restated to reflect the impact of SFAS 123R. The Company has recorded stock compensation expense of \$27,470 and \$75,414 for the three and nine months ended September 30, 2006, respectively.

On November 10, 2005 the Financial Accounting Standards Board ( FASB ) issued FASB Staff Position No. 123R-3, Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards. The Company has elected to adopt the alternative transition method provided in the FASB Staff Position for calculating the tax effects of share-based compensation pursuant to SFAS 123R. The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in capital pool ( APIC Pool ) related to the tax effects of employee share-based compensation, and to determine the subsequent impact on the APIC Pool and consolidated statements of cash flows of the tax effects of employee and director share-based awards that are outstanding upon adoption of SFAS 123R.

### **Recent Accounting Pronouncements**

See note 2 to the consolidated financial statements for a full description of recent accounting pronouncements including the respective expected dates of adoption and effects on results of operations and financial condition.

**Nine Months Ended September 30, 2006 Compared to the Nine Months Ended September 30, 2005****Revenues**

Net revenues during the first nine months of 2006 decreased to \$37.4 million from \$39.8 million in 2005. As discussed in further detail below, the decrease resulted primarily from lower theatre revenues.

	<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
Theatre	\$ 34,310,747	\$ 36,806,106
Lighting	2,493,761	2,359,449
Restaurant	553,271	648,145
Total net revenues	\$ 37,357,779	\$ 39,813,700

Theatre Segment

Sales of theatre products decreased 6.8% from \$36.8 million in 2005 to \$34.3 million in 2006 due to lower demand for analog projection equipment which decreased to \$20.3 million in 2006 from \$25.9 million in 2005, a decrease of 21.6%. The Company has begun to see the theatre exhibition industry's transition to digital cinema and theatre owners appear to be evaluating their options as they plan capital expenditures relative to new or used film projectors or digital equipment. While digital cinema remains a critical component of the Company's long-term growth strategy, management is unsure how the transition will affect future revenues but do expect revenues to continue to fall short of 2005 levels during the fourth quarter of fiscal 2006. Sales of digital projection equipment and accessories amounted to \$0.7 million in 2006. There were no such sales a year-ago.

During 2006, the Company entered the service and maintenance side of the theatre industry with the acquisition of National Cinema Service Corp. (NCSC). This business was rolled into a wholly-owned subsidiary named Strong Technical Services, Inc. (STS). Revenues generated since the acquisition effective date of May 31, 2006 have amounted to \$1.7 million of which \$0.6 million were parts revenues and \$1.1 million were service revenues.

Sales of xenon lamps rose 28.9% in 2006 to \$4.4 million from \$3.4 million a year-ago primarily a result of the Company gaining market share and a general improvement of the theatre exhibition industry. The uncertainty regarding digital cinema has not impacted lamp sales as they are a necessary replacement item for projectors in service.

Sales of lenses declined 31.2% in 2006 to \$1.6 million from \$2.4 million a year-ago. The decrease pertains to fewer sales of projectors and a general decrease in demand. Management believes the sales should rise to more normal levels in the fourth quarter.

Revenues from theatre replacement parts amounted to \$6.2 million in 2006 compared to \$5.1 million in 2005. As with lamp sales, the uncertainty regarding digital cinema has not yet impacted part sales as they are a necessary maintenance item needed to keep film projectors operating properly. In addition, the acquisition of NCSC generated \$0.6 million of replacement part sales.

The Company's top ten theatre customers accounted for approximately 50% of total theatre revenues compared to 55% a year-ago and 54% a quarter-ago.

Lighting Segment

Sales of lighting products rose 5.7% to \$2.5 million in 2006 from \$2.4 million a year-ago. The increase primarily resulted from a \$0.2 million sale of 10K lights to be used by NASA. Spotlight sales declined to \$1.0 million in 2006 from \$1.1 million in 2005. Sales of Sky-trackers and replacement parts were



comparable to a year-ago at \$0.4 million each, respectively.

Sales of all other lighting products, including but not limited to, xenon lamps and nocturns were also comparable to 2005 at approximately \$0.5 million, respectively.

#### Restaurant Segment

Sales of restaurant products amounted to approximately \$0.6 million in both 2006 and 2005 periods.

#### **Export Revenues**

Sales outside the United States (mainly theatre sales) declined to \$10.0 million in 2006 from \$10.4 million in 2005 resulting primarily from a decline in business in South America. The decline pertains to lower demand for theatre products coupled with increased competition from companies selling used equipment in that region. The Company did experience higher demand in Asia with sales rising from \$4.7 million in 2005 to \$5.6 in 2006. Export sales are sensitive to worldwide economic and political conditions that can lead to volatility. Additionally, certain areas of the world are more cost conscious than the U.S. market and there are instances where Ballantyne's products are priced higher than local manufacturers making it more difficult to generate sufficient profit to justify selling into these regions. Additionally, foreign exchange rates and excise taxes sometimes make it difficult to market the Company's products overseas at reasonable selling prices.

#### **Gross Profit**

Consolidated gross profit decreased to \$8.3 million in 2006 from \$11.1 million in 2005 and as a percent of revenue declined to 22.1% from 28.0% in 2005 due to the reasons discussed below.

Gross profit in the theatre segment fell to \$7.3 million in 2006 from \$10.1 million in 2005 and as a percentage of sales declined to 21.2% from 27.4% a year-ago. The results primarily reflect lower production demand in the manufacturing plant in Omaha which resulted in certain manufacturing inefficiencies and the Company not covering fixed overhead costs in a productive manner. The Company has reduced production personnel and is working towards bringing in other products to manufacture to offset expected lower demand for analog projectors in the future which will substantially reduce production demand in the Company's plants in Omaha, Nebraska and Fisher, Illinois. Margins were also dampened by the deferral of revenue recognition and the expensing of the entire cost of certain digital projectors that were sold and financed by Ballantyne in the quarter. Only the payments received on this sale were recorded as revenue in the period. This accounting treatment was driven by the fact that the collection of the remaining payments over five years were not reasonably assured primarily due to the uncertainties surrounding the long-term nature of the contract and other items. As future payments are received related to this agreement, revenue will be recognized with no associated cost.

Gross profit in the lighting segment decreased to \$0.7 million in 2006 compared to \$0.8 million in 2005 and as a percent of revenues fell to 30.0% from 32.2% a year-ago. The results reflect manufacturing inefficiencies as the decline in theatre projection equipment sales had a ripple effect throughout the manufacturing plant in Omaha.

Restaurant margins were approximately \$0.2 million in 2006 compared to \$0.3 million in 2005 and as a percent of revenues fell to 42.8% from 45.5% a year-ago.

#### **Selling and Administrative Expenses**

Selling and administrative expenses decreased to \$5.8 million in 2006 from \$6.2 million in 2005 but as a percent of revenue increased to 15.6% in 2006 from 15.5% in 2005.

Administrative costs decreased to \$3.7 million or 9.9% of revenue compared to \$4.1 million or 10.3% a year-ago. The decrease in administrative costs primarily pertains to the lack of bonus expense as

management is not meeting certain financial targets. Other administrative expenses have risen compared to 2005 and include those pertaining to legal, severance, compliance and compensation costs. The legal costs come from the settlement of an asbestos case during the first quarter while the severance costs relate to planned workforce reductions also incurred in the first quarter. Compliance costs pertain to filing more regulatory reports in multiple states while higher compensation costs relate to accounting for SFAS 123R and higher health insurance costs.

Selling expenses rose to \$2.2 million in 2006 from \$2.1 in 2005 and as a percent of revenues rose to 5.8% from 5.2% a year-ago as the majority of the Company's selling expenses do not necessarily rise and fall with revenue levels.

#### **Other Financial Items**

Net other expense amounted to \$28,400 in 2006 compared to \$20,100 in 2005 due to higher cash discounts given in 2006 related to higher accounts receivable collections.

During 2006, the Company recorded interest income of \$0.6 million compared to \$0.3 million a year-ago as the Company earned interest from higher cash levels. Interest expense rose to \$40,100 in 2006 from \$25,900 a year-ago due primarily to the acquisition of National Cinema Service Corp.

The Company recorded income tax expense of \$0.9 million in 2006 compared to \$2.0 million in 2005. The effective tax rate declined to 31.9% in 2006 compared to 38.0% a year-ago due primarily to the Company investing in more tax-free municipal bonds during 2006 and taking advantage of the tax deduction on qualified production activities provided by the American Jobs Creation Act of 2004 which allows for a special deduction as incentive for U.S. qualified production activities.

For the reasons outlined herein, the Company earned net income of \$2.0 million and basic and diluted earnings per share of \$0.15 and \$0.14 in 2006, respectively, compared to net income of \$3.2 million and basic and diluted earnings per share of \$0.24 and \$0.23 a year-ago, respectively.

**Three Months Ended September 30, 2006 Compared to the Three Months Ended September 30, 2005****Revenues**

Net revenues during the three months ended September 30, 2006 decreased to \$13.1 million from \$14.3 million during the three months ended September 30, 2005. As discussed in further detail below, the decrease resulted primarily from lower theatre revenues.

	<b>Three Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
Theatre	\$ 12,246,608	\$ 13,228,282
Lighting	634,817	822,404
Restaurant	188,248	209,551
Total net revenues	\$ 13,069,673	\$ 14,260,237

**Theatre Segment**

Sales of theatre products decreased 7.4% from \$13.2 million in 2005 to \$12.3 million in 2006 due to lower demand for projection equipment which decreased to \$7.0 million in 2006 from \$9.6 million in 2005, a decrease of 27.8%. The Company has begun to see the theatre exhibition industry's transition to digital cinema and theatre owners appear to be evaluating their options as they plan capital expenditures relative to new or used film projectors or digital equipment. While digital cinema remains a critical component of the Company's long-term growth strategy, management is unsure how the transition will affect future revenues but do expect revenues to continue to fall short of 2005 levels during the remainder of 2006. Sales of digital projection equipment and accessories amounted to \$0.4 million in 2006. There were no such sales a year-ago.

During 2006, the Company entered the service and maintenance side of the theatre industry with the acquisition of National Cinema Service Corp. (NCSC). This business was rolled into a wholly-owned subsidiary of the Company named Strong Technical Services, Inc. (STS). Revenues generated from STS have amounted to \$1.3 million of which \$0.5 million were parts revenues and \$0.8 million were service revenues.

Sales of lenses declined 51.6% to \$0.4 million compared to \$0.9 million in 2005. The decrease pertains to fewer sales of projectors and a general decrease in demand. Management believes that sales should rise to more normal levels in the fourth quarter.

Revenues from theatre replacement parts and services amounted to \$2.2 million in 2006 compared to \$1.6 million in 2005. Part sales have not been impacted by the uncertainty in the industry as theatres are still using film projectors for the most part and these parts are necessary to keep the projection equipment operating properly. In addition, the acquisition of National Cinema Service Corp. generated \$0.5 million of parts sales.

Sales of xenon lamps rose 32.2% in 2006 to \$1.5 million from \$1.1 million a year-ago primarily a result of the Company gaining market share and a general improvement of the theatre exhibition industry. As with replacement parts, sales of lamps have not been impacted by the uncertainty regarding digital cinema as they are a necessary item to keep the projection equipment operating effectively.

The Company's top ten theatre customers accounted for approximately 43% of total theatre revenues compared to 68% a year-ago.

### Lighting Segment

Sales of lighting products declined to \$0.6 million from \$0.8 million a year-ago. The decrease primarily resulted from spotlight sales which declined to \$0.2 million during the quarter from \$0.4 million a year-ago. Sales of Sky-trackers also declined during the quarter from \$0.2 million in 2005 to \$0.1 million in 2006. Replacement parts were steady at \$0.1 million for both periods. Sales of all other lighting products rose to \$0.2 million in 2006 from \$0.1 million a year-ago primarily a result of selling more resale items not manufactured by the Company.

### Restaurant Segment

Sales of restaurant products amounted to \$0.2 million in both 2006 and 2005 as sales of both replacement parts and marinades were comparable to last year.

### **Export Revenues**

Sales outside the United States (mainly theatre sales) rose to \$4.0 million in 2006 from \$3.1 million in 2005, primarily due to higher demand in Asia with sales rising from \$1.5 million in 2005 to \$2.5 million in 2006. The Company did experience a decline in business in South America resulting from a combination of lower demand and more competition from used equipment dealers. Export sales are sensitive to worldwide economic and political conditions that can lead to volatility. Additionally, certain areas of the world are more cost conscious than the U.S. market and there are instances where Ballantyne's products are priced higher than local manufacturers making it more difficult to generate sufficient profit to justify selling into these regions. Additionally, foreign exchange rates and excise taxes sometimes make it difficult to market the Company's products overseas at reasonable selling prices.

### **Gross Profit**

Consolidated gross profit decreased to \$2.2 million in 2006 from \$4.1 million in 2005 and as a percent of revenue declined to 16.8% from 28.4% in 2005.

Gross profit in the theatre segment fell to \$1.9 million in 2006 from \$3.7 million in 2005 and as a percentage of sales declined to 15.7% from 27.9% a year-ago. The results reflect lower production demand in the manufacturing plant in Omaha which resulted in certain manufacturing inefficiencies and the Company not covering fixed overhead costs in as profitable a manner. The Company has reduced production personnel and is working towards bringing in other products to manufacture to offset expected lower demand for analog projectors in the future, which will substantially reduce production demand in the Company's plants in Omaha, Nebraska and Fisher, Illinois. Margins were also dampened by the deferral of revenue recognition and the expensing of the entire cost of certain digital projectors that were sold and financed by Ballantyne in the quarter. Only payments received on this sale were recorded as revenue in the period. This accounting treatment was driven by the fact that the collection of the remaining payments over five years were not reasonably assured primarily due to the uncertainties surrounding the long-term nature of the contract and other items. As future payments are received related to this agreement, revenue will be recognized with no associated cost.

Gross profit in the lighting segment amounted to \$0.2 million in 2006 compared to \$0.3 million in 2005 and as a percent of revenues fell to 29.7% from 32.9%. The results reflect manufacturing inefficiencies as the decline in theatre projection equipment sales had a ripple effect throughout the manufacturing plant in Omaha.

Restaurant margins amounted to approximately \$0.1 million for both the 2006 and 2005 periods. The results were expected as the Company is now only selling coater, marinades and replacement parts.

### **Selling and Administrative Expenses**

Selling and administrative expenses amounted to \$1.9 million in 2006 compared to \$2.2 million in 2005

and as a percent of revenue declined to 14.9% from 15.3% in 2005.

Administrative costs declined to \$1.2 million or 9.4% of revenue compared to \$1.5 million or 10.4% a year-ago. The reduction in expense is primarily due to lower bonus expense as management is not meeting the necessary financial targets to trigger payments under its bonus plans.

Selling expenses amounted to \$0.7 million in both 2006 and 2005 periods but as a percent of revenues increased to 5.5% from 4.9% a year-ago. The increase as a percent of revenues resulted from fixed selling costs not falling in line with revenue levels.

#### **Other Financial Items**

Net other income amounted to \$11,800 in 2006 compared to net other expense of \$18,800 in 2005.

During 2006, the Company recorded interest income of \$0.2 million compared to \$0.1 million in 2005 as the Company earned interest from higher cash levels. Interest expense rose to \$11,700 in 2006 from \$8,400 a year-ago as a result of the acquisition of National Cinema Service Corp.

The Company recorded income tax expense of \$0.1 million in 2006 compared to \$0.8 million in 2005. The effective tax rate declined to 16.8% in 2006 compared to 38.3% a year-ago due primarily to the Company investing in more tax-free municipal bonds during 2006 and taking advantage of the tax deduction on qualified production activities provided by the American Jobs Creation Act of 2004 which allows for a special deduction as incentive for U.S. qualified production activities.

For the reasons outlined herein, the Company earned net income of \$0.4 million and basic and diluted earnings per share of \$0.03 in 2006, respectively, compared to net income of \$1.2 million and basic and diluted earnings per share of \$0.09 in 2005, respectively.

#### **Liquidity and Capital Resources**

The Company is a party to a revolving credit facility with First National Bank of Omaha expiring August 27, 2007. The Company plans on renewing the credit facility in the ordinary course of business. The credit facility provides for borrowings up to the lesser of \$4.0 million or amounts determined by an asset-based lending formula, as defined. Borrowings available under the credit facility amounted to \$4.0 million at September 30, 2006. No amounts are currently outstanding. The Company pays interest on outstanding amounts equal to the Prime Rate plus 0.25% (8.5% at September 30, 2006) and pays a fee of 0.125% on the unused portion. The credit facility contains certain restrictive covenants mainly related to maintaining certain earnings, as defined, and restrictions on acquisitions and dividends. All of the Company's personal property and stock in its subsidiaries secure this credit facility.

Net cash provided by operating activities declined to \$2.9 million in 2006 from \$3.3 million a year-ago. The decrease pertains to lower operating income, more other current assets, fewer customer deposits and bonus payments. Inventory at customer locations, but included in other current assets, rose \$0.7 million as the Company has temporarily installed several digital projectors at customer locations for demonstration and testing purposes. In addition, cash received from customers in advance of the sales revenue (customer deposits) declined \$0.4 million from year-end. Finally, the Company paid out \$0.9 million in bonus payments accrued for at December 31, 2005. The Company was able to increase cash flows by reducing accounts receivable and inventory balances by \$0.6 million each, respectively. In addition, the timing of income tax payments increased cash flow by an additional \$0.5 million compared to 2005.

Net cash used in investing activities amounted to \$2.2 million in 2006 compared to \$0.7 million in 2005. The increase primarily pertains to the purchase of National Cinema Service Corp. for approximately \$1.4 million, net of cash acquired. The Company also incurred approximately \$0.5 million of capital expenditures during 2006 and received proceeds from the sale of assets of \$0.3 million. Investing activities in 2005 primarily related to capital expenditures of \$0.7 million.

Net cash provided by financing activities amounted to \$0.4 million compared to \$0.8 million in 2005. The Company received proceeds of \$0.3 million from its stock option plans in 2006, recorded a \$0.4 million income tax benefit pertaining to these plans and made debt payments of \$0.2 million. The debt payments resulted primarily from paying off certain notes payable pertaining to the National Cinema Service acquisition. During 2005, the Company received proceeds of \$0.8 million from its stock plans and made debt payments of \$19,300.

#### **Transactions with Related and Certain Other Parties**

There were no significant transactions with related and certain other parties during 2006.

#### **Internal Controls Over Financial Reporting**

Current SEC rules implementing Section 404 of the Sarbanes-Oxley Act of 2002 will require the Company's Annual Report on Form 10-K for fiscal 2007 to include a report on management's assessment of the effectiveness of the Company's internal controls over financial reporting and a statement that the Company's independent registered public accounting firm has issued an attestation report on management's assessment of the Company's internal controls over financial reporting and a report on the effectiveness of the Company's internal controls over financial reporting. While the Company has not yet identified any material weaknesses in internal controls over financial reporting, there are no assurances that the Company will not discover deficiencies in its internal controls as it implements new documentation and testing procedures to comply with the Section 404 reporting requirement. If the Company discovers deficiencies or is unable to complete the work necessary to properly evaluate its internal controls over financial reporting, there is a risk that management and/or the Company's independent registered public accounting firm may not be able to conclude that the Company's internal controls over financial reporting are effective.

#### **Concentrations**

The Company's top ten customers accounted for approximately 45% of 2006 consolidated net revenues. Trade accounts receivable from these customers represented approximately 54% of net consolidated receivables at September 30, 2006. Sales to AMC Theatres, Inc. represented over 10% of consolidated revenues. In addition, receivables from Regal Cinemas represented over 10% of net consolidated receivables at September 30, 2006. While the Company believes its relationships with such customers are stable, most arrangements are made by purchase order and are terminable at will by either party. A significant decrease or interruption in business from the Company's significant customers could have a material adverse effect on the Company's business, financial condition and results of operations. The Company could also be adversely affected by such factors as changes in foreign currency rates and weak economic and political conditions in each of the countries in which the Company sells its products. In addition, advancing technologies, such as digital cinema, could disrupt historical customer relationships.

Financial instruments that potentially expose the Company to a concentration of credit risk principally consist of accounts receivable. The Company sells product to a large number of customers in many different geographic regions. To minimize credit concentration risk, the Company performs ongoing credit evaluations of its customers' financial condition or uses letters of credit.

Increased competition also results in continued exposure to the Company. If the Company loses market share or encounters more competition relating to the development of new technology for alternate means of motion picture presentation such as digital technology, the Company may be unable to lower its cost structure quickly enough to offset the lost revenue. To counter these risks, the Company has initiated a cost and inventory reduction program, continues to streamline its manufacturing processes and is formulating a strategy to respond to the digital marketplace. The Company also is focusing on a growth and diversification strategy to find alternative product lines to become less dependent on the theatre exhibition industry. However, no assurances can be given that this strategy will succeed or that the Company will be able to obtain adequate financing to take advantage of potential opportunities.

The principal raw materials and components used in the Company's manufacturing processes include aluminum, reflectors, electronic subassemblies and sheet metal. The Company utilizes a single contract manufacturer for each of its intermittent movement components, reflectors, certain aluminum castings, lenses and xenon lamps. Although the Company has not to-date experienced a significant difficulty in obtaining these components, no assurance can be given that shortages will not arise in the future. The loss of any one or more of such contract manufacturers could have a short-term adverse effect on the Company until alternative manufacturing arrangements were secured. The Company is not dependent upon any one contract manufacturer or supplier for the balance of its raw materials and components. The Company believes that there are adequate alternative sources of such raw materials and components of sufficient quantity and quality.

### Hedging and Trading Activities

The Company does not engage in any hedging activities, including currency-hedging activities, in connection with its foreign operations and sales. To date, all of the Company's international sales have been denominated in U.S. dollars, exclusive of Strong Westrex, Inc. sales, which are denominated in Hong Kong dollars. In addition, the Company does not have any trading activities that include non-exchange traded contracts at fair value.

### Off Balance Sheet Arrangements and Contractual Obligations

The Company's off balance sheet arrangements consist principally of leasing various assets under operating leases. The future estimated payments under these arrangements are summarized below along with the Company's other contractual obligations:

Contractual Obligations	Payments Due by Period		Remaining in 2006	Thereafter
	Total			
Long-term debt	\$ 22,350		7,450	14,900
Non-Competition Agreement	125,000			125,000
Postretirement benefits	253,052		3,758	249,294
Operating leases	99,999		14,417	85,582
Net contractual cash obligations	\$ 500,401		25,625	474,776

There were no other contractual obligations other than inventory and property, plant and equipment purchases in the ordinary course of business.

### Seasonality

Generally, the Company's business exhibits a moderate level of seasonality as sales of theatre products typically increase during the third and fourth quarters. The Company believes that such increased sales reflect seasonal increases in the construction of new motion picture screens in anticipation of the holiday movie season.

### Environmental and Legal

See note 2 to the consolidated financial statements for a full description of all environmental and legal matters.

### Inflation

The Company believes that the relatively moderate rates of inflation in recent years have not had a significant impact on its net revenues or profitability. The Company did experience higher than normal prices on certain raw materials during fiscal 2005 coupled with higher freight costs as freight companies passed on a portion of higher gas and oil costs. Historically, the Company has been able to offset any

inflationary effects by either increasing prices or improving cost efficiencies.

### **2006 Outlook**

The Company is seeing evidence of the theatre exhibition industry's expected transition to digital cinema during 2006. Theatre owners are now evaluating their options as they plan capital expenditures relative to new or used film projectors or digital equipment. While the extent and timing of the impact to Ballantyne's 2006 revenues and operations is currently unclear, management does expect revenues to continue to fall below 2005 levels during the fourth quarter of 2006. Digital cinema remains an important component of the Company's long-term growth strategy, and it continues to work closely with its partner, NEC Solutions (America), Inc., to launch this next generation technology within the exhibition industry.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

The Company markets its products throughout the United States and the world. As a result, the Company could be adversely affected by such factors as changes in foreign currency rates and weak economic conditions. In particular, the Company was impacted by the downturn in the North American theatre exhibition industry in fiscal years 2000 to 2002 in the form of lost revenues and bad debts. Additionally, as a majority of sales are currently denominated in U.S. dollars, a strengthening of the dollar can and sometimes has made the Company's products less competitive in foreign markets. As stated above, the majority of the Company's foreign sales are denominated in U.S. dollars except for its subsidiary in Hong Kong. The Company purchases the majority of its lenses from a German manufacturer. Based on forecasted purchases during 2006, an average 10% devaluation of the dollar compared to the Euro would cost the Company approximately \$0.2 million per annum.

The Company has also evaluated its exposure to fluctuations in interest rates. If the Company would borrow up to the maximum amount available under its variable interest rate credit facility, a one percent increase in the interest rate would increase interest expense by \$40,000 per annum. No amounts are currently outstanding under the credit facility. Interest rate risks from the Company's other interest-related accounts such as its postretirement obligations are deemed to not be significant.

The Company has not historically and is not currently using derivative instruments to manage the above risks.

### **Item 4. Controls and Procedures**

The Company carried out an evaluation under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Securities Exchange Act Rule 13a-15. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that as of the end of the period covered by this report, the Company's disclosure controls and procedures are effective at ensuring that information required to be disclosed in the reports that the Company files or submits under the Securities Exchange Act of 1934 (as amended) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. There have been no changes in the Company's internal control over financial reporting during the period covered by this report that have materially affected, or are reasonably likely to materially affect, such internal control over financial reporting.



**PART II. Other Information**

**Item 1. Legal Proceedings**

A review of the Company's current litigation is disclosed in note 2 to the consolidated financial statements.

**Item 1A. Risk Factors**

Item 1A, Risk Factors of the Company's 2005 Annual Report on Form 10-K includes a detailed discussion of the Company's risk factors. There have been no material changes to the risk factors as previously disclosed in Item 1A of the Form 10-K.

**Item 6. Exhibits**

See the Exhibit Index on page 39.

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) 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.

BALLANTYNE OF OMAHA, INC.

By: /s/ JOHN WILMERS  
John Wilmers, President,  
Chief Executive Officer, and Director  
Date: November 13, 2006

By: /s/ BRAD FRENCH  
Brad French, Secretary/Treasurer and  
Chief Financial Officer  
Date: November 13, 2006

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**EXHIBIT INDEX**

4.2.5	Fifth Amendment to the Revolving Credit Agreement dated August 28, 2006 between the Company and First National Bank of Omaha. •
4.2.6	Consent and Waiver Agreement dated September 29, 2006 between the Company and First National Bank of Omaha. •
10.1	Definitive Agreement between the Company and NEC Viewtechnology Ltd. •
10.2	Equipment Purchase Agreement between the Company and Digital Link LLC. •
10.2.1	Amendment No. 1 to Equipment Purchase Agreement between the Company and Digital Link LLC. •
31.1	Rule 13a-14(a) Certification of Chief Executive Officer. •
31.2	Rule 13a-14(a) Certification of Chief Financial Officer. •
32.1	18 U.S.C. Section 1350 Certification of Chief Executive Officer. •
32.2	18 U.S.C. Section 1350 Certification of Chief Financial Officer. •

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• - Filed herewith