

BALLANTYNE OF OMAHA INC  
Form 10-Q  
May 11, 2007

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended March 31, 2007

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 1-13906

**BALLANTYNE OF OMAHA, INC.**

(Exact Name of Registrant as Specified in Its Charter)

**Delaware**

(State or Other Jurisdiction of  
Incorporation or Organization)

**47-0587703**

(IRS Employer  
Identification Number)

**4350 McKinley Street, Omaha, Nebraska**  
(Address of Principal Executive Offices)

**68112**  
Zip Code

**(402) 453-4444**

Registrant's telephone number, including area code:

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

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

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Large accelerated filer

Accelerated filer

Non-accelerated filer

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

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

| <u>Class</u>                   | <u>Outstanding as of May 4, 2007</u> |
|--------------------------------|--------------------------------------|
| Common Stock, \$.01, par value | 13,800,584 shares                    |

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## PART I. Financial Information

## Item 1. Financial Statements

**Ballantyne of Omaha, Inc. and Subsidiaries**  
**Consolidated Balance Sheets**  
**March 31, 2007 and December 31, 2006**

| Assets  | March 31<br>2007<br>(Unaudited) | December 31,<br>2006 |
|---|---------------------------------|----------------------|
| <b>Assets</b>   |                                 |                      |
| Current assets:   |                                 |                      |
| Cash and cash equivalents   | \$ 23,089,020                   | \$ 22,622,654        |
| Restricted cash   | 615,874                         | 611,391              |
| Accounts receivable (less allowance for doubtful accounts of \$523,465 in 2007 and \$498,783 in 2006)                                 | 8,826,460                       | 7,468,533            |
| Inventories, net  | 10,861,661                      | 8,848,396            |
| Deferred income taxes   | 1,742,146                       | 1,491,458            |
| Other current assets  | 1,184,435                       | 1,019,007            |
| Total current assets  | 46,319,596                      | 42,061,439           |
| Investment in Digital Link II joint venture   | 2,358,251                       |                      |
| Property, plant and equipment, net  | 4,753,091                       | 4,854,508            |
| Goodwill, net   | 1,809,426                       | 1,794,426            |
| Intangible assets, net  | 633,336                         | 486,003              |
| Other assets  | 19,757                          | 27,057               |
| Deferred income taxes   | 719,253                         | 684,067              |
| Total assets  | \$ 56,612,710                   | \$ 49,907,500        |
| <b>Liabilities and Stockholders Equity</b>  |                                 |                      |
| Current liabilities:  |                                 |                      |
| Current portion of long-term debt   | \$ 7,367                        | \$ 14,608            |
| Accounts payable  | 8,820,403                       | 3,257,948            |
| Warranty reserves   | 578,703                         | 617,052              |
| Accrued group health insurance claims   | 300,812                         | 276,405              |
| Accrued bonuses   | 95,978                          |                      |
| Other accrued expenses  | 2,419,112                       | 2,310,339            |
| Customer deposits   | 272,056                         | 344,599              |
| Income tax payable  | 433,561                         | 266,395              |
| Total current liabilities   | 12,927,992                      | 7,087,346            |
| Other accrued expenses, net of current portion  | 588,922                         | 431,207              |
| Total liabilities   | 13,516,914                      | 7,518,553            |
| Commitments and contingencies   |                                 |                      |
| Stockholders equity:  |                                 |                      |
| Preferred stock, par value \$.01 per share; Authorized 1,000,000 shares, none outstanding   |                                 |                      |
| Common stock, par value \$.01 per share; Authorized 25,000,000 shares; issued 15,898,389 shares in 2007 and 15,824,389 shares in 2006 | 158,983                         | 158,243              |
| Additional paid-in capital  | 34,349,597                      | 34,216,227           |
| Accumulated other comprehensive income  | 14,746                          | 14,746               |
| Retained earnings   | 23,887,924                      | 23,315,185           |
|   | 58,411,250                      | 57,704,401           |
| Less 2,097,805 common shares in treasury, at cost   | (15,315,454)                    | (15,315,454)         |
| Total stockholders equity   | 43,095,796                      | 42,388,947           |
| Total liabilities and stockholders equity   | \$ 56,612,710                   | \$ 49,907,500        |

See accompanying notes to consolidated financial statements.



**Ballantyne of Omaha, Inc. and Subsidiaries**  
**Consolidated Statements of Operations**  
**Three Months Ended March 31, 2007 and 2006**  
**(Unaudited)**

|   | 2007          | 2006          |
|---|---------------|---------------|
| Net revenues                              | \$ 12,930,750 | \$ 12,433,338 |
| Cost of revenues                          | 10,208,966    | 9,102,371     |
| Gross profit                              | 2,721,784     | 3,330,967     |
| Selling and administrative expenses:      |               |               |
| Selling                                   | 782,616       | 734,523       |
| Administrative                            | 1,433,047     | 1,369,684     |
| Total selling and administrative expenses | 2,215,663     | 2,104,207     |
| Gain on the transfer of assets            | 233,327       |               |
| Loss on disposal of fixed assets, net     | (11,004)      | )             |
| Income from operations                    | 728,444       | 1,226,760     |
| Interest income                           | 218,313       | 166,185       |
| Interest expense                          | (10,257)      | ) (8,022)     |
| Other income (expense), net               | (48,021)      | ) 18,880      |
| Income before income taxes                | 888,479       | 1,403,803     |
| Income tax expense                        | (315,740)     | ) (489,055)   |
| Net income                                | \$ 572,739    | \$ 914,748    |
| Basic earnings per share                  | \$ 0.04       | \$ 0.07       |
| Diluted earnings per share                | \$ 0.04       | \$ 0.07       |
| Weighted average shares outstanding:      |               |               |
| Basic                                     | 13,765,897    | 13,440,500    |
| Diluted                                   | 14,065,208    | 13,947,291    |

See accompanying notes to consolidated financial statements.

**Ballantyne of Omaha, Inc. and Subsidiaries**  
**Consolidated Statements of Cash Flows**  
**Three Months Ended March 31, 2007 and 2006**  
**(Unaudited)**

|   | 2007          | 2006          |
|---|---------------|---------------|
| Cash flows from operating activities:   |               |               |
| Net income  | \$ 572,739    | \$ 914,748    |
| Adjustments to reconcile net income to net cash provided by operating activities: |               |               |
| Provision for doubtful accounts   | 24,750        | 18,750        |
| Provision for obsolete inventory  | 137,950       | 114,801       |
| Depreciation of property, plant and equipment                                     | 269,978       | 279,934       |
| Amortization of intangibles   | 17,667        |               |
| Loss on disposal of fixed assets  | 11,004        |               |
| Deferred income taxes   | (285,874)     | (145,547)     |
| Share-based compensation expense  | 29,338        | 31,723        |
| Excess tax benefits from stock options exercised                                  | (77,252)      | (180,397)     |
| Changes in assets and liabilities:  |               |               |
| Accounts receivable   | (1,382,677)   | 1,215,063     |
| Inventories   | (4,426,102)   | (1,382,423)   |
| Other assets  | (158,128)     | 80,977        |
| Accounts payable  | 5,562,455     | 1,282,671     |
| Warranty reserves   | (38,349)      | 10,145        |
| Accrued group health insurance claims   | 24,407        | (84,632)      |
| Other accrued expenses  | 207,647       | (452,964)     |
| Customer deposits   | (72,543)      | (162,043)     |
| Current income taxes  | 244,418       | 632,202       |
| Net cash provided by operating activities   | 661,428       | 2,173,008     |
| Cash flows from investing activities:   |               |               |
| Acquisition of business   | (183,364)     | )             |
| Increase in restricted investments  | (4,483)       | )             |
| Capital expenditures  | (109,565)     | (118,776)     |
| Net cash used in investing activities   | (297,412)     | (118,776)     |
| Cash flows from financing activities:   |               |               |
| Payments on long-term debt  | (7,241)       | (6,764)       |
| Proceeds from exercise of stock options   | 32,339        | 193,550       |
| Excess tax benefits from stock options exercised                                  | 77,252        | 180,397       |
| Net cash provided by financing activities   | 102,350       | 367,183       |
| Net increase in cash and cash equivalents   | 466,366       | 2,421,415     |
| Cash and cash equivalents at beginning of year                                    | 22,622,654    | 19,628,348    |
| Cash and cash equivalents at end of year  | \$ 23,089,020 | \$ 22,049,763 |

See accompanying notes to consolidated financial statements.

**Ballantyne of Omaha, Inc. and Subsidiaries**  
**Notes to Consolidated Financial Statements**

**Three Months Ended March 31, 2007 and 2006**

**(Unaudited)**

**1. Company**

Ballantyne of Omaha, Inc., a Delaware corporation ( Ballantyne or the Company ), and its wholly-owned subsidiaries Strong Westrex, Inc., Strong Technical Services, Inc., and Design & Manufacturing, Inc., design, develop, manufacture, service and distribute theatre and lighting equipment. The Company s products are distributed to movie exhibition companies, sports arenas, auditoriums, amusement parks and special venues. Refer to the Business Segment Section (note 20) for further information.

**2. Summary of Significant Accounting Policies**

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

**a. Basis of Presentation and Principles of Consolidation**

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation. The investment in and the operating results of the Digital Link II joint venture are not required to be consolidated and are included in the financial statements on the basis of the equity method of accounting.

The consolidated financial statements included herein are presented in accordance with the requirements of Form 10-Q and consequently do not include all of the disclosures normally required by accounting principles generally accepted in the United States of America for annual reporting purposes or those made in the Company s annual Form 10-K filing. These consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company s Form 10-K for fiscal 2006.

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

**b. Use of Estimates**

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

**c. Trade Accounts Receivable**

Trade accounts receivable are recorded at the invoiced amount and do not bear interest. Amounts collected on trade accounts receivable are included in net cash provided by operating activities in the consolidated statements of cash flows.

The Company maintained an allowance for doubtful accounts of \$523,465 and \$498,783 at March 31, 2007 and December 31, 2006, respectively. This allowance is developed based on several factors including overall customer credit quality, historical write-off experience and a specific analysis that projects the ultimate collectibility of the account. As such, these factors may change over time causing the reserve level to adjust accordingly.



**d. Inventories**

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

**e. Goodwill and Intangible Assets**

Goodwill represents the excess of cost over the fair value of assets of businesses acquired through purchase business combinations in accordance with the provisions of Statement of Financial Accounting Standards ( SFAS ) No. 142, *Goodwill and Other Intangible Assets*. Goodwill and intangible assets that are determined to have an indefinite useful life are not amortized but instead tested for impairment at least annually as well as when events and circumstances indicate that an impairment may have occurred. Certain factors that may occur and indicate that an impairment exists include, but are not limited to, operating results that are lower than expected and adverse industry or market economic trends.

The impairment testing requires management to estimate the fair value of the assets or reporting unit. The estimate of the fair value of the assets is determined on the basis of discounted cash flows. In estimating the fair value, management must make assumptions and projections regarding such items as future cash flows, future revenues, future earnings in addition to other factors. The fair value of the reporting unit is then compared to the carrying amount of the assets to quantify an impairment charge as of the assessment date for the excess of the carrying amount of the reporting unit's assets over the fair value of the reporting unit's assets.

Intangible assets with estimatable useful lives are amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment in accordance with SFAS No. 144, *Accounting for Impairment or Disposal of Long-Lived Assets*.

**f. Property, Plant and Equipment**

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

**g. Major Maintenance Activities**

The Company incurs maintenance costs on all its major equipment. Repair and maintenance costs are expensed as incurred.

**h. Income Taxes**

Income taxes are accounted for under the asset and liability method. The Company uses an estimate of its annual effective rate based on the facts and circumstances at the time while the actual effective rate is calculated at year-end. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized.

**i. Revenue Recognition**

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

The Company enters into transactions that represent multiple element arrangements, which may include a combination of services and asset sales. Under EITF 00-21, *Revenue Arrangements with Multiple Deliverables*, multiple element



arrangements are assessed to determine whether they can be separated into more than one unit of accounting. A multiple element arrangement is separated into more than one unit of accounting if all of the following criteria are met.

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

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

#### j. Fair Value of Financial Instruments

The fair value of a financial instrument is the amount at which the instruments could be exchanged in a current transaction between willing parties. Cash and cash equivalents, accounts receivable, debt, accounts payable and accrued expenses reported in the consolidated balance sheets equal or approximate their fair values.

#### k. Cash and Cash Equivalents

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

#### l. Earnings Per Common Share

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

|   | <b>Three Months Ended March 31,</b> |             |
|---|-------------------------------------|-------------|
|   | <b>2007</b>                         | <b>2006</b> |
| <b>Basic earnings per share:</b>                        |                                     |             |
| Earnings applicable to common stock                     | \$ 572,739                          | \$ 914,748  |
| Weighted average common shares outstanding              | 13,765,897                          | 13,440,500  |
| Basic earnings per share                                | \$ 0.04                             | \$ 0.07     |
| <b>Diluted earnings per share:</b>                      |                                     |             |
| Earnings applicable to common stock                     | \$ 572,739                          | \$ 914,748  |
| Weighted average common shares outstanding              | 13,765,897                          | 13,440,500  |
| Assuming conversion of options outstanding              | 299,311                             | 506,791     |
| Weighted average common shares outstanding, as adjusted | 14,065,208                          | 13,947,291  |
| Diluted earnings per share                              | \$ 0.04                             | \$ 0.07     |

At March 31, 2007, options to purchase 181,388 shares of common stock at a weighted average price of \$9.89 per share were outstanding, but were not included in the computation of diluted earnings per share for the three months ended March 31, 2007 as the options' exercise price was greater than the average market price of the common shares. These options expire between April 2007 and October 2007. At March 31, 2006, options to purchase 286,733 shares of common stock at a weighted average price of \$8.15 per share were outstanding but were not included in the computation of diluted earnings per



share for the three months ended March 31, 2006 as the options' exercise price was greater than the average market price of the common shares.

#### m. Stock Option Plans

Effective January 1, 2006, the Company adopted FASB Statement No. 123(R), *Share-Based Payment* (SFAS No. 123R). This statement replaced FASB Statement No. 123, *Accounting for Stock-Based Compensation* (Statement 123) and supersedes APB No. 25. Statement 123(R) requires that all stock-based compensation be recognized as an expense in the financial statements and that such cost be measured at the fair value of the award. This statement was adopted using the modified prospective method of application, which requires the Company to recognize compensation cost on a prospective basis. Therefore, prior years' financial statements have not been restated. Under this method, the Company recorded stock-based compensation expense for awards granted prior to, but not yet vested as of January 1, 2006, using the fair value amounts determined for pro forma disclosures under Statement 123. For stock-based awards granted after January 1, 2006, the Company recognizes compensation expense based on estimated grant date fair value using the Black-Scholes option-pricing model. In a change from previous standards, Statement 123(R) also requires that excess tax benefits related to stock option exercises be reflected as financing cash inflows.

Share-based compensation cost that has been included in income from operations amounted to \$29,338 and \$31,723 for the three months ended March 31, 2007 and 2006, respectively. No share-based compensation cost was capitalized as a part of inventory as of March 31, 2007.

#### n. Impairment of Long-Lived Assets

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

The Company's most significant long-lived assets subject to these periodic assessments of recoverability are property, plant and equipment, which have a net book value of \$4.8 million at March 31, 2007. Because the recoverability of property, plant and equipment is based on estimates of future undiscounted cash flows, these estimates may vary due to a number of factors, some of which may be outside of management's control. To the extent that the Company is unable to achieve management's forecasts of future income, it may become necessary to record impairment losses for any excess of the net book value of property, plant and equipment over its fair value. In addition, the Company has long-lived assets which consist of the Company's equity method investment in the joint venture. The Company would recognize a loss when there is a loss in value of the equity method investment which is other than a temporary decline. No impairment existed for this investment as of March 31, 2007.

#### o. Warranty Reserves

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

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

|   | <b>Three Months Ended March 31,</b> |             |
|---|-------------------------------------|-------------|
|   | <b>2007</b>                         | <b>2006</b> |
| Warranty accrual at beginning of period | \$ 617,052                          | \$ 680,017  |
| Charged to expense                      | 43,250                              | 57,750      |
| Amounts written off, net of recoveries  | (81,599 )                           | (47,605 )   |
| Warranty accrual at end of period       | \$ 578,703                          | \$ 690,162  |



**p. Reclassifications**

Certain amounts in the accompanying consolidated financial statements and notes thereto have been reclassified to conform to the 2007 presentation.

**q. Adoption of New Accounting Pronouncements**

On July 13, 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109 ( *FIN 48* ). FIN 48 clarifies the accounting for uncertainty in income taxes by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods and disclosure. The adoption of this interpretation as of January 1, 2007, did not have a material impact on the Company's consolidated financial position or results of operations.

During 2006, the Emerging Issues Task Force issued EITF Issue No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should be Presented in the Income Statement* (that is, gross versus net presentation) for tax receipts on the face of their income statements. The scope of this guidance includes any tax assessed by a governmental authority that is directly imposed on a revenue-producing transaction between a seller and a customer and may include, but is not limited to, sales, use, value added and some excise taxes (gross receipts taxes are excluded). The Company has historically presented such taxes on a net basis.

**r. Recently Issued Accounting Pronouncements**

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

In February 2007, the FASB issued SFAS No. 159 *The Fair Value Option for Financial Assets and Financial Liabilities* . SFAS No. 159 permits entities to choose to measure many financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company is currently assessing the impact of SFAS No. 159 on its consolidated financial position and results of operations.

**3. Investment in Digital Link II Joint Venture**

On March 6, 2007, the Company entered into an agreement with RealD to form an operating entity Digital Link II, LLC (the *LLC* ). Under the agreement, the LLC was formed with the Company and RealD as the only two members with membership interests of 44.4% and 55.6%, respectively. The LLC was formed for purposes of commercializing certain 3D technology and to fund the deployment of digital projector systems and servers to exhibitors.

On March 30, 2007, Ballantyne transferred \$5.7 million of equipment and provided installation services to the LLC in exchange for a 44.4% ownership interest in the LLC which amounted to \$2.4 million and cash consideration. At March 31, 2007, Ballantyne recorded a receivable of approximately \$0.7 million for the amount of cash consideration outstanding. The gain on the transfer of equipment was \$0.2 million. The Company's investment balance in the joint venture represents the retained interest in the cost basis of the projectors transferred to the joint venture. An additional gain will be recognized upon sale of the equipment by the joint venture to the third party exhibitors. No revenue was recorded in conjunction with the transaction.

The Company accounts for its investment by the equity method. Under this method, we record our proportionate share of Digital Link II's net income or loss based on the most recently available quarterly financial statements.

**4. Acquisition of National Cinema Service Corp.**

On May 31, 2006, the Company acquired certain assets and assumed certain liabilities of National Cinema Service Corp. (NCSC). The total purchase price of NCSC at the date of acquisition was \$1.7 million including cash acquired. The Company entered into an agreement to pay the former owner of NCSC, \$150,000 in consideration for a five-year covenant not to compete, of which \$25,000 was paid at closing, with the remaining \$125,000 being placed in escrow to be paid over five-years. The payments are contingent upon the satisfaction of the requirement to not compete with the Company in the cinema service business over a five-year period. The purchase price initially excluded an additional \$0.5 million of restricted funds that were placed in escrow for contingent payments. These contingencies related to certain aged accounts receivable,

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inventories deemed to have a heightened risk of becoming obsolete and certain contingent sales tax liabilities. During 2006, the satisfaction of the terms outlined in the purchase agreement related to aged accounts receivable, inventories and certain sales tax liabilities were satisfied, however, there are still remaining contingencies pertaining primarily to sales tax liabilities at March 31, 2007.

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

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## 5. Acquisition of Technobeam

During 2007, the Company acquired certain assets of a business in the lighting segment from High End Systems, Inc. The Company made an initial payment of \$0.2 million. Additional consideration to be paid of up to \$150,000 is contingent upon satisfaction and attainment of certain future sales of the business product line. Direct transaction costs were not material to the acquisition.

The assets acquired and liabilities assumed were recorded as estimated fair values as determined by the Company's management based on information currently available, assumptions as to future operations and preliminary independent appraisals. The allocation of the purchase price is subject to revision, which is not expected to be material, based on final determination of appraised and other fair values. The following table summarizes the estimated fair value of the assets acquired at the date of the acquisition:

|                               |            |
|-------------------------------|------------|
| Inventory                     | \$ 83,364  |
| Tooling equipment             | 70,000     |
| Amortizable intangible assets | 165,000    |
| Goodwill                      | 15,000     |
| Total assets acquired         | 333,364    |
| Long-term liabilities         | (150,000 ) |
| Net assets acquired           | \$ 183,364 |

Goodwill represents the excess of the purchase price over the fair value of the net tangible and intangible assets acquired and are expected to be deductible for tax purposes. There have been no revenues or expenses generated since the closing date of the acquisition.

## 6. Intangible Assets

Intangible assets consist of the following:

|                                | March 31,<br>2007 | December 31,<br>2006 |
|--------------------------------|-------------------|----------------------|
| Amortizable intangible assets: |                   |                      |
| Customer relationships         | \$ 511,265        | \$ 391,265           |
| Trademarks                     | 25,000            |                      |
| Non-competition agreement      | 155,962           | 135,962              |
|                                | \$ 692,227        | \$ 527,227           |
| Accumulate amortization:       |                   |                      |
| Customer relationships         | \$ (36,227 )      | \$ (25,360 )         |
| Non-competition agreement      | (22,664 )         | (15,864 )            |
|                                | \$ (58,891 )      | \$ (41,224 )         |

Intangible assets, other than goodwill, with definite lives are amortized over their useful lives.

During 2006, the Company purchased certain intangible assets pertaining to an asset purchase agreement between the Company and National Cinema Service Corporation. The assets were recorded at fair value. Customer relationships are being amortized over useful lives of nine years and the non-competition agreement is being amortized over a useful life of five years.

During 2007, the Company purchased certain intangible assets pertaining to an agreement between High End Systems, Inc. and the Company. The assets were recorded at fair value. Customer relationship and trademark intangibles will be amortized over a useful life of five years and a non-competition agreement will be amortized over three years.

The Company recorded amortization expense relating to other identifiable intangible assets of \$17,667 and \$0 for the three months ended March 31, 2007 and 2006, respectively.



## 7. Goodwill

As of March 31, 2007 and December 31, 2006, the Company had unamortized goodwill of \$1,809,426 and \$1,794,426, respectively. The change in goodwill resulted from an increase in goodwill of \$15,000 related to an acquisition in the lighting segment of a business from High End Systems, Inc.

Goodwill represents the excess of cost over the fair value of assets of businesses acquired through purchase business combinations in accordance with the provisions of Statement of Financial Accounting Standards ( SFAS ) No. 142, *Goodwill and Other Intangible Assets*. Goodwill and intangible assets that are determined to have an indefinite useful life are not amortized but instead tested for impairment at least annually as well as when events and circumstances indicate that an impairment may have occurred. Certain factors that may occur and indicate that impairment exists include, but are not limited to, operating results that are lower than expected and adverse industry or market economic trends.

The impairment testing requires management to estimate the fair value of the assets or reporting unit. The estimate of the fair value of the assets is determined on the basis of discounted cash flows. In estimating the fair value, management must make assumptions and projections regarding such items as future cash flows, future revenues, future earnings in addition to other factors. The fair value of the reporting unit is then compared to the carrying amount of the assets to quantify an impairment charge as of the assessment date for the excess of the carrying amount of the reporting unit's assets over the fair value of the reporting unit's assets.

## 8. Inventories

Inventories consist of the following:

|                              | March 31,<br>2007 | December 31,<br>2006 |
|------------------------------|-------------------|----------------------|
| Raw materials and components | \$ 5,933,301      | \$ 6,041,409         |
| Work in process              | 1,346,899         | 769,575              |
| Finished goods               | 3,581,461         | 2,037,412            |
|                              | \$ 10,861,661     | \$ 8,848,396         |

The inventory balances are net of reserves of approximately \$1,847,000 and \$1,535,000 as of March 31, 2007 and December 31, 2006, respectively.

## 9. Property, Plant and Equipment

Property, plant and equipment include the following:

|                                   | March 31,<br>2007 | December 31,<br>2006 |
|-----------------------------------|-------------------|----------------------|
| Land                              | \$ 343,500        | \$ 343,500           |
| Buildings and improvements        | 4,699,981         | 4,699,981            |
| Machinery and equipment           | 9,166,998         | 9,150,422            |
| Office furniture and fixtures     | 2,511,451         | 2,427,577            |
|                                   | 16,721,930        | 16,621,480           |
| Less accumulated depreciation     | 11,968,839        | 11,766,972           |
| Net property, plant and equipment | \$ 4,753,091      | \$ 4,854,508         |

Depreciation expense amounted to \$269,978 and \$279,934 for the three months ended March 31, 2007 and 2006, respectively.

## 10. Income Taxes

Income taxes are accounted for under the asset and liability method. The Company uses an estimate of its annual effective rate based on the facts and circumstances at the time while the actual effective rate is calculated at year-end. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized.

On July 13, 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods and disclosure. The adoption of this interpretation did not have a material impact on the Company's consolidated financial position.

The Company's uncertain tax positions are related to tax years that remain subject to examination by the relevant taxable authorities. The Company has examinations not yet initiated for Federal purposes for fiscal years 2004 through 2006. In most cases, the Company has examinations open for State or local jurisdictions based on the particular jurisdictions statute of limitations. The Company does not currently have any examinations in process. As of January 1, 2007, the Company had \$0.3 million of unrecognized tax benefits. If recognized, the tax benefits would be recorded as a component of income tax expense.

Estimated amounts related to estimated underpayment of income taxes, including interest and penalties, are classified as a component of tax expense in the consolidated statements of operations and were not material for the quarter ended March 31, 2007. Amounts accrued for estimated underpayment of income taxes amounted to \$0.3 million as of January 1, 2007 and March 31, 2007, respectively. The accruals largely related to state tax matters.

## 11. Debt

The Company is a party to a revolving credit facility with First National Bank of Omaha expiring August 27, 2007. The Company expects to renew the credit facility in the ordinary course of business. The credit facility provides for borrowings up to the lesser of \$4.0 million or amounts determined by an asset-based lending formula, as defined. Borrowings available under the credit facility amounted to \$4.0 million at March 31, 2007. No amounts are currently outstanding. The Company would pay interest on outstanding amounts equal to the Prime Rate plus 0.25% (8.50% at March 31, 2007) and pays a fee of 0.125% on the unused portion. The credit facility contains certain restrictive covenants primarily related to maintaining certain earnings, as defined, and restrictions on acquisitions and dividends. All of the Company's personal property and stock in its subsidiaries secure this credit facility.

Long-term debt at March 31, 2007 consisted entirely of installment payments relating to the purchase of certain intangible assets with the final payments of \$7,367 to be made before the end of fiscal 2007.

## 12. Note Receivable

During July 2006, the Company entered into a note receivable arrangement with Digital Link LLC (Digital Link) pertaining to the sale and installation of digital projectors. The sale amounted to \$780,000 of which 25% was due upon installation and was collected. The remaining amounts are due over a 5-year period at an 8% interest rate. At March 31, 2007, \$519,378 is due from Digital Link. The payments received during 2007 on the note receivable totaling \$25,004 were recorded as revenue during 2007 with the remaining amounts to be recognized as revenue in future periods when the cash is received from Digital Link as described in the note receivable arrangement or when collections from the Digital Link can be reasonably assured. The costs incurred with the sale of projectors to Digital Link were expensed during 2006 with no future associated costs to be incurred.

### 13. Supplemental Cash Flow Information

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

|  | <b>Three Months Ended March 31,</b> |             |
|--|-------------------------------------|-------------|
|  | <b>2007</b>                         | <b>2006</b> |
| <b>Cash paid during the period for:</b>              |                                     |             |
| Interest   | \$ 5,383                            | \$ 1,938    |
| Income taxes   | \$ 357,196                          | \$ 2,400    |
| <b>Non-cash investing activities:</b>                |                                     |             |
| Non-cash investment in Digital Link II joint venture | \$ 2,358,251                        | \$          |

### 14. Stock Compensation

#### *Options*

The Company currently maintains a 2001 Non-Employee Directors Stock Option Plan ( 2001 Directors Plan ) which has not been approved by the Company's stockholders. The plan exists to provide incentive to non-employee directors to serve on the Board and exert their best efforts. The 2001 Director's Plan provides an option to purchase common stock in lieu of all or part of the retainer paid to directors for their services. The Board of Directors fix the amount of the retainer fee for the coming year at least thirty days prior to beginning of plan year. At that time, each non-employee director may elect to receive stock options for all or part of the retainer fee to be provided.

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

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

A total of 1,105,690 shares of common stock have been reserved for issuance pursuant to the Company's stock option plans for directors at March 31, 2007.

No stock options were granted during the three months ended March 31, 2007 and 2006.

On January 1, 2006, the Company adopted SFAS No. 123(R), Share Based Payment (SFAS No. 123(R)). As a result of the adoption of SFAS No. 123(R), the Company records compensation expense for stock options based on the estimated fair value of the options on the date of grant using the Black-Scholes option-pricing model. The Company uses historical data among other factors to estimate the expected price volatility, the expected option life and the expected forfeiture rate. The risk-free rate is based on the U.S. Treasury yield in effect at the time of grant for the estimated life of the option. The Company has not and is not expected to pay cash dividends in the future. The Company policy is to record the fair value of the options to selling, general and administrative expenses on a straight-line basis over the requisite service period.

Earnings before income taxes included \$24,519 and \$23,781 of share-based compensation expense related to stock options, with associated tax benefits of approximately \$9,100 and \$8,700 for the three months ended March 31, 2007 and 2006, respectively.

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SFAS No. 123(R) requires the cash flows resulting from tax deductions in excess of the compensation cost recognized for share-based payments ( excess tax benefits ) to be classified as financing cash flows. As such, excess tax benefits of \$77,252 and 180,397 were classified as financing cash flows for the three months ended March 31, 2007 and 2006, respectively.

The following table summarizes the Company's activities with respect to its stock options for the three months ended March 31, 2007:

|  | Number of Options | Weighted Average Exercise Price Per Share | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value |
|--|-------------------|---|---|---------------------------|
| Options outstanding at December 31, 2006 | 720,925           | \$ 3.77                                   | \$ 3.30                                     | \$ 1,906,462              |
| Granted                                  |                   |   |   |                           |
| Exercised                                | (74,000 )         | \$ 0.44                                   |   |                           |
| Forfeited                                | (16,538 )         | \$ 8.10                                   |   |                           |
| Outstanding at March 31, 2007            | 630,387           | \$ 4.05                                   | \$ 3.00                                     | \$ 1,495,433              |
| Exercisable at March 31, 2007            | 575,263           | \$ 4.01                                   | \$ 2.93                                     | \$ 1,469,446              |

The aggregate intrinsic value in the table above represents the total that would have been received by the option holders if all in-the-money options had been exercised on March 31, 2007. The total intrinsic value for options exercised during the three months ended March 31, 2007 and 2006 amounted to \$358,360 and \$563,145, respectively.

Cash received from option exercises under all plans for the three months ended March 31, 2007 and 2006 was \$32,339 and \$193,550, respectively. The actual tax benefit realized for the tax deductions from option exercises under all plans totaled \$77,252 and \$180,397 for the three months ended March 31, 2007 and 2006, respectively. The Company currently uses authorized and un-issued shares to satisfy share award exercises.

The following table summarizes information about stock options outstanding and exercisable at March 31, 2007:

| Range of option exercise price | Options outstanding at March 31, 2007 |   |  | Exercisable at March 31, 2007 |   |  |
|--------------------------------|---------------------------------------|---|--|-------------------------------|---|--|
|                                | Number of options                     | Weighted average remaining contractual life | Weighted average exercise price per option | Number of options             | Weighted average remaining contractual life | Weighted average exercise price per option |
| \$0.47 to 1.19                 | 330,875                               | 4.13  | \$ 0.67                                    | 330,875                       | 4.13  | \$ 0.67                                    |
| 4.25 to 4.75                   | 118,124                               | 3.57  | 4.55                                       | 63,000                        | 3.42  | 4.63                                       |
| 7.30 to 11.43                  | 181,388                               | 0.57  | 9.89                                       | 181,388                       | 0.57  | 9.89                                       |
| \$0.47 to 11.43                | 630,387                               | 3.00  | \$ 4.05                                    | 575,263                       | 2.93  | \$ 4.01                                    |

As of March 31, 2007, the total unrecognized compensation cost related to non-vested stock option awards was approximately \$37,134 and is expected to be recognized over a weighted average period of 9 months.

*Restricted Stock Plan*

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

*Employee Stock Purchase Plan*

The Company's Employee Stock Purchase Plan, approved by the stockholders, provides for the purchase of shares of Ballantyne common stock by eligible employees at a per share purchase price equal to 85% of the fair market value of a share of



Ballantyne common stock at either the beginning or end of the offering period, as defined, whichever is lower. Purchases are made through payroll deductions of up to 10% of each participating employee's salary. The maximum number of shares that can be purchased by participants in any offering period is 2,000 shares. Additionally, the Plan has set certain limits, as defined, in regard to the number of shares that may be purchased by all eligible employees during an offering period. At March 31, 2007, 134,350 shares of common stock remained available for issuance under the Plan. The Plan expires in October 2010. The Company recorded \$4,819 and \$7,942 of share-based compensation expense pertaining to the stock purchase plan with associated taxes benefit of approximately \$1,100 and \$1,200 for the three months ended March 31, 2007 and 2006, respectively. At March 31, 2007, the total unrecognized estimated compensation cost pertaining to the stock purchase plan was \$11,242 which is expected to be recognized over a period of seven months.

The fair value of option grants of \$1.82 and \$2.07 during the three months ended March 31, 2007 and 2006, respectively, was estimated using the following weighted average assumptions:

|                          | 2007   | 2006   |
|--------------------------|--------|--------|
| Expected dividend yield  | 0.0 %  | 0.0 %  |
| Risk-free interest rate  | 4.90 % | 4.31 % |
| Expected volatility      | 36.2 % | 43.4 % |
| Expected life (in years) | 1.0    | 1.0    |

## 15. Stockholder Rights Plan

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

## 16. Postretirement Health Care

In accordance with SFAS No. 132, *Disclosures About Pensions and Other Postretirement Benefits*, the following table sets forth the components of the net period benefit cost for the three months ended March 31, 2007 and 2006:

|                                    | 2007      | 2006      |
|------------------------------------|-----------|-----------|
| Service cost                       | \$ 2,979  | \$ 3,116  |
| Interest cost                      | 5,418     | 6,083     |
| Amortization of prior-service cost | 5,598     | 6,718     |
| Net periodic benefit cost          | \$ 13,995 | \$ 15,917 |

The Company expects to pay \$22,415 of benefits under its postretirement benefit plan in 2007. As of March 31, 2007, benefits of \$2,406 have been paid.

## 17. Concentrations

The Company's top ten customers accounted for approximately 48% of 2007 consolidated net revenues and were primarily from the theatre segment. Trade accounts receivable from these customers represented approximately 37% of net consolidated receivables at March 31, 2007. Sales to AMC Theatres, Inc. represented over 10% of consolidated sales. While the Company believes its relationships with such customers are stable, most arrangements are made by purchase order and are terminable at will by either party. A significant decrease or interruption in business from our significant customers could have a material adverse effect on the Company's business, financial condition and results of operations. It could also be adversely affected by such factors as changes in foreign currency rates and weak economic and political conditions in each of





the countries in which it sells its products. In addition, advancing technologies, such as digital cinema, could disrupt historical customer relationships.

## 18. Self-Insurance

The Company is self-insured up to certain stop loss limits for group health insurance. Accruals for claims incurred but not paid as of March 31, 2007 and December 31, 2006 are included in accrued group health insurance claims in the accompanying consolidated balance sheets. The Company's policy is to accrue the employee health benefit accruals based on historical information along with certain assumptions about future events.

## 19. Litigation

Ballantyne is currently a defendant in an asbestos case entitled *Larry C. Stehman and Leila Stehman v. Asbestos Corporation, Limited and Ballantyne of Omaha, Inc. individually and as successor in interest to Strong International, Strong Electric Corporation and Century Projector Corporation, et al.*, filed December 8, 2006 in the Superior Court of the State of California, County of San Francisco. The Company believes that it has strong defenses and intends to defend the suit vigorously. It is not possible at this time to predict the outcome of this case, or the amount of damages, if any, that a jury may award. The plaintiffs have made no monetary demand upon Ballantyne. It is possible that an adverse resolution of this case could have a material adverse effect on the Company's financial position.

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

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

## 20. Business Segment Information

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

As of March 31, 2007, the Company's operations were conducted principally through two business segments: Theatre and Lighting. Theatre operations include the design, manufacture, assembly, sale and service of motion picture projectors, xenon lamphouses, power supplies, sound systems, film handling equipment and the sale and service of xenon lamps, lenses and digital projection equipment. The lighting segment operations include the design, manufacture, assembly and sale of follow spotlights, stationary searchlights and computer operated lighting systems for the motion picture production, television, live entertainment, theme parks and architectural industries. The Company allocates resources to business segments and evaluates the performance of these segments based upon reported segment gross profit. However, certain key operations of a particular segment are tracked on the basis of operating profit. There are no significant intersegment sales. All intersegment transfers are recorded at historical cost.

## Summary by Business Segments

|                                       | Three Months Ended March 31, |               |
|---------------------------------------|------------------------------|---------------|
|                                       | 2007                         | 2006          |
| Net revenue                           |                              |               |
| Theatre                               |                              |               |
| Products                              | \$ 10,792,161                | \$ 11,132,206 |
| Services                              | 935,380                      |               |
| Total theatre                         | 11,727,541                   | 11,132,206    |
| Lighting                              | 1,044,368                    | 1,120,424     |
| Other                                 | 158,841                      | 180,708       |
| Total revenue                         | \$ 12,930,750                | \$ 12,433,338 |
| Gross profit                          |                              |               |
| Theatre                               |                              |               |
| Products                              | \$ 2,178,541                 | \$ 2,932,970  |
| Services                              | 217,883                      |               |
| Total theatre                         | 2,396,424                    | 2,932,970     |
| Lighting                              | 253,576                      | 318,643       |
| Other                                 | 71,784                       | 79,354        |
| Total gross profit                    | 2,721,784                    | 3,330,967     |
| Selling and administrative expenses   | (2,215,663 )                 | (2,104,207 )  |
| Gain on transfer of assets            | 233,327                      |               |
| Loss on disposal of fixed assets, net | (11,004 )                    |               |
| Operating income                      | 728,444                      | 1,226,760     |
| Net interest income                   | 208,056                      | 158,163       |
| Other income (expense), net           | (48,021 )                    | 18,880        |
| Income before income taxes            | \$ 888,479                   | \$ 1,403,803  |
| Expenditures on capital equipment     |                              |               |
| Theatre                               |                              |               |
| Products                              | \$ 72,224                    | \$ 112,082    |
| Services                              | 31,732                       |               |
| Total theatre                         | 103,956                      | 112,082       |
| Lighting                              | 5,609                        | 6,694         |
| Total                                 | \$ 109,565                   | \$ 118,776    |
| Depreciation and amortization         |                              |               |
| Theatre                               |                              |               |
| Products                              | \$ 228,695                   | \$ 258,353    |
| Services                              | 45,150                       |               |
| Total theatre                         | 273,845                      | 258,353       |
| Lighting                              | 13,800                       | 21,581        |
| Total                                 | \$ 287,645                   | \$ 279,934    |
| Loss on disposal of fixed assets      |                              |               |
| Theatre                               |                              |               |
| Products                              | \$ 11,004                    | \$            |
| Services                              |                              |               |
| Total theatre                         | 11,004                       |               |
| Lighting                              |                              |               |
| Total                                 | \$ 11,004                    | \$            |

**Summary by Business Segments (continued)**

|                            | <b>Three Months Ended March 31,</b> |             |
|----------------------------|-------------------------------------|-------------|
|                            | <b>2007</b>                         | <b>2006</b> |
| Gain on transfer of assets |                                     |             |
| Theatre                    |                                     |             |
| Products                   | \$ 233,327                          | \$          |
| Services                   |                                     |             |
| Total theatre              | 233,327                             |             |
| Lighting                   |                                     |             |
| Total                      | \$ 233,327                          | \$          |

|                           | <b>March 31</b> | <b>December 31</b> |
|---------------------------|-----------------|--------------------|
|                           | <b>2007</b>     | <b>2006</b>        |
| Identifiable assets       |                 |                    |
| Theatre                   |                 |                    |
| Products                  | \$ 49,217,512   | \$ 46,034,955      |
| Services                  | 3,015,644       |                    |
| Total theatre             | 52,233,156      | 46,034,955         |
| Lighting                  | 3,918,393       | 3,387,523          |
| Other                     | 461,161         | 485,022            |
| Total identifiable assets | \$ 56,612,710   | \$ 49,907,500      |

**Summary by Geographical Area**

|                          | <b>Three Months Ended March 31,</b> |                          |
|--------------------------|-------------------------------------|--------------------------|
|                          | <b>2007</b>                         | <b>2006</b>              |
| Net revenue              |                                     |                          |
| United States            | \$ 10,454,244                       | \$ 9,297,051             |
| Canada                   | 75,380                              | 70,622                   |
| Asia                     | 1,338,105                           | 1,641,048                |
| Mexico and South America | 638,313                             | 1,098,280                |
| Europe                   | 423,831                             | 310,077                  |
| Other                    | 877                                 | 16,260                   |
| Total                    | \$ 12,930,750                       | \$ 12,433,338            |
|                          |                                     |                          |
|                          | <b>March 31, 2007</b>               | <b>December 31, 2006</b> |
| Identifiable assets      |                                     |                          |
| United States            | \$ 54,951,085                       | \$ 47,975,865            |
| Asia                     | 1,661,625                           | 1,931,635                |
| Total                    | \$ 56,612,710                       | \$ 49,907,500            |

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

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

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

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

**Overview**

We are a manufacturer, distributor and service provider for the theatre exhibition industry on a worldwide basis. We also design, develop, manufacture and distribute lighting systems to the worldwide entertainment lighting industry through our Strong Entertainment lighting segment.

**Critical Accounting Policies and Estimates**

**General**

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

An accounting policy is deemed to be critical if it requires an accounting estimate to be made based on assumptions about matters that are uncertain at the time the estimate is made, and if different estimates that reasonably could have been used, or changes in the accounting estimates that are reasonably likely to occur periodically, could materially impact the consolidated financial statements.

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

**Revenue Recognition**

We normally recognize revenue upon shipment of goods or delivery of the service to customers when collectibility is reasonably assured. In certain circumstances revenue is not recognized until the goods are received by the customer or upon



installation and customer acceptance based on the terms of the sale agreement. During 2003, we adopted the provisions of EITF 00-21, *Revenue Arrangements with Multiple Deliverables* (EITF 00-21). EITF 00-21 addresses certain aspects of revenue recognition on contracts with multiple deliverable elements. We permit product returns from customers under certain circumstances and also allow returns under Ballantyne's warranty policy. Allowances for product returns are estimated and recorded at the time revenue is recognized. The return allowance is recorded as a reduction to revenues for the estimated sales value of the projected returns and as a reduction in cost of products for the corresponding cost amount.

#### **Allowance for Doubtful Accounts**

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

At March 31, 2007, there were approximately \$9.3 million in gross outstanding accounts receivable and \$0.5 million recorded in the allowance for doubtful accounts to cover potential future customer non-payments. At December 31, 2006, there were approximately \$8.0 million in gross outstanding accounts receivable and \$0.5 million recorded in the allowance for doubtful accounts. If economic conditions deteriorate significantly or if one of our large customers were to declare bankruptcy, a larger allowance for doubtful accounts might be necessary.

#### **Inventory Valuation**

Inventories are stated at the lower of cost (first-in, first-out) or market and include appropriate elements of material, labor and overhead. Our policy is to evaluate all inventory quantities for amounts on-hand that are potentially in excess of estimated usage requirements, and to write down any excess quantities to estimated net realizable value. Inherent in the estimates of net realizable values are management's estimates related to our future manufacturing schedules, customer demand and the development of digital technology, which could make our theatre products obsolete, among other items. Management has managed these risks in the past and believes that it can manage them in the future, however, operating margins may suffer if they are unable to effectively manage these risks. At March 31, 2007 we had recorded gross inventory of approximately \$12.7 million and \$1.8 million of inventory reserves. This compared to \$10.3 million and \$1.5 million, respectively, at December 31, 2006.

#### **Warranty**

Our products must meet certain product quality and performance criteria. In addition to known claims or warranty issues, we estimate future claims on recent sales. We rely on historical product claims data to estimate the cost of product warranties at the time revenue is recognized. In determining the accrual for the estimated cost of warranty claims, we consider experience with: 1) costs for replacement parts; 2) costs of scrapping defective products; 3) the number of product units subject to warranty claims and 4) other direct costs associated with warranty claims. If the cost to repair a product or the number of products subject to warranty claims is greater than originally estimated, our accrued cost for warranty claims would increase.

At March 31, 2007, the warranty accrual amounted to \$0.6 million and amounts charged to expense were \$0.04 million. At March 31, 2006, the warranty accrual amounted to \$0.7 million and amounts charged to expense amounted to \$0.06 million.

#### **Long-lived Assets**

We review long-lived assets, exclusive of goodwill, for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such

assets are considered to be impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the assets exceeds their fair value. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

Our most significant long-lived assets subject to these periodic assessments of recoverability are property, plant and equipment, which have a net book value of \$4.8 million at March 31, 2007. Because the recoverability of property, plant and equipment is based on estimates of future undiscounted cash flows, these estimates may vary due to a number of factors, some of which may be outside of management's control. To the extent that we are unable to achieve management's forecasts of future income, it may become necessary to record impairment losses for any excess of the net book value of property, plant and equipment over its fair value.

### **Goodwill**

Goodwill represents the excess of cost over the fair value of assets of businesses acquired through purchase business combinations in accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets*. Goodwill is not amortized but instead tested for impairment at least annually. An impairment loss is recognized to the extent that the carrying amount exceeds the asset's estimated fair value.

Goodwill totaling \$1.8 million was included in the consolidated balance sheets at March 31, 2007 and December 31, 2006, respectively. Management's assumptions about future cash flows for the reporting units require significant judgment and actual cash flows in the future may differ significantly from those forecasted today.

### **Deferred Income Taxes**

Income taxes are accounted for under the asset and liability method. We use an estimate of our annual effective rate at each interim period based on the facts and circumstances known at the time, while the actual effective rate is calculated at year-end. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

### **Self-insurance Reserves**

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

### **Stock-based Compensation**

Effective January 1, 2006, we adopted FASB Statement No. 123(R), *Share-Based Payment* (SFAS No. 123(R)). This statement replaced FASB Statement No. 123, *Accounting for Stock-Based Compensation* (Statement 123) and supersedes APB No. 25. Statement 123(R) requires that all stock-based compensation be recognized as an expense in the financial statements and that such cost be measured at the fair value of the award. This statement was adopted using the modified prospective method of application. Under this method, we recorded stock-based compensation expense for awards granted prior to, but not yet vested as of January 1, 2006, using the fair value amounts determined for pro forma disclosures under Statement 123. For stock-based awards granted after January 1, 2006, we recognized compensation expense based on estimated grant date fair value using the Black-Scholes option-pricing model.

Share-based compensation cost that has been included in income from operations amounted to \$29,338 and \$31,723 for the three months ended March 31, 2007 and 2006, respectively. No share-based compensation cost was capitalized as a part of inventory as of March 31, 2007, respectively.



**Recent Accounting Pronouncements**

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

In February 2007, the FASB issued SFAS No. 159 The Fair Value Option for Financial Assets and Financial Liabilities (SFAS No. 159). SFAS No. 159 permits entities to choose to measure many financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. We are currently assessing the impact of SFAS No. 159 on our consolidated financial position and results of operations.

**Three Months Ended March 31, 2007 Compared to the Three Months Ended March 31, 2006****Revenues**

Net revenues rose to \$12.9 million during the three months ended March 31, 2007 ( 2007 ) from \$12.4 million for the three months ended March 31, 2006 ( 2006 ). As discussed in further detail below, the increase resulted from higher theatre segment revenues.

|                        | <b>Three Months Ended<br/>March 31,</b> |               |
|------------------------|---|---------------|
|                        | <b>2007</b>                             | <b>2006</b>   |
| Theatre                |   |               |
| Products               | \$ 10,792,161                           | \$ 11,132,206 |
| Services               | 935,380                                 |               |
| Total theatre revenues | 11,727,541                              | 11,132,206    |
| Lighting               | 1,044,368                               | 1,120,424     |
| Other                  | 158,841                                 | 180,708       |
| Total net revenues     | \$ 12,930,750                           | \$ 12,433,338 |

***Theatre Segment***

Sales of theatre products and services increased 5.3% to \$11.7 million in 2007 from \$11.1 million in 2006 due primarily to revenues pertaining to the acquisition of National Cinema Service Corp in June of 2006. This business was rolled into a wholly-owned subsidiary named Strong Technical Services, Inc. (STS). Revenues generated from STS amounted to \$1.3 million during the quarter of which \$0.4 million were parts revenues and \$0.9 million were service revenues.

We also experienced our first significant sales of digital projectors and accessories during the quarter with sales amounting to \$0.7 million. There were no such sales a year-ago.

We experienced lower demand for film projection equipment during the quarter which decreased to \$6.1 million from \$7.3 million a year-ago. The decrease pertains to the theatre exhibition industry being in the initial stages of the conversion to digital cinema projectors. Theatre owners are evaluating their options as they plan capital expenditures relative to new or used film projectors or digital equipment.

Sales of xenon lamps rose 11.4% to \$1.6 million from \$1.4 million a year ago reflecting market share gains. The uncertainty regarding digital cinema has not impacted lamp sales as they are a necessary replacement item for projectors in service.

Sales of lenses declined 25.1% in 2007 to \$0.4 million from \$0.6 million a year ago. The decrease pertains to fewer sales of projectors and a general decrease in demand.

Revenues from theatre replacement parts amounted to \$2.0 million in 2007 (including the \$0.4 million generated by STS) compared to \$1.8 million in 2006.

Our top ten theatre customers accounted for approximately 53% of total theatre revenues in both 2007 and 2006 periods.

***Lighting Segment***

Sales of lighting products decreased 6.8% to \$1.0 million in 2007 from \$1.1 million a year ago.

Sales of lighting equipment and accessories decreased to \$0.8 million in 2007 compared to \$0.9 million a year-ago primarily resulting from the year-ago period including a special \$0.2 million sale of lights used by NASA. Sales of replacement parts were steady at \$0.2 million each period.

**Export Revenues**

Sales outside the United States (mainly theatre sales) amounted to \$2.5 million in 2007 from \$3.1 million in 2006 resulting primarily from a decrease in business in Mexico due to the timing of theatre construction and also where we are experiencing increased competition from companies selling used equipment in the country. Export sales are sensitive to worldwide economic and political



conditions that can lead to volatility. Additionally, certain areas of the world are more cost conscious than the U.S. market and there are instances where our products are priced higher than local manufacturers making it more difficult to generate sufficient profit to justify selling into these regions. Additionally, foreign exchange rates and excise taxes sometimes make it difficult to market our products overseas at reasonable selling prices.

### **Gross Profit**

Consolidated gross profit decreased to \$2.7 million in 2007 from \$3.3 million a year-ago and as a percent of revenue declined to 21.0% from 26.8% in 2006 due to the reasons discussed below.

The gross profit in the theatre segment fell to \$2.4 million in 2007 from \$2.9 million in 2006 and as a percentage of sales declined to 20.4% from 26.3% a year ago. The results largely reflect lower production demand which resulted in certain manufacturing inefficiencies and not covering fixed overhead costs as effectively as a year-ago. The margin also reflects \$0.7 million of digital equipment sales which we distribute through an agreement with NEC Solutions America, Inc. The gross margin on these sales are lower than the margin we currently experience on our film projectors. It is unclear at this time if this lower margin can be offset by the expected increased sales volume digital cinema is expected to add when the full-scale digital rollout occurs. The margin was also impacted by service revenues becoming a larger part of our business. The current service business primarily relates to servicing film projection equipment which is in a mature industry and as such, gross profit percentages typically range between 15-16%. Finally, we continue to amortize certain digital projectors out at customer locations for testing and demo purposes. During the first three months of 2007, we recorded approximately \$0.3 million of expense compared to \$0.1 million in the year-ago quarter.

The gross profit in the lighting segment amounted to approximately \$0.3 million in both 2007 and 2006 periods but as a percent of revenues fell to 24.3% from 28.4% a year ago. The results reflect manufacturing inefficiencies as the decline in theatre projection equipment sales had an effect throughout the manufacturing plant in Omaha.

### **Selling and Administrative Expenses**

Selling and administrative expenses increased to \$2.2 million in 2007 from \$2.1 million in 2006 and as a percent of revenue increased to 17.1% from 16.9% a year-ago.

Administrative costs amounted to \$1.4 million or 11.1% of revenues in 2007 compared to \$1.4 million or 11.0% in 2006. While administrative expenses were comparable to a year-ago, certain expenses were different. Administrative expenses incurred by STS were not in the year-ago period as we had not yet purchased them. We also incurred expenses pertaining to a computer system upgrade during the quarter. Offsetting these items were expenses which did not reoccur during 2007, including severance costs incurred as a result of planned workforce reductions as well as for legal expenses to settle an asbestos lawsuit during the year-ago quarter.

Selling expenses rose to \$0.8 million from \$0.7 million in 2006 and as a percent of revenues rose to 6.1% from 5.9% a year ago as the majority of our selling expenses do not necessarily rise and fall with revenue levels. We are also working on certain initiatives to strengthen our position in the digital cinema marketplace.

### **Gain on Transfer of Assets**

On March 6, 2007, the Company entered into an agreement with RealD to form an operating entity Digital Link II, LLC (the LLC). Under the agreement, the LLC was formed with the Company and RealD as the only two members with membership interests of 44.4% and 55.6%, respectively. The LLC was formed for purposes of commercializing certain 3D technology and to fund the deployment of digital projector systems and servers to exhibitors. On March 30, 2007, Ballantyne transferred \$5.7 million of equipment and provided installation services to the LLC in exchange for a 44.4% ownership interest in the LLC which amounted to \$2.4 million and cash consideration. At March 31, 2007, Ballantyne recorded a receivable of approximately \$0.7 million for the amount of cash consideration outstanding. The gain on the transfer of equipment was \$0.2 million. The Company's investment balance in the joint venture represents the retained interest in the cost basis of the projectors transferred to the joint venture. An additional gain will be recognized upon the sale of equipment by the joint venture to the third party exhibitors.

### **Other Financial Items**

Net other expense amounted to approximately \$48,000 in 2007 compared to net other income of approximately \$18,900 in 2006 as we received an insurance settlement during 2006 and gave fewer cash discounts to customers a year-ago.

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We recorded interest income (net of expense) of approximately \$0.2 million during both 2007 and 2006 periods, respectively.

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We recorded income tax expense of \$0.3 million in 2007 compared to \$0.5 million in 2006. The effective tax rate increased to 35.5% in 2007 compared to 34.8% a year ago due to higher state tax rates from filing in more state jurisdictions.

For the reasons outlined herein, we earned net income of \$0.6 million during 2007 and basic and diluted earnings per share of \$0.04, respectively, compared to net income of \$0.9 million and basic and diluted earnings per share of \$0.07 a year ago, respectively.

### Three Months Ended March 31, 2006 Compared to the Three Months Ended March 31, 2005

#### Revenues

Net revenues in 2006 decreased to \$12.4 million from \$12.5 million in 2005. As discussed in further detail below, the decrease resulted primarily from lower theatre revenues.

|                    | Three Months Ended March 31, |               |
|--------------------|------------------------------|---------------|
|                    | 2006                         | 2005          |
| Theatre            | \$ 11,132,206                | \$ 11,471,203 |
| Lighting           | 1,120,424                    | 829,364       |
| Other              | 180,708                      | 211,302       |
| Total net revenues | \$ 12,433,338                | \$ 12,511,869 |

#### Theatre Segment

Sales of theatre products decreased 3.0% from \$11.5 million in 2005 to \$11.1 million in 2006 due to lower demand for projection equipment which decreased to \$7.3 million in 2006 from \$8.1 million in 2005. The results reflect the theatre exhibition industry's transition to digital cinema. Theatre owners were evaluating their options as they plan capital expenditures relative to new or used film projectors or digital equipment. In large part, the decrease in theatre revenues pertain to this uncertainty as certain customers delayed or cancelled previous film projector orders with the Company.

Sales of xenon lamps rose 33.5% in 2006 to \$1.4 million from \$1.1 million a year ago primarily a result of the Company gaining market share and a general improvement of the theatre exhibition industry.

Sales of lenses rose 7.8% in 2006 to \$0.6 million from \$0.5 million a year ago.

Sales of theatre replacement parts amounted to \$1.8 million in 2006 compared to \$1.7 million in 2005.

Our top ten theatre customers accounted for approximately 53% of total theatre revenues compared to 52% in 2005.

#### Lighting Segment

Sales of lighting products rose 35.1% to \$1.1 million in 2006 from \$0.8 million a year ago. The increase primarily pertains to higher revenues from britelights, sky-trackers and replacement parts. Spotlight sales were flat at \$0.4 million for both 2006 and 2005 periods. The increase in britelight sales was due to a \$0.2 million sale of 10K lights to be used by NASA. Sky-tracker revenues rose to approximately \$0.2 million in 2006 from \$0.1 million in 2005 due to higher demand for these large lights. Replacement parts also rose to \$0.2 million from \$0.1 million a year-ago due primarily to improved industry conditions.

Sales of all other lighting products, including but not limited to, xenon lamps and nocturns fell to \$0.1 million from \$0.2 million a year-ago, as we experienced weaker demand for xenon lamps in the lighting segment.

### **Export Revenues**

Sales outside the United States (mainly theatre sales) declined to \$3.1 million in 2006 from \$3.9 million in 2005, due to lower demand in Mexico, South America, Asia and Canada. Export sales are sensitive to worldwide economic and political conditions that can lead to volatility. Additionally, certain areas of the world are more cost conscious than the U.S. market and there are instances where Ballantyne's products are priced higher than local manufacturers making it more difficult to generate sufficient profit to justify selling into these regions. Additionally, foreign exchange rates and excise taxes sometimes make it difficult to market the Company's products overseas at reasonable selling prices.

### **Gross Profit**

Consolidated gross profit decreased to \$3.3 million in 2006 from \$3.4 million in 2005 and as a percent of revenue declined to 26.8% from 27.1% in 2005.

Gross profit in the theatre segment fell to \$2.9 million in 2006 from \$3.1 million in 2005 and as a percentage of sales declined to 26.3% from 26.7% a year ago. The results reflect lower production demand in the manufacturing plant in Omaha which resulted in the Company not covering fixed overhead costs in a productive manner and certain manufacturing inefficiencies. We have reduced production personnel and are working towards bringing in other products to manufacture to offset expected lower demand for analog projectors in the future.

Gross profit in the lighting segment was approximately \$0.3 million in both 2006 and 2005 but as a percent of revenues fell to 28.4% from 30.7%. The results reflect a less favorable product mix consisting of higher revenues of lighting equipment as opposed to higher-margin replacement part sales. We also experienced manufacturing inefficiencies as the decline in theatre projection equipment sales had an effect throughout the manufacturing plant in Omaha.

### **Selling and Administrative Expenses**

Selling and administrative expenses amounted to \$2.1 million in 2006 compared to \$1.9 million in 2005 and as a percent of revenue rose to 16.9% in 2006 from 15.5% in 2005.

Administrative costs rose to \$1.4 million or 11.0% of revenue compared to \$1.2 million or 9.5% a year ago. The increase was primarily due to employee severance costs incurred as a result of planned workforce reductions as well as for legal expenses to settle the Company's remaining asbestos lawsuit. Compliance and compensation costs were also higher during 2006 but were offset to a degree by lower bonus expenses.

Selling expenses amounted to \$0.7 million in both 2006 and 2005 periods and as a percent of revenues remained at 5.9%.

### **Other Financial Items**

Net other income amounted to \$18,900 in 2006 compared to net other expense of \$29,500 in 2005 as we received an insurance settlement during 2006 and gave fewer cash discounts to customers in 2006.

During 2006, we recorded interest income of \$166,000 compared to \$72,000 in 2005 as we earned interest from higher cash levels. Interest expense declined to \$8,000 in 2006 from \$8,700 in 2005.

We recorded income tax expense of \$0.5 million in 2006 compared to \$0.6 million in 2005. The effective tax rate declined to 34.8% in 2006 compared to 37.0% a year-ago due primarily to investing in more tax-free municipal bonds during 2006.

For the reasons outlined herein, we earned net income of \$0.9 million and basic and diluted earnings per share of \$0.07 in both 2006 and 2005, respectively.

### **Liquidity and Capital Resources**

Our cash and cash equivalents totaled \$23.1 million at March 31, 2007 compared to \$22.6 million at December 31, 2006. During the past several years, we have met our working capital and capital resource needs from our operating cash flows.

We are a party to a revolving credit facility with First National Bank of Omaha expiring August 27, 2007. We plan on renewing the credit facility in the ordinary course of business. The credit facility provides for borrowings up to the lesser of \$4.0 million or amounts determined by an asset-based lending formula, as defined. Borrowings available under the credit facility amounted to \$4.0 million at March 31, 2007. No amounts are currently outstanding. We pay interest on outstanding amounts equal to the Prime Rate plus 0.25% (8.5% at March 31, 2007) and pay a fee of 0.125% on the unused portion. The credit facility contains certain restrictive covenants mainly related to maintaining certain earnings, as defined, and restrictions on acquisitions and dividends. All of our personal property and stock in our subsidiaries secure this credit facility.

Net cash provided by operating activities decreased to \$0.7 million in 2007 from \$2.2 million a year ago. Certain items reduced cash flow including increases in accounts receivable and inventory of \$1.4 million and \$4.4 million, respectively. The increase in accounts receivable pertained to the timing of sales and payments received. The increase in inventory was primarily due to the purchase of the projectors that were transferred to Digital Link II, LLC in exchange for a non-controlling ownership interest in Digital Link II, LLC and cash consideration. The subsequent transfer of inventory up to the amount of the investment in Digital Link II was considered a non-cash transfer of assets. Therefore, the decrease in inventory did not have an effect to cash flow. An increase in accounts payable of \$5.4 million also increased cash flow. However, given our accounts payable position relative to smaller increases in inventory and accounts receivable, we expect operating cash flow to decrease to a degree in the second quarter.

Net cash used in investing activities amounted to \$0.3 million in 2007 compared to \$0.1 million in 2006. During 2007, we purchased a small business during the quarter making an initial payment of \$0.2 million. Subject to the attainment of certain future sales of the business product line, as defined, we may be required to pay up to an additional \$150,000. We also incurred approximately \$0.1 million of capital expenditures during the 2007 and 2006 periods, respectively.

Net cash provided by financing activities amounted to approximately \$0.1 million compared to \$0.4 million in 2006. We received proceeds of \$0.03 million from our stock option plans during 2007 and recorded an \$0.08 million income tax benefit pertaining to these plans. During 2006, we received proceeds of \$0.2 million from our stock plans and recorded a \$0.2 million income tax benefit pertaining to these plans.

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

There were no significant transactions with related and certain other parties during 2007.

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

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

If we become an accelerated filer as defined in Rule 12b-2 of the Exchange Act, our compliance with Section 404 of the Sarbanes-Oxley Act will need a statement that our independent registered public accounting firm has issued an attestation report on management's assessment of our internal controls over financial reporting and a report on the effectiveness of our internal controls over financial reporting be included into Form 10-K for fiscal 2007 in addition to a report on management's assessment. We will not know whether we will become an accelerated filer until June 30, 2007, which is the next date at which this status is determined.

### **Concentrations**

Our top ten customers accounted for approximately 48% of 2007 consolidated net revenues and were primarily from the theatre segment. Trade accounts receivable from these customers represented approximately 37% of net consolidated receivables at March 31, 2007. Sales to AMC



Theatres, Inc. represented over 10% of consolidated sales. While we believe

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our relationships with such customers are stable, most arrangements are made by purchase order and are terminable at will by either party. A significant decrease or interruption in business from our significant customers could have a material adverse effect on our business, financial condition and results of operations. We could also be adversely affected by such factors as changes in foreign currency rates and weak economic and political conditions in each of the countries in which we sell our products. In addition, advancing technologies, such as digital cinema, could disrupt historical customer relationships.

Financial instruments that potentially expose us to a concentration of credit risk principally consist of accounts receivable. We sell product to a large number of customers in many different geographic regions. To minimize credit concentration risk, we perform ongoing credit evaluations of our customers' financial condition or use letters of credit.

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

### Hedging and Trading Activities

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

### Off Balance Sheet Arrangements and Contractual Obligations

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

| Contractual Obligations            | Total      | Payments Due by Period |        |        |        |        |            |
|------------------------------------|------------|------------------------|--------|--------|--------|--------|------------|
|                                    |            | Remaining in 2007      | 2008   | 2009   | 2010   | 2011   | Thereafter |
| Long-term debt, including interest | \$ 7,450   | 7,450                  |        |        |        |        |            |
| Non-competition agreement          | 125,000    | 25,000                 | 25,000 | 25,000 |        | 50,000 |            |
| Postretirement benefits            | 238,903    | 20,009                 | 24,101 | 25,745 | 20,725 | 21,934 | 126,389    |
| Operating leases                   | 85,136     | 44,976                 | 36,722 | 3,438  |        |        |            |
| Contractual cash obligations       | \$ 456,489 | 97,435                 | 85,823 | 54,183 | 20,725 | 71,934 | 126,389    |

We have a contractual obligation to pay up to \$150,000 to High End Systems, Inc. Payment is contingent on satisfaction of certain future sales of the product line purchased as part of the business. In addition, we have accrued approximately \$0.3 million for the estimated underpayment of income taxes we are obligated to pay. The accrual is primarily related to state tax matters. There were no other contractual obligations other than inventory and property, plant and equipment purchases in the ordinary course of business.

### Seasonality

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

### Environmental and Legal

See Note 19 to the consolidated financial statements for a full description of all environmental and legal matters.



## **Inflation**

We believe that the relatively moderate rates of inflation in recent years have not had a significant impact on our net revenues or profitability. Historically, we have been able to offset any inflationary effects by either increasing prices or improving cost efficiencies.

## **2007 Outlook**

We have begun to see evidence of the theatre exhibition industry's expected transition to digital cinema during 2007. Theatre owners are now evaluating their options as they plan capital expenditures relative to new or used film projectors or digital equipment. However, the extent and timing of the impact to Ballantyne's 2007 revenues and operations is currently unclear. Digital cinema remains an important component of our long-term growth strategy, and we continue to work closely with our partner, NEC Solutions (America), Inc., to launch this next generation technology within the exhibition industry.

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

We market our products throughout the United States and the world. As a result, we could be adversely affected by such factors as changes in foreign currency rates and weak economic conditions. As a majority of our sales are currently denominated in U.S. dollars, a strengthening of the dollar can and sometimes has made our products less competitive in foreign markets. As stated above, the majority of our foreign sales are denominated in U.S. dollars except for our subsidiary in Hong Kong. We purchase the majority of our lenses from a German manufacturer. Based on forecasted purchases during 2007, an average 10% devaluation of the dollar compared to the Euro would cost us approximately \$0.2 million.

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

We have not historically and are not currently using derivative instruments to manage the above risks.

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

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

**PART II. Other Information**

**Item 1. Legal Proceedings**

A review of the Company's current litigation is disclosed in note 19 to the consolidated financial statements.

**Item 1A. Risk Factors**

Item 1A, Risk Factors of the Company's 2006 Annual Report on Form 10-K includes a detailed discussion of the Company's risk factors. There have been no material changes to the risk factors as previously disclosed in Item 1A of the Form 10-K.

**Item 6. Exhibits**

See the Exhibit Index on page 31.

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

BALLANTYNE OF OMAHA, INC.

By: /s/ John Wilmers  
John Wilmers, President,  
Chief Executive Officer, and Director  
Date: May 11, 2007

By: /s/ Kevin Herrmann  
Kevin Herrmann, Secretary/Treasurer and  
Chief Financial Officer  
Date: May 11, 2007

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**EXHIBIT INDEX**

- 10.1 Short-Term Incentive Plan.\*•
- 31.1 Rule 13a-14(a) Certification of Chief Executive Officer.●
- 31.2 Rule 13a-14(a) Certification of Chief Financial Officer.●
- 32.1 18 U.S.C. Section 1350 Certification of Chief Executive Officer.●
- 32.2 18 U.S.C. Section 1350 Certification of Chief Financial Officer.●

- Filed herewith

\* Management contract or compensatory plan

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