

ARCH WIRELESS INC
Form 10-Q
October 28, 2004

Table of Contents

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 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,
2004

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 001-14248

Arch Wireless, Inc.

(Exact name of Registrant as specified in its Charter)

DELAWARE

(State of incorporation)

31-1358569

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

1800 West Park Drive, Suite 250

Westborough, Massachusetts

(address of principal executive offices)

01581

(Zip Code)

(508) 870-6700

(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 an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes No

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Section 12, 13, or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. 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: no shares of the Registrant's Common Stock (\$.001 per value per share) and 19,657,094 shares of the Registrant's Class A Common Stock (\$0.0001 par value per share) were outstanding as of October 21, 2004.

Table of Contents

**ARCH WIRELESS, INC.
QUARTERLY REPORT ON FORM 10-Q
Index**

	<u>Page</u>
<u>PART I. FINANCIAL INFORMATION</u>	
<u>Item 1. Financial Statements</u>	
<u>Unaudited Consolidated Balance Sheets as of September 30, 2004 and December 31, 2003</u>	3
<u>Unaudited Consolidated Statements of Operations for the Three and Nine Months Ended September 30, 2004 and 2003</u>	4
<u>Unaudited Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2004 and 2003</u>	5
<u>Unaudited Notes to Consolidated Financial Statements</u>	6
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	9
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	33
<u>Item 4. Controls and Procedures</u>	33
<u>PART II. OTHER INFORMATION</u>	
<u>Item 1. Legal Proceedings</u>	34
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	34
<u>Item 3. Defaults upon Senior Securities</u>	34
<u>Item 4. Submission of Matters to a Vote of Security Holders</u>	34
<u>Item 5. Other Information</u>	34
<u>Item 6. Exhibits</u>	34
<u>Ex-31.1 Section 302 Certification of CEO</u>	
<u>Ex-31.2 Section 302 Certification of CFO</u>	
<u>Ex-32.1 Section 906 Certification of CEO</u>	
<u>Ex-32.2 Section 906 Certification of CFO</u>	

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements**

ARCH WIRELESS, INC.
CONSOLIDATED BALANCE SHEETS
(unaudited and in thousands)

	September 30, 2004	December 31, 2003
	<hr/>	<hr/>
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 45,292	\$ 34,582
Accounts receivable, net	20,987	26,052
Deposits	3,122	6,776
Prepaid rent	489	514
Prepaid expenses and other	13,381	7,381
Deferred income taxes	22,226	30,206
	<hr/>	<hr/>
Total current assets	105,497	105,511
	<hr/>	<hr/>
Property and equipment	392,869	394,436
Less accumulated depreciation and amortization	(242,029)	(180,563)
	<hr/>	<hr/>
Property and equipment, net	150,840	213,873
	<hr/>	<hr/>
Assets held for sale	1,322	1,139
Intangible and other assets, net	3	3
Deferred income taxes	191,395	189,346
	<hr/>	<hr/>
	\$ 449,057	\$ 509,872
	<hr/>	<hr/>
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current maturities of long-term debt	\$	\$ 20,000
Accounts payable	11,580	8,836
Accrued compensation and benefits	9,850	17,820
Accrued network costs	7,274	7,893
Accrued property and sales taxes	9,102	10,076
Accrued interest		1,520
Accrued restructuring charges	5,541	11,481
Accrued other	5,956	8,104
Customer deposits and deferred revenue	19,396	25,477

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Total current liabilities	<u>68,699</u>	<u>111,207</u>
Long-term debt, less current maturities	<u> </u>	<u>40,000</u>
Other long-term liabilities	<u>8,203</u>	<u>4,042</u>
Stockholders' equity:		
Common stock - \$0.0001 par value	2	2
Treasury stock	(3,112)	
Additional paid-in capital	344,876	339,928
Deferred stock compensation	(1,644)	(2,682)
Retained earnings	<u>32,033</u>	<u>17,375</u>
Total stockholders' equity	<u>372,155</u>	<u>354,623</u>
	<u>\$ 449,057</u>	<u>\$ 509,872</u>

The accompanying notes are an integral part of these unaudited consolidated financial statements.

Table of Contents**ARCH WIRELESS, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except share and per share amounts)
(unaudited)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2004	2003	2004	2003
Revenues:				
Service, rental and maintenance	\$ 104,785	\$ 137,759	\$ 335,505	\$ 442,456
Product sales	4,632	5,864	13,368	19,996
	<hr/>	<hr/>	<hr/>	<hr/>
Total revenues	109,417	143,623	348,873	462,452
Operating expenses:				
Cost of products sold (exclusive of depreciation and amortization shown separately below)	691	1,319	2,485	4,351
Service, rental, and maintenance (exclusive of depreciation, amortization and stock based and other compensation shown separately below)	36,904	46,736	112,880	145,382
Selling (exclusive of stock based and other compensation shown separately below)	7,862	11,488	25,687	35,703
General and administrative (exclusive of depreciation, amortization and stock based and other compensation shown separately below)	27,438	39,526	87,523	132,505
Depreciation and amortization	22,302	27,998	79,682	91,859
Stock based and other compensation	3,093	2,761	8,541	9,232
Restructuring charge			3,018	
	<hr/>	<hr/>	<hr/>	<hr/>
Total operating expenses	98,290	129,828	319,816	419,032
	<hr/>	<hr/>	<hr/>	<hr/>
Operating income	11,127	13,795	29,057	43,420
Interest income (expense), net	71	(3,511)	(4,958)	(13,984)
Other income, net	66	232	411	315
	<hr/>	<hr/>	<hr/>	<hr/>

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Income before income tax expense	11,264	10,516	24,510	29,751
Income tax expense	(4,527)	(4,330)	(9,852)	(12,250)
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Net income	\$ 6,737	\$ 6,186	\$ 14,658	\$ 17,501
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Basic net income per common share	\$ 0.34	\$ 0.31	\$ 0.73	\$ 0.88
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Diluted net income per common share	\$ 0.34	\$ 0.31	\$ 0.73	\$ 0.87
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Basic weighted average common shares outstanding	19,914,099	20,000,000	19,967,708	20,000,000
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Diluted weighted average common shares outstanding	20,041,555	20,080,572	20,091,801	20,028,504
	<u> </u>	<u> </u>	<u> </u>	<u> </u>

The accompanying notes are an integral part of these unaudited consolidated financial statements.

Table of Contents**ARCH WIRELESS, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS***(unaudited and in thousands)*

	Nine Months Ended September 30,	
	2004	2003
Cash flows from operating activities:		
Net income	\$ 14,658	\$ 17,501
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	79,682	91,859
Accretion of long-term debt		4,681
Amortization of stock based compensation	2,065	2,436
Deferred income tax expense	9,852	12,250
(Gain) loss on disposals of property and equipment	(240)	6
Other income	(168)	(179)
Provisions for doubtful accounts and service adjustments	7,517	20,065
Changes in assets and liabilities:		
Accounts receivable	(2,452)	(4,032)
Prepaid expenses and other	(5,182)	14,724
Accounts payable and accrued expenses	(16,427)	(7,968)
Customer deposits and deferred revenue	(6,081)	(7,124)
Other long-term liabilities	4,083	2,600
	<hr/>	<hr/>
Net cash provided by operating activities	87,307	146,819
	<hr/>	<hr/>
Cash flows from investing activities:		
Additions to property and equipment	(15,328)	(18,395)
Proceeds from disposals of property and equipment	1,675	3,106
Receipts from note receivable	168	173
	<hr/>	<hr/>
Net cash used for investing activities	(13,485)	(15,116)
	<hr/>	<hr/>
Cash flows from financing activities:		
Repayment of long-term debt	(60,000)	(110,000)
Purchase of treasury shares	(3,112)	
	<hr/>	<hr/>
Net cash used for financing activities	(63,112)	(110,000)
	<hr/>	<hr/>

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Net increase (decrease) in cash and cash equivalents	10,710	21,703
Cash and cash equivalents, beginning of period	34,582	37,187
	<hr/>	<hr/>
Cash and cash equivalents, end of period	\$ 45,292	\$ 58,890
	<hr/>	<hr/>
Supplemental disclosures:		
Interest paid	\$ 6,709	\$ 6,177
Asset retirement obligations	\$	\$ 1,244

The accompanying notes are an integral part of these unaudited consolidated financial statements.

Table of Contents

ARCH WIRELESS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

(a) *Preparation of Interim Financial Statements* - The consolidated financial statements of Arch Wireless, Inc. (Arch or the Company) have been prepared in accordance with the rules and regulations of the U.S. Securities and Exchange Commission. The financial information included herein, other than the consolidated balance sheet as of December 31, 2003, has been prepared without audit. The consolidated balance sheet at December 31, 2003 has been derived from, but does not include all the disclosures contained in, the audited consolidated financial statements for the year ended December 31, 2003. In the opinion of management, these unaudited statements include all adjustments and accruals consisting only of normal recurring adjustments, which are necessary for a fair presentation of the results of all interim periods reported herein. These consolidated financial statements should be read in conjunction with the consolidated financial statements and accompanying notes included in Arch s Annual Report on Form 10-K for the year ended December 31, 2003. The results of operations for the interim periods presented are not necessarily indicative of the results that may be expected for a full year.

(b) *Risks and Other Important Factors* Based on current and anticipated levels of operations, management anticipates net cash provided by operating activities, together with the \$45.3 million of cash on hand at September 30, 2004, will be adequate to meet Arch s anticipated cash requirements for the foreseeable future.

In the event that net cash provided by operating activities and cash on hand are not sufficient to meet future cash requirements, Arch may be required to reduce planned capital expenditures, sell assets or seek additional financing. Arch can provide no assurances that reductions in planned capital expenditures or proceeds from asset sales would be sufficient to cover shortfalls in available cash or that additional financing would be available or, if available, offered on acceptable terms.

Arch believes that future fluctuations in its revenues and operating results may occur due to many factors, particularly the decreased demand for its messaging services. If the rate of decline of messaging units in service exceeds Arch s expectations, its revenues will be negatively impacted, and such impact could be material. Arch s plan to consolidate its networks may also negatively impact revenues as customers may experience a reduction in, and possible disruptions of, service in certain areas. Arch may be unable to adjust spending in a timely manner to compensate for any future revenue shortfall. It is possible that, due to these fluctuations, Arch s revenue or operating results may not meet the expectations of investors and creditors, which could impair the value of its equity securities.

(c) *Proposed Merger* On March 29, 2004, Arch announced the execution of a definitive merger agreement with Metrocall Holdings, Inc. (Metrocall). Pursuant to the terms of the merger agreement, a new holding company was formed to own both Arch and Metrocall. In the aggregate, Metrocall common stockholders will receive \$150 million in cash pursuant to a cash election and approximately 27.5% of the shares of the new holding company s common stock on a fully diluted basis. Under the cash election, Metrocall shareholders will be entitled to elect to receive cash in the amount of \$75.00 per Metrocall share for up to two million Metrocall shares. The remaining approximately four million fully diluted Metrocall shares will be converted into approximately 27.5% of the new holding company s outstanding common stock on a fully diluted basis. To the extent that cash elections are made in respect of a number greater than or less than two million shares, the merger consideration will be adjusted on a pro rata basis so that two million of Metrocall s outstanding shares are exchanged for cash.

Arch shareholders will receive one share of new holding company common stock for each share of Arch common stock they own. Based on Arch s outstanding shares and options as of October 22, 2004, 20,151,773 shares and options of the new holding company would be issued to Arch stakeholders. This amount consists of 19,657,094 shares

currently outstanding, 278,683 shares remaining to be issued pursuant to Arch's plan of reorganization and options to purchase 215,996 shares of Arch common stock issued to certain members of the

Table of Contents

board of directors which fully vested on May 29, 2004. The current balance of outstanding shares above includes 316,002 shares of restricted stock issued to certain members of management that are currently subject to repurchase and other restrictions. If all 316,002 shares were repurchased, Arch shareholders would receive 19,835,771 shares of the new holding company's common stock and Metrocall's shareholders would receive 7,560,515 shares of the new holding company's common stock, reflecting an exchange ratio of 1.876 new holding company shares for each Metrocall share.

Arch and Metrocall have received opinions from tax counsel indicating the merger will qualify as a tax-free reorganization to the extent that shareholders receive stock rather than cash. Upon completion of the merger, Arch shareholders will own approximately 72.5% and Metrocall shareholders will own approximately 27.5% of the new company on a fully diluted basis.

Arch expects the new holding company will incur up to \$140.0 million of indebtedness to provide the funds necessary to purchase the two million Metrocall shares subject to the cash election referred to above. Therefore, on October 11, 2004, Arch and Metrocall entered into a commitment letter with UBS Loan Finance LLC and UBS Securities LLC that provides for a senior secured term loan facility of up to \$140.0 million for Arch Wireless Operating Company, Inc. and Metrocall, Inc., the operating subsidiaries of Arch and Metrocall. The facility will have a term of two years from the closing date and will amortize in eight equal quarterly installments with interest equal to (i) an interest margin of 150 basis points, plus the higher of the Federal Funds Rate, as published by the Federal Reserve Bank of New York, plus 1/2 of 1% and the prime commercial lending rate of UBS AG, as established from time to time, or (ii) an interest margin of 250 basis points, plus the rate equal to the London Interbank Offered Rate for corresponding deposits of U.S. dollars.

The facility will be guaranteed on a joint and several basis by USA Mobility, Inc., the corporate entity formed to serve as the new publicly-traded parent company of Arch and Metrocall following consummation of the merger, and substantially all of its subsidiaries. The facility will be secured by pledges of the equity interests of Arch, Metrocall and substantially all of their respective subsidiaries and liens on most of their respective assets and will contain covenants that are customary for a facility of this type, including a minimum interest coverage ratio, maximum leverage ratio and maximum capital expenditure levels. While Arch expects to close the facility with UBS, there can be no assurance that negotiations on the facility will result in definitive agreements or that the facility, as negotiated, will be on the terms and conditions described herein or otherwise acceptable to it.

The merger will be accounted for under the purchase method of accounting pursuant to Statement of Financial Accounting Standards (SFAS) No. 141, *Business Combinations*. Arch has been deemed the acquiring entity due primarily to its former shareholders holding a majority of the common stock of the new holding company. Accordingly, the basis of Arch's assets and liabilities as of the acquisition date will be reflected on the new holding company's balance sheet at their historical basis. Amounts allocated to Metrocall's assets and liabilities will be based upon the total purchase price and the estimated fair values of such assets and liabilities as of the acquisition date.

Arch expects the merger, which has been approved by the boards of directors of Arch and Metrocall, but is subject to regulatory review, shareholder approval and other third-party consents, to be completed in the fourth quarter of 2004. The special meetings of shareholders for Arch and Metrocall are scheduled for November 8, 2004.

(d) *Long-lived Assets* Intangible and other assets were comprised of the following at September 30, 2004 and December 31, 2003 (in thousands):

**Gross
Useful Carrying Accumulated**

	<u>Life</u>	<u>Amount</u>	<u>Amortization</u>	<u>Net Balance</u>
Purchased subscriber lists	3 yrs	\$3,547	\$ 3,547	\$
Purchased Federal Communications Commission licenses	5 yrs	2,119	2,119	
Other		3		3
		<u>5,669</u>	<u>5,666</u>	<u>\$ 3</u>

Table of Contents

Aggregate amortization expense for intangible assets for the nine months ended September 30, 2004 and 2003 was zero and \$2.1 million, respectively. The balance of Arch's intangible assets were fully amortized in 2003, therefore there is no additional amortization expense to recognize in future periods.

(e) *Restructuring Charges* - In the year ended December 31, 2003 and the nine month period ended September 30, 2004, Arch recorded restructuring charges of \$11.5 million and \$3.0 million, respectively, related to certain lease agreements for transmitter locations. Under the terms of these agreements, Arch is required to pay minimum amounts for a designated number of transmitter locations. However, Arch determined the designated number of transmitter locations was in excess of its current and anticipated needs. At September 30, 2004, the balance of the restructuring reserve was as follows (in thousands):

	Balance at Restructuring			Remaining Reserve at September 30
	December 31, 2003	Charge in 2004	Cash Paid	2004
Lease obligation costs	\$ 11,481	\$ 3,018	\$8,957	\$ 5,541

The remaining obligations associated with these agreements are expected to be paid over the next three quarters.

(f) *Income Taxes* - Arch accounts for income taxes under the provisions of SFAS No. 109, *Accounting for Income Taxes* (SFAS No. 109). Deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities, given the provisions of enacted laws.

On May 29, 2004, 316,999 shares of restricted stock previously issued to certain members of senior management vested. The value of the shares when they vested was higher than the compensation expense recorded in accordance with generally accepted accounting principles, which will result in an incremental deduction for tax purposes. In accordance with SFAS No. 109, the tax effect of this incremental deduction of \$3.6 million was recognized as an increase to Arch's long-term deferred tax assets and additional paid-in capital.

SFAS No. 109 requires Arch to evaluate the recoverability of its deferred tax assets on an ongoing basis. The assessment is required to consider all available positive and negative evidence to determine whether, based on such evidence, it is more likely than not that some portion or all of Arch's net deferred assets will be realized in future periods.

During the quarter ended December 31, 2003, management determined the available positive evidence carried more weight than the historical negative evidence and concluded it was more likely than not that the net deferred tax assets would be realized in future periods. The positive evidence management considered included operating income and cash flows for 2002 and 2003, Arch's repayment of debt ahead of scheduled maturities and anticipated operating income and cash flows for future periods in sufficient amounts to realize the net deferred tax assets. Results for the nine months ended September 30, 2004 and anticipated future results remain consistent with the assessment made in 2003; therefore, management continues to believe no valuation allowance is required.

The effective income tax rate is expected to continue to differ from the statutory federal tax rate primarily due to the effect of state income taxes.

(g) *Earnings per Share* - Basic earnings per share is computed on the basis of the weighted average common shares outstanding. Diluted earnings per share is computed on the basis of the weighted average common shares outstanding plus the effect of outstanding stock options using the treasury stock method. The components of basic and diluted earnings per share were as follows (in thousands, except share and per share amounts):

Table of Contents

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Net income	\$ 6,737	\$ 6,186	\$ 14,658	\$ 17,501
Weighted average common shares outstanding	19,914,099	20,000,000	19,967,708	20,000,000
Dilutive effect of:				
Options to purchase common stock	127,456	80,572	124,093	28,504
Common stock and common stock equivalents	20,041,555	20,080,572	20,091,801	20,028,504
Earnings per share:				
Basic	\$.34	\$ 0.31	\$.73	\$ 0.88
Diluted	\$.34	\$ 0.31	\$.73	\$ 0.87

For the three and nine months ended September 30, 2004 and 2003, no shares were excluded from the calculations above due to the shares being anti-dilutive.

(h) *Treasury Stock* - On May 29, 2004, Arch received 98,223 shares of its class A common stock with a value of approximately \$3.1 million surrendered from certain members of senior management as consideration for Arch remitting certain payroll withholding taxes related to the vesting of 316,999 shares of restricted stock on that date. Arch accounted for this treasury stock at cost.

(i) *Long-term Debt* - On May 28, 2004, Arch completed the final redemption of its 12% notes and has no other borrowings outstanding.

(j) *Recently Issued Accounting Pronouncements* In January 2003, the Financial Accounting Standards Board (FASB) issued FIN No. 46, *Consolidation of Variable Interest Entities, an interpretation of ARB 51(FIN No. 46)* and issued a revision to that guidance, FIN No. 46-R, in December 2003. FIN No. 46 and FIN No. 46-R provide guidance on the identification of entities for which control is achieved through means other than through voting rights called variable interest entities or VIEs and how to determine when and which business enterprise should consolidate the VIE (the primary beneficiary). This model for consolidation applies to an entity in which either (1) the equity investors (if any) do not have a controlling financial interest or (2) the equity investment at risk is insufficient to finance that entity's activities without receiving additional subordinated financial support from other parties. In addition, these interpretations require both the primary beneficiary and all other enterprises with a significant variable interest in a VIE to make additional disclosures. The provisions of FIN No. 46 were applicable to Arch for any interests entered into after January 31, 2003 and the provisions of FIN No. 46-R were effective on January 1, 2004. Arch does not have any interests that would change its current reporting entity or require additional disclosures outlined in FIN No. 46 or FIN No. 46-R.

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

Forward-Looking Statements

This quarterly report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, also known as the Exchange Act. For this purpose, any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. Without limiting the foregoing, the words *believes*, *anticipates*, *plans*, *expects* and similar expressions are intended to identify forward-looking statements. There are a number of important factors that could cause our actual results to differ materially from those indicated or suggested by such forward-looking statements. These factors include, without limitation, those set forth below under the caption *Factors Affecting Future Operating Results*.

Table of Contents

Pending Metrocall Merger

On March 29, 2004, we announced the execution of a definitive merger agreement with Metrocall Holdings, Inc., also known as Metrocall. Pursuant to the terms of the merger agreement, a new holding company was formed to own both Arch and Metrocall. In the aggregate, Metrocall common stockholders will receive \$150 million in cash pursuant to a cash election and approximately 27.5% of the shares of the new holding company's common stock on a fully diluted basis. Under the cash election, Metrocall shareholders will be entitled to elect to receive cash in the amount of \$75.00 per Metrocall share for up to two million Metrocall shares. The remaining approximately four million fully diluted Metrocall shares will be converted into approximately 27.5% of the new holding company's outstanding common stock on a fully diluted basis. To the extent that cash elections are made in respect of a number greater than or less than two million shares, the merger consideration will be adjusted on a pro rata basis so that two million of Metrocall's outstanding shares are exchanged for cash.

Our shareholders will receive one share of new holding company common stock for each share of our common stock they own. Based on our outstanding shares and options as of October 22, 2004, 20,151,773 shares and options of the new holding company will be issued to our stakeholders. This amount consists of 19,657,094 shares currently outstanding, 278,683 shares remaining to be issued pursuant to our plan of reorganization and options to purchase 215,996 shares of our common stock issued to certain members of the board of directors which became fully vested on May 29, 2004. The current balance of outstanding shares above includes 316,002 shares of restricted stock issued to certain members of our management that are currently subject to repurchase and other restrictions. If all 316,002 shares were repurchased, our shareholders will receive 19,835,771 shares of the new holding company's common stock and Metrocall's shareholders would receive 7,560,515 shares of the new holding company's common stock, reflecting an exchange ratio of 1.876 new holding company shares for each Metrocall share.

Arch and Metrocall have received opinions from tax counsel indicating the merger will qualify as a tax-free reorganization to the extent that shareholders receive stock rather than cash. Upon completion of the merger, Arch shareholders will own approximately 72.5% and Metrocall shareholders will own approximately 27.5% of the new company on a fully diluted basis.

We expect the new holding company to incur up to \$140.0 million of indebtedness to provide the funds necessary to purchase the two million Metrocall shares subject to the cash election referred to above. See "Liquidity and Capital Resources-Source of Funds" for a description of the financing commitment.

The merger will be accounted for under the purchase method of accounting pursuant to Statement of Financial Accounting Standards, known as SFAS, No. 141, *Business Combinations*. Arch has been deemed the acquiring entity due primarily to its former shareholders holding a majority of the common stock of the new holding company. Accordingly, the basis of our assets and liabilities as of the acquisition date will be reflected on the new holding company's balance sheet at their historical basis. Amounts allocated to Metrocall's assets and liabilities will be based upon the total purchase price and the estimated fair values of such assets and liabilities as of the acquisition date.

Arch expects the merger, which has been approved by the boards of directors of Arch and Metrocall, but is subject to regulatory review, shareholder approval and other third-party consents, to be completed in the fourth quarter of 2004. The special meetings of shareholders for Arch and Metrocall are scheduled for November 8, 2004.

Overview

The following discussion and analysis should be read in conjunction with our consolidated financial statements and related notes and the discussions under "Application of Critical Accounting Policies," which describes key estimates and assumptions we make in the preparation of our consolidated financial statements and "Factors Affecting Future

Operating Results, which describes key risks associated with our operations and industry and the following subsections of the Management's Discussion and Analysis of Financial Condition and Results of Operations section of our Annual Report on Form 10-K for the fiscal year ended December 31, 2003: Overview, Results of Operations and Inflation.

We market and distribute our services through a direct sales force and a small indirect sales force.

Direct. Our direct sales force leases or sells devices and messaging services directly to customers ranging from small and medium-sized businesses to Fortune 500 companies, health care and related businesses and government

Table of Contents

agencies. Our direct sales force represents our most significant sales and marketing efforts and we intend to continue to market to commercial enterprises utilizing our direct sales force as these commercial enterprises have typically disconnected service at a lower rate than individual consumers.

Indirect. Our indirect sales force sells devices and access to our messaging networks to third parties, or resellers, who then resell messaging services to consumers or small businesses. Resellers generally are not exclusive distributors of our services and often have access to the networks of more than one provider. Competition among network providers to attract and maintain resellers is based primarily upon price. We intend to continue to provide access to our messaging networks to resellers and to concentrate on relationships that are profitable and in which longer-term partnerships can be established and maintained.

The following tables set forth units in service and revenue associated with our channels of distribution:

(units in thousands)	As of September 30, 2004		As of September 30, 2003		As of June 30, 2004	
	Units	%	Units	%	Units	%
Direct	3,247	86%	3,600	81%	3,380	85%
Indirect	525	14	868	19	589	15
Total	3,772	100%	4,468	100%	3,969	100%

(dollars in thousands)	For the Quarter Ended September 30, 2004		For the Quarter Ended September 30, 2003		For the Quarter Ended June 30, 2004	
	Revenue	%	Revenue	%	Revenue	%
Direct	\$103,216	94%	\$133,395	93%	\$108,819	94%
Indirect	6,201	6	10,228	7	6,978	6
Total	\$109,417	100%	\$143,623	100%	\$115,797	100%

We derive the majority of our revenues from fixed monthly or other periodic fees charged to subscribers for wireless messaging services. Such fees are not generally dependent on usage. As long as a subscriber maintains service, operating results benefit from recurring payment of these fees. Revenues are generally dependent on the number of units in service and the monthly charge per unit. The number of units in service changes based on subscribers added, referred to as gross placements, less subscriber cancellations, or disconnects. The net of gross placements and disconnects is commonly referred to as net gains or losses of units in service. The absolute number of gross placements and the number of gross placements relative to average units in service in a period, referred to as the

gross placement rate, are monitored on a monthly basis. In addition, the ratio of gross placements for a period to the number of sales representatives for the same period, referred to as gross placements per sales representative, is also reviewed. This measurement together with the gross placement rate reflects the productivity of our direct sales force. Disconnects are also monitored on a monthly basis. The ratio of units disconnected in a period to average units in service for the same period, called the disconnect rate, is an indicator of our success retaining subscribers which is important in order to maintain recurring revenues and to control operating expenses. The following table sets forth our gross placements and disconnects for the periods stated.

	For the Quarter Ended September 30, 2004			For the Quarter Ended September 30, 2003			For the Quarter Ended June 30, 2004		
	Gross Placements (units in thousands)	Disconnects	Net Loss	Gross Placements	Disconnects	Net Loss	Gross Placements	Disconnects	Net Loss
Direct	122	255	(133)	141	327	(186)	131	267	(136)
Indirect	29	93	(64)	51	170	(119)	35	108	(73)
Total	151	348	(197)	192	497	(305)	166	375	(209)

The other factor that contributes to revenue, in addition to the number of units in service, is the monthly charge per unit. As previously discussed, the monthly charge is dependent on the subscriber's service, extent of geographic coverage, whether the subscriber leases or owns the messaging device and the number of units the

Table of Contents

customer has on his or her account. The ratio of service revenues for a period to the average units in service for the same period, commonly referred to as average revenue per unit, is a key revenue measurement as it indicates whether monthly charges for similar services and distribution channels are increasing or decreasing. Average revenue per unit by distribution channel and messaging service are monitored regularly. The following table sets forth our average revenue per unit by distribution channel for the periods stated. The rates for the prior year periods below have been recalculated to reflect a 249,000 unit adjustment recorded at December 31, 2003 which is discussed in our annual report on Form 10-K for the fiscal year ended December 31, 2003.

(in thousands, except per unit amounts)	For the Quarter Ended September 30,		For the Quarter Ended
	2004	2003	June 30, 2004
Direct:			
Service revenue	\$ 98,640	\$ 127,742	\$ 104,323
Average monthly units in service	3,310	3,688	3,442
Average revenue per units in service	\$ 9.93	\$ 11.55	\$ 10.10
Indirect:			
Service revenue	\$ 6,145	\$ 10,017	\$ 6,851
Average monthly units in service	553	923	623
Average revenue per units in service	\$ 3.70	\$ 3.62	\$ 3.66
Consolidated:			
Service revenue	\$ 104,785	\$ 137,759	\$ 111,174
Average monthly units in service	3,863	4,611	4,065
Average revenue per units in service	\$ 9.04	\$ 9.96	\$ 9.12

Average revenue per unit for similar services and distribution channels is indicative of changes in monthly charges; however, this measurement on a consolidated basis is affected by several factors, most notably the mix of units in service. The decrease in our consolidated average revenue per unit for the quarter ended September 30, 2004 from the quarters ended September 30, 2003 and June 30, 2004 was due primarily to the change in average revenue per unit in service in our direct distribution channel. We anticipate average revenue per unit for our direct units in service will decline in future periods and the decline will be primarily due to the mix of messaging services demanded by our customers, a decline in the percentage of customers with fewer units in service and, to a lesser extent, changes in monthly charges and competitive pricing pressure.

As discussed earlier, customers with more units in service generally have lower monthly charges for similar services due to volume discounts and historically have had lower disconnect rates. Therefore, as the percentage of our direct units in service becomes more concentrated with customers that have more units in service, our average revenue per unit and disconnect rate should decline. The following table sets forth units in service for our direct channel of distribution grouped by the number of units in service on customer accounts for the quarter ended September 30, 2004. The ratio of contractual recurring fees to the average units in service for a period is referred to below as average contractual recurring fees per unit in service. Contractual recurring fees are derived from our billing system and represent the fees that would be billed to customers assuming all units in service were billed at their contractual amounts, but they are not our actual service revenues. Contractual recurring fees are generally lower than actual service revenues recognized due to usage and transaction based revenues which occur on a recurring basis, but are not included in the contractual recurring billing rate.

Table of Contents**For the Quarter Ended September 30, 2004**

(units in thousands)	Number of Customers	Units in Service	% of Total Units in Service	Average Contractual Recurring Fees per Unit
Beginning Units in Service				
Customers with 1-10 units in service	353,370	601	17.8%	\$ 12.16
Customers with 11-100 units in service	23,934	678	20.0	9.71
Customers with >100 units in service	3,614	2,101	62.2	7.65
Total	380,918	3,380	100.0%	8.88
Ending Units in Service				
Customers with 1-10 units in service	322,810	553	17.0%	\$ 12.12
Customers with 11-100 units in service	22,582	642	19.8	9.66
Customers with >100 units in service	3,472	2,052	63.2	7.50
Total	348,864	3,247	100.0%	8.73

The following table sets forth our gross placements, disconnects and net gains (losses) of units in service for our direct channel of distribution grouped by the number of units in service on customer accounts for the quarter ended September 30, 2004. The gross placement, disconnect and net gain (loss) rates set forth below are calculated by dividing the relevant measure, gross placements, disconnects or net gains (losses) by average units in service and are presented on an average monthly basis.

Table of Contents

(units in thousands)	For the Quarter Ended September 30, 2004		
	Units Placed/ Disconnected	% of Total	Placement, Disconnect and Net Loss Rate
Gross Placements			
Customers with 1-10 units in service	11	9.0%	0.6%
Customers with 11-100 units in service	24	19.7	1.2
Customers with >100 units in service	87	71.3	1.4
Total	122	100.0%	1.2%
Disconnects			
Customers with 1-10 units in service	(59)	23.3%	3.4%
Customers with 11-100 units in service	(60)	23.3	3.0
Customers with >100 units in service	(136)	53.4	2.2
Total	(255)	100.0%	2.6%
Net Gains (Losses)			
Customers with 1-10 units in service	(48)	36.4%	(2.8)%
Customers with 11-100 units in service	(36)	26.7	(1.8)
Customers with >100 units in service	(49)	36.9	(0.8)
Total	(133)	100.0%	(1.4)%

The tables above illustrate the increasing concentration of customers with more units in service and how the net gain (loss) rate decreases as the number of units with a customer increases, thereby resulting in lower overall disconnect rates and average revenue per unit. We anticipate this trend to continue in future periods, which should result in lower revenues, although the rate of revenue decline should also decrease.

As the tables above indicate, we have experienced significant reductions in units in service and revenues. The demand for our one and two-way messaging services has declined over the past several years and we believe demand will continue to decline for the foreseeable future largely attributable to competition from cellular and broadband PCS service providers. Reductions in the number of units in service significantly affects our results of operations since operations no longer benefit from the recurring revenue generated from these units in service. In order to continue to generate net cash provided by operating activities, given the anticipated decreases in revenues, reductions in operating expenses have been, and will continue to be, necessary. In particular, lease payments on transmitter locations and telephone expenses are the most significant costs associated with the operation of our messaging networks, accounting

for 37.6% of our service, rental and maintenance, selling and general and administrative expenses thus far in 2004. Reductions in these expenses depend on our ability to successfully consolidate the number of messaging networks we operate, ultimately resulting in fewer locations on which we are required to pay monthly lease and telephone costs.

We are dependent on net cash provided by operating activities as our principal source of liquidity. If our expected reductions in operating expenses are not met, or if revenues decline at a more rapid rate than anticipated and that decline cannot be offset with additional expense reductions, net cash provided by operating activities would be adversely affected. If we are not able to achieve anticipated levels of net cash provided by operating activities, we may be required to reduce desired capital expenditures, which could result in higher losses of units in service.

Our revenues were \$109.4 million and \$143.6 million for the quarters ended September 30, 2004 and 2003, respectively. As noted above, the demand for one and two-way messaging services has declined over the past several years and, as a result, management of operating expenses is important to our financial results. Certain of our operating expenses are especially important to overall expense control. These operating expenses are categorized as follows:

Table of Contents

Service, rental and maintenance. These are the expenses associated with the operation of our networks and the provision of messaging services. These expenses consist largely of telephone charges to deliver messages over our networks and lease payments for locations on which we maintain transmitters.

Selling. These are the costs associated with our direct and indirect sales forces. These costs consist primarily of salaries and commissions and advertising expense.

General and administrative. These are costs associated with customer service, inventory management, billing, collections, bad debts and other administrative functions.

We review the percentages of these operating expenses to revenues on a regular basis. These ratios indicate whether operating expenses are decreasing at the same rate as revenues which are key indicators of our operating efficiency. Even though operating expenses are classified as described above, expense controls are also performed on a functional expense basis. For the three months ended September 30, 2004, we incurred approximately 74% of the expenses referred to above in three functional expense categories: payroll and related expenses, lease payments for transmitter locations and telephone expenses.

Payroll and related expenses include wages, commissions, incentives, employee benefits and related taxes. We review the number of employees in major functional work groups, such as direct sales, collections and customer service on a monthly basis. The ratio of the number of employees in each functional work group to the number of direct units in service or total units in service is reviewed to ensure that functional groups that are largely dependent on the number of units in service maintain or improve this ratio. We also review the design and physical locations of functional groups to continuously improve efficiency, simplify organizational structures and minimize physical locations.

Lease payments for transmitter locations are largely dependent on our messaging networks. We operate local, regional and nationwide one-way messaging networks and a two-way messaging network. These networks each require locations on which to place transmitters, receivers and antennas. Generally, lease payments are incurred for each transmitter location. Therefore, lease payments for transmitter locations are highly dependent on the number of transmitters, which in turn is dependent on the number of networks. In addition, these expenses generally do not vary directly with the number of subscribers or units in service and are generally fixed in the short term. In order to reduce this expense, we have an active program to consolidate the number of networks and thus transmitter locations, referred to as network rationalization. We have identified frequencies in each geographic region onto which we are migrating customers as network capacity allows. We attempt to migrate customers in a manner which minimizes customer impact; however, in certain circumstances messaging coverage may not entirely replicate that of the network being consolidated, which may result in some customers experiencing differences in coverage patterns or possible disruptions of service. Network rationalization results in consolidated networks, and therefore fewer transmitter locations, which we believe will result in lower operating expenses. Due to the nature of the underlying contractual agreements for our transmitter locations, there can be no assurance that network rationalization will result in immediate, proportionate savings in lease payments.

In 2003, we removed 4,520 transmitters from various networks and plan to remove approximately 1,200 additional transmitters in 2004, including approximately 660 that were removed during the nine months ended September 30, 2004.

Telephone expenses are incurred to provide interconnection of our messaging networks, telephone numbers for customer use, points of contact for customer service and connectivity among our offices. These expenses are dependent on the number of units in service and the number of office and network locations we maintain. The dependence on units in service is related to the number of telephone numbers provided to customers and the number of telephone calls made to our call centers, though this is not always a direct dependency. For example, the number or

duration of telephone calls to our call centers may vary from period to period based on factors other than the number of units in service, which could cause telephone expense to vary regardless of the number of units in service. In addition, certain telephone numbers we provide to our customers may have a usage component based on the number and duration of calls to the subscriber's messaging device. Therefore, based on the factors discussed above, absent the efforts that have been underway to review telephone circuit inventories and capacities

Table of Contents

and to reduce the number of transmitter and office locations at which we operate, telephone expenses do not necessarily vary in a direct relationship to units in service.

The total of our cost of products sold, service, rental and maintenance, selling and general and administrative expenses was \$228.6 million and \$317.9 million for the nine months ended September 30, 2004 and 2003, respectively. The decrease in these operating expenses is discussed in Results of Operations. Since it is anticipated that demand for one and two-way messaging will continue to decline, expense reductions will continue to be necessary for the foreseeable future.

Results of Operations*Comparison of the Results of Operations for the Three Months Ended September 30, 2004 and 2003*

	For the Quarter Ended September 30, 2004		For the Quarter Ended September 30, 2003		Change Between 2004 and 2003	
	Amount	% of Revenue	Amount	% of Revenue	Amount	%
Revenues						
Service, rental & maintenance	\$104,785	95.8%	\$137,759	95.9%	\$(32,974)	(23.9)%
Product sales	4,632	4.2	5,864	4.1	(1,232)	(21.0)
Selected operating expenses:						
Cost of products sold	691	0.6	1,319	0.9	(628)	(47.6)
Service, rental & maintenance	36,904	33.7	46,736	32.5	(9,832)	(21.0)
Selling	7,862	7.2	11,488	8.0	(3,626)	(31.6)
General and administrative	27,438	25.1	39,526	27.5	(12,088)	(30.5)

Revenues

Service, rental & maintenance revenues consist primarily of recurring fees associated with the provision of messaging services and rental of leased units. Product sales consists largely of revenues associated with the sale of devices and charges for leased devices that are not returned. We do not differentiate between service and rental revenues. The table below sets forth units in service and service revenue, the changes in each between the three months ended September 30, 2004 and 2003 and the change in revenue associated with differences in the numbers of units in service and the average revenue per unit, known as ARPU.

	Units in Service			Service Revenue				
	2004	2003	Change	2004	2003	Change	Change due to ARPU	Change due to Units
One-way messaging	3,507	4,160	(653)	\$ 84,791	\$112,336	\$(27,545)	\$ (8,662)	\$(18,883)
Two-way messaging	265	308	(43)	19,994	25,423	(5,429)	(1,926)	(3,503)

Total	<u>3,772</u>	<u>4,468</u>	<u>(696)</u>	<u>\$104,785</u>	<u>\$137,759</u>	<u>\$(32,974)</u>	<u>\$(10,588)</u>	<u>\$(22,386)</u>
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As previously discussed, demand for messaging services has declined over the past several years and we anticipate that it will continue to decline for the foreseeable future, which will result in reductions in service revenue due to the lower volume of subscribers. In addition, as the percentage of customers with more than 100 units in service increases, our average revenue per unit and disconnect rate is expected to decline. We expect that the impact of these events should result in a lower rate of decline in revenues.

Operating Expenses

Payroll and Related Expenses. Payroll and related expenses are our largest expense, representing 35.4% and 38.7% of the total of cost of products sold, service, rental and maintenance, selling and general and administrative for the three months ended September 30, 2004 and 2003, respectively. The payroll and related expenses in each significant category of expense are included in the following table:

Table of Contents

	For the Quarter Ended September 30, 2004		2003		Change Between 2004 and 2003	
	Amount	% of Revenue	Amount	% of Revenue	Amount	%
Service, rental & maintenance	\$ 6,043	5.5%	\$ 7,816	5.4%	\$ (1,773)	(22.7)%
Selling	7,585	6.9	10,951	7.6	(3,366)	(30.7)
General and administrative	12,182	11.1	19,534	13.6	(7,352)	(37.6)
Total	\$25,810	23.5%	\$38,301	26.6%	\$(12,491)	(32.6)%

As discussed earlier, we review the ratio of the number of direct units in service per employee in each functional work group to ensure that functional groups, which are largely dependent on the number of units in service, maintain or improve this ratio. The number of employees and the ratio of direct units in service per employee for each category of expense are included in the table below:

	For the Quarter Ended September 30, 2004		2003		Change Between 2004 and 2003	
	# of Employees	Units per Employee	# of Employees	Units per Employee	# of Employees	Units per Employee
Service, rental & maintenance	427	7,603	522	6,897	(95)	706
Selling	458	7,089	687	5,240	(229)	1,849
General and administrative	800	4,058	1,293	2,785	(493)	1,273
Total	1,685	1,927	2,502	1,439	(817)	488

The decrease in the number of employees resulted in \$12.5 million lower payroll and related expense for the quarter ended September 30, 2004, and the ratio of direct units in service per employee improved in each functional work group.

Service, rental and maintenance consists largely of field technicians and their managers. This functional work group does not vary as closely to direct units in service as other work groups since these individuals are related to the number of networks we operate rather than the number of units in service on our networks. In the quarter ended September 30, 2004, we maintained, and will continue to maintain, higher staffing levels to support our efforts to consolidate our networks.

The decrease in payroll expenses related to selling was due primarily to a decrease in the number of sales representatives and sales management which resulted from our continuing efforts to maintain or improve sales

force productivity; consequently, as units in service decline, fewer sales personnel are required.

The decrease in payroll and related expenses included in general and administrative expenses was due to 493 fewer employees in this category at September 30, 2004. The improvement in the ratio of direct units in service per general and administrative employee was due primarily to additional outsourcing of customer service activities. In addition, bonus expense was \$1.9 million less in 2004 compared to the same period in 2003 due to changes in the 2004 plan and a lower number of participants.

Table of Contents

Service, Rental and Maintenance. Service, rental and maintenance expenses consist primarily of the following significant items:

	For the Quarter Ended September 30, 2004		2003		Change Between 2004 and 2003	
	Amount	% of Revenue	Amount	% of Revenue	Amount	%
Lease payments for transmitter locations	\$19,742	18.0%	\$25,095	17.5%	\$(5,353)	(21.3)%
Telephone related expenses	6,588	6.0	8,593	6.0	(2,005)	(23.3)
Payroll and related expenses	6,043	5.5	7,816	5.4	(1,773)	(22.6)
Fees paid to other network providers	423	0.4	627	0.4	(204)	(32.5)
Operator dispatch fees	870	0.8	1,200	0.8	(330)	(27.5)
Other	3,238	3.0	3,405	2.4	(167)	(4.9)
Total	\$36,904	33.7%	\$46,736	32.5%	\$(9,832)	(21.0)%

As illustrated in the table above, service, rental and maintenance expenses decreased \$9.8 million from the quarter ended September 30, 2003, however the percentage of these costs to revenues increased marginally, primarily due to lease payments for transmitter locations and other expenses. Following is a discussion of each significant item listed above:

As discussed earlier, we have reduced the number of transmitters in service in conjunction with our plan to consolidate our networks. In 2003, transmitter consolidation activity was significantly higher in the latter half of the year resulting in lower lease payments in 2004. In addition, the restructuring charges recorded in the fourth quarter of 2003 and the first quarter of 2004 resulted in approximately \$3.0 million lower lease expense in the current year period compared to the same period in 2003.

Our efforts to consolidate our networks should continue to result in lower lease payments for transmitter locations, however these payments are subject to underlying obligations contained in each lease agreement, some of which do not allow for immediate savings when our equipment is removed and most of which require annual payment increases. Leases may also consist of payments for multiple sets of transmitters, antenna structures or network infrastructures on a particular site. In some cases, we remove only a portion of the equipment to which the lease payment relates. Under these circumstances, reduction of future rent payments is often subject to negotiation and our success is dependent on many factors, including the number of other sites we lease from the lessor, the amount and location of equipment remaining at the site and the remaining term of the lease. Therefore, lease payments for transmitter locations are generally fixed in the short term.

The decrease in telephone expenses resulted from savings associated with the consolidation of network facilities, lower usage-based charges due to declining units in service and rationalization of telephone trunk capacities. The costs associated with network facilities and telephone trunks are generally fixed in nature and the usage-based charges generally vary with units in service.

The change in payroll and related expenses was discussed above.

The decrease in operator dispatch fees was due primarily to lower units in service and, to a lesser extent, the utilization of other means to contact alphanumeric subscribers, such as the Internet.

Other expenses consist largely of repairs and maintenance expenses. Repairs and maintenance expenses relate to two primary activities, device repairs and transmission sites. These expenses do not vary directly with units in service or revenue and therefore, the percentage of these expenses to revenue increased in the current year period.

We believe the primary service, rental and maintenance expense reduction in 2004 will relate to lease payments for transmitter locations. In 2003, we recognized a beneficial trend in these payments as a result of our ongoing program to consolidate the number of networks we operate. We expect this trend to continue in future periods, although we cannot guarantee the level and specific timing of savings because these expenses are based on

Table of Contents

underlying contracts which, depending on the particular contract, may or may not result in immediate expense savings.

Selling. Selling expense consists primarily of payroll and related expense which was discussed above.

General and Administrative. General and administrative expenses consist of the following significant items:

	For the Quarter Ended September 30, 2004		2003		Change Between 2004 and 2003	
	Amount	% of Revenue	Amount	% of Revenue	Amount	%
Payroll and related expenses	\$12,182	11.1%	\$19,534	13.6%	\$ (7,352)	(37.6)%
Bad debt	1,138	1.0	1,267	0.9	(129)	(10.1)
Facility expenses	3,372	3.1	4,711	3.3	(1,339)	(28.4)
Telephone	1,610	1.5	2,380	1.7	(770)	(32.4)
Outside services	2,978	2.7	3,346	2.3	(368)	(11.0)
Taxes and permits	1,986	1.8	2,022	1.4	(36)	(1.8)
Other	4,172	3.8	6,266	4.3	(2,094)	(33.4)
Total	\$27,438	25.0%	\$39,526	27.5%	\$(12,088)	(30.6)%

As illustrated in the table above, general and administrative expenses decreased \$12.1 million from the quarter ended September 30, 2003 and the percentage of these costs to revenue also decreased. Following is a discussion of each significant item listed above:

The change in payroll and related expenses was discussed above.

The decrease in bad debt expense was due to lower levels of overall accounts receivable, which resulted from decreases in revenues and strong collections, and lower amounts of write-offs. We anticipate bad debt expense as a percentage of revenue to remain flat or increase in the future since we do not anticipate similar decreases in future accounts receivable balances.

The \$1.3 million decrease in facilities expense was due to the closure of various office facilities in conjunction with our efforts to reduce the number of physical locations at which we operate.

The decrease in telephone expense was due primarily to fewer calls to our call centers as a result of fewer units in service and the reduction of physical locations at which we operate.

Outside services expense consists primarily of costs associated with printing and mailing invoices, outsourced customer service, temporary help and various professional fees. The decrease in these expenses is due primarily to lower professional fees during the third quarter of 2004.

Taxes and permits consists primarily of property, franchise and gross receipts taxes. The decrease for the three months ended September 30, 2004 was due primarily to lower revenue, since certain of these charges are levied on revenue. We expect these taxes as a percentage of revenue to remain flat or increase in the future since certain of these taxes are not dependent on revenues.

Other expenses consist primarily of postage and express mail costs associated with the shipping and receipt of messaging devices, repairs and maintenance associated with computer hardware and software, insurance and bank fees associated with lockbox and other activities. The largest component of the reduction in other expense in 2004 related to insurance in the amount of \$722,000. This reduction was due to lower premiums in the current year and receipt of a \$257,000 refund related to an audit of prior year premiums.

Depreciation and Amortization. Depreciation and amortization expenses decreased to \$22.3 million for the quarter ended September 30, 2004 from \$28.0 million for the same period in 2003. This decrease was due primarily to lower depreciation on messaging devices since certain asset layers became fully depreciated in the quarter ended June 30, 2004.

Table of Contents

Stock Based and Other Compensation. Stock based and other compensation consists primarily of severance payments to persons we previously employed, amortization of compensation expense associated with common stock and options issued to certain members of management and the board of directors and compensation cost associated with a long-term management incentive plan. Stock based and other compensation was \$3.1 million for the third quarter of 2004, compared to \$2.8 million in the third quarter of 2003. The increase in this expense was due primarily to higher expense associated with the long-term incentive plan.

Interest Income (Expense). The decrease in interest expense was due to lower average outstanding debt balances in the quarter ended September 30, 2004 due to the redemption of our 12% notes on May 28, 2004. We expect interest expense to increase in future periods in conjunction with our merger with Metrocall since we expect to incur up to \$140 million of indebtedness to finance the cash election contemplated in the merger agreement.

Income Tax Expense. For the quarter ended September 30, 2004, we recognized \$4.5 million of deferred income tax expense based on an effective tax rate of approximately 40%. The expense for the three months ended September 30, 2003 of \$4.3 million was recorded at an effective tax rate of approximately 41%. We anticipate recognition of income tax expense to be required for the foreseeable future, but we do not anticipate these provisions to result in current tax liabilities. See *Factors Affecting Future Operating Results - Deductions for tax purposes from future activities and from retained tax attributes may be insufficient to offset future federal taxable income and/or significant changes in the ownership of our common stock may increase income tax payments* and *Application of Critical Accounting Policies - Income Taxes* for further discussion.

Comparison of the Results of Operations for the Nine Months Ended September 30, 2004 and 2003

	For the Nine Months Ended September 30, 2004		2003		Change Between 2004 and 2003	
	Amount	% of Revenue	Amount	% of Revenue	Amount	%
Revenues:						
Service, rental & maintenance	\$335,505	96.2%	\$442,456	95.7%	\$(106,951)	(24.2)%
Product sales	13,368	3.8	19,996	4.3	(6,628)	(33.1)
Selected operating expenses:						
Cost of products sold	2,485	0.7	4,351	0.9	(1,866)	(42.9)
Service, rental & maintenance	112,880	32.4	145,382	31.4	(32,502)	(22.4)
Selling	25,687	7.4	35,703	7.7	(10,016)	(28.1)
General and administrative	87,523	25.1	132,505	28.7	(44,982)	(33.9)

Revenues

Service, rental and maintenance revenues consist primarily of recurring fees associated with the provision of messaging services and rental of leased devices. Product sales consists largely of revenues associated with the sale of devices and charges for leased devices that are not returned. We do not differentiate between service and rental revenues. The table below sets forth units in service and service revenue, the changes in each between the nine months ended September 30, 2004 and 2003 and the change in revenue associated with differences in the numbers of units in service and the average revenue per unit, known as ARPU.

	Units in Service			Service Revenue				
	2004	2003	Change	2004	2003	Change	Change due to ARPU	Change due to Units
One-way messaging	3,507	4,160	(653)	\$271,808	\$363,482	\$ (91,674)	\$(21,919)	\$(69,755)
Two-way messaging	265	308	(43)	63,697	78,974	(15,277)	(3,461)	(11,816)
Total	3,772	4,468	(696)	\$335,505	\$442,456	\$(106,951)	\$(25,380)	\$(81,571)

As previously discussed, demand for messaging services has declined over the past several years and we anticipate that it will continue to decline for the foreseeable future, which will result in reductions in service revenue due to the lower volume of subscribers. In addition, as the percentage of customers with more than 100

Table of Contents

units in service increases, our average revenue per unit and disconnect rate is expected to decline. We expect that the impact of these events should result in a lower rate of decline in revenues.

Operating Expenses

Payroll and Related Expenses. Payroll and related expenses are our largest expense, representing 36.7% and 38.0% of the total of cost of products sold, service, rental and maintenance, selling and general and administrative expenses for the nine months ended September 30, 2004 and 2003, respectively. The payroll and related expenses in each significant category of expense are included in the following table:

	For the Nine Months Ended September 30, 2004		2003		Change Between 2004 and 2003	
	Amount	% of Revenue	Amount	% of Revenue	Amount	%
Service, rental & maintenance	\$18,848	5.4%	\$ 23,006	5.0%	\$ (4,158)	(18.1)%
Selling	24,782	7.1	34,006	7.4	(9,224)	(27.1)
General and administrative	40,281	11.5	63,704	13.8	(23,423)	(36.8)
Total	\$83,911	24.0%	\$120,716	26.2%	\$(36,805)	(30.5)%

The decrease in the number of employees resulted in \$36.8 million lower payroll and related expense for the nine months ended September 30, 2004 for largely the same reasons as discussed in the comparison of the three months ended September 30, 2004.

Service, Rental and Maintenance. Service, rental and maintenance expenses consist primarily of the following significant items:

	For the Nine Months Ended September 30, 2004		2003		Change Between 2004 and 2003	
	Amount	% of Revenue	Amount	% of Revenue	Amount	%
Lease payments for transmitter locations	\$ 60,444	17.3%	\$ 78,424	17.0%	\$(17,980)	(22.9)%
Telephone related expenses	20,376	5.8	28,485	6.2	(8,109)	(28.5)
Payroll and related expenses	18,848	5.4	23,006	5.0	(4,158)	(18.1)
Fees paid to other network providers	1,405	0.4	2,061	0.4	(656)	(31.8)
Operator dispatch fees	2,499	0.7	3,472	0.8	(973)	(28.0)
Other	9,308	2.7	9,934	2.0	(626)	(6.3)

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	_____	_____	_____	_____	_____	
Total	\$112,880	32.3%	\$145,382	31.4%	\$(32,502)	(22.4)%
	_____	_____	_____	_____	_____	

As illustrated in the table above, service, rental and maintenance expenses decreased \$32.5 million from the nine months ended September 30, 2003, however the percentage of these costs to revenues increased, primarily due to lease payments for transmitter locations and payroll and related expenses. Following is a discussion of each significant item listed above:

Lease payments for transmitter locations decreased \$18.0 million largely due to the same reasons as discussed in the comparison of the three month period ended September 30, 2004. In addition, the restructuring charges recorded in the fourth quarter of 2003 and the first quarter of 2004 resulted in approximately \$8.9 million lower lease expense in the current year period compared to the same period in 2003.

During the nine months ended September 30, 2004, we recorded a \$3.0 million restructuring charge associated with a lease agreement for transmitter locations. Under the terms of this agreement, we are required to pay certain minimum amounts for a designated number of transmitter locations. During the three months ended March 31, 2004, we determined the designated number of transmitter locations was in excess of our current and anticipated needs and as a result we ceased use of these locations. The remaining obligations associated with these agreements will be paid over the next three quarters.

Table of Contents

The decreases in telephone, fees paid to other providers and operator dispatch expenses are largely due to the same reasons as discussed in the comparison of the three month period ended September 30, 2004.

The change in payroll and related expenses was discussed above.

Other expenses consist largely of repairs and maintenance expenses. Repairs and maintenance expenses relate to two primary activities, device repairs and transmission sites. These expenses do not vary directly with units in service or revenue and therefore, the percentage of these expenses to revenue increased in the current year period. *Selling*. Selling expense consists primarily of payroll and related expense which was discussed above.

General and Administrative. General and administrative expenses consist of the following significant items:

	For the Nine Months Ended September 30, 2004		2003		Change Between 2004 and 2003	
	Amount	% of Revenue	Amount	% of Revenue	Amount	%
Payroll and related expenses	\$40,281	11.6%	\$ 63,704	13.8%	\$(23,423)	(36.8)%
Bad debt	1,949	0.6	7,550	1.6	(5,601)	(74.7)
Facility expenses	10,346	3.0	13,175	2.9	(2,829)	(21.5)
Telephone	4,925	1.4	8,024	1.7	(3,099)	(38.6)
Outside services	8,584	2.5	9,786	2.1	(1,202)	(12.3)
Taxes and permits	8,081	2.3	9,763	2.1	(1,682)	(17.2)
Other	13,357	3.8	20,503	4.5	(7,146)	(34.8)
Total	\$87,523	25.2%	\$132,505	28.7%	\$(44,982)	(33.9)%

As illustrated in the table above, general and administrative expenses decreased \$45.0 million from the nine months ended September 30, 2003 and the percentage of these costs to revenue also decreased, primarily due to lower payroll and related expenses and bad debt expense. Following is a discussion of each significant item listed above:

The change in payroll and related expenses was discussed above.

The decrease in bad debt expense was due to lower levels of overall accounts receivable, which resulted from decreases in revenues and strong collections, and lower amounts of write-offs. We anticipate bad debt expense to remain flat or increase in the future since we do not anticipate similar decreases in future accounts receivable balances.

The \$2.8 million decrease in facilities expense was due to the closure of various office facilities in conjunction with our efforts to reduce the number of physical locations at which we operate.

The decrease in telephone expense was due primarily to fewer calls to our call centers as a result of fewer units in service and the reduction of physical locations at which we operate.

Outside services expense consists primarily of costs associated with printing and mailing invoices, outsourced customer service, temporary help and various professional fees. The decrease in these expenses is due primarily to lower professional fees in the current year period.

Taxes and permits consists primarily of property, franchise and gross receipts taxes. The decrease for the nine months ended September 30, 2004 was due primarily to lower revenue, since certain of these charges are levied on revenue.

Other expenses consist primarily of postage and express mail costs associated with the shipping and receipt of messaging devices, repairs and maintenance associated with computer hardware and software, insurance and bank fees associated with lockbox and other activities. The largest components of the reduction in other expense in 2004 related to insurance of \$1.9 million and express mail of \$1.4 million. The reduction related to insurance expense was due primarily to lower premiums in the current year. The reduction in

Table of Contents

express mail was due to fewer shipments of messaging devices as a result of lower numbers of units in service.

Depreciation and Amortization. Depreciation and amortization expenses decreased to \$79.7 million for the nine months ended September 30, 2004 from \$91.9 million for the same period in 2003. This decrease was due primarily to certain assets becoming fully depreciated during 2003 for which no depreciation expense was recorded in the nine months ended September 30, 2004, partially offset by the write down of \$2.9 million related to prepayments made to a device manufacturer that ceased operations.

Stock Based and Other Compensation. Stock based and other compensation consists primarily of severance payments to persons we previously employed, amortization of compensation expense associated with common stock and options issued to certain members of management and the board of directors and compensation cost associated with a long-term management incentive plan. Stock based and other compensation was \$8.5 million for the nine months ended September 30, 2004, compared to \$9.2 million in the same period of 2003. The decrease in this expense was due primarily to higher compensation expense associated with the options granted to our board of directors since these options became fully vested on May 29, 2004.

Interest Income (Expense). Interest expense, net decreased to \$5.0 million for the nine months ended September 30, 2004 from \$14.0 million for the same period in 2003. This decrease was due to lower average outstanding debt balances in the nine months ended September 30, 2004 compared to the same period in 2003. During the quarter ended June 30, 2004, we completed the redemption of our 12% notes. In conjunction with our merger with Metrocall we expect to incur up to \$140 million of indebtedness to finance the cash election contemplated in the merger.

Income Tax Expense. For the nine months ended September 30, 2004, we recognized \$9.9 million of deferred income tax expense based on an effective tax rate of approximately 40%. The expense for the nine months ended September 30, 2003 of \$12.3 million was recorded at an effective tax rate of approximately 41%. We anticipate recognition of income tax expense to be required for the foreseeable future, but we do not anticipate these provisions to result in current tax liabilities. See *Factors Affecting Future Operating Results - Deductions for tax purposes from future activities and from retained tax attributes may be insufficient to offset future federal taxable income and/or significant changes in the ownership of our common stock may increase income tax payments* and *Application of Critical Accounting Policies - Income Taxes* for further discussion.

Liquidity and Capital Resources

Overview

Based on current and anticipated levels of operations, we anticipate net cash provided by operating activities, together with the \$45.3 million of cash on hand at September 30, 2004, will be adequate to meet our anticipated cash requirements for the foreseeable future.

In the event that net cash provided by operating activities and cash on hand are not sufficient to meet future cash requirements, we may be required to reduce planned capital expenditures, sell assets or seek additional financing. We can provide no assurance that reductions in planned capital expenditures or proceeds from asset sales would be sufficient to cover shortfalls in available cash or that additional financing would be available on acceptable terms.

Sources of Funds

Our principal sources of cash are net cash provided by operating activities plus cash on hand.

On October 11, 2004, Arch and Metrocall entered into a commitment letter with UBS Loan Finance LLC and UBS Securities LLC that provides for a senior secured term loan facility of up to \$140.0 million for Arch Wireless

Operating Company, Inc. and Metrocall, Inc., the operating subsidiaries of Arch and Metrocall. The facility will have a term of two years from the closing date and will amortize in eight equal quarterly installments with interest equal to (i) an interest margin of 150 basis points, plus the higher of the Federal Funds Rate, as published by the Federal Reserve Bank of New York, plus 1/2 of 1% and the prime commercial lending rate of UBS AG, as

Table of Contents

established from time to time, or (ii) an interest margin of 250 basis points, plus the rate equal to the London Interbank Offered Rate for corresponding deposits of U.S. dollars.

The facility will be guaranteed on a joint and several basis by USA Mobility, Inc., the corporate entity formed to serve as the new publicly-traded parent company of Arch and Metrocall following consummation of the merger, and substantially all of its subsidiaries. The facility will be secured by pledges of the equity interests of Arch, Metrocall and substantially all of their respective subsidiaries and liens on most of their respective assets and will contain covenants that are customary for a facility of this type, including a minimum interest coverage ratio, maximum leverage ratio and maximum capital expenditure levels. While Arch expects to close the facility with UBS, there can be no assurance that negotiations on the facility will result in definitive agreements or that the facility, as negotiated, will be on the terms and conditions described herein or otherwise acceptable to it.

Cash Flows

Our net cash flows from operating, investing and financing activities for the periods indicated in the table below are as follows (in thousands):

	Nine Months Ended September 30,	
	2004	2003
Net cash provided by operating activities	\$ 87.3	\$ 146.8
Net cash used in investing activities	\$(13.5)	\$ (15.1)
Net cash used in financing activities	\$(63.1)	\$(110.0)

Net Cash Provided by Operating Activities. As discussed above, we are dependent on cash flows from operating activities to meet our cash requirements. Cash from operations varies depending on changes in various working capital items including deferred revenues, accounts payable, accounts receivable, prepaid expenses and various accrued expenses. The following table includes the significant cash receipt and expenditure components of our cash flows from operating activities for the periods indicated and sets forth the change between the indicated periods (in thousands):

	Nine Months Ended September 30,		
	2004	2003	Change
Cash received from customers	\$347,623	\$471,380	\$(123,757)
Cash paid for -			
Payroll and related expenses	94,411	128,595	(34,184)
Lease payments for tower locations	67,983	77,447	(9,464)
Telephone expenses	26,494	39,386	(12,892)
Interest expense	6,709	6,177	532
Other operating expenses	64,719	72,956	(8,237)

Net cash provided by operating activities for the nine months ended September 30, 2004 decreased \$59.5 million from the same period in 2003 due primarily to the following:

Cash received from customers declined \$123.8 million in 2004 compared to the same period in 2003. This measure consists of revenues and direct taxes billed to customers adjusted for changes in accounts receivable, deferred revenue and tax withholding amounts. The decrease was due primarily to revenue declines of \$113.6 million, as discussed earlier, and a lower change in accounts receivable, \$5.1 million in 2004 compared to \$16.0 million in 2003. The change in accounts receivable was due to lower billings resulting from fewer units in service, lower revenue and more timely payments from our customers. This improvement was illustrated by the decrease in our days billings outstanding from 38 days at September 30, 2003 to 35 days at September 30, 2004.

Table of Contents

Cash payments for payroll and related expenses decreased \$34.2 million due primarily to lower payroll expenses of \$36.8 million, as discussed above, and lower severance payments of \$1.7 million partially offset by reductions in accrued bonus and other payroll amounts.

Lease payments for tower locations decreased \$9.5 million. This decrease was due primarily to savings associated with network rationalization discussed above, offset by rent payments being applied to the previously established restructuring charge. As discussed earlier, the remaining balance of the restructuring charge will be paid over the next three quarters.

Cash used for telephone related expenditures decreased \$12.9 million for the nine months ended September 30, 2004 compared to the same period in 2003. This decrease was due primarily to factors presented above in the discussions of service, rental and maintenance expense and general and administrative expenses.

The increase in interest payments for the nine months ended September 30, 2004 was due to the interest rate on debt paid in the prior year period being 2% below that of the current year period. Additionally, debt payments in the current year period included a 6% premium required by the note indentures to prepay the notes. Lower average debt balances in the 2004 period partially offset these higher rate-related payments.

Cash payments for other expenses primarily includes repairs and maintenance, outside services, facility rents, taxes and permits, office and various other expenses. The decrease in these payments was primarily related to lower outside services of \$2.0 million, office expense of \$2.1 million, insurance of \$1.9 million and taxes and permits of \$1.7 million.

Net Cash Used for Investing Activities. Net cash used for investing activities decreased \$1.6 million due primarily to the timing of capital expenditures. Our business requires funds to finance capital expenditures which primarily include the purchase and repair of wireless messaging devices, system and transmission equipment and information systems.

Capital expenditures for the third quarter of 2004 were \$7.1 million compared to \$2.4 million for the second quarter of 2004. We anticipate capital expenditures to decrease during the fourth quarter and that total capital expenditures for 2004 will be approximately \$20 to \$22 million. These expenditures will be used primarily for messaging devices. However, the actual amount of capital we require will depend on a number of factors, including the number of existing subscriber devices to be replaced, the number of new gross placements, technological developments, competitive conditions and the nature and timing of our strategy to consolidate our networks. We have funded and plan to fund our 2004 capital expenditures from net cash provided by operating activities.

Net Cash Used for Financing Activities. Net cash used for financing activities for the nine months ended September 30, 2004 consisted of repayments of our long-term debt and the purchase of treasury shares. On May 28, 2004, we made the final redemption of our 12% notes. Excess cash will be accumulated in anticipation of our proposed merger with Metrocall. As discussed earlier, a component of the Metrocall purchase price is a cash election for up to 2,000,000 Metrocall shares at \$75 per share, or \$150 million. It is currently anticipated that the cash election and any closing costs will be funded by Arch's and Metrocall's cumulative available cash on hand and the issuance by the new holding company of up to \$140 million of long-term debt.

Borrowings

On May 28, 2004, we completed the final redemption of our 12% notes. As a result of that redemption, we had no borrowings outstanding as of September 30, 2004.

Commitments

Contractual Obligations. Our contractual payment obligations under our operating leases for office and transmitter locations as of September 30, 2004 are indicated in the table below. For purposes of this table, purchase obligations are defined as agreements to purchase goods or services that are enforceable and legally binding and that specify all significant terms, including: (1) fixed or minimum quantities to be purchased; (2)

Table of Contents

fixed, minimum or variable pricing provisions; and (3) the approximate timing of transactions. These obligations primarily relate to devices and certain telephone expenses. The amounts are based on our contractual commitments; however, it is possible we may be able to negotiate lower payments if we choose to exit these contracts earlier.

	Payments Due by Period				
	(in thousands)				
	Total	Less than 1 year	1-3 years	4-5 years	More than 5 years
Operating lease obligations	\$ 105,400	\$ 53,133	\$ 48,912	\$ 2,724	\$ 631
Purchase obligations	10,456	10,456			
Other long-term liabilities	8,006		7,044		962
Total	\$ 123,862	\$ 63,589	\$ 55,956	\$ 2,724	\$ 1,593

Off-Balance Sheet Arrangements. We do not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. As such, we are not exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships.

Application of Critical Accounting Policies

The following discussion and analysis of financial condition and results of operations are based on our consolidated financial statements, which have been prepared in conformity with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, expenses and related disclosures. On an on-going basis, we evaluate estimates and assumptions, including but not limited to those related to the impairment of long-lived assets, reserves for doubtful accounts and service credits, revenue recognition, capitalization of device refurbishment costs, asset retirement obligations, restructuring reserves and income taxes. We base our estimates on historical experience and 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. Actual results may differ from these estimates under different assumptions or conditions.

Impairment of Long-Lived Assets

In accordance with Statement of Financial Accounting Standards, known as SFAS, No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, we are required to evaluate the carrying value of our long-lived assets and certain intangible assets. SFAS No. 144 first requires an assessment of whether circumstances currently exist which suggest the carrying value of long-lived assets may not be recoverable. At September 30, 2004 we did not believe any such conditions existed. Had these conditions existed, we would assess the recoverability of the carrying value of our long-lived assets and certain intangible assets based on estimated undiscounted cash flows to be

generated from such assets. In assessing the recoverability of these assets, we would have projected estimated enterprise-level cash flows based on various operating assumptions such as average revenue per unit, disconnect rates, and sales and workforce productivity ratios. If the projection of undiscounted cash flows did not exceed the carrying value of the long-lived assets, we would be required to record an impairment charge to the extent the carrying value exceeded the fair value of such assets.

In conjunction with the application of SOP 90-7, our assets were recorded at their estimated fair values as of May 29, 2002. However, if the assessment of the criteria above were to change and the projected undiscounted cash flows were lower than the carrying value of the assets, we would be required to record impairment charges related to our long-lived assets.

Table of Contents

Reserves for Doubtful Accounts and Service Credits

We record two valuation amounts against our gross accounts receivable balance: an allowance for doubtful accounts and an allowance for service credits. Provisions for these allowances are recorded on a monthly basis and are included as a component of general and administrative expense and a reduction of revenue, respectively.

Estimates are used in determining the allowance for doubtful accounts and are based on historical collection experience, current trends and a percentage of the accounts receivable aging categories. In determining these percentages we review historical write-offs, including comparisons of write-offs to provisions for doubtful accounts and as a percentage of revenues. We compare the ratio of the reserve to gross receivables to historical levels and we monitor amounts collected and related statistics. Our allowance for doubtful accounts was \$2.0 million and \$5.0 million at September 30, 2004 and December 31, 2003, respectively. While write-offs of customer accounts have historically been within our expectations and the provisions established, we cannot guarantee that future write-off experience will be consistent with historical experience, which could result in material differences in the allowance for doubtful accounts and related provisions.

The allowance for service credits and related provisions are based on historical credit percentages, current credit and aging trends and days billings outstanding. Days billings outstanding is determined by dividing the daily average of amounts billed to customers into the accounts receivable balance. This approach is used because it more accurately represents the amounts included in accounts receivable and minimizes fluctuations that occur in days sales outstanding due to the billing of quarterly, semi-annual and annual contracts and the associated revenue that is deferred. A range is developed and an allowance is recorded within that range based on our assessment of trends in days billings outstanding, aging characteristics and other operating factors. Our allowance for service credits was \$1.4 million and \$3.6 million at September 30, 2004 and December 31, 2003, respectively. While credits issued have been within our expectations and the provisions established, we cannot guarantee that future credit experience will be consistent with historical experience, which could result in material differences in the allowance for service credits and related provisions.

Revenue Recognition

Our revenue consists primarily of monthly service and lease fees charged to customers on a monthly, quarterly, semi-annual or annual basis. Revenue also includes the sale of messaging devices directly to customers and other companies that resell our services. In accordance with the provisions of Emerging Issues Task Force Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*, known as EITF No. 00-21, we evaluated these revenue arrangements and determined that two separate units of accounting exist: messaging service revenue and device sale revenue. Accordingly, we recognize messaging service revenue over the period the service is performed and revenue from device sales is recognized at the time of shipment. We recognize revenue when four basic criteria have been met: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred or services rendered, (3) the fee is fixed or determinable and (4) collectibility is reasonably assured.

Prior to July 1, 2003, in accordance with SAB 101, *Revenue Recognition in Financial Statements*, known as SAB 101, we bundled the sale of two-way messaging devices with the related service, since we had determined the sale of the service was essential to the functionality of the device. Therefore, revenue from two-way device sales and the related cost of sales were recognized over the expected customer relationship, which was estimated to be two years. In accordance with the transition provisions of EITF No. 00-21, we will continue to recognize previously deferred revenue and expense from the sale of two-way devices based upon the amortization schedules in place at the time of deferral. At September 30, 2004, we had approximately \$387,000 of deferred revenue and \$120,000 of deferred expense that will be recognized in future periods, principally over the next three fiscal quarters.

Capitalization of Device Refurbishment Costs

We incur significant costs associated with messaging devices, including the purchase of new devices as well as the refurbishment of devices leased to customers. Device refurbishment falls into two general categories: (1) cosmetic cleaning and repair of external components (such as lenses, clips or plastic cases) and (2) significant refurbishment or replacement of internal components, including component level repair and changes, which allow

Table of Contents

the device to function on different messaging networks and on different frequencies. The costs associated with cosmetic cleaning and repair of external components are expensed in the period incurred. The costs associated with significant refurbishment extend the useful life of the device and allow us to forego the purchase of a new messaging device. Therefore, these costs are capitalized to fixed assets and depreciated over a one year estimated life.

We had approximately 3.0 million leased units in service as of September 30, 2004 which are subject to customer return primarily for cancellation of service or exchanges for different devices. We process several hundred thousand such returns on a quarterly basis and most devices returned require either cosmetic or significant refurbishment. Due to the high volume of devices processed, specific identification of repairs to specific pieces of equipment is not practical. Significant refurbishment costs consist of both internal costs, primarily payroll and related expenses, parts consumed in the repair process and third party subcontracted repair services. The capitalization rate was determined based on an internal product flow and cost analysis of our in-house repair facility. The capitalization of these expenses results in lower operating expenses, but higher capital expenditures in each period. For the nine months ended September 30, 2004 and 2003, \$206,000 and \$255,000, respectively, were capitalized. If the capitalization rate were different from the rate currently used, service, rental and maintenance expense and capital expenditures would be affected in equal but opposite amounts and depreciation expense would differ on a prospective basis.

Asset Retirement Obligations

We adopted the provisions of SFAS No. 143, *Accounting for Asset Retirement Obligations*, known as SFAS No. 143, in 2002 in accordance with the requirements of SOP 90-7. SFAS No. 143 requires the recognition of liabilities and corresponding assets for future obligations associated with the retirement of assets. We have network assets that are located on leased transmitter locations. The underlying leases generally require the removal of our equipment at the end of the lease term; therefore, a future obligation exists. We have recognized cumulative asset retirement obligation assets of \$4.7 million through September 30, 2004. Network assets have been increased to reflect these costs and depreciation is being recognized over their estimated lives, which range between one and ten years. Depreciation and amortization expense for the nine months ended September 30, 2004 includes \$444,000 related to depreciation of these assets. The asset retirement obligation assets, and their corresponding liabilities, recorded to date relate to either our current plans to consolidate our networks or to the removal of assets at an estimated future terminal date.

At September 30, 2004 and December 31, 2003, accrued expenses included \$464,000 and \$1.0 million, respectively, of asset retirement liabilities related to our efforts to reduce the number of networks we operate. The primary variables associated with this estimate are the number and types of equipment to be removed and an estimate of the outside contractor fees to remove each asset. Since this is a short-term liability, the present value of the estimated retirement obligations is not materially different from the gross liability.

At September 30, 2004 and December 31, 2003, other long-term liabilities included \$962,000 and \$815,000, respectively, related primarily to an estimate of assets to be removed at an estimated terminal date and was recorded at its present value assuming a 24% credit adjusted risk free rate, which was derived based upon the yield of our 12% notes at the time we adopted SFAS No. 143. The undiscounted future obligation of approximately \$5.6 million is being accreted to operating expense over a ten-year period using the interest method. This estimate is based on the transmitter locations remaining after we have consolidated the number of networks we operate and assumes the underlying leases continue to be renewed to that future date. The fees charged by outside contractors were assumed to increase by 3% per year.

We believe these estimates are reasonable at the present time, but we can give no assurance that changes in technology, our financial condition, the economy or other factors would not result in higher or lower asset retirement obligations. Any variations from our estimates would generally result in a change in the assets and liabilities in equal

amounts and our operating results would differ in the future by any difference in depreciation expense and accreted operating expense.

Table of Contents*Restructuring Reserves*

From time to time, we cease to use certain facilities, such as office buildings and transmitter locations, including available capacity under certain agreements, prior to expiration of the underlying lease agreements. We review exit costs in each of these circumstances on a case-by-case basis to determine whether a restructuring charge is required to be recorded in accordance with SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, known as SFAS No. 146. The provisions of SFAS No. 146 require us to record an estimate of the fair value of the exit costs based on certain facts, circumstances and assumptions, including remaining minimum lease payments, potential sublease income and specific provisions included in the underlying lease agreements. Subsequent to recording a reserve, changes in market or other conditions may result in changes to assumptions upon which the original reserve was recorded that could result in an adjustment to the reserve and, depending on the circumstances, such adjustment could be material.

Income Taxes

The preparation of consolidated financial statements in conformity with generally accepted accounting principles requires us to make estimates and assumptions that affect the reported amount of tax-related assets and liabilities and income tax provisions. We assess the recoverability of our deferred tax assets on an ongoing basis. In making this assessment, we are required to consider all available positive and negative evidence to determine whether, based on such evidence, it is more likely than not that some portion or all of our net deferred tax assets will be realized in future periods. This assessment requires significant judgment. In addition, we have made significant estimates involving current and deferred income taxes, tax attributes relating to the interpretation of various tax laws, historical bases of tax attributes associated with certain tangible and intangible assets and limitations surrounding the realizability of our deferred tax assets. We do not recognize current and future tax benefits until it is deemed probable that certain tax positions will be sustained.

We established a valuation allowance against our net deferred tax assets upon emergence from bankruptcy since, based on information available at that time, it was deemed more likely than not that the deferred tax assets would not be realized. During the quarter ended December 31, 2003, we determined, based on operating income for the two years then ended, repayment of our notes well ahead of schedule and anticipated operating income and cash flows for future periods that it was more likely than not that certain deferred tax assets would be realized in the future. Accordingly, we determined that it was appropriate to release the valuation allowance recorded against those deferred tax assets. Our results for the nine months ended September 30, 2004 and anticipated future results remain consistent with our previous assessment, therefore we continue to believe no valuation allowance against our deferred tax assets is required.

Under the provisions of SFAS No. 109, *Accounting for Income Taxes*, and related interpretations, reductions in a deferred tax asset valuation allowance that existed as of the date of fresh start accounting are first credited against an asset established for reorganization value in excess of amounts allocable to identifiable assets, then to other identifiable intangible assets existing at the date of fresh start accounting and then, once these assets have been reduced to zero, credited directly to additional paid in capital. The release of the valuation allowance reduced the carrying value of intangible assets by \$2.3 million and \$13.4 million for the seven month period ended December 31, 2002 and the year ended December 31, 2003, respectively. After reduction of our intangibles recorded in conjunction with fresh start accounting, the remaining reduction of the valuation allowance of \$217.0 million was recorded as an increase to stockholders' equity as of December 31, 2003.

We believe that we are more likely than not to recover our net deferred tax assets of \$213.6 million through reductions in tax liabilities in future periods. However, recovery is dependent on achieving our forecast of future operating income over a protracted period of time. As of September 30, 2004, we would require approximately

\$531 million in cumulative future operating income to be generated at various times over approximately the next twenty years to realize our net deferred tax assets. We will review our forecast in relation to actual results and expected trends on an ongoing basis. Failure to achieve our operating income targets may change our assessment regarding the recoverability of our net deferred tax assets and such change could result in a valuation allowance being recorded against some or all of our deferred tax assets. Any increase in a valuation allowance would result in additional income tax expense, lower stockholders' equity and could have a significant impact on our earnings in future periods.

Table of Contents

Factors Affecting Future Operating Results

The following important factors, among others, could cause our actual operating results to differ materially from those indicated or suggested by forward-looking statements made in this Quarterly Report on Form 10-Q or presented elsewhere by management from time to time.

Declines in our units in service will likely continue or could accelerate, causing decreases in revenues. Operating expenses may not decline at a rate that matches the decline in revenues.

Reductions in the number of units in service significantly affects the results of operations of wireless messaging service providers since operations no longer benefit from the recurring revenue generated from the units in service. In addition, the sales and marketing costs associated with attracting new subscribers are substantial compared to the costs of providing service to existing customers. Our units in service have declined for the past several years resulting in substantial decreases in revenues. We expect to continue to experience significant declines in units in service and revenues for the foreseeable future.

In order to continue to generate net cash provided by operating activities, given the anticipated decreases in revenues described above, reductions in operating expenses have been, and will continue to be, necessary. In particular, lease payments on transmitter locations and telephone expenses are the most significant costs associated with the operation of our messaging networks, accounting for 37.6% of our cost of products sold, service, rental and maintenance, selling and general and administrative expenses thus far in 2004. Reductions in these expenses are dependent on our ability to successfully consolidate the number of messaging networks we operate, ultimately resulting in fewer locations on which we are required to pay monthly lease and telephone interconnection costs. Our ability to consolidate networks is dependent on a number of factors. One key factor is network loading, which does not necessarily decrease in proportion to our units in service and revenue. Network loading is dependent on a number of conditions including the amount of traffic emanating from the Internet, which generally has increased message lengths, and the mix of alphanumeric users who in turn consume significantly more network capacity than numeric users. Further, due to the nature of the underlying contractual agreements for our transmitter locations, there can be no assurance that the consolidation of the transmitter locations will result in immediate, proportionate savings in lease payments. Additionally, our efforts to consolidate the number of transmitter locations could lead to further unit cancellations as some subscribers may experience a reduction in, or possible disruptions of, service.

We are dependent on net cash provided by operating activities as our principal source of liquidity. If our assumed reductions in operating expenses are not met, or if revenues decline at a more rapid rate than anticipated and that decline cannot be offset with additional expense reductions, net cash provided by operating activities would be adversely affected. If we are not able to achieve anticipated levels of net cash provided by operating activities, we may be required to reduce desired capital expenditures, which could result in higher losses of units in service.

We believe that future fluctuations in revenues, operating expenses and operating results may occur due to many factors, particularly the decreased demand for one and two-way messaging services, and these fluctuations could be material. These fluctuations, if material, could have a significant impact on our net cash provided by operating activities, which could impair the value of our securities.

Competition from mobile, cellular and PCS telephone companies is intense. Many companies have introduced phones and services with substantially the same features and functions as the one and two-way messaging products and services provided by us, and have priced such devices and services competitively.

We face competition from other messaging providers in all markets in which we operate, as well as from cellular, PCS and other mobile wireless telephone companies. Competitors providing wireless messaging and information

services continue to create significant competition for a depleting customer base, and providers of mobile wireless phone services such as AT&T Wireless, Cingular, Sprint PCS, Verizon, T-Mobile and Nextel now include wireless messaging as an adjunct service to voice services. In addition, the availability of coverage for mobile phone services has increased, making the two types of service and product offerings more comparable. Cellular and PCS companies seeking to provide wireless messaging services have been able to bring their products

Table of Contents

to market faster, at lower prices or in packages of products that consumers and businesses find more valuable than those we provide. In addition, many of these competitors, particularly cellular and PCS phone companies, possess greater financial, technical and other resources than those available to us.

Deductions for tax purposes from future activities and from retained tax attributes may be insufficient to offset future federal taxable income and/or significant changes in the ownership of our common stock may increase income tax payments.

We currently anticipate that we will have sufficient tax deductions from our operations, including from the federal income tax attributes that we retained after our emergence from chapter 11, to offset future federal taxable income (before these deductions) for the next several years. The extent to which these tax attributes will be available to offset future federal taxable income depends on factual and legal matters that are subject to varying interpretations. Therefore, despite our expectations, it is possible that we may not have sufficient tax attributes to offset future federal taxable income.

If we experience a change in ownership, as defined in sections 382 and 383 of the Internal Revenue Code, we could have significant limits on the amounts and timing of the use of various tax attributes. Generally, a change in ownership will occur if a cumulative change in ownership of more than 50% occurs. The cumulative change in ownership is a measurement of the change in ownership of our stock held by stockholders that own 5% or more of our stock. In general terms, it will equal the aggregate of any increase in the percentage of stock owned by stockholders that own 5% or more of our stock over the lowest percentage of stock owned by each of them during the prior three years, but not prior to May 29, 2002, the day we emerged from bankruptcy.

For example, if a stockholder owned 5.5% of our outstanding stock on May 29, 2002 and subsequently purchased additional shares so that it now owns 9.5% of our outstanding stock, that stockholder's subsequent acquisitions of our shares would contribute to a change in ownership of 9.5% minus 5.5%, or 4.0%. We would combine the change in ownership calculations for all of our 5% or more stockholders whose interests have increased to calculate the cumulative change in ownership. If the aggregate increase in the ownership percentage of all of these stockholders exceeds 50%, then a change in ownership will have occurred. In making these calculations, all holders of less than 5% of our outstanding stock are combined and treated as one stockholder with more than 5% of our stock.

We believe that since our emergence from chapter 11 we have undergone a cumulative change in ownership of approximately 17.0%, as of September 30, 2004. The determination of our percentage ownership change is dependent on provisions of the tax law that are subject to varying interpretations and on facts that are not precisely determinable by us at this time. Therefore, our cumulative change in ownership may be more or less than 17.0% and, in any event, will increase by reason of any subsequent transactions in our stock by stockholders who own 5% or more of our stock.

If the deductions associated with our tax attributes are insufficient to offset future federal taxable income, or if a change in ownership occurs and our deductions are limited, we would likely generate taxable income and would be required to make current income tax payments. Any such payments could impair the value of our securities.

To help protect these tax benefits, our board of directors and stockholders approved the merger of our company with a wholly-owned subsidiary. In the merger, which became effective on June 13, 2003, each issued and outstanding share of our common stock was converted into the right to receive one new share of our Class A common stock, which is subject to certain restrictions on transfer. After a cumulative change in ownership of our stock of more than 40%, any transfer of Class A common stock by or to a holder of 5% or more of our outstanding stock will be prohibited unless the transferee or transferor provides notice of the transfer to us and our board of directors approves the transfer. Our board of directors will approve a transfer of Class A common stock if it determines in good faith that the transfer (1) would not result in a cumulative change in ownership of our stock of more than 42% or (2) would not

increase the cumulative change in ownership of our stock. Prior to a cumulative change in ownership of our stock of more than 40%, transfers of Class A common stock will not be prohibited except to the extent that they result in a cumulative change in ownership of more than 42%, but any transfer by or to a holder of 5% or more of our outstanding stock requires a notice to us. Similar restrictions apply to the issuance or transfer of an option to purchase Class A common stock if the exercise of the option would result in a

Table of Contents

transfer that would be prohibited pursuant to the restrictions described above. Transfers by or to us and any transfer pursuant to a merger approved by the board of directors, or any tender offer to acquire all of our outstanding stock where a majority of the shares have been tendered, will be exempt from these restrictions. Once the transfer restrictions are no longer necessary to protect the tax benefits associated with our federal income tax attributes, the Class A common stock will be subject to conversion back into common stock without transfer restrictions on a share-for-share basis.

We cannot guarantee that the June 13, 2003 merger and the transfer restrictions on the Class A common stock will prevent a change in ownership or otherwise enable us to avoid significant limitations on the amounts and timing of the use of our tax attributes.

The proposed merger with Metrocall is subject to receipt of consents and approvals from government entities and shareholders that could delay completion of the merger or impose conditions that could have a material adverse effect on the value of the new holding company's common stock or cause abandonment of the merger.

Consummation of the proposed merger is subject to shareholder and various regulatory approvals. The special meetings of shareholders for Arch and Metrocall are scheduled for November 8, 2004. The proposed merger is subject to review by the Federal Communications Commission, also referred to as the FCC, and by the Antitrust Division of the Department of Justice, also referred to as the DOJ. The Communications Act of 1934, as amended, and the FCC's rules require that the FCC consent to the merger before we complete it. We have applied to receive the necessary consents, but the FCC may not grant our applications, or it may impose adverse conditions on its consent. Similarly, the merger is subject to pre-merger notification and challenge on antitrust grounds by the DOJ. Based upon its review, the DOJ could oppose the merger or it could condition its not opposing the merger on divestitures of certain assets or lines of business of the combined company. Arch and Metrocall filed the required pre-merger notification on April 5, 2004. On May 5, 2004, the DOJ submitted to each of Arch and Metrocall a Request for Additional Information and Documentary Material, also referred to as a second request, thereby extending the pre-merger statutory waiting period until thirty days after Arch and Metrocall substantially comply with the DOJ's request, unless the waiting period is terminated earlier or extended with the consent of Arch and Metrocall. Metrocall filed its responses to this second request with the DOJ on July 26, 2004 and Arch filed its responses on August 3, 2004. The DOJ advised Arch and Metrocall on September 9, 2004, that the DOJ's review of the companies' filings and additional information and documentary material will not be completed until early October 2004. The DOJ subsequently advised Arch and Metrocall that its review was continuing and would not be completed until sometime during October 2004. Arch and Metrocall are continuing to work cooperatively with the DOJ as it reviews the merger.

The process of obtaining DOJ or FCC consent could result in material delays. Third parties, including our customers and competitors, could oppose our applications and ask the FCC to deny approval of the merger. Although the statutory period for third parties to oppose our applications before the FCC has expired without any such oppositions being filed, the FCC has not yet completed its review of our applications. If third parties now oppose the merger, although outside the statutory period, additional delays could result. If there is any material delay in obtaining any governmental approval, there could be a delay in completing the merger. If completion of the merger is delayed, USA Mobility's ability to achieve anticipated cost-savings and synergies would be also delayed and the ultimate value of shares of USA Mobility common stock could be materially adversely affected. Moreover, the value of USA Mobility could be materially diminished if the FCC or the DOJ imposes adverse conditions, such as divestiture requirements, on their consent.

Additionally, the merger agreement provides that neither Arch nor Metrocall is required to accept or agree to the divestiture of any of their businesses or assets as a condition to receiving any approval or waiver from any governmental authority or the imposition of any conditions by, or payment of, any material amounts to any governmental authority or third party in order to obtain any necessary consents or approvals. In the event that any

such divestitures, conditions or payments are required to complete the merger, each of Arch or Metrocall could abandon the proposed merger instead of agreeing to take such actions, which could impair the value of our securities. Any significant delays in effecting the merger could also impair the value of our securities.

Table of Contents

If the proposed merger is consummated, management of the new holding company may fail to successfully integrate our operations with those of Metrocall. As a result, the anticipated potential benefits of the merger may not be realized, which may materially adversely affect the value of the common stock of the new holding company.

Management of the new holding company will face significant challenges in consolidating operations, integrating the two organizations and services in a timely and efficient manner and retaining executives and other personnel. Some of the key issues include managing messaging networks, maintaining adequate focus on existing business and operations while integrating the two companies, managing marketing and sales efforts and implementing a single billing system and other critical systems. The integration of the two companies will require substantial attention from management, particularly in light of geographically dispersed operations, differing business cultures and compensation structures at the two companies. The diversion of management attention and any difficulties associated with integrating our operations with those of Metrocall could have a material adverse effect on the revenues, level of expenses and results of operations of the new holding company which may materially adversely affect the value of the new holding company's common stock.

Loss of our key personnel could adversely impact our operations.

Our success depends, to a significant extent, upon the continued service of a relatively small group of key executive and management personnel. We have employment agreements with our chairman of the board and chief executive officer, our president and chief operating officer and our executive vice president and chief financial officer, and we have issued restricted stock, vesting over three years, to ten members of our senior management.

The loss or unavailability of one or more members of senior management prior to completion of the Metrocall merger or the inability to attract or retain key employees prior to or after the merger could have a material adverse effect on our future operating results, financial position and cash flows.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

None.

Item 4. Controls and Procedures

Our company's management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of September 30, 2004. Based on this evaluation, our chief executive officer and chief financial officer concluded that, as of September 30, 2004, our disclosure controls and procedures were (1) designed to ensure that material information relating to our company, including our consolidated subsidiaries, is made known to our chief executive officer and chief financial officer by others within those entities, particularly during the period in which this report was being prepared and (2) effective, in that they provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our chief executive and chief financial officers, to allow timely decisions regarding required disclosure and such information is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

No change in our internal controls over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the three months ended September 30, 2004 that has materially affected, or is reasonably likely to materially affect, the Company's internal controls over financial reporting.

Table of Contents

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

We are involved in a number of lawsuits which we do not believe will have a material adverse effect on our financial condition, results of operations or cash flows.

Arch has been named as a defendant, along with Metrocall, Metrocall's board of directors and USA Mobility, Inc., in two lawsuits filed in the Court of the Chancery of the State of Delaware, New Castle County, on June 29, 2004 and July 28, 2004, respectively. Each action is brought by a Metrocall shareholder on his own behalf and purportedly on behalf of all public shareholders of Metrocall's common stock, excluding the defendants and their affiliates. Each complaint alleges, among other things, that the Metrocall directors violated their fiduciary duties to Metrocall shareholders in connection with the proposed merger between Arch and Metrocall and that Arch and USA Mobility, Inc. aided and abetted the Metrocall directors' alleged breach of their fiduciary duties. The plaintiff seeks compensatory relief as well as an injunction to prevent consummation of the merger. Arch and the other defendants believe the allegations made in the complaint are without merit. However, given the uncertainties and expense of litigation, Arch and the other defendants have entered into a memorandum of understanding with the plaintiffs to settle these actions. The proposed settlement, which must be approved by the court following the merger, requires Arch and Metrocall to issue a supplement to the joint proxy/prospectus (which was filed on October 22, 2004, and sent to shareholders thereafter), to provide financial results for the quarter ended September 30, 2004, in advance of the shareholder meeting scheduled for November 8, 2004, and to not oppose the plaintiffs' request for attorneys' fees, not to exceed \$275,000.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 5. Other Information

None.

Item 6. Exhibits

(a) The exhibits listed in the accompanying exhibit index are filed as part of this Quarterly Report on Form 10-Q.

Table of Contents

SIGNATURES

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

ARCH WIRELESS, INC.

Dated: October 28, 2004

By: /s/ J. Roy Pottle
J. Roy Pottle
Executive Vice President and
Chief Financial Officer
(principal financial and
duly authorized officer)

Table of Contents**EXHIBIT INDEX**

Exhibit No.	Description
2.1	Agreement and Plan of Merger, by and among Wizards-Patriots Holdings, Inc., Wizards Acquiring Sub, Inc., Metrocall Holdings, Inc., Patriots Acquiring Sub, Inc. and Arch Wireless, Inc., dated as of March 29, 2004. (1)
2.2	Amendment No. 1, dated as of October 5, 2004, to the Agreement and Plan of Merger, dated as of March 29, 2004, by and among the USA Mobility, Inc. (formerly Wizards-Patriots Holdings, Inc.), Wizards Acquiring Sub, Inc., Metrocall Holdings, Inc., Patriots Acquiring Sub, Inc., and Arch Wireless, Inc. (2)
31.1*	Certificate of the Chief Executive Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, dated October 28, 2004
31.2*	Certificate of the Chief Financial Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, dated October 28, 2004
32.1*	Certificate of the Chief Executive Officer pursuant to Rule 13a-14(b) or Rule 15d-14(b) and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, dated October 28, 2004
32.2*	Certificate of the Chief Financial Officer pursuant to Rule 13a-14(b) or Rule 15d-14(b) and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, dated October 28, 2004

* Filed herewith

- (1) Incorporated by reference from the Current Report on Form 8-K of Arch Wireless, Inc. dated March 29, 2004 and filed March 31, 2004.
- (2) Incorporated by reference from the Current Report on Form 8-K of Arch Wireless, Inc. filed on October 12, 2004.