MICROFINANCIAL INC
Form 10-K
March 28, 2007

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-K

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2006

or

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

Commission file no. 1-14771
MicroFinancial Incorporated
(Exact name of Registrant as Specified in its Charter)

Massachusetts	**04-2962824**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
10M Commerce Way, Woburn, MA	**01801**
(Address of Principal Executive Offices)	*(Zip Code)*

Registrant s telephone number, Including Area Code:
(781) 994-4800

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Shares, $0.01 par value per share	American Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:
None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes o No þ

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.
Large Accelerated Filer o Accelerated Filer o Non-Accelerated Filer þ

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

The aggregate market value of the registrant s voting and non-voting common equity held by non-affiliates of the registrant as of June 30, 2006, the last day of the registrant s most recently completed second fiscal quarter, was approximately $30,044,000, computed by reference to the closing price of such stock as of such date.

As of March 15, 2007, 13,891,596 shares of the registrant s common stock were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant s proxy statement to be filed pursuant to Regulation 14A within 120 days after the Registrant s fiscal year end of December 31, 2006, are incorporated by reference in Part III hereof.

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PART I

Item 1. *Business*

General

MicroFinancial Incorporated (referred to as MicroFinancial, we, us or our) was formed as a Massachusetts corporat on January 27, 1987. We operate primarily through our wholly-owned subsidiaries, TimePayment Corp. and Leasecomm Corporation. TimePayment is a specialized commercial finance company that leases and rents microticket equipment and provides other financing services. TimePayment commenced originating leases in July 2004. Leasecomm started originating leases in January 1986 and in October 2002 suspended virtually all originations due to a lack of financing. The average amount financed by TimePayment in 2006 was approximately $5,900 while Leasecomm historically financed contracts averaging approximately $1,900. We have used proprietary software in developing a sophisticated, risk-adjusted pricing model and in automating our credit approval and collection systems, including a fully-automated Internet-based application, credit scoring and approval process.

We provide financing alternatives to a wide range of lessees ranging from start-up businesses to established businesses. We primarily lease and rent low-priced commercial equipment, which is used by these lessees in their daily operations. We do not market our services directly to lessees. We source our leasing transactions through a nationwide network of equipment vendors, independent sales organizations and brokers (dealers).

TimePayment finances a wide variety of products with no single product representing more than 30% of its portfolio. However, the majority of our portfolio, based on the number of contracts, consists of contracts originated by Leasecomm for authorization systems for point-of-sale (POS), card-based payments by debit, credit, gift and charge cards. POS authorization systems require the use of a POS terminal capable of reading a cardholder s account information from the card s magnetic strip and combining this information with the amount of the sale entered via a POS terminal keypad, or POS software used on a personal computer to process a sale. The terminal electronically transmits this information over a communications network to a computer data center and then displays the returned authorization or verification response on the POS terminal.

Historically, we have depended heavily on external financing to fund new leases and contracts. In September 2002, our then-existing credit facility failed to renew. As a result, in October 2002, we were forced to suspend virtually all contract originations until a source of funding was obtained or the senior credit facility was paid in full. In June 2004, MicroFinancial secured a $10 million credit facility, comprised of a one-year $8 million line of credit and a $2 million three-year subordinated note which allowed us to resume originations. In conjunction with raising new capital, we also formed a wholly-owned operating subsidiary, TimePayment Corp. In September 2004, MicroFinancial secured a three-year, $30 million, senior secured revolving line of credit from CIT Commercial Services, a unit of CIT Group. This line of credit replaced the $8 million line of credit under more favorable terms and conditions. In addition, we retired the outstanding debt with the former bank group. In the near term, we expect to finance our business with cash on hand and our line of credit with CIT. We do not expect to renew the CIT line of credit in September 2007 and are currently exploring new financing options.

Leasing, Servicing and Financing Programs

We originate leases for products that typically have limited distribution channels and high selling costs. We facilitate sales of such products by allowing dealers to make them available to their customers for a small monthly lease payment rather than a higher initial purchase price. We primarily lease and rent low-priced commercial equipment to small merchants. The majority of our portfolio is currently for POS authorization systems; however, we currently lease a wide variety of other equipment including advertising and display equipment, security equipment, coffee machines, paging systems, water coolers and restaurant equipment. In addition, we have acquired service contracts and contracts in certain other financing markets. We opportunistically seek to enter other financing markets.

Our consumer financings include acquiring service contracts from dealers that primarily provide residential security monitoring services, as well as consumer leases for a wide range of consumer products.

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Since resuming originations in June 2004 we have originated and continue to service contracts in all 50 states and the District of Columbia. As of both December 31, 2005 and 2006, leases in California, Florida, Texas, Massachusetts and New York accounted for approximately 40% of our portfolio. Only California accounted for more than 10% of the total portfolio as of December 31, 2005 at approximately 14%. As of December 31, 2006, California, Florida, New York and Texas accounted for approximately 13%, 11%, 8%, and 7%, respectively, of the total portfolio. None of the remaining states other than those listed above accounted for more than 4% of such total.

Terms of Equipment Leases

Substantially all equipment leases originated or acquired by us are non-cancelable. We generally originate leases on transactions referred to us by a dealer where we buy the underlying equipment from the referring dealer upon funding the approved application. Leases are structured with limited recourse to the dealer, with risk of loss in the event of default by the lessee residing with us in most cases. We perform all the processing, billing and collection functions under our leases.

During the term of a typical lease, we receive payments sufficient, in the aggregate, to cover our borrowing cost, the cost of the underlying equipment, and to provide us with an appropriate profit. Throughout the term of the lease, we charge late fees, prepayment penalties, loss and damage waiver fees and other service fees, when applicable. Initial terms of our leases generally range from 12 to 60 months, with an average initial term of 45 months as of December 31, 2006.

The terms and conditions of all of our leases are substantially similar. In most cases, the contracts require lessees to: (i) maintain, service and operate the equipment in accordance with the manufacturer s and government-mandated procedures; (ii) insure the equipment against property and casualty loss; (iii) pay all taxes associated with the equipment; and (iv) make all scheduled contract payments regardless of the performance of the equipment. Our standard lease forms provide that in the event of a default by the lessee, we can require payment of liquidated damages and can seize and remove the equipment for sale, refinancing or other disposal at our discretion. Any additions, modifications or upgrades to the equipment, regardless of the source of payment, are automatically incorporated into, and deemed a part of, the equipment financed.

We seek to protect ourselves from credit exposure relating to dealers by entering into limited recourse agreements with our dealers, under which the dealer agrees to reimburse us for defaulted contracts under certain circumstances, primarily upon evidence of dealer errors or misrepresentations in originating a lease or contract.

Residual Interests in Underlying Equipment

We typically own a residual interest in the equipment covered by our leases. The value of such interest is estimated at inception of the lease based upon our estimate of the fair market value of the asset at lease maturity. At the end of the lease term, the lessee has the option to buy the equipment at a price quoted by us, return the equipment or continue to rent the equipment on a month-to-month basis. If the equipment is returned, we may either sell the equipment, or place it into our used equipment rental or leasing program.

Service Contracts

In a typical transaction for the acquisition of service contracts, a homeowner will purchase a security system and simultaneously sign a contract with the dealer for the monitoring of that system for a monthly fee. The dealer will then sell the right to payment under that contract to us for a multiple of the monthly payments. We contract with third party monitoring stations to perform the monitoring service and we perform all the processing, billing and collection functions under these contracts.

Dealers

We provide financing to obligors under microticket leases and contracts through a nationwide network of equipment vendors, independent sales organizations and brokers. Historically, we had over 1,000 different dealers originating leases and contracts on a regular basis. When we suspended nearly all of our contract originations in October 2002, the number of dealers we utilized for the limited number of contracts we were able to originate declined substantially. As we began to originate more contracts following the establishment of our line of credit with CIT in September 2004, we also began to expand the number of dealers in our network. During the year ended December 31, 2004 our top four dealers accounted for 65.09% of the leases originated at 21.84%, 16.83%, 15.71%, and 10.71%, respectively. During the year ended December 31, 2005 our top three dealers accounted for 47.29% of the leases originated at 26.61%, 10.64% and 10.04%, respectively. During the year ended December 31, 2006 our top dealer accounted for 13.91% of the leases originated.

We do not sign exclusive agreements with our dealers. Dealers interact directly with potential lessees and typically market not only their products and services, but also the financing arrangements offered through us.

Use of Technology

Our business is operationally intensive, due in part to the small average amount financed. Accordingly, technology and automated processes are critical in keeping servicing costs to a minimum while providing quality customer service.

We have developed TimePaymentDirect, an Internet-based application processing, credit approval and dealer information tool. Using TimePaymentDirect, a dealer can input an application and obtain almost instantaneous approval automatically over the Internet, all without any contact with our employees. We also offer InstaleaseR, a program that allows a dealer to submit applications to us by telephone, telecopy or e-mail, receive approval, and complete a sale from a lessee s location. By assisting the dealers in providing timely, convenient and competitive financing for their equipment or service contracts and offering dealers a variety of value-added services, we simultaneously promote equipment and service contract sales and the utilization of TimePayment as the preferred finance provider, thus differentiating us from our competitors.

We have used our proprietary software to develop a multidimensional credit-scoring model which generates pricing of our leases and contracts commensurate with the risk assumed. This software does not produce a binary yes or no decision, but rather, for a yes decision, determines the price at which the lease or contract might be profitably underwritten. We use credit scoring in most, but not all, of our credit decisions.

Underwriting

The nature of our business requires that the underwriting process perform two levels of review: the first focused on the ultimate end-user of the equipment or service and the second focused on the dealer. The approval process begins with the submission by telephone, facsimile or electronic transmission of a credit application by the dealer. Upon submission, we either manually or through TimePaymentDirect conduct our own independent credit investigation of the lessee using our proprietary database and recognized commercial credit reporting agencies such as Dun & Bradstreet, Paynet and Experian. Our software evaluates this information on a two-dimensional scale, examining both credit depth (how much information exists on an applicant) and credit quality (credit performance, including past payment history). We analyze both the quality and amount of credit history available with respect to both obligors and dealers to assess the credit risk. We use this information to underwrite a broad range of credit risks and provide financing in situations where our competitors may be unwilling to provide such financing. The credit-scoring model is complex and automatically adjusts for different transactions. In situations where the amount financed is over $7,500, we may go beyond our own data base and recognized commercial credit reporting agencies to obtain information from less readily available sources such as banks. In certain instances, we will require the lessee to provide verification of employment and salary.

The second aspect of the credit decision involves an assessment of the originating dealer. Dealers undergo both an initial screening process and ongoing evaluation, including an examination of dealer portfolio credit quality and performance, lessee complaints, cases of fraud or misrepresentation, aging studies, number of applications and conversion rates for applications. This ongoing assessment enables us to manage our dealer relationships, including ending relationships with poorly performing dealers.

Upon credit approval, we require receipt of a signed lease on our standard or other pre-approved lease form. After the equipment is shipped and installed, the dealer invoices us and we verify that the lessee has received and accepted the equipment. Upon the completion of a satisfactory verification with the lessee, the lease is forwarded to our funding and documentation department for payment to the dealer and the establishment of the accounting and billing procedures for the transaction.

Bulk and Portfolio Acquisitions

In addition to originating leases through our dealer relationships, we have also purchased lease portfolios from dealers. While certain of these leases may not have met our underwriting standards at inception, we will purchase the leases once the lessee demonstrates a satisfactory payment history. We prefer to acquire these smaller lease portfolios in situations where the seller will continue to act as a dealer following the acquisition.

Servicing and Collections

We perform all the servicing functions on our leases and contracts through our automated servicing and collection system. Servicing responsibilities generally include billing, processing payments, remitting payments to dealers, paying taxes and insurance and performing collection and liquidation functions.

Our automated lease administration system handles application tracking, invoicing, payment processing, automated collection queuing, portfolio evaluation and report writing. The system is linked with our bank accounts for payment processing and also provides for direct withdrawal of lease and contract payments from a lessee s bank account. We monitor delinquent accounts using our automated collection process. We use several computerized processes in our customer service and collection efforts, including the generation of daily priority call lists and scrolling for daily delinquent account servicing, generation and mailing of delinquency letters, and routing of incoming customer service calls to appropriate employees with instant computerized access to account details. Our collection efforts include sending collection letters, making collection calls, reporting delinquent accounts to credit reporting agencies, and litigating delinquent accounts when necessary to obtain and enforce judgments.

Competition

The microticket leasing and financing industry is highly competitive. We compete for customers with a number of national, regional and local banks and finance companies. Our competitors also include equipment manufacturers that lease or finance the sale of their own products. While the market for microticket financing has traditionally been fragmented, we could also be faced with competition from small- or large-ticket leasing companies that could use their expertise in those markets to enter and compete in the microticket financing market. Our competitors include larger, more established companies, some of which may possess substantially greater financial, marketing and operational resources than us, including a lower cost of funds and access to capital markets and other funding sources, which may be unavailable to us.

Employees

As of December 31, 2006, we had 67 full-time employees, of whom 20 were engaged in sales and underwriting activities and dealer service, 25 were engaged in servicing and collection activities, and 22 were engaged in general administrative activities. We believe that our relationship with our employees is good. None of our employees are members of a collective bargaining unit in connection with their employment with us.

Executive Officers

Name and Age of Executive Officers	Title

Richard F. Latour, 53	Director, President, Chief Executive Officer, Treasurer, Secretary and Clerk
James R. Jackson, Jr., 45	Vice President and Chief Financial Officer
Steven J. LaCreta, 47	Vice President, Lessee Relations and Legal
Stephen J. Constantino, 41	Vice President, Human Resources
Thomas Herlihy, 48	Vice President, Sales and Marketing, of TimePayment Corp.

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Backgrounds of Executive Officers

Richard F. Latour has served as our President, Chief Executive Officer, Treasurer, Clerk and Secretary since October 2002 and as President, Chief Operating Officer, Treasurer, Clerk and Secretary, as well as a director of the Corporation, since February 2002. From 1995 to January 2002, he served as Executive Vice President, Chief Operating Officer, Chief Financial Officer, Treasurer, Clerk and Secretary. From 1986 to 1995 Mr. Latour served as Vice President of Finance and Chief Financial Officer. Prior to joining us, Mr. Latour was Vice President of Finance for eleven years with Trak Incorporated, an international manufacturer and distributor of consumer goods, where he was responsible for all financial and operational functions. Mr. Latour earned a B.S. in accounting from Bentley College in Waltham, Massachusetts.

James R. Jackson Jr. has served as our Vice President and Chief Financial Officer since April 2002. Prior to joining us, from 1999 to 2001, Mr. Jackson was Vice President of Finance for Deutsche Financial Services Technology Leasing Group. From 1992 to 1999, Mr. Jackson held positions as Manager of Pricing and Structured Finance and Manager of Business Planning with AT&T Capital Corporation.

Steven J. LaCreta has served as our Vice President, Lessee Relations and Legal since May 2005. From May 2000 to May 2005, Mr. LaCreta served as Vice President, Lessee Relations. From November 1996 to May 2000, Mr. LaCreta served as our Director of Lessee Relations. Prior to joining us, Mr. LaCreta was a Leasing Collection Manager with Bayer Corporation.

Stephen J. Constantino has served as our Vice President, Human Resources since May 2000. From 1994 to May 2000, Mr. Constantino served as our Director of Human Resources. From 1992 to 1994, Mr. Constantino served as our Controller. From 1991 to 1992, Mr. Constantino served as our Accounting Manager.

Thomas Herlihy has served as Vice President, Sales and Marketing, of our operating subsidiary, TimePayment Corp. since May 2005. From 2004 to March 2005, Mr. Herlihy served as General Manager of US Express Leasing and from 2000 to 2003, Mr. Herlihy served as Executive Vice President of ABB Business Finance. From 1989 to 2000, Mr. Herlihy served as Senior Vice President of AT&T Capital and its successor companies.

Availability of Information

We maintain an Internet website at http://www.microfinancial.com. Our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to such reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as well as Section 16 reports on Form 3, 4, or 5, are available free of charge on this site as soon as is reasonably practicable after we file or furnish these reports with the Securities and Exchange Commission (SEC). Our Guidelines on Corporate Governance, our Code of Business Conduct and Ethics and the charters for the Audit Committee, Nominating and Corporate Governance Committee, Compensation and Benefits Committee, Credit Policy Committee and Strategic Planning Committee of our Board of Directors are also available on our Internet site. The Guidelines, Code of Ethics and charters are also available in print to any shareholder upon request. Requests for such documents should be directed to Richard F. Latour, Chief Executive Officer, at 10M Commerce Way, Woburn, Massachusetts 01801. Our Internet site and the information contained therein or connected thereto are not incorporated by reference into this Form 10-K. Our filings with the SEC are also available on the SEC s website at http://www.sec.gov.

Item 1A. ***Risk Factors***

Set forth below and elsewhere in this report and in other documents we file with the Securities and Exchange Commission are risks and uncertainties that could cause our actual results to differ materially from the results contemplated by the forward-looking statements contained in this report and other periodic statements we make.

We depend on external financing to fund leases and contracts, and adequate financing may not be available to us in amounts, together with our cash flow, sufficient to originate new leases.

Our lease and finance business is capital-intensive and requires access to substantial short-term and long-term credit to fund leases and contracts. We will continue to require significant additional capital to maintain and expand our funding of leases and contracts, as well as to fund any future acquisitions of leasing companies or portfolios.

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As of September 30, 2002, our $192 million credit facility failed to renew and consequently, we were forced to suspend substantially all origination activity in October 2002. In June 2004, we secured a one-year $8 million line of credit and a $2 million three-year subordinated note that enabled us to resume originations. On September 29, 2004, we secured a three-year, $30 million, senior secured revolving line of credit from CIT Commercial Services, a unit of CIT Group. The CIT line of credit replaced the one-year $8 million line of credit under more favorable terms and conditions. In addition, it retired the outstanding debt with our former lenders. We do not expect to renew the CIT line of credit in September 2007 and are currently exploring new financing options. We cannot guarantee that we will find new financing on acceptable terms.

Our uses of cash include the origination and acquisition of leases and contracts, payment of interest and principal on borrowings, payment of selling, general and administrative expenses, income taxes and capital expenditures. Any default or other interruption of our external funding could have a material negative effect on our ability to fund new leases and contracts, and could, as a consequence, have an adverse effect on our financial results.

The delay in originations caused by our former credit facility s failure to renew in 2002 has decreased the size of our portfolio and may continue to adversely affect our financial performance.

As a result of the failure of our old credit facility to renew, in October 2002, we were forced to suspend virtually all contract originations until we obtained a source of funding or the senior credit facility was paid in full. During 2003, we were able to fund a very limited number of new contracts using our free cash flow. For example, total revenues for the year ended December 31, 2004 were $60.4 million, a decrease of $31.2 million, or 34.1%, from the year ended December 31, 2003. The overall decrease in revenue was due to the decrease in the overall size of our portfolio of leases, rentals and service contracts as a direct result of our decision to cease originations. Our credit facilities entered into in June and September 2004 enabled us to resume contract originations. The absence of contract originations from October 2002 to June 2004 has had a continuing affect on our portfolio and financial performance. It will take some time to bring our portfolio to the point where it was when we suspended originations.

In addition, after we ceased funding originations in 2002, we were required to terminate a number of our sales, sales support and credit personnel. As we have made progress in originating contracts in light of our new credit facilities, we face challenges in rebuilding those competencies through new hires. This illustrates how disruptions to our financing and origination capabilities can have long-lasting effects on our financial condition that extend beyond the resumption of originations.

We are vulnerable to changes in the demand for the types of systems we lease or price reductions in such systems.

The majority of our portfolio is comprised of authorization systems for point-of-sale (POS), card-based payments by, for example, debit, credit, gift and charge cards. We currently lease a wide variety of other equipment including advertising and display equipment, coffee machines, security equipment, paging systems, water coolers and restaurant equipment. Reduced demand for financing of these types of equipment, in particular POS authorization systems, could adversely affect our lease origination volume, which in turn could have a material adverse effect on our business, financial condition and results of operations. Technological advances may lead to a decrease in the price of these types of systems or equipment and a consequent decline in the need for financing of such equipment. In addition, for POS authorization systems, business and technological changes could change the manner in which POS authorization is obtained. These changes could reduce the need for outside financing sources that would reduce our lease financing opportunities and origination volume in such products.

In the event that demand for financing POS authorization systems or other types of equipment that we lease declines, we will need to expand our efforts to provide lease financing for other products. There can be no assurance, however, that we will be able to do so successfully. Because many dealers specialize in particular products, we may not be able to capitalize on our current dealer relationships in the event we shift our business focus to originating leases of other products. Our failure to successfully enter into new relationships with dealers of other products or to extend existing relationships with such dealers in the event of reduced demand for financing of the systems and equipment we currently lease would have a material adverse effect on us.

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Even if we have adequate financing, our expansion strategy may be affected by our limited sources for originations and our inexperience with leasing new products.

Our revenue growth since the third quarter of 2002 has been severely affected by the failure of our former credit facility to renew and the lack of financing until June 2004. Even with our line of credit, our principal growth strategy of expansion into new products and markets may be adversely affected by (i) our inability to re-establish old sources or cultivate new sources of originations and (ii) our inexperience with products with different characteristics from those we currently offer, including the type of obligor and the amount financed.

New Sources. A majority of our leases and contracts were historically originated through a network of dealers that deal exclusively in POS authorization systems. We are currently unable to capitalize on these relationships to originate leases for products other than POS authorization systems. In addition, we lost contact with some of our old sources during the period we suspended originations. Some of these dealers have found other financing sources. We may face difficulties in re-establishing our relationships with such sources. Our failure to develop additional relationships with dealers of products, which we lease or seek to lease, would hinder our growth strategy.

New Products. Our existing portfolio primarily consists of leases to owner-operated or other small commercial enterprises with little business history and limited or challenged personal credit history. These leases are characterized by small average monthly payments for equipment with limited residual value at the end of the lease term. Our ability to successfully underwrite new products with different characteristics is highly dependent on our ability (i) to successfully analyze the credit risk associated with the users of such products so as to appropriately apply our risk-adjusted pricing and (ii) to utilize our proprietary software to efficiently service and collect on our portfolio. We can give no assurance that we will be able to successfully manage these credit risk issues, which could have a material adverse effect on us.

We experience a significant rate of default under our leases, and a higher than expected default rate would have an adverse affect on our cash flow and earnings.

The credit characteristics of our lessee base correspond to a high incidence of delinquencies, which in turn may lead to significant levels of defaults. The credit profile of our lessees heightens the importance of both pricing our leases and contracts for the risk assumed, as well as maintaining an adequate allowance for losses. Significant defaults by lessees in excess of those we anticipate in setting our prices and allowance levels may adversely affect our cash flow and earnings. Reduced cash flow and earnings could limit our ability to repay debt and obtain financing, which could have a material adverse effect on our business, financial condition and results of operations.

In addition to our usual practice of originating leases through our dealer relationships, from time to time we have purchased lease portfolios from dealers. While certain of these leases at inception would not have met our underwriting standards, we will purchase leases once the lessee demonstrates a payment history. We prefer to acquire these smaller lease portfolios in situations where the company selling the portfolio will continue to act as a dealer following the acquisition.

We may face adverse consequences of litigation, including consequences of using litigation as part of our collection policy.

Our use of litigation as a means of collection of unpaid receivables exposes us to counterclaims on our suits for collection, to class action lawsuits and to negative publicity surrounding our leasing and collection policies. We have been a defendant in attempted class action suits as well as counterclaims filed by individual obligors in attempts to dispute the enforceability of the lease or contract. This type of litigation may be time consuming and expensive to defend, even if not meritorious, may result in the diversion of management time and attention, and may subject us to significant liability for damages or result in invalidation of our proprietary rights. We believe our collection policies and use of litigation comply fully with all applicable laws. Because of our persistent enforcement of our leases and contracts through the use of litigation, we may have created ill will toward us on the part of certain lessees and other obligors who were defendants in such lawsuits. Our litigation strategy has also generated adverse publicity in certain circumstances. Adverse publicity could negatively impact public perception of our business and may materially impact the price of our common stock. In addition to legal proceedings that may arise out of our collection activities, we may face other litigation arising in the ordinary course of business. Any of these factors could adversely affect our business, financial condition and results of operations.

Increased interest rates may make our leases or contracts less profitable.

Since we generally fund our leases and contracts through our credit facilities or from working capital, our operating margins could be adversely affected by an increase in interest rates. The implicit yield on all of our leases and contracts is fixed due to the leases and contracts having scheduled payments that are fixed at the time of origination. When we originate or acquire leases or contracts, we base our pricing in part on the spread we expect to achieve between the implicit yield on each lease or contract and the effective interest cost we expect to pay when we finance such leases and contracts. Increases in interest rates during the term of each lease or contract could narrow or eliminate the spread, or result in a negative spread, to the extent such lease or contract was financed with variable-rate funding. We may undertake to hedge against the risk of interest rate increases, based on the size and interest rate profile of our portfolio. Such hedging activities, however, would limit our ability to participate in the benefits of lower interest rates with respect to the hedged portfolio. In addition, our hedging activities may not protect us from interest rate-related risks in all interest rate environments. Adverse developments resulting from changes in interest rates or hedging transactions could have a material adverse effect on our business, financial condition and results of operations.

An economic downturn may cause an increase in defaults under our leases and lower demand for the commercial equipment we lease.

An economic downturn could result in a decline in the demand for some of the types of equipment or services we finance, which could lead to additional defaults and a decline in originations. An economic downturn may slow the development and continued operation of small commercial businesses, which are the primary market for POS authorization systems and the other commercial equipment leased by us. Such a downturn could also adversely affect our ability to obtain capital to fund lease and contract originations or acquisitions, or to complete securitizations. In addition, such a downturn could result in an increase in delinquencies and defaults by our lessees and other obligors, which could have an adverse effect on our cash flow and earnings, as well as on our ability to securitize leases. These factors could have a material adverse effect on our business, financial condition and results of operations.

Additionally, as of both December 31, 2005 and 2006, leases in California, Florida, Texas, Massachusetts and New York accounted for approximately 40% of our portfolio. Economic conditions in these states may affect the level of collections from, as well as delinquencies and defaults by, these obligors.

We face intense competition, which could cause us to lower our lease rates, hurt our origination volume and strategic position and adversely affect our financial results.

The microticket leasing and financing industry is highly competitive. We compete for customers with a number of national, regional and local banks and finance companies. Our competitors also include equipment manufacturers that lease or finance the sale of their own products. While the market for microticket financing has traditionally been fragmented, we could also be faced with competition from small- or large-ticket leasing companies that could use their expertise in those markets to enter and compete in the microticket financing market. Our competitors include larger, more established companies, some of which may possess substantially greater financial, marketing and operational resources than us, including lower cost of funds and access to capital markets and other funding sources, which may be unavailable to us. If a competitor were to lower their lease rates, we could be forced to follow suit or be unable to regain origination volume, either of which would have a material adverse effect on our business, financial condition and results of operations. In addition, competitors may seek to replicate the automated processes used by us to monitor dealer performance, evaluate lessee credit information, appropriately apply risk-adjusted pricing, and efficiently service a nationwide portfolio. The development of computer software similar to that developed by us may jeopardize our strategic position and allow our competitors to operate more efficiently than we do.

Government regulation could restrict our business.

Our leasing business is not currently subject to extensive federal or state regulation. While we are not aware of any proposed legislation, the enactment of, or a change in the interpretation of, certain federal or state laws affecting our ability to price, originate or collect on receivables (such as the application of usury laws to our leases and contracts) could negatively affect the collection of income on our leases and contracts, as well as the collection of fee income. Any such legislation or change in interpretation, particularly in Massachusetts, whose laws govern the majority of our leases and contracts, could have a material adverse effect on our ability to originate leases and contracts at current levels of profitability, which in turn could have a material adverse effect on our business, financial condition or results of operations.

The Sarbanes-Oxley Act of 2002 requires companies such as us that are not accelerated filers to comply with more stringent internal control system and monitoring requirements beginning in 2007. Compliance with this new requirement may place an expensive burden and significant time constraint on us.

We may face risks in acquiring other portfolios and companies, including risks relating to how we finance any such acquisition or how we are able to assimilate any portfolios or operations we acquire.

A portion of our growth strategy depends on the consummation of acquisitions of leasing companies or portfolios. Our inability to identify suitable acquisition candidates or portfolios, or to complete acquisitions on favorable terms, could limit our ability to grow our business. Any major acquisition would require a significant portion of our resources. The timing, size and success, if at all, of our acquisition efforts and any associated capital commitments cannot be readily predicted. We may finance future acquisitions by using shares of our common stock, cash or a combination of the two. Any acquisition we make using common stock would result in dilution to existing stockholders. If the common stock does not maintain a sufficient market value, or if potential acquisition candidates are otherwise unwilling to accept common stock as part or all of the consideration for the sale of their businesses, we may be required to utilize more of our cash resources, if available, or to incur additional indebtedness in order to initiate and complete acquisitions. Additional debt, as well as the potential amortization expense related to goodwill and other intangible assets incurred as a result of any such acquisition, could have a material adverse effect on our business, financial condition or results of operations. In addition, certain of our credit facilities contain covenants that do not permit us to merge or consolidate into or with any other person or entity, issue any shares of our capital stock if, after giving effect to such issuance, certain shareholders cease to own or control specified percentages of our voting capital stock, create or acquire any subsidiaries other than certain permitted special purpose subsidiaries, or implement certain changes to our board of directors. These provisions could prevent us from making an acquisition using shares of our common stock as consideration.

We also may experience difficulties in the assimilation of the operations, services, products and personnel of acquired companies, an inability to sustain or improve the historical revenue levels of acquired companies, the diversion of management s attention from ongoing business operations, and the potential loss of key employees of such acquired companies. Any of the foregoing could have a material adverse effect on our business, financial condition or results of operations.

If we were to lose key personnel, our operating results may suffer or it may cause a default under our debt facilities.

Our success depends to a large extent upon the abilities and continued efforts of Richard Latour, President and Chief Executive Officer and James R. Jackson, Jr., Vice President and Chief Financial Officer, and our other senior management. We have entered into employment agreements with Mr. Latour and Mr. Jackson, as well as other members of our senior management. The loss of the services of one or more of the key members of our senior management before we are able to attract and retain qualified replacement personnel could have a material adverse effect on our financial condition and results of operations. In addition, under our credit facilities, an event of default would arise if Mr. Latour or Mr. Jackson were to leave their positions as our Chief Executive Officer or Chief Financial Officer, respectively, unless a suitable replacement were appointed within 60 days. Our failure to comply with these provisions could have a material adverse effect on our business, financial condition or results of operations.

Certain provisions of our articles and bylaws may have the effect of discouraging a change in control or acquisition of the company.

Our restated articles of organization and restated bylaws contain certain provisions that may have the effect of discouraging, delaying or preventing a change in control or unsolicited acquisition proposals that a stockholder might consider favorable, including (i) provisions authorizing the issuance of blank check preferred stock, (ii) providing for a Board of Directors with staggered terms, (iii) requiring super-majority or class voting to effect certain amendments to the articles and bylaws and to approve certain business combinations, (iv) limiting the persons who may call special stockholders meetings and (v) establishing advance notice requirements for nominations for election to the Board of Directors or for proposing matters that can be acted upon at stockholders meetings. In addition, certain provisions of Massachusetts law to which we are subject may have the effect of discouraging, delaying or preventing a change in control or an unsolicited acquisition proposal.

Our stock price may be volatile, which could limit our access to the equity markets and could cause you to incur losses on your investment.

If our revenues do not grow or grow more slowly than we anticipate, or if operating expenditures exceed our expectations or cannot be adjusted accordingly, the market price of our common stock could be materially and adversely affected. In addition, the market price of our common stock has been in the past and could in the future be materially and adversely affected for reasons unrelated to our specific business or results of operations. General market price declines or volatility in the future could adversely affect the price of our common stock. In addition, short-term trading strategies of certain investors can also have a significant effect on the price of specific securities. In addition, the trading price of the common stock may be influenced by a number of factors, including the liquidity of the market for the common stock, investor perceptions of us and the equipment financing industry in general, variations in our quarterly operating results, interest rate fluctuations and general economic and other conditions. Moreover, the stock market has experienced significant price and value fluctuations, which have not necessarily been related to corporate operating performance. The volatility of the stock market could adversely affect the market price of our common stock and our ability to raise funds in the public markets.

There is no assurance that we will continue to pay dividends on our common stock in the future.

During the fourth quarter of 2002, our Board of Directors suspended the payment of dividends on our common stock to comply with our banking agreements and we paid no dividends in the years ended December 31, 2003 and 2004. During 2005, we declared dividends of $0.05 per share payable to shareholders of record on each of February 9, 2005, April 29, 2005, July 27, 2005, October 27, 2005 and December 28, 2005, and a special dividend of $0.25 per share payable to shareholders of record on January 31, 2006. During 2006, we declared dividends of $0.05 per share payable to shareholders of record on each of March 31, 2006, June 30, 2006, September 29, 2006 and December 29, 2006. Future dividend payments are subject to ongoing review and evaluation by our Board of Directors. The decision as to the amount and timing of future dividends we may pay, if any, will be made in light of our financial condition, capital requirements and growth plans, as well as our external financing arrangements and any other factors our Board of Directors may deem relevant. We can give no assurance as to the amount and timing of the payment of future dividends.

Item 2. *Properties*

At December 31, 2006, our corporate headquarters and operations center occupied approximately 24,400 square feet of office space at 10M Commerce Way, Woburn, Massachusetts 01801. The lease for this space expires on December 31, 2010.

Item 3. ***Legal Proceedings***

We are subject to claims and suits arising in the ordinary course of business. At this time, it is not possible to estimate the ultimate loss or gain, if any, related to these lawsuits, nor if any such loss will have a material adverse effect on our results of operations or financial position.

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In October 2003, we were served with a purported class action complaint filed in United States District Court for the District of Massachusetts alleging violations of the federal securities laws. The purported class would have consisted of all persons who purchased our securities between February 5, 1999 and October 30, 2002. The Complaint asserted that during this period we made a series of materially false or misleading statements about our business, prospects and operations, including with respect to certain lease provisions, our course of dealings with our vendor/dealers, and our reserves for credit losses. In April 2004, an Amended Class Action Complaint was filed which added additional defendants and expanded upon the prior allegations with respect to us. We filed a Motion to Dismiss the Amended Complaint. On June 13, 2006, the Court granted our Motion to Dismiss the Amended Complaint with Prejudice. On July 12, 2006, the plaintiffs filed an appeal. On December 6, 2006, the parties filed an Agreement of Dismissal whereby the plaintiffs voluntarily agreed to dismiss their appeal with prejudice and without payment by us.

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

No matters were submitted to a vote of our security holders during the fourth quarter of our fiscal year ended December 31, 2006.

PART II

Item 5. ***Market for Registrant s Common Equity and Related Stockholder Matters***

Market Information

Our common stock, par value $0.01 per share is currently listed on the American Stock Exchange under the symbol MFI. Our common stock was previously listed on the New York Stock Exchange under the symbol MFI through the close of business on January 16, 2006. The following chart shows the high and low sales price of our common stock in each quarter over the past two fiscal years.

	2005				2006			
	First Quarter	**Second Quarter**	**Third Quarter**	**Fourth Quarter**	**First Quarter**	**Second Quarter**	**Third Quarter**	**Fourth Quarter**
Stock Price								
High	$ 5.00	$ 4.77	$ 4.74	$ 4.20	$ 3.95	$ 3.89	$ 3.49	$ 3.89
Low	$ 3.61	$ 2.76	$ 3.54	$ 3.10	$ 3.26	$ 3.20	$ 3.01	$ 3.12

Holders

At March 15, 2007, there were approximately 39 stockholders of record of our common stock. However, many holders shares are listed under their brokerage firms names. We estimate the number of beneficial shareholders to be approximately 1,000.

Dividends

During the fourth quarter of 2002, our Board of Directors suspended the payment of dividends to comply with our banking agreements and we paid no dividends during the years ended December 31, 2003 and 2004.

During 2005, we declared dividends of $0.05 per share payable to shareholders of record on each of February 9, 2005, April 29, 2005, July 27, 2005, October 27, 2005 and December 28, 2005, and a special dividend of $0.25 per share payable to shareholders of record on January 31, 2006.

During 2006, we declared dividends of $0.05 per share payable to shareholders of record on each of March 31, 2006, June 30, 2006, September 29, 2006 and December 29, 2006.

Future dividend payments are subject to ongoing review and evaluation by our Board of Directors. The decision as to the amount and timing of future dividends, if any, will be made in light of our financial condition, capital requirements and growth plans, as well as our external financing arrangements and any other factors our Board of Directors may deem relevant. We can give no assurance as to the amount and timing of future dividends.

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Performance Graph

The following graph compares our cumulative total stockholder return since December 31, 2001 with the NYSE Composite Stock Index, the American Stock Exchange Composite Stock Index and the S&P 400 Mid-Cap Financials Index. Both the NYSE and American Stock Exchange Composite Stock Indices are presented here because we moved our listing from the New York Stock Exchange to the American Stock Exchange in January 2006. Cumulative total stockholder return shown in the performance graph is measured assuming an initial investment of $100 on December 31, 2001 and the reinvestment of dividends. The historic stock price performance information shown in this graph may not be indicative of current stock price levels or future stock price performance.

Comparison of 5 Year Cumulative Total Return
Assumes Initial Investment of $100
December 2006

The information under the caption Performance Graph above is not deemed to be filed as part of this Annual Report, and is not subject to the liability provisions of Section 18 of the Securities Exchange Act of 1934. Such information will not be deemed to be incorporated by reference into any filing we make under the Securities Act of 1933 unless we explicitly incorporate it into such a filing at the time.

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Item 6. *Selected Financial Data*

The following tables set forth selected consolidated financial and operating data for the periods and at the dates indicated. The selected consolidated financial data were derived from our financial statements and accounting records. The data presented below should be read in conjunction with the consolidated financial statements, related notes and other financial information included herein.

	Year Ended December 31,				
	2002	2003	2004	2005	2006
	(Dollars in thousands, except share and per share data)				
Income Statement Data:					
Revenues:					
Income on financing leases	$ 53,012	$ 30,904	$ 11,970	$ 4,140	$ 3,917
Rental income	37,154	34,302	31,009	25,359	20,897
Income on service contracts	9,734	8,593	5,897	3,467	1,870
Other income(1)	26,922	17,775	11,491	6,318	5,758
Total revenues	126,822	91,574	60,367	39,284	32,442
Expenses:					
Selling, general and administrative	45,535	33,856	26,821	20,884	14,499
Provision for credit losses	88,948(2)	59,758	47,918	10,468	6,985
Depreciation and amortization	18,385	16,592	14,010	9,497	5,326
Interest	10,787	7,515	2,283	1,148	162
Total expenses	163,655	117,721	91,032	41,997	26,972
Income (loss) before provision (benefit) for income taxes	(36,833)	(26,147)	(30,665)	(2,713)	5,470
Provision (benefit) for income taxes	(14,735)	(10,460)	(20,449)(3)	(1,053)	1,555
Net income (loss)	$ (22,098)	$ (15,687)	$ (10,216)	$ (1,660)	$ 3,915
Net income (loss) per common share:					
Basic	$ (1.72)	$ (1.20)	$ (0.77)	$ (0.12)	$ 0.28
Diluted	(1.72)	(1.20)	(0.77)	(0.12)	0.28
Weighted-average shares:					
Basic	12,821,946	13,043,744	13,182,833	13,567,640	13,791,403

Diluted		12,821,946		13,043,744		13,182,833		13,567,640	13,958,759
Dividends declared per common share	$	0.15	$		$		$	0.50	$ 0.20

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	December 31, 2002	2003	2004	2005	2006
	(Dollars in thousands)				
Balance Sheet Data:					
Cash and cash equivalents	$ 5,494	$ 6,533	$ 9,709	$ 32,926	$ 28,737
Restricted cash	18,516	2,376			
Gross investment in leases(4)	367,173	194,898	69,181	33,004	44,314
Unearned income	(67,574)	(23,729)	(6,313)	(3,658)	(13,682)
Allowance for credit losses	(69,294)	(43,011)	(14,963)	(8,714)	(5,223)
Investment in service contracts, net	14,463	8,844	4,777	1,626	613
Investment in rental contracts, net	5,633	3,758	1,785	3,025	313
Total assets	295,085	156,414	71,270	65,188	59,721
Notes payable	168,927	58,843	34	161	5
Subordinated notes payable	3,262	3,262	4,589	2,602	
Total liabilities	208,482	85,148	9,177	10,501	3,585
Total stockholders equity	86,603	71,266	62,093	54,687	56,136

	December 31, 2002	2003	2004	2005	2006
	(Dollars in thousands, except statistical data)				
Other Data:					
Operating Data:					
Value of leases originated(5)	$ 111,829	$ 3,429	$ 920	$ 7,296	$ 33,343
Value of service contracts acquired(6)	6,773				
Value of rental contracts originated	677	157	77	1,731	
Dealer funding(7)	74,000	1,600	668	6,364	21,498
Average yield on leases(8)	36.9%	32.5%	30.1%	30.6%	30.0%
Cash Flows From (Used In):					
Operating activities	$ 120,628	$ 98,052	$ 58,694	$ 35,228	$ 26,870
Investing activities	(80,141)	(2,839)	(813)	(6,978)	(22,114)
Financing activities	(35,139)	(94,174)	(54,705)	(5,033)	(8,945)
Net change in cash and cash equivalents	$ 5,348	$ 1,039	$ 3,176	$ 23,217	$ (4,189)
Selected Ratios:					
Return on average assets	(6.73)%	(6.95)%	(8.98)%	(2.43)%	6.27%
Return on average stockholders equity	(22.42)	(19.87)	(15.32)	(2.84)	7.07
Operating margin(9)	41.09	36.70	28.58	19.74	38.39
Credit Quality Statistics:					
Net charge-offs	$ 65,081	$ 86,041	$ 75,967	$ 16,717	$ 10,476
Net charge-offs as a percentage of average gross investment(10)	15.60%	29.40%	54.71%	30.79%	26.34%

Provision for credit losses as a percentage of average gross investment(10)	21.32	20.42	34.51	19.28	17.56
Allowance for credit losses as a percentage of gross investment(11)	18.16	21.11	20.23	25.16	11.63

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(1) Includes loss and damage waiver fees, service fees, interest income, and miscellaneous revenue.

(2) Includes a provision of $35 million to reserve against certain dealer receivables as well as delinquent portfolio assets. In the past, some dealer receivables had been offset against the funding of new contracts. When we suspended the funding of new contracts, we felt that the collection of these receivables would be more difficult. Although we continued to pursue collections on these accounts, we believed that the cost associated with legal enforcement would outweigh the benefits realized.

(3) Includes an income tax benefit of $7.9 million that resulted from a reduction in our estimate of certain tax liabilities.

(4) Consists of receivables due in installments and estimated residual value.

(5) Represents the amount paid to dealers upon funding of leases plus the associated unearned income.

(6) Represents the amount paid to dealers upon the acquisition of service contracts.

(7) Represents the amount paid to dealers upon funding of leases and contracts.

(8) Represents the aggregate of the implied interest rate on each lease originated during the period weighted by the amount funded.

(9) Represents income before provision (benefit) for income taxes and provision for credit losses as a percentage of total revenues.

(10) Represents a percentage of average gross investment in leases and net investment in service contracts.

(11) Represents allowance for credit losses as a percentage of gross investment in leases and net investment in service contracts.

Item 7. *Management s Discussion and Analysis of Financial Condition and Results of Operations, Including Selected Quarterly Financial Data (Unaudited)*

The following discussion includes forward-looking statements (as such term is defined in the Private Securities Litigation Reform Act of 1995). When used in this discussion, the words may, will, expect, intend, anticipate, estimate, continue, plan and similar expressions are intended to identify forward-looking statements. Such forward-looking statements involve known and unknown risks, uncertainties and other important factors that could cause our actual results, performance or achievements to differ materially from any future results, performance or achievements expressed or implied by such forward-looking statements. The forward-looking statements are subject to risks, uncertainties and assumptions, including, among other things, those associated with:

our dependence on point of sale authorization systems, expansion into new markets and the development of a sizeable dealer base;

our significant capital requirements;

our ability or inability to obtain the financing we need, or to use internally generated funds, in order to continue originating contracts;

the risks of defaults on our leases;

possible adverse consequences associated with our collection policy;

the effect of higher interest rates on our portfolio;

increasing competition;

increased governmental regulation of the rates and methods we use in financing and collecting on our leases and contracts;

acquiring other portfolios or companies;

dependence on key personnel;

adverse results in litigation and regulatory matters, or promulgation of new or enhanced legislation or regulations; and

general economic and business conditions.

The risk factors above and those under Risk Factors beginning on page 6, as well as any other cautionary language included herein, provide examples of risks, uncertainties and events that may cause our actual results to differ materially from the expectations we described in our forward-looking statements. Many of these factors are significantly beyond our control. We expressly disclaim any obligation or undertaking to disseminate any updates or revisions to any forward-looking statement contained herein to reflect any change in our expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based. In light of these risks and uncertainties, there can be no assurance that the forward-looking information contained herein will in fact transpire.

Overview

We are a specialized commercial finance company that provides microticket equipment leasing and other financing services. The average amount financed by TimePayment during 2006 was approximately $5,900 while Leasecomm historically financed contracts averaging approximately $1,900. Our portfolio consists of point-of-sale (POS) authorization systems and other small business equipment leased or rented to small commercial enterprises.

We derive the majority of our revenues from leases originated and held by us, payments on service contracts, rental contracts and fee income. Historically, we funded the majority of our leases and contracts through our revolving-credit loans, term loans and on-balance sheet securitizations, and to a lesser extent our subordinated debt program and internally generated funds. Between October 2002 and June 2004, an interruption in our financing sources had a significant impact on our ability to originate contracts. As of September 30, 2002, our then-existing credit facility failed to renew and we began paying down the debt. In April 2003, we entered into a long-term agreement with our lenders which waived certain covenant defaults and required us to repay the credit facility over a 22-month term at an interest rate of prime plus 2.0%. We also received a waiver for the covenant violations in the securitization agreement and amended the securitization agreement to conform its covenants to the covenants in the senior credit facility. In October 2002, we were forced to suspend virtually all contract originations until a new source of financing could be obtained or until such time as the credit facility had been paid in full.

In June 2004, we secured a one-year $8 million line of credit and a $2 million three-year subordinated note that allowed us to resume microticket contract originations. In conjunction with raising new capital, we also formed a new wholly-owned operating subsidiary, TimePayment Corp. On September 29, 2004, we secured a three-year, $30 million, senior secured revolving line of credit from CIT Commercial Services, a unit of CIT Group. The CIT line of credit replaced the $8 million line of credit obtained in June 2004 under more favorable terms and conditions. In addition, we used the proceeds from the CIT line of credit to retire the existing debt with the former bank group. During the year ended December 31, 2005, we began to actively increase our industry presence with a more focused and targeted sales and marketing effort. We continue to invest capital to build an infrastructure to support our sales and marketing initiatives, and have brought in experienced sales and marketing management to spearhead the effort. We are currently exploring financing options to replace the CIT line of credit, which expires in September 2007.

In a typical lease transaction, we originate a lease through our nationwide network of equipment vendors, independent sales organizations and brokers. Upon our approval of a lease application and verification that the lessee has received the equipment and signed the lease, we pay the dealer for the cost of the equipment, plus the dealer s profit margin. In a typical transaction for the acquisition of service contracts, a homeowner purchases a security system and simultaneously signs a contract with the dealer for the monitoring of that system for a monthly fee. Upon approval of the monitoring application and verification with the homeowner that the system is installed, we purchase the right to the payment stream under that monitoring contract at a negotiated multiple of the monthly payments from the dealer.

Substantially all leases originated or acquired by us are non-cancelable. During the term of the lease, we are scheduled to receive payments sufficient to cover our borrowing costs, the cost of the underlying equipment and provide us with an appropriate profit. We enhance the profitability of our leases and contracts by charging late fees, prepayment penalties, loss and damage waiver fees and other service fees, when applicable. Collection fees are imposed based on our estimate of the costs of collection. We only impose late fees on the first four months of late payments and are prohibited from imposing compound late fees or from assessing late fees as a percentage of the total outstanding late payments including outstanding late fees. The loss and damage waiver fees are charged if a customer fails to provide proof of insurance and are reasonably related to the cost of replacing the lost or damaged equipment or product. The initial non-cancelable term of the lease is equal to or less than the equipment s estimated economic life and often provides us with additional revenues based on the residual value of the equipment at the end of the lease. Initial terms of the leases in our portfolio generally range from 12 to 60 months, with an average initial term of 45 months as of December 31, 2006.

Critical Accounting Policies

We consider certain of our accounting policies to be the most critical to our financial condition and results of operations in the sense that they involve the most complex or subjective decisions or assessments. We have identified our most critical accounting policies as those policies related to revenue recognition, the allowance for credit losses, income taxes and accounting for share-based compensation. These accounting policies are discussed below as well as within the notes to our consolidated financial statements.

Revenue Recognition

Our lease contracts are accounted for as financing leases. At origination, we record the gross lease receivable, the estimated residual value of the leased equipment, initial direct costs incurred and the unearned lease income. Unearned lease income is the amount by which the gross lease receivable plus the estimated residual value exceeds the cost of the equipment. Unearned lease income and initial direct costs incurred are amortized over the related lease term using the interest method. Amortization of unearned lease income and initial direct costs is suspended if, in our opinion, full payment of the contractual amount due under the lease agreement is doubtful. In conjunction with the origination of leases, we may retain a residual interest in the underlying equipment upon termination of the lease. The value of such interest is estimated at inception of the lease and evaluated periodically for impairment. At the end of the lease term, the lessee has the option to buy the equipment at a price quoted by us, return the equipment or continue to rent the equipment on a month-to-month basis. If the lessee continues to rent the equipment, we record our investment in the rental contract at its estimated residual value. Rental revenue and depreciation are recognized based on the methodology described below. Other revenues such as loss and damage waiver fees and service fees relating to the leases and contracts are recognized as they are earned.

Our investments in cancelable service contracts are recorded at cost and amortized over the expected life of the contract. Income on service contracts from monthly billings is recognized as the related services are provided. Our investment in rental contracts is either recorded at estimated residual value and depreciated using the straight-line method over a period of 12 months or at the acquisition cost and depreciated using the straight line method over a period of 36 months. Rental income from monthly billings is recognized as the customer continues to rent the equipment. We periodically evaluate whether events or circumstances have occurred that may affect the estimated useful life or recoverability of our investments in service and rental contracts.

Allowance for Credit Losses

We maintain an allowance for credit losses on our investment in leases, service contracts and rental contracts at an amount that we believe is sufficient to provide adequate protection against losses in our portfolio. Given the nature of the microticket market and the individual size of each transaction, we do not have a formal credit review committee to review individual transactions. Rather, we developed a sophisticated, risk-adjusted pricing model and have automated the credit scoring, approval and collection processes. We believe that with the proper risk-adjusted pricing model, we can grant credit to a wide range of applicants provided we have priced appropriately for the associated risk. As a result of approving a wide range of credits, we experience a relatively high level of delinquency and write-offs in our portfolio. We periodically review the credit scoring and approval process to ensure that the automated system is making appropriate credit decisions. Given the nature of the microticket market and the individual size of each transaction, we do not evaluate transactions individually for the purpose of developing and

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determining the adequacy of the allowance for credit losses. Contracts in our portfolio are not re-graded subsequent to the initial extension of credit and the allowance is not allocated to specific contracts. Rather, we view the contracts as having common characteristics and maintain a general allowance against our entire portfolio utilizing historical collection statistics as the basis for the amount.

We have adopted a consistent, systematic procedure for establishing and maintaining an appropriate allowance for credit losses for our microticket transactions. We review, on a static pool basis, the collection experience on various months originations and the recoveries made on accounts written off. The results of these static pool analyses reflect our actual historical collection experience. We then consider current delinquency statistics, credit scores of the lessees, current economic conditions, and other relevant factors which might affect the performance of our portfolio. The combination of historical experience, credit scores, delinquency levels, and the review of current factors provide the basis for our analysis of the adequacy of the allowance for credit losses. We take charge-offs against our receivables when such receivables are 360 days past due and no contact has been made with the lessee for 12 months. Historically, the typical monthly payment under our microticket leases has been small and as a result, our experience is that lessees will pay past due amounts later in the process because of the small amount necessary to bring an account current.

Income Taxes

Significant judgment is required in determining the provision for income taxes, deferred tax assets and liabilities, and the valuation allowance recorded against net deferred tax assets. The process involves summarizing temporary differences resulting from the different treatment of items, such as leases, for tax and accounting purposes. In addition, our income tax calculations involve the application of complex tax regulations in a multitude of jurisdictions. Differences between the basis of assets and liabilities result in deferred tax assets and liabilities, which are recorded on the balance sheet. We must then assess the likelihood that deferred tax assets will be recovered from future taxable income or tax carry-back availability and to the extent management believes recovery is more likely than not, a valuation allowance is unnecessary.

Share-Based Compensation

As of January 1, 2005, we adopted SFAS 123(R), which requires the measurement of compensation cost for all outstanding unvested share-based awards at fair value and recognition of compensation over the service period for awards expected to vest. The estimation of stock awards that will ultimately vest requires judgment, and to the extent actual results differ from our estimates, such amounts will be recorded as a cumulative adjustment in the period estimates are revised. We estimate the fair value of stock options using a Black-Scholes valuation model, consistent with the provisions of SFAS 123(R), SEC Staff Accounting Bulletin No. 107 and our prior period pro forma disclosures of net earnings, including stock-based compensation (determined under a fair value method as prescribed by SFAS 123). Key input assumptions used to estimate the fair value of stock options include the expected option term, volatility of our stock, the risk-free interest rate and our dividend yield. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by employees who receive equity awards, and subsequent events are not indicative of the reasonableness of the original estimates of fair value made by us under SFAS 123(R).

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Results of Operations

Revenues

	2004	Change	2005	Change	2006
			(In thousands)		
Income on financing leases	$ 11,970	(65.4)%	$ 4,140	(5.4)%	$ 3,917
Rental income	31,009	(18.2)	25,359	(17.6)	20,897
Income on service contracts	5,897	(41.2)	3,467	(46.1)	1,870
Loss and damage waiver fees	4,016	(28.7)	2,863	(33.8)	1,895
Service fees and other	7,444	(60.3)	2,953	(17.1)	2,448
Interest income	31	1,519.4	502	181.9	1,415
Total revenues	$ 60,367	(34.9)%	$ 39,284	(17.4)%	$ 32,442

Our lease contracts are accounted for as financing leases. At origination, we record the gross lease receivable, the estimated residual value of the leased equipment, initial direct costs incurred and the unearned lease income. Unearned lease income is the amount by which the gross lease receivable plus the estimated residual value exceeds the cost of the equipment. Unearned lease income and initial direct costs incurred are amortized over the related lease term using the interest method. Other revenues such as loss and damage waiver fees, service fees relating to the leases and contracts, and rental revenues are recognized as they are earned.

Total revenues for the year ended December 31, 2006 were $32.4 million, a decrease of $6.8 million, or 17.4%, from the year ended December 31, 2005. The decline in revenue included decreases of $4.5 million or 17.6% in rental income, $1.6 million or 46.1% in income on service contracts and $968,000 or 33.8% in loss and damage waiver fees. Income on financing leases also declined by $223,000 or 5.4%. The decrease in income on financing leases improved significantly from the 65.4% decrease in 2005 as a result of our recent increase in originations. The overall decrease in revenue is primarily due to the decrease in the size of our portfolio of rental and service contracts that resulted from the lack of financing between October 2002 and June 2004. Offsetting these decreases was a $913,000 increase in interest income on our cash and cash equivalents. Revenues are expected to remain at current levels until originations begin to outpace the rate of attrition of contracts in the existing portfolio.

Total revenues for the year ended December 31, 2005, were $39.3 million, a decrease of $21.1 million, or 34.9%, from the year ended December 31, 2004, due primarily to decreases of $7.8 million, or 65.4%, in income on financing leases and $4.5 million, or 60.3%, in service fees and other income. In addition, rental revenue decreased $5.7 million or 18.2% and income on service contracts decreased $2.4 million, or 41.2%, as compared to such amounts in the prior year. The decrease in income on financing leases was due to the decreased number of leases originated as a result of our suspending the funding of new contracts in 2002 when our lenders did not renew our revolving credit facility. The decrease in service fees and other income was the result of decreased fees from the lessees related to our collection process. The decrease in rental and service contract income was a result of a decreased number of lessees that continued to rent their equipment beyond their original lease term, and decreased originations in rental and service contracts.

Selling, General and Administrative

	2004	Change	2005	Change	2006
			(In thousands)		
Selling, general and administrative	$ 26,821	(22.1)%	$ 20,884	(30.6)%	$ 14,499
As a percent of revenue	44.4%		53.2%		44.7%

Our selling, general and administrative (SG&A) expenses include costs of maintaining corporate functions such as accounting, finance, collections, legal, human resources, sales and underwriting, and information systems. SG&A expenses also include commissions, service fees and other marketing costs associated with our portfolio of leases and rental contracts. SG&A expenses decreased by $6.4 million, or 30.6%, for the year ended December 31, 2006, as compared to the year ended December 31, 2005. The decrease was primarily driven by a reduction in personnel-related expenses of approximately $2.0 million, as management reduced headcount from 87 to 67, and decreases of $1.6 million in collection expenses and $1.6 million in professional fees. The expense reductions resulted from the decrease in the overall size of our portfolio, an improvement in the credit quality of our portfolio, the settlement of outstanding litigation and our cost control efforts.

SG&A expenses decreased by $5.9 million, or 22.1%, for the year ended December 31, 2005, as compared to the year ended December 31, 2004. The decrease was primarily driven by a reduction in debt closing expenses and bank charges of $1.4 million, a decrease of $1.8 million in collection expenses, a decrease of $554,000 in cost of goods sold, a decrease of $649,000 in insurance expense and a decrease of $738,000 in sales programs and inventory services expenses. Also included in the expense reduction was a credit of approximately $700,000 relating to the favorable settlement of a disputed liability related to a previous acquisition. Despite a reduction in headcount from 103 at December 31, 2004 to 87 at December 31, 2005, personnel-related expenses increased by $183,000 as cost reductions achieved were offset by $1.0 million in non-cash compensation expense related to the adoption of SFAS 123(R). The expense reductions were achieved as a result of the decrease in the overall size of our portfolio of leases, rentals and service contracts and as a result of our continuing efforts to align our infrastructure with existing business conditions.

Provision for Credit Losses

	2004	Change	2005	Change	2006
			(In thousands)		
Provision for credit losses	$ 47,918	(78.2)%	$ 10,468	(33.3)%	$ 6,985
As a percent of revenue	79.4%		26.6%		21.5%

We maintain an allowance for credit losses on our investment in leases, service contracts and rental contracts at an amount that we believe is sufficient to provide adequate protection against losses in our portfolio. Our provision for credit losses decreased by $3.5 million, or 33.3%, for the year ended December 31, 2006, as compared to the year ended December 31, 2005, while net charge-offs decreased 37.3% to $10.5 million. The provision was based on providing a general allowance against leases funded during the year and our analysis of actual and expected losses in our portfolio as a whole.

Our provision for credit losses decreased by $37.5 million, or 78.2%, for the year ended December 31, 2005, as compared to the year ended December 31, 2004, while net charge-offs decreased 78.0% to $16.7 million. The provision was based on our historical policy of providing a provision for credit losses based upon dealer funding and revenue recognized in the period, as well as taking into account actual and expected losses in the portfolio as a whole and the relationship of the allowance to our net investment in leases, service contracts and rental contracts.

Depreciation and Amortization

	2004	Change	2005	Change	2006
			(In thousands)		
Depreciation fixed assets	$ 801	(48.8)%	$ 410	(50.7)%	$ 202
Depreciation rental equipment	9,142	(35.1)	5,936	(30.8)	4,108
Amortization service contracts	4,067	(22.5)	3,151	(67.8)	1,016
Total depreciation and amortization	$ 14,010	(32.2)%	$ 9,497	(43.9)%	$ 5,326

As a percent of revenue	23.2%	24.2%	16.4%

Depreciation and amortization expense consists of depreciation on fixed assets and rental equipment, and the amortization of service contracts. Fixed assets are recorded at cost and depreciated over their expected useful lives. Certain rental contracts are originated as a result of the renewal provisions of our lease agreements where at the end of the lease term, the customer may elect to continue to rent the leased equipment on a month-to-month basis. The rental equipment is recorded at its residual value and depreciated over a term of 12 months. This term represents the estimated life of a previously leased piece of equipment and is based upon our historical experience. In the event the contract terminates prior to the end of the 12 month period, the remaining net book value is expensed.

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We also offer a financial product where the customer may sign a rental agreement, which allows the customer, assuming the contract is current and no event of default exists, to terminate the contract at any time by returning the equipment and providing us with 30 days notice. These assets are recorded at cost and depreciated over an estimated life of 36 months. This term is based upon our historical experience. In the event that the contract terminates prior to the end of the 36 month period, the remaining net book value is expensed.

Service contracts are recorded at cost and amortized over their estimated life of 84 months. In a typical service contract acquisition, a homeowner will purchase a home security system and simultaneously sign a contract with the security dealer for monthly monitoring of the system. The security dealer will then sell the rights to that monthly payment to us. We perform all of the processing, billing, collection and administrative work on the service contract. The estimated life of 84 months for service contracts is based upon the expected life of such contracts in the security monitoring industry and our historical experience. In the event the contract terminates prior to the end of the 84 month term, the remaining net book value is expensed.

Depreciation expense on rentals decreased by $1.8 million, or 30.8% and amortization of service contracts decreased by $2.1 million, or 67.8%, for the year ended December 31, 2006, as compared to the year ended December 31, 2005. Depreciation and amortization expense is expected to continue to decline in 2007 as the carrying value of our rental equipment and service contracts decreased from $4.7 million at December 31, 2005 to $926,000 at December 31, 2006. Depreciation on property and equipment decreased by $208,000, or 50.7%, for the year ended December 31, 2006, as compared to the year ended December 31, 2005.

For the year ended December 31, 2005 as compared to the year ended December 31, 2004, depreciation related to rental equipment decreased by $3.2 million, or 35.1% and amortization related to service contracts decreased by $916,000, or 22.5%. The decrease in depreciation and amortization can be attributed to the decrease in the overall size of our portfolio of rental equipment and service contracts. Depreciation on our property and equipment decreased by $391,000, or 48.8%, for the year ended December 31, 2005, as compared to the year ended December 31, 2004.

Interest Expense

	2004	Change	2005	Change	2006
			(In thousands)		
Interest	$ 2,283	(49.7)%	$ 1,148	(85.9)%	$ 162
As a percent of revenue	3.8%		2.9%		0.5%

We pay interest on borrowings under our senior credit facility and subordinated debt. Interest expense decreased by $986,000, or 85.9%, for the year ended December 31, 2006, as compared to the year ended December 31, 2005. This decrease resulted primarily from our decreased level of borrowings. At December 31, 2006, we had notes payable of $5,000 and our subordinated debt was paid in full, compared to $2.8 million in debt at December 31, 2005.

Interest expense decreased by $1.1 million, or 49.7%, for the year ended December 31, 2005, as compared to the year ended December 31, 2004. This decrease resulted primarily from our decreased level of borrowings. At December 31, 2005, we had notes payable of $161,000 and subordinated debt of $2.6 million, compared to $4.6 million in debt at December 31, 2004.

Provision (Benefit) for Income Taxes

	2004	Change	2005	Change	2006
			(In thousands)		
Provision (benefit) for income taxes	$ (20,449)	(94.9)%	$ (1,053)	247.6%	$ 1,555
As a percent of revenue	33.9%		2.7%		4.8%

The provision for income taxes, deferred tax assets and liabilities and any necessary valuation allowance recorded against net deferred tax assets, involves summarizing temporary differences resulting from the different treatment of items, such as leases, for tax and accounting purposes. These differences result in deferred tax assets and liabilities which are recorded on the balance sheet. We must then assess the likelihood that deferred tax assets will be recovered from future taxable income or tax carry-back availability and to the extent we believe recovery is more likely than not, a valuation allowance is unnecessary.

The provision (benefit) for income taxes increased by $2.6 million, or 247.6%, for the year ended December 31, 2006, as compared to the year ended December 31, 2005. This increase resulted primarily from the $8.2 million increase in income before income taxes.

Benefit for income taxes decreased by $19.4 million, or 94.9%, for the year ended December 31, 2005, as compared to the year ended December 31, 2004. This decrease resulted primarily from a corresponding decrease in the Company s loss before benefit for income taxes and the prior year $7.9 million reduction in tax liabilities.

Our 1997 through 2003 tax years were audited by the Internal Revenue Service. As part of the audit, the Internal Revenue Service Agent had proposed several adjustments to our federal income tax returns that would have required us to pay the IRS an amount between $8.0 and $10.0 million. Such payments would have been offset by an adjustment to our deferred tax asset as the amount would likely have been recoverable in future periods. We filed a formal protest under the appeals process challenging these adjustments and reached a final settlement in December 2006 which required us to pay $31,000 in additional taxes and $9,000 in interest.

Other Operating Data

Dealer fundings were $21.5 million during the year ended December 31, 2006, an increase of $15.1 million, or 237.8%, compared to the year ended December 31, 2005. This increase is a result of our continuing effort to increase originations through business development efforts that include increasing the size of our vendor base and sourcing a larger number of applications from those vendors. We funded these contracts using cash provided by operating activities. Receivables due in installments, estimated residual values, investment in service contracts, and investment in rental equipment increased from $45.9 million at December 31, 2005 to $52.3 million at December 31, 2006, an increase of $6.4 million, or 14.0%. Unearned income increased by $10.0 million, or 274.0%, from $3.7 million at December 31, 2005 to $13.7 million at December 31, 2006. This increase was due to the $21.5 million in originations in 2006. Net cash provided by operating activities decreased by $8.4 million, or 23.8%, to $26.9 million during the year ended December 31, 2006, from the year ended December 31, 2005, because of the decrease in the size of our overall portfolio.

Dealer fundings were $6.4 million during the year ended December 31, 2005, an increase of $5.7 million, or 852.7%, compared to the year ended December 31, 2004. This increase was a result of our resuming contract originations in July 2004 and our continuing efforts to increase originations during 2005 through business development efforts that included increasing the size of the vendor base and sourcing a larger number of applications from those vendors. We funded these contracts using cash provided by operating activities. Receivables due in installments, estimated residual values, investment in service contracts, and investment in rental equipment also decreased from $85.0 million at December 31, 2004 to $45.9 million at December 31, 2005, representing a decrease of $39.1 million, or 46.0%. Unearned income decreased by $2.7 million, or 42.1%, from $6.3 million at December 31, 2004 to $3.7 million at December 31, 2005. This decrease was primarily due to continued amortization of existing leases partially offset by the unearned income on the $6.4 million of lease originations in 2005. Net cash provided by operating activities decreased by $23.6 million, or 40.1%, to $35.2 million during the year ended December 31, 2005, from the year ended December 31, 2004, because of the decrease in the size of our overall portfolio.

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Selected Quarterly Data

The following is a summary of our unaudited quarterly results of operations for 2005 and 2006. This unaudited quarterly information was prepared on the same basis as the audited Consolidated Financial Statements and, in the opinion of our management, reflects all necessary adjustments, consisting only of normal recurring accruals, necessary for a fair presentation of the information for the periods presented. The quarterly operating results are not necessarily indicative of future results of operations, and you should read them in conjunction with the audited Consolidated Financial Statements and Notes thereto included elsewhere in this Annual Report on Form 10-K.

	2005				2006			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Revenues:								
Income on leases	$ 1,508	$ 1,103	$ 832	$ 697	$ 672	$ 724	$ 1,007	$ 1,514
Rental income	6,429	6,431	6,469	6,030	5,721	5,594	5,121	4,461
Income on service contracts	1,088	938	792	649	555	488	435	392
Loss and damage waiver fees	819	751	681	612	551	493	431	420
Service fees and other	985	859	439	670	1,103(1)	535	437	373
Interest income	32	88	156	226	315	323	411	366
Total revenues	10,861	10,170	9,369	8,884	8,917	8,157	7,842	7,526
Expenses:								
Selling, general and administrative	6,348	5,889	4,461	4,185	4,207	3,926	3,312	3,054
Provision for credit losses	5,810	1,484	1,576	1,598	1,610	1,627	1,887	1,861
Depreciation and amortization	2,484	2,465	2,465	2,083	1,765	1,674	1,195	692
Interest	205	578	203	162	81	31	23	27
Total expenses	14,847	10,416	8,705	8,028	7,663	7,258	6,417	5,634
Income (loss) before provision (benefit) for income taxes	(3,986)	(246)	664	856	1,254	899	1,425	1,892
Provision (benefit) for income taxes	(1,322)	(20)	310	(21)	490	361	573	131(2)
Net income (loss)	$ (2,664)	$ (226)	$ 354	$ 877	$ 764	$ 538	$ 852	$ 1,761

Net income (loss) per common share basic	$	(0.20)	$	(0.02)	$	0.03	$	0.06	$	0.06	$	0.04	$	0.06	$	0.13
Net income (loss) per common share diluted		(0.20)		(0.02)		0.03		0.06		0.05		0.04		0.06		0.13
Dividends declared per common share		0.10				0.10		0.30		0.05		0.05		0.05		0.05
Dividends paid per common share		0.05		0.05		0.05		0.05		0.30		0.05		0.05		0.05

(1) Includes a $212,000 gain on the sale of rental contracts.

(2) Includes a net benefit of $385,000 resulting from the settlement of the IRS audit.

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Exposure to Credit Losses

The amounts in the table below represent the balance of delinquent receivables on an exposure basis for all leases, rental contracts and service contracts in our portfolio as of December 31, 2004, 2005 and 2006. An exposure basis aging classifies the entire receivable based on the invoice that is the most delinquent. For example, in the case of a rental or service contract, if a receivable is 90 days past due, all amounts billed and unpaid are placed in the over 90 days past due category. In the case of lease receivables, where the minimum contractual obligation of the lessee is booked as a receivable at the inception of the lease, if a receivable is 90 days past due, the entire receivable, including all amounts billed and unpaid as well as the minimum contractual obligation yet to be billed, will be placed in the over 90 days past due category. The recent improvement in our aging exposure is due to the increase in lease originations in 2006 and an overall improvement in the credit quality of our portfolio.

	December 31, 2004		December 31, 2005 (Dollars in thousands)		December 31, 2006	
Current	$ 19,945	33.4%	$ 8,486	29.1%	$ 29,027	71.8%
31-60 days past due	1,079	1.8	637	2.2	1,607	4.0
61-90 days past due	987	1.7	601	2.1	825	2.0
Over 90 days past due	37,668	63.1	19,415	66.6	8,996	22.2
Receivables due in installments	$ 59,679	100.0%	$ 29,139	100.0%	$ 40,455	100.0%

Liquidity and Capital Resources

General

Our lease and finance business is capital-intensive and requires access to substantial short-term and long-term credit to fund lease originations. Since inception, we have funded our operations primarily through borrowings under our credit facilities, on-balance sheet securitizations, the issuance of subordinated debt, free cash flow and our initial public offering completed in February 1999. We will continue to require significant additional capital to maintain and expand our funding of leases and contracts, as well as to fund any future acquisitions of leasing companies or portfolios. In the near term, we expect to finance our business utilizing the cash on hand and our line of credit which matures in September 2007. Additionally, our uses of cash include the payment of interest and principal on borrowings, selling, general and administrative expenses, income taxes and capital expenditures.

For the year ended December 31, 2004, our primary source of liquidity was cash provided by operating activities due to the unavailability of a credit facility between October 2002 and June 2004. See Overview above. We generated cash flow from operations of $26.9 million for the year ended December 31, 2006, $35.2 million for the year ended December 31, 2005 and $58.7 million for the year ended December 31, 2004.

We used net cash in investing activities of $22.1 million for the year ended December 31, 2006, $7.0 million for the year ended December 31, 2005 and $813,000 for the year ended December 31, 2004. Investing activities primarily relate to the origination of leases and the increase in cash used is consistent with our recent sales and marketing efforts.

Net cash used in financing activities was $8.9 million for the year ended December 31, 2006, $5.0 million for the year ended December 31, 2005 and $54.7 million for the year ended December 31, 2004. Financing activities include borrowings and repayments on our various financing sources. We repaid debt of $2.9 million during the year ended December 31, 2006, $1.9 million during the year ended December 31, 2005 and $70.3 million during the year ended December 31, 2004. In addition, we paid dividends of $6.2 million in the year ended December 31, 2006 and $2.7 million in the year ended December 31, 2005.

We believe that cash flows from our existing portfolio, cash on hand and available borrowings on the existing credit facility will be sufficient to support our operations and lease origination activity in the near term. We do not expect to renew our current revolving credit facility in September 2007 and are currently exploring new financing options.

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Total assets	$197,497,527	$74,462,327
LIABILITIES AND SHAREHOLDERS DEFICIT		
Current liabilities:		
Accounts payable	$2,188,461	$2,838,053
Accrued research and development	3,946,970	4,083,894
Accrued interest	2,750,000	1,500,000
Accrued compensation	2,649,640	1,239,247
Accrued and other liabilities	1,344,876	743,515
Total current liabilities	12,879,947	10,404,709
Convertible notes payable and equipment loan, net of current portion	300,053,796	100,000,000
Shareholders deficit:		
Preferred stock, no par value: Authorized 5,000,000 shares		
Common stock, no par value:		
Authorized 100,000,000 shares; issued and outstanding		
38,143,678 and 37,368,658 shares at December 31, 2005 and 2004, respectively	178,830,421	175,713,265
Warrants	620,223	828,804
Deferred stock compensation	(59,045)	(324,607)
Accumulated deficit	(294,674,874)	(212,120,547)
Accumulated other comprehensive loss	(152,941)	(39,297)
Total shareholders deficit	(115,436,216)	(35,942,382)
Total liabilities and shareholders deficit	$197,497,527	$74,462,327

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

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ATHEROGENICS, INC.
STATEMENTS OF OPERATIONS

	Year Ended December 31,		
	2005	2004	2003
Revenues	$	$	$
Operating expenses:			
Research and development	71,278,945	59,235,833	46,660,960
General and administrative	9,050,290	6,607,506	5,930,675
Total operating expenses	80,329,235	65,843,339	52,591,635
Operating loss	(80,329,235)	(65,843,339)	(52,591,635)
Interest and other income	6,691,965	1,447,001	1,258,216
Interest expense	(8,917,057)	(5,192,894)	(1,954,402)
Net loss	$ (82,554,327)	$ (69,589,232)	$ (53,287,821)
Net loss per share basic and diluted	$ (2.19)	$ (1.88)	$ (1.49)
Weighted average shares outstanding basic and diluted	37,774,203	37,070,235	35,770,994

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

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ATHEROGENICS, INC.
STATEMENTS OF SHAREHOLDERS (DEFICIT) EQUITY

	Common Stock			Deferred Stock	Accumulated	Accumulated Other Comprehensive (Loss)	Total Shareholders (Deficit)
	Shares	Amount	Warrants	Compensation	Deficit	Income	Equity
Balance at January 1, 2003	28,133,560	$ 122,182,607	$ 798,076	$ (1,243,786)	$ (89,243,494)	$ 310	$ 32,493,713
Issuance of common stock for exercise of stock options at $.30 to $8.25 per share	340,395	1,382,972					1,382,972
Issuance of common stock for exercise of warrants	9,452	150,400	(150,400)				
Issuance of common stock, net of issuance cost of $3,264,905	8,280,000	48,411,649					48,411,649
Adjustments to market value for variable stock options and warrants issued to non-employees		324,908	302,912	(627,820)			
Amortization of deferred stock compensation				1,365,898			1,365,898
Net loss					(53,287,821)		(53,287,821)
Unrealized gain on available-for-sale securities						10,595	10,595
Comprehensive loss							(53,277,226)
Balance at December 31, 2003	36,763,407	172,452,536	950,588	(505,708)	(142,531,315)	10,905	30,377,006
Issuance of common stock for	495,265	2,783,894					2,783,894

exercise of stock options at $.30 to $16.52 per share							
Issuance of common stock for exercise of warrants	109,986	289,540	(289,540)				
Adjustments to market value for variable stock options and warrants issued to non-employees		145,663	167,756	(313,419)			
Amortization of deferred stock compensation		41,632		494,520			536,152
Net loss					(69,589,232)		(69,589,232)
Unrealized loss on available-for-sale securities						(50,202)	(50,202)
Comprehensive loss							(69,639,434)
Balance at December 31, 2004	37,368,658	175,713,265	828,804	(324,607)	(212,120,547)	(39,297)	(35,942,382)
Issuance of common stock for exercise of stock options at $.10 to $14.86 per share	727,178	2,989,844					2,989,844
Issuance of common stock for exercise of warrants	47,842	154,768	(154,768)				
Adjustments to market value for variable stock options and warrants issued to non-employees		(27,456)	(53,813)	81,269			
Amortization of deferred stock compensation				184,293			184,293
Net loss					(82,554,327)		(82,554,327)
Unrealized loss on available-for-sale securities						(113,644)	(113,644)

Comprehensive loss							(82,667,971)
Balance at December 31, 2005	38,143,678	$ 178,830,421	$ 620,223	$ (59,045)	$ (294,674,874)	$ (152,941)	$ (115,436,216)

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

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ATHEROGENICS, INC.
STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	2005	2004	2003
Operating activities			
Net loss	$ (82,554,327)	$ (69,589,232)	$ (53,287,821)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	808,599	883,312	839,503
Amortization of debt issuance costs	1,504,172	652,981	217,660
Amortization of deferred stock compensation	184,293	536,152	1,365,898
Changes in operating assets and liabilities:			
Prepaid expenses	(5,603)	(1,490,291)	(977,011)
Interest receivable and other assets	(351,787)	(28,963)	(252,126)
Accounts payable	(649,592)	1,059,866	(181,108)
Accrued research and development	(136,924)	1,122,809	2,015,579
Accrued interest	1,250,000	(162,500)	1,662,500
Accrued compensation	1,410,393	200,340	81,851
Accrued and other liabilities	755,076	203,893	(133,345)
Net cash used in operating activities	(77,785,700)	(66,611,633)	(48,648,420)
Investing activities			
Purchases of short-term investments	(200,633,447)	(76,544,056)	(128,913,764)
Sales and maturities of short-term investments	151,882,055	103,984,437	61,337,482
Purchases of equipment and leasehold improvements	(2,977,050)	(302,533)	(535,026)
Net cash (used in) provided by investing activities	(51,728,442)	27,137,848	(68,111,308)
Financing activities			
Proceeds from the convertible notes	193,566,977		96,735,095
Proceeds from the exercise of common stock options	2,989,844	2,783,894	1,382,972
Payments on equipment loan	(99,919)	(479,439)	(444,068)
Proceeds from the issuance of common stock			48,411,649
Net cash provided by financing activities	196,456,902	2,304,455	146,085,648
Increase (decrease) in cash and cash equivalents	66,942,760	(37,169,330)	29,325,920

Cash and cash equivalents at beginning of year		15,888,919		53,058,249		23,732,329
Cash and cash equivalents at end of year	$	82,831,679	$	15,888,919	$	53,058,249
Supplemental disclosures of cash flow information						
Interest paid	$	6,162,886	$	4,676,472	$	61,844
Re-measurement adjustment for variable options and warrants issued for technology license agreements and consulting agreements	$	(81,269)	$	313,419	$	627,820

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

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NOTES TO FINANCIAL STATEMENTS

1. Description of Business and Significant Accounting Policies

Description of Business

AtheroGenics, Inc. (AtheroGenics) was incorporated on November 23, 1993 (date of inception) in the State of Georgia to focus on the discovery, development and commercialization of novel therapeutics for the treatment of chronic inflammatory diseases, such as heart disease (atherosclerosis), rheumatoid arthritis and asthma.

Use of Estimates

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

Cash and Cash Equivalents

AtheroGenics considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents. AtheroGenics cash equivalents consist primarily of money market accounts, commercial paper, government agency notes and corporate notes on deposit with several financial institutions, and the carrying amounts reported in the balance sheets approximate their fair value.

Short-Term Investments

Short-term investments consist of government agency notes, corporate notes, commercial paper, auction rate securities and certificates of deposit with original maturities of greater than three months when purchased.

Management determines the appropriate classification of debt securities at the time of purchase and reevaluates such designation as of each balance sheet date. These investments are accounted for in accordance with SFAS 115. AtheroGenics has classified all investments as available-for-sale. Available-for-sale securities are carried at fair value, with the unrealized gains and losses, net of tax, reported in a separate component of shareholders (deficit) equity. Realized gains and losses are included in investment income and are determined on a specific identification basis.

Fair Value of Financial Instruments and Concentration of Credit Risk

Financial instruments that subject AtheroGenics to concentration of credit risk consist primarily of cash, cash equivalents and short-term investments. These assets are maintained by reputable third party financial institution custodians. The carrying values reported in the balance sheets for cash, cash equivalents and short-term investments approximate fair values.

Equipment and Leasehold Improvements

Equipment and leasehold improvements are stated at cost. Depreciation of computer and lab equipment is computed using the straight-line method over the estimated useful lives of three and five years, respectively. Amortization of leasehold improvements is recorded over the shorter of: (a) the estimated useful lives of the related assets; or (b) the lease term.

Research and Development Accrual

As part of the process of preparing its financial statements, AtheroGenics is required to estimate expenses that it believes it has incurred, but has not yet been billed for. This process involves identifying services and activities that have been performed by third party vendors on its behalf and estimating the level to which they have been performed and the associated cost incurred for such service as of each

NOTES TO FINANCIAL STATEMENTS (Continued)

balance sheet date in its financial statements. Examples of expenses for which AtheroGenics accrues include fees for professional services, such as those provided by certain clinical research organizations and investigators in conjunction with clinical trials, and fees owed to contract manufacturers in conjunction with the manufacture of clinical trial materials. AtheroGenics makes these estimates based upon progress of activities related to contractual obligations and also information received from vendors.

Research and Development and Patent Costs

Research and development costs, including all related salaries, clinical trial expenses, facility costs and expenditures related to obtaining patents, are charged to expense when incurred.

Stock-Based Compensation

AtheroGenics has elected to follow Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), in accounting for its stock-based employee compensation plans, rather than the alternative fair value accounting method provided for under SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS 123). AtheroGenics accounts for transactions in which services are received in exchange for equity instruments based on the fair value of such services received from non-employees, in accordance with SFAS 123 and Emerging Issues Task Force (EITF) Issue No. 96-18, *Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring, or in Conjunction with Selling, Goods or Services.* SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure* (SFAS 148), an amendment to SFAS 123, requires disclosure in the summary of significant accounting policies of the effects of an entity s accounting policy with respect to stock-based employee compensation on reported net income and earnings per share in annual and interim financial statements.

The following table illustrates the effect on net loss and net loss per share as if the fair value based method had been applied to all outstanding and unvested options in each period, based on the provisions of SFAS 123 and SFAS 148.

		2005		2004		2003
Net loss, as reported	$	(82,554,327)	$	(69,589,232)	$	(53,287,821)
Add: Stock-based employee compensation expense included in reported net loss				57,511		553,309
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards		(8,764,619)		(6,125,770)		(3,375,253)
Pro forma net loss	$	(91,318,946)	$	(75,657,491)	$	(56,109,765)
Net loss per share:						
Basic and diluted, as reported	$	(2.19)	$	(1.88)	$	(1.49)
Basic and diluted, pro forma	$	(2.42)	$	(2.04)	$	(1.57)

The fair value for these options (which are granted with an exercise price equal to fair market value on the grant date) was estimated using the Black-Scholes option valuation model with the following weighted average assumptions:

	2005	2004	2003
Expected life	5 years	5 years	5 years

Risk free interest rate	4.21%	4.25%	3.91%
Volatility	77.75%	78.67%	81.10%
Fair value of grants	$ 8.80	$ 15.27	$ 9.64

NOTES TO FINANCIAL STATEMENTS (Continued)

Income Taxes

The liability method is used in accounting for income taxes. Deferred income tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that are expected to be in effect when the differences are anticipated to reverse.

Comprehensive Income (Loss)

AtheroGenics computes comprehensive income (loss) in accordance with SFAS No. 130, *Reporting Comprehensive Income* (SFAS 130). SFAS 130 establishes standards for the reporting and display of comprehensive income (loss) and its components in the financial statements. Comprehensive income (loss), as defined, includes all changes in equity during a period from non-owner sources, such as unrealized gains and losses on available-for-sale securities. Comprehensive loss was $82,667,971, $69,639,434 and $53,277,226 for the years ended December 31, 2005, 2004 and 2003, respectively.

Recently Issued Accounting Standards

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123(R), *Share-Based Payment* (SFAS 123(R)), which revises SFAS 123 and supersedes APB 25. SFAS 123(R) requires that companies recognize compensation expense associated with stock option grants and other equity instruments to employees in the financial statements and is effective as of January 1, 2006. SFAS 123(R) applies to all grants after the effective date and to the unvested portion of stock options outstanding as of the effective date. Under SFAS 123(R), AtheroGenics must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at the date of adoption. The permitted transition methods are either a modified prospective method or a modified retrospective method. The modified prospective method requires that compensation expense be recorded for all unvested options at the beginning of the first quarter of adoption of SFAS 123(R), while the modified retrospective method requires that compensation expense be recorded for all unvested options beginning with the first period presented. Under the modified retrospective method, prior periods may be restated either as of the beginning of the year of adoption or for all periods presented. The pro forma disclosures previously permitted under SFAS 123 will no longer be an alternative to financial statement recognition. AtheroGenics will adopt the provisions of SFAS 123(R) as of January 1, 2006 and it intends to use the modified prospective method and the Black-Scholes valuation model for valuing share-based payments. AtheroGenics expects that the adoption will have a material impact on its results of operations and net loss per share. The actual impact of SFAS 123(R) cannot be predicted at this time because it will depend on levels of stock option grants and changes in valuation assumptions. However, had AtheroGenics adopted SFAS 123(R) in prior periods, the impact would have approximated the impact of SFAS 123 as previously described in the pro forma disclosures.

2. Short-Term Investments

Short-term investments consist of debt securities classified as available-for-sale and have maturities greater than 90 days from the date of acquisition. AtheroGenics has invested primarily in corporate notes and commercial paper, all of which have a minimum investment rating of A1/P1, and government agency notes. The realized loss from the sale of investments was $11,768 for the year ended December 31, 2005. There were no realized gains or losses from the sale of investments for the year ended December 31, 2004.

NOTES TO FINANCIAL STATEMENTS (Continued)

The cumulative unrealized losses were $152,941 and $39,297 at December 31, 2005 and 2004, respectively. The following table summarizes the estimated fair value of AtheroGenics short-term investments:

	December 31, 2005	December 31, 2004
Corporate notes	$ 46,246,424	$ 10,751,955
Government agency notes	37,216,713	19,803,045
Commercial paper	14,708,628	9,939,363
Auction rate securities		10,500,000
Certificate of deposit	1,501,079	40,733
Total	$ 99,672,844	$ 51,035,096

All available-for-sale securities held at December 31, 2005 will mature during 2006.

3. Equipment and Leasehold Improvements

Equipment and leasehold improvements consist of the following:

	December 31, 2005	December 31, 2004
Laboratory equipment	$ 2,564,319	$ 2,538,760
Leasehold improvements	1,959,129	1,563,084
Construction-in-progress	1,877,596	
Computer and office equipment	1,757,905	1,479,392
	8,158,949	5,581,236
Accumulated depreciation and amortization	(4,050,487)	(3,641,225)
Net equipment and leasehold improvements	$ 4,108,462	$ 1,940,011

In March 2005, AtheroGenics had committed to purchase approximately $3,500,000 of commercial manufacturing equipment for AGI-1067, to be delivered in 2006. As of December 31, 2005 $1,860,765 has been recorded in construction-in-progress for this equipment.

4. Convertible Notes Payable and Equipment Loans

In August 2003, AtheroGenics issued $100,000,000 in aggregate principal amount of 4.5% convertible notes due September 1, 2008 with interest payable semi-annually in March and September. Net proceeds to AtheroGenics were approximately $96,700,000, after deducting expenses and underwriter s discounts and commissions. The issuance costs related to the notes are recorded as debt issuance costs and other assets and are being amortized to interest expense over the five-year life of the notes.

The notes may be converted into shares of AtheroGenics common stock, at the option of the holder, prior to the close of business on September 1, 2008 at a conversion rate of 65.1890 shares per $1,000 principal amount of notes, representing a conversion price of approximately $15.34, subject to adjustment. Under certain circumstances, AtheroGenics may be obligated to redeem all or part of the notes prior to their maturity at a redemption price equal to 100% of their principal amount, plus accrued and unpaid interest and liquidated damages, if any, up to but excluding the maturity date.

In January 2005, AtheroGenics issued $200,000,000 in aggregate principal amount of 1.5% convertible notes due February 1, 2012 with interest payable semi-annually in February and August. Net proceeds to AtheroGenics were approximately $193,600,000, after deducting expenses and underwriter s discounts and

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NOTES TO FINANCIAL STATEMENTS (Continued)

commissions. The issuance costs related to the notes are recorded as debt issuance costs and other assets and are being amortized to interest expense over the seven-year life of the notes.

The 1.5% convertible notes may be converted into shares of AtheroGenics common stock, at the option of the holder, at a conversion rate of 38.5802 shares per $1,000 principal amount of notes, which represents a conversion price of approximately $25.92, subject to adjustment. Under certain circumstances, AtheroGenics may be obligated to redeem all or part of the 1.5% convertible notes prior to their maturity at a redemption price equal to 100% of their principal amount, plus accrued and unpaid interest and liquidated damages, if any, up to but excluding the maturity date. In addition, under certain circumstances, AtheroGenics may adjust the conversion rate.

As of December 31, 2005, AtheroGenics has reserved a total of 14,234,953 shares of common stock for future issuance in connection with the 4.5% convertible notes and the 1.5% convertible notes. In addition, as of December 31, 2005, there was approximately $1,500,000 of accrued interest related to the 4.5% convertible notes, which is due March 1, 2006, and $1,250,000 of accrued interest related to the 1.5% convertible notes, which is due February 1, 2006.

In March 2002, AtheroGenics entered into an equipment loan facility, as amended, with Silicon Valley Bank for up to a maximum amount of $2,500,000 to be used to finance existing and new equipment purchases. The equipment loan facility was paid in full during 2005.

In June 2005, AtheroGenics entered into an equipment loan for approximately $103,800 for the purchase of software and computer equipment. The loan is payable over 36 months at an annual interest rate of 4.78%.

Maturities of long-term debt as of December 31, 2005 are as follows:

2007	$	35,435
2008		100,018,361
2012		200,000,000
	$	300,053,796

5. Net Loss Per Share

SFAS No. 128, *Earnings per Share,* requires presentation of both basic and diluted earnings per share. Basic earnings per share is computed by dividing net income (loss) by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share is computed in the same manner as basic earnings per share except that diluted earnings per share reflects the potential dilution that would occur if outstanding options, warrants and convertible notes payable were exercised.

During all periods presented, AtheroGenics had securities outstanding that could potentially dilute basic earnings per share in the future, but were excluded from the computation of diluted net loss per

NOTES TO FINANCIAL STATEMENTS (Continued)

share, as their effect would have been antidilutive. These outstanding securities consist of the following at the dates indicated:

	Year Ended December 31,		
	2005	2004	2003
Shares underlying convertible notes	14,234,953	6,518,904	6,518,904
Options	4,375,632	4,955,801	4,403,179
Warrants	82,436	142,310	267,622
Total	18,693,021	11,617,015	11,189,705
Weighted average conversion price of shares underlying convertible notes	$ 22.39	$ 15.34	$ 15.34
Weighted average exercise price of options	$ 11.17	$ 10.20	$ 6.27
Weighted average exercise price of warrants	$ 5.64	$ 4.78	$ 4.32

Because AtheroGenics reported a net loss for all periods presented, shares associated with stock options, warrants and the convertible notes are not included because they are antidilutive. Basic and diluted net loss per share amounts are the same for the periods presented.

6. Common Stock

In November 2001, AtheroGenics Board of Directors adopted a Shareholder Rights Plan, declaring a dividend distribution of one common stock purchase right on each outstanding share of its common stock. Until the rights become exercisable, the rights will trade automatically with the common stock of AtheroGenics and separate rights certificates will not be issued. Under the rights plan, each right consists of an initial right and subsequent rights. Initial rights will be exercisable only if a person or group acquires 15% or more of AtheroGenics common stock, whether through open market or private purchases or consummation of a tender or exchange offer. Any shareholders who owned, as of November 9, 2001, in excess of 17% of AtheroGenics common stock will be permitted to acquire up to an aggregate of 20% of AtheroGenics outstanding common stock without triggering the rights plan. If, following the exercise of initial rights, a person or group again acquires 15% or more of AtheroGenics common stock, or a person or group who had previously acquired 15% or more of AtheroGenics common stock acquires an additional 10% or more of the common stock, the subsequent rights become exercisable. Each right will initially entitle shareholders to buy eight shares of common stock at an exercise price equal to 20% of the then current market value of the common stock, calculated and adjusted according to the terms of the rights plan. The number of shares that can be purchased upon exercise will increase as the number of shares held by the bidder increases.

If AtheroGenics is acquired in a merger or other business combination, each right will entitle its holder to purchase, at the right s then-current exercise price, a number of the acquiring company s shares equal in value to those obtainable if the rights were exercisable in AtheroGenics common stock.

The rights are intended to enable all shareholders to realize the long-term value of their investment in AtheroGenics. They will not prevent a takeover, but should encourage anyone seeking to acquire AtheroGenics to negotiate with the Board of Directors prior to attempting a takeover. The Board of Directors may redeem any non-exercisable rights at any time at its option at a redemption price of $.0001 per right. The rights plan expires at the close of business on November 8, 2011.

7. Stock Options and Warrants

During 1995, AtheroGenics established a stock option plan (the 1995 Plan) which, as amended, provided that options to purchase AtheroGenics common stock could be granted to employees, directors,

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NOTES TO FINANCIAL STATEMENTS (Continued)

consultants or contractors with exercise prices not less than 75% of the fair values of the shares on the dates of grant.

The 1995 Plan, as amended, authorized the grant of options for up to 1,264,084 shares of AtheroGenics common stock. Options granted under the 1995 Plan vest over periods ranging from the date of grant to five years from that date. The 1995 Plan expired in 2005 and 17,800 shares that were available for grant expired. No options remained outstanding under the 1995 Plan at December 31, 2005.

During 1997, AtheroGenics established an equity ownership plan (the 1997 Plan) whereby options to purchase AtheroGenics common stock may be granted to employees, directors, consultants or contractors with exercise prices not less than the fair value of the shares on the dates of grant. The 1997 Plan, as amended, authorizes the grant of options for up to 3,724,416 shares of AtheroGenics common stock. As of December 31, 2005, AtheroGenics had 1,577,172 shares of common stock reserved for issuance under the 1997 Plan in connection with outstanding options or future grants. The 1997 Plan allows for grants of non-qualified options, incentive stock options and shares of restricted stock. Non-qualified options granted under the 1997 Plan may vest immediately for non-employees, but vest over a four-year period for employees. Incentive stock options generally vest over four years. The majority of the stock options granted under the 1997 Plan are incentive stock options.

During 2001, AtheroGenics established an equity ownership plan (the 2001 Plan) whereby options to purchase AtheroGenics common stock may be granted to employees, directors, consultants or contractors with exercise prices not less than the fair value of the shares on the dates of grant. The 2001 Plan authorizes the grant of options for up to 2,000,000 shares of AtheroGenics common stock. As of December 31, 2005, AtheroGenics had 1,677,668 shares of common stock reserved for issuance under the 2001 Plan in connection with outstanding options or future grants. The terms of the 2001 Plan are substantially similar to the terms of the 1997 Plan.

During 2004, AtheroGenics established an equity ownership plan (the 2004 Plan) whereby options to purchase AtheroGenics common stock may be granted to employees, directors, consultants or contractors with exercise prices not less than the fair value of the shares on the dates of grant. The 2004 Plan authorizes the grant of options for up to 4,500,000 shares of AtheroGenics common stock. As of December 31, 2005, AtheroGenics had 4,500,000 shares of common stock reserved for issuance under the 2004 Plan in connection with outstanding options or future grants. The terms of the 2004 Plan are substantially similar to the terms of the 2001 Plan and the 1997 Plan.

NOTES TO FINANCIAL STATEMENTS (Continued)

A summary of stock option activity under the 1995 Plan, the 1997 Plan, the 2001 Plan and the 2004 Plan follows:

	Number of Shares	Price Range		Weighted Average Price
Outstanding at January 1, 2003	3,895,420	$ .10	$9.88	$ 4.06
Granted	986,983	7.55	16.65	14.40
Exercised	(340,395)	.30	8.25	4.06
Canceled	(138,829)	.31	14.51	7.68
Outstanding at December 31, 2003	4,403,179	.10	16.65	6.27
Granted	1,166,125	14.38	32.95	23.16
Exercised	(496,908)	.30	16.52	5.72
Canceled	(116,595)	4.53	14.93	10.23
Outstanding at December 31, 2004	4,955,801	.10	32.95	10.20
Granted	317,900	10.74	18.55	13.46
Exercised	(727,178)	.10	14.86	4.11
Canceled	(170,891)	6.05	25.30	17.49
Outstanding at December 31, 2005	4,375,632	.30	32.95	11.17

The following table summarizes information concerning currently outstanding and exercisable options granted under the 1997 Plan, the 2001 Plan and the 2004 Plan as of December 31, 2005.

		Options Outstanding			Options Exercisable	
Exercise Price		Number Outstanding	Weighted Average Remaining Years	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$ .30	$5.00	1,174,466	3.97	$ 1.01	1,174,466	$ 1.01
5.75	10.74	1,106,296	6.53	7.12	898,378	6.96
11.16	19.20	1,162,912	8.34	15.11	521,640	14.76
22.87	32.95	931,958	8.91	23.86	319,881	24.22
.30	32.95	4,375,632	6.83	11.17	2,914,365	7.85

In 1999 and 2000, in connection with the grant of certain options to employees, AtheroGenics recorded non-cash deferred stock compensation of $13,989,088, representing the difference between the exercise price and the deemed fair value of AtheroGenics common stock on the dates these stock options were granted. Deferred stock compensation is included as a reduction of shareholders (deficit) equity and is being amortized to expense using the graded vesting method. The graded vesting method provides for vesting of each portion of the overall award over its respective vesting period, and results in higher vesting in earlier years than straight-line vesting. These options were fully amortized in 2004. During 2004 and 2003, AtheroGenics recorded amortization of deferred stock compensation for these options of $57,511 and $553,309, respectively.

In June 2001, in connection with the grant of certain warrants as part of a licensing agreement with National Jewish Medical and Research Center and options granted for the addition of new members to the Scientific Advisory Board, AtheroGenics recorded non-cash deferred stock compensation of $1,092,200. In August 2005 and December 2004, in connection with the modification of certain options held by employees who changed their status to become consultants, AtheroGenics recorded non-cash deferred stock compensation of $17,155 and $18,685, respectively. The fair value of the warrants and options for purposes of these calculations was determined by using the Black-Scholes model. These amounts are

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NOTES TO FINANCIAL STATEMENTS (Continued)

included as a reduction of shareholders (deficit) equity and are being amortized over the vesting periods of the individual warrants and options. During 2005, 2004 and 2003, an additional $(81,269), $313,419 and $627,820, respectively, of non-cash deferred stock compensation was recorded due to re-measurement of the fair value of the options and warrants at each measurement date. During 2005, 2004 and 2003, AtheroGenics recorded a total of $184,293, $478,641 and $812,589, respectively, of amortization of deferred stock compensation for these options and warrants. At December 31, 2005, 56,000 shares of common stock were reserved for issuance upon the exercise of these outstanding warrants.

At December 31, 2005, AtheroGenics had a total of $59,045 remaining to be amortized over the vesting periods of all of the option and warrant grants discussed above, which ends in 2006.

8. Employee Benefit Plan

AtheroGenics has a defined contribution plan covering eligible employees, which is qualified under Section 401(k) of the Internal Revenue Code (IRC). Under the provisions of the plan, eligible participating employees may elect to contribute up to the maximum amount of tax deferred contribution allowed by the IRC. AtheroGenics may make a discretionary contribution. During 2005, AtheroGenics matched 50% of employees contributions, up to a maximum of 6% of the employees annual base compensation. AtheroGenics contributions to the plan for 2005, 2004 and 2003 aggregated $237,652, $204,094 and $161,576, respectively. AtheroGenics stock is not an eligible investment under this plan.

9. Income Taxes

At December 31, 2005, AtheroGenics had net operating loss carryforwards and research and development credit carryforwards of $299,097,178 and $9,360,213, respectively, for income tax purposes, which both begin to expire in 2010. The significant components of the deferred tax assets are:

	December 31,	
	2005	2004
Net operating loss carryforwards	$ 113,542,150	$ 78,154,551
Research credits	9,360,213	6,366,269
Deferred stock compensation	501,775	3,075,991
Other	396,948	194,803
Total deferred tax assets	123,801,086	87,791,614
Valuation allowance	(123,801,086)	(87,791,614)
Net deferred tax assets	$	$

Because of AtheroGenics lack of earnings history, the deferred tax assets have been fully offset by a valuation allowance. The valuation allowance increased $36,009,472 and $29,967,355 in 2005 and 2004, respectively, due to the change in net cumulative tax differences and the excess tax benefit from disqualifying dispositions of incentive stock options.

AtheroGenics net operating loss carryforwards and research and development credit carryforwards may be subject to certain IRC Section 382 and Section 383 limitations on annual utilization in the event of changes in ownership. These limitations could significantly reduce the amount of the net operating loss carryforwards available in the future. The utilization of the carryforwards is dependent upon the timing and extent of AtheroGenics future profitability. The annual limitations combined with the expiration dates of the carryforwards may prevent the utilization of all of the net operating loss and research and development credit carryforwards if AtheroGenics does not attain sufficient profitability by the expiration dates of the carryforwards.

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NOTES TO FINANCIAL STATEMENTS (Continued)

10. Commitments and Contingencies

On June 19, 1998, AtheroGenics entered into a ten-year operating lease for office and laboratory space through March 1, 2009. Monthly lease payments of approximately $89,400 began March 2, 1999, the date occupancy commenced. These payments are subject to increases during each successive 12-month period based on changes in the Consumer Price Index (CPI). Future increases in monthly lease payments due to increases in the CPI are considered to be contingent rentals, and, therefore, will be charged to expense over the lease term as they become payable. AtheroGenics may extend the lease term for two successive five-year periods. AtheroGenics other operating lease obligations are not significant.

At December 31, 2005, AtheroGenics minimum aggregate commitments under long-term, non-cancelable operating leases are as follows:

2006	$	1,369,315
2007		1,349,238
2008		1,213,267
2009		203,676
Thereafter		
	$	4,135,496

Net rent expense under operating leases amounted to $1,161,682, $1,050,333 and $1,026,495 in 2005, 2004 and 2003, respectively.

In March 2005, AtheroGenics committed to purchase approximately $3,500,000 of commercial manufacturing equipment for AGI-1067 to be delivered in 2006. The cost of the equipment will be shared by both AtheroGenics and AstraZeneca as part of the joint license and collaboration agreements that were signed in December 2005.

In October 2005, AtheroGenics entered into a commercial supply agreement with The Dow Chemical Company for the manufacture of the bulk active ingredient of AGI-1067. The agreement also provides for the manufacture of Probucol USP, the starting material used in the manufacturing process of AGI-1067. Under AtheroGenics joint license and collaboration agreement with AstraZeneca, the manufacturing agreement with Dow will be assigned to AstraZeneca which is responsible for all of the AGI-1067 manufacturing, packaging and labeling activities.

11. Related Party Transactions

AtheroGenics had a sublease agreement for a portion of its office and laboratory space with Inhibitex, Inc. The monthly lease payments averaged approximately $14,200. The lease term ended on December 31, 2005. The President and Chief Executive Officer of AtheroGenics and the Chairman of AtheroGenics Board of Directors are both members of the Inhibitex, Inc. Board of Directors.

12. Subsequent Event

In January 2006, AtheroGenics exchanged $14,000,000 in aggregate principal amount of the 4.5% convertible notes for 1,085,000 shares of AtheroGenics common stock. In accordance with SFAS 84, *Induced Conversion of Convertible Debt,* this transaction will result in a non-cash charge of approximately $3,500,000

In February 2006, AtheroGenics received an upfront license fee of $50,000,000 as part of a license and collaboration agreement with AstraZeneca, announced in December 2005, for the global development and commercialization of AGI-1067. In addition to the upfront license fee and subject to the achievement of specific milestones, including a successful outcome in ARISE, AtheroGenics will be eligible for development and regulatory milestones of up to an aggregate of $300,000,000. The agreement also provides

NOTES TO FINANCIAL STATEMENTS (Continued)

for progressively demanding sales performance related milestones of up to an additional $650,000,000 in the aggregate. In addition, AtheroGenics will also receive royalties on product sales. AstraZeneca has the right to terminate the license and collaboration agreement at specified periods as further described in Item 1. Business Collaborations of this Form 10-K.

13. Quarterly Results of Operations (Unaudited)

The following is a summary of the unaudited quarterly results of operations:

	Year Ended December 31, 2005			
	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
Operating loss	$ (17,975,888)	$ (21,612,599)	$ (22,541,263)	$ (18,199,485)
Net loss	(18,631,557)	(22,205,379)	(23,057,352)	(18,660,039)
Net loss per share data:				
Basic and diluted	(0.50)	(0.59)	(0.61)	(0.49)

	Year Ended December 31, 2004			
	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
Operating loss	$ (15,680,847)	$ (15,597,955)	$ (18,046,883)	$ (16,517,654)
Net loss	(16,602,700)	(16,525,159)	(19,003,116)	(17,458,257)
Net loss per share data:				
Basic and diluted	(0.45)	(0.45)	(0.51)	(0.47)

Because of the method used in calculating per share data, the quarterly per share data will not necessarily add to the per share data as computed for the year.

Item 9. *Changes in and Disagreements with Accountants on Accounting and Financial Disclosure*

None.

Item 9A. *Controls and Procedures*

Management s annual report on internal control over financial reporting. Section 404 of the Sarbanes-Oxley Act of 2002 requires management to include in this Annual Report on Form 10-K a report on management s assessment of the effectiveness of our internal control over financial reporting, as well as an attestation report from our independent registered public accounting firm on management s assessment of the effectiveness of our internal control over financial reporting. Management s annual report on internal control over financial reporting and the related attestation report from our independent registered public accounting firm are located in Item 8 of this Form 10-K and are incorporated herein by reference.

Evaluation of disclosure controls and procedures. Our chief executive officer and chief financial officer are responsible for establishing and maintaining disclosure controls and procedures (as defined in the Securities Exchange Act of 1934 Rules 13a-15(e) and 15d-15(e)) for AtheroGenics. Our chief executive officer and chief financial officer, after evaluating the effectiveness of our disclosure controls and procedures as of the end of the period covered by this annual report, have concluded that our disclosure controls and procedures are adequate and effective in timely alerting them to material information relating to us required to be included in our periodic SEC filings.

Changes in internal control over financial reporting. There were no changes in our internal control over financial reporting that occurred during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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NOTES TO FINANCIAL STATEMENTS (Continued)

Item 9B. ***Other Information***

None.

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PART III

Item 10. ***Directors and Executive Officers of the Registrant***

We have set forth information relating to the directors and executive officers and compliance with Section 16(a) of the Securities Exchange Act of 1934 under the captions Nominees, Executive Officers and Directors, Board Meetings and Committees and Section 16(a) Beneficial Ownership Reporting Compliance, respectively, in our proxy statement for our 2006 annual meeting of shareholders to be held on April 26, 2006. We are incorporating this information by reference in this Form 10-K. Our definitive proxy statement will be filed with the SEC no later than 120 days after December 31, 2005.

Code of Ethics

We have adopted a code of business conduct and ethics for directors, officers and employees, including our principal executive officer and principal financial officer, known as the AtheroGenics, Inc. Code of Business Conduct and Ethics. You may request a free copy from:

AtheroGenics, Inc.
Attention: Investor Relations
8995 Westside Parkway
Alpharetta, Georgia 30004
(678) 336-2500
http://www.investor@atherogenics.com

Item 11. ***Executive Compensation***

We have set forth information relating to executive compensation under the captions Director Compensation, Executive Compensation, Employment Agreements and Compensation Committee Interlocks and Insider Participation in the proxy statement referred to in Item 10 above. We are incorporating this information by reference in this Form 10-K.

Item 12. ***Security Ownership of Certain Beneficial Owners and Management***

We have set forth information relating to ownership of our common stock by certain persons and to our equity compensation plans under the captions Security Ownership of Certain Beneficial Owners and Management and Equity Compensation Plan Information, respectively, in the proxy statement referred to in Item 10 above. We are incorporating this information by reference in this Form 10-K.

Item 13. ***Certain Relationships and Related Transactions***

We have set forth information relating to existing or proposed relationships or transactions between us and certain of our affiliates under the caption Certain Relationships and Related Transactions in the proxy statement referred to in Item 10 above. We are incorporating this information by reference in this Form 10-K.

Item 14. ***Principal Accountant Fees and Services***

We have set forth information relating to our principal accountant fees and services under the caption Principal Accountant Fees and Services in the proxy statement referred to in Item 10 above. We are incorporating this information by reference in this Form 10-K.

PART IV

Item 15. ***Exhibits and Financial Statement Schedules***

(1) Financial Statements, filed as part of this report

Report of Independent Registered Public Accounting Firm on Financial Statements
Report of Independent Registered Public Accounting Firm on Internal Control
Balance Sheets as of December 31, 2005 and 2004
Statements of Operations for the years ended December 31, 2005, 2004 and 2003
Statements Shareholders (Deficit) Equity for the years ended December 31, 2005, 2004 and 2003
Statements of Cash Flows for the years ended December 31, 2005, 2004 and 2003
Notes to Financial Statements

(2) Financial Statement Schedules

No financial statement schedules are provided, because the information called for is not required or is shown either in the financial statements or the notes thereto.

(3) Listing of Exhibits

Exhibit No.	Description
3.01	Fourth Amended and Restated Articles of Incorporation of AtheroGenics, Inc. (filed as Exhibit 3.01 to Amendment No. 1 to AtheroGenics Annual Report on Form 10-K for the year ended December 31, 2004 on April 6, 2005 and incorporated herein by reference).
3.02	Third Amended and Restated Bylaws of AtheroGenics, Inc., as amended (filed as Exhibit 3.02 to AtheroGenics Annual Report on Form 10-K for the year ended December 31, 2001 and incorporated herein by reference).
4.01	Form of Common Stock Certificate (filed as Exhibit 4.01 to Amendment No. 4 to AtheroGenics Registration Statement on Form S-1, Registration No. 333-31140, on August 4, 2000 and incorporated herein by reference).
4.02	Rights Agreement dated as of November 9, 2001 between AtheroGenics, Inc. and American Stock Transfer & Trust Company, as Rights Agent (filed as Exhibit 4.4 of AtheroGenics Form 8-K on November 19, 2001 and incorporated herein by reference).
4.03	Indenture dated August 19, 2003 between AtheroGenics, Inc. and The Bank of New York Trust Company of Florida N.A., as Trustee (filed as Exhibit 4.1 to AtheroGenics Registration Statement on Form S-3, Registration No. 333-110160, on October 31, 2003, and incorporated herein by reference).
4.04	Global $4^1/2$% Convertible Note Due 2008 (filed as Exhibit 4.04 to Amendment No. 1 to AtheroGenics Annual Report on Form 10-K for the year ended December 31, 2004 on April 6, 2005 and incorporated herein by reference).
4.05	Indenture dated January 12, 2005 between AtheroGenics, Inc. and The Bank of New York Trust Company of Florida N.A., as Trustee, including the form of Global 1.50% Convertible Note Due 2012 filed as Appendix A thereto (filed as Exhibit 4.5 to AtheroGenics Registration Statement on Form S-3, Registration No. 333-123895, on April 6, 2005 and incorporated herein by reference).
10.01	Amended and Restated Master Rights Agreement dated October 31, 1995, as amended by First Amendment dated November 1, 1995; Second Amendment dated July 30, 1996; Third Amendment dated April 13, 1999; Fourth Amendment dated May 11, 1999; and Fifth Amendment dated August 30, 1999 (filed as Exhibit 4.02 to AtheroGenics Registration Statement on Form S-1, Registration No. 333-31140, on

February 25, 2000 and incorporated herein by reference).

Exhibit No.	Description
10.02+	Exclusive License Agreement dated July 17, 1998 between The Regents of the University of California and AtheroGenics, Inc. (filed as Exhibit 10.02 to Amendment No. 4 to AtheroGenics Registration Statement on Form S-1, Registration No. 333-31140, on August 4, 2000 and incorporated herein by reference).
10.03+	License Agreement dated January 11, 1995 between Emory University and AtheroGenics, Inc. (filed as Exhibit 10.03 to Amendment No. 2 to AtheroGenics Registration Statement on Form S-1, Registration No. 333-31140, on July 13, 2000 and incorporated herein by reference).
10.04+	Patent Purchase Agreement dated April 26, 1995 between AtheroGenics, Inc. and Sampath Parthasarathy, together with Services Agreement dated April 26, 1995 between AtheroGenics, Inc. and Sampath Parthasarathy (filed as Exhibit 10.04 to Amendment No. 2 to AtheroGenics Registration Statement on Form S-1, Registration No. 333-31140, on July 13, 2000 and incorporated herein by reference).
10.05+	Sponsored Research Agreement dated October 14, 1996 between Emory University and AtheroGenics, Inc. (filed as Exhibit 10.05 to Amendment No. 2 to AtheroGenics Registration Statement on Form S-1, Registration No. 333-31140, on July 13, 2000 and incorporated herein by reference).
10.06#	AtheroGenics, Inc. 1995 Stock Option Plan, together with form of nonqualified stock option agreement (filed as Exhibit 10.07 to AtheroGenics Registration Statement on Form S-1, Registration No. 333-31140, on February 25, 2000 and incorporated herein by reference).
10.07#	AtheroGenics, Inc. 1997 Equity Ownership Plan, as amended by Amendment No. 1 and Amendment No. 2 (filed as Exhibit 10.08 to Amendment No. 2 to AtheroGenics Registration Statement on Form S-1, Registration No. 333-31140, on July 13, 2000 and incorporated herein by reference).
10.08	Preferred Shares Purchase Warrant dated August 24, 1998 between AtheroGenics, Inc. and certain Lenders named therein (filed as Exhibit 10.09 to AtheroGenics Registration Statement on Form S-1, Registration No. 333-31140, on February 25, 2000 and incorporated herein by reference).
10.09	Series C Convertible Preferred Stock Purchase Warrants of AtheroGenics, Inc. (filed as Exhibit 10.10 to AtheroGenics Registration Statement on Form S-1, Registration No. 333-31140, on February 25, 2000 and incorporated herein by reference).
10.10	Promissory Note dated April 1, 1999 between Inhibitex, Inc. and AtheroGenics, Inc. (filed as Exhibit 10.11 to AtheroGenics Registration Statement on Form S-1, Registration No. 333-31140, on February 25, 2000 and incorporated herein by reference).
10.11++	Lease Agreement dated June 19, 1998 between Cousins Properties, Inc. and AtheroGenics, Inc. (filed as Exhibit 10.12 to AtheroGenics Registration Statement on Form S-1, Registration No. 333-31140, on February 25, 2000 and incorporated herein by reference).
10.12#	Employment Agreement dated March 1, 2001 between AtheroGenics, Inc. and Russell M. Medford (filed as Exhibit 10.14 to AtheroGenics Annual Report on Form 10-K for the year ended December 31, 2000, and incorporated herein by reference).
10.13	Amendment dated January 1, 2001 to Promissory Note dated April 1, 1999 between Inhibitex, Inc. and AtheroGenics, Inc. (filed as Exhibit 10.15 to AtheroGenics Annual Report on Form 10-K for the year ended December 31, 2000, and incorporated herein

	by reference).
10.14+	Exclusive License Agreement dated as of June 29, 2001 between AtheroGenics, Inc. and National Jewish Medical and Research Center (filed as Exhibit 10.17 to Amendment No. 1 to AtheroGenics Registration Statement on Form S-1, Registration No. 333-64228, on July 23, 2001 and incorporated herein by reference).
10.15#	AtheroGenics, Inc. 2001 Equity Ownership Plan (filed as Appendix B to the proxy statement on Schedule 14A for AtheroGenics 2001 Annual Shareholders Meeting as filed on March 22, 2001 and incorporated herein by reference).

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Exhibit No.	Description
10.16	Equipment Term Note dated March 6, 2002 between AtheroGenics, Inc. and Silicon Valley Bank (filed as Exhibit 10.20(b) to AtheroGenics Quarterly Report on Form 10-Q for the quarter ended March 31, 2002 and incorporated herein by reference).
10.17	Loan and Security Agreement dated March 6, 2002 between AtheroGenics, Inc. and Silicon Valley Bank (filed as Exhibit 10.20(c) to AtheroGenics Quarterly Report on Form 10-Q for the quarter ended March 31, 2002 and incorporated herein by reference).
10.18	First Loan Modification dated June 20, 2003 between AtheroGenics, Inc. and Silicon Valley Bank (filed as Exhibit 10.23 to AtheroGenics Quarterly Report on Form 10-Q for the quarter ended June 30, 2003 and incorporated herein by reference).
10.19	Second Loan Modification dated August 13, 2003 between AtheroGenics, Inc. and Silicon Valley Bank (filed as Exhibit 10.25 to AtheroGenics Annual Report on Form 10-K for the year ended December 31, 2003 and incorporated herein by reference).
10.20	Third Loan Modification dated December 29, 2003 between AtheroGenics, Inc. and Silicon Valley Bank (filed as Exhibit 10.26 to AtheroGenics Annual Report on Form 10-K for the year ended December 31, 2003 and incorporated herein by reference).
10.21	Negative Pledge Agreement dated December 29, 2003 between AtheroGenics, Inc. and Silicon Valley Bank (filed as Exhibit 10.27 to AtheroGenics Annual Report on Form 10-K for the year ended December 31, 2003 and incorporated herein by reference).
10.22#	Employment Agreement dated December 22, 2004 between AtheroGenics, Inc. and Mark P. Colonnese (filed as Exhibit 10.28 to AtheroGenics Form 8-K on December 22, 2004 and incorporated herein by reference).
10.23#	Employment Agreement dated December 22, 2004 between AtheroGenics, Inc. and Martin A. Wasserman (filed as Exhibit 10.29 to AtheroGenics Form 8-K on December 22, 2004 and incorporated herein by reference).
10.24#	Employment Agreement dated December 22, 2004 between AtheroGenics, Inc. and Robert A. D. Scott (filed as Exhibit 10.30 to AtheroGenics Form 8-K on December 22, 2004 and incorporated herein by reference).
10.25#	Employment Agreement dated December 22, 2004 between AtheroGenics, Inc. and W. Charles Montgomery (filed as Exhibit 10.31 to AtheroGenics Form 8-K on December 22, 2004 and incorporated herein by reference).
10.26#	AtheroGenics, Inc. 2004 Equity Ownership Plan (filed as Appendix B to the proxy statement on Schedule 14A for AtheroGenics 2004 Annual Shareholders Meeting as filed on March 26, 2004 and incorporated herein by reference).
10.27#	AtheroGenics, Inc. 2004 Equity Ownership Plan form of incentive equity ownership agreement and form of directors nonqualified equity ownership agreement (filed as Exhibit 10.33 to AtheroGenics Annual Report on Form 10-K for the year ended December 31, 2004 on March 16, 2005 and incorporated herein by reference).
10.28#	Summary of non-employee director compensation (filed as the first paragraph under the caption Director Compensation in the proxy statement on Schedule 14A for AtheroGenics 2005 Annual Meeting of Shareholders as filed with the SEC on March 28, 2005 and incorporated herein by reference).

10.29#	Summary of non-employee directors compensation and 2005 executive officers target cash incentive (filed under Item 1.01 of AtheroGenics, Inc. Form 8-K on April 29, 2005 and incorporated herein by reference).
10.30#	Employment Agreement dated May 31, 2005 between AtheroGenics, Inc. and Joseph M. Gaynor, Jr. (filed as Exhibit 10.1 to AtheroGenics Current on Form 8-K on June 30, 2005 and incorporated herein by reference).
10.31#	Transition Agreement dated June 22, 2005 between AtheroGenics, Inc. and Martin A. Wasserman (filed as Exhibit 10.1 to AtheroGenics Current Report on Form 8-K on July 22, 2005 and incorporated herein by reference).

Exhibit No.	Description
10.32+	First Amendment dated August 3, 2005 to License Agreement dated January 11, 1995 between AtheroGenics, Inc. and Emory University (filed as Exhibit 10.1 to AtheroGenics Current Report on Form 10-Q on November 2, 2005 and incorporated herein by reference).
10.33	Registration Rights Agreement dated January 12, 2005 among AtheroGenics, Inc., as Issuer, and Morgan Stanley & Co. Incorporated, Lehman Brothers, Inc., JPMorgan Securities, Inc. and Lazard Freres & Co., as Initial Purchasers (filed as Exhibit 99.1 to AtheroGenics Current Report on Form 8-K on January 12, 2005 and incorporated herein by reference).
10.34*+	Commercial Supply Agreement for Production of AGI-1067 and Probucol between The Dow Chemical Company and AtheroGenics, Inc., dated October 6, 2005.
10.35*+	License and Collaboration Agreement between AtheroGenics, Inc and IPR Pharmaceuticals, LP, dated December 22, 2005.
10.36*+	Co-Promotion Agreement by and between AstraZeneca Pharmaceuticals LP and AtheroGenics, Inc., dated as of December 22, 2005
10.37*+	Transition Services Agreement, by and between IPR Pharmaceuticals, LP and AtheroGenics, Inc., dated December 22, 2005.
10.38#	AtheroGenics, Inc. 2004 Equity Ownership Plan form of nonqualified equity ownership agreement (filed as Exhibit 10.02 to AtheroGenics Current Report on Form 8-K on March 10, 2006 and incorporated herein by reference).
23.01*	Consent of Ernst & Young LLP.
24.01*	Powers of Attorney.
31.1*	Certifications of Chief Executive Officer under Rule 13a-14(a).
31.2*	Certifications of Chief Financial Officer under Rule 13a-14(a).
32*	Certifications of Chief Executive Officer and Chief Financial Officer under Section 1350.

* Filed herewith.

** Filed as the exhibit of the same number with AtheroGenics registration statement on Form S-1, Registration No. 333-31140, declared effective by the SEC on August 8, 2000, and incorporated herein by reference.

\+ Certain confidential information contained in this document has been omitted and filed separately with the Commission pursuant to a request for confidential treatment under Rule 406 of the Securities Act of 1933, as amended.

++ We agree to furnish supplementally to the Commission a copy of any omitted schedule or exhibit to this agreement upon request by the Commission.

\# Management contract or compensatory plan or arrangement.

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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, on March 10, 2006.

ATHEROGENICS, INC.
By: /s/ RUSSELL M. MEDFORD

Russell M. Medford, M.D., Ph.D.
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Name	Title	Date
Principal Executive Officer:		
/s/ RUSSELL M. MEDFORD **Russell M. Medford**	President and Chief Executive Officer, Director	March 10, 2006
Principal Financial and Principal Accounting Officer:		
/s/ MARK P. COLONNESE **Mark P. Colonnese**	Senior Vice President of Finance and Administration and Chief Financial Officer	March 10, 2006
* **Michael A. Henos**	Director	March 10, 2006
* **R. Wayne Alexander**	Director	March 10, 2006
* **David Bearman**	Director	March 10, 2006
* **Vaughn D. Bryson**	Director	March 10, 2006
*	Director	March 10, 2006

T. Forcht Dagi		
*	Director	March 10, 2006
Arthur M. Pappas		
*	Director	March 10, 2006
William A. Scott		

*By: /s/ JOSEPH M. GAYNOR

Joseph M. Gaynor, Jr.
Attorney-in-Fact

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