TERAYON COMMUNICATION SYSTEMS
Form 10-Q
August 09, 2005

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q
þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED June 30, 2005
OR
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE TRANSITION PERIOD FROM __________TO __________.
Commission File Number: 000-24647
TERAYON COMMUNICATION SYSTEMS, INC.
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE	77-0328533
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(IRS EMPLOYER IDENTIFICATION NO.)

4988 GREAT AMERICA PARKWAY
SANTA CLARA, CALIFORNIA 95054
(408) 235-5500
(ADDRESS, INCLUDING ZIP CODE, AND TELEPHONE NUMBER, INCLUDING AREA CODE, OF THE REGISTRANT S PRINCIPAL EXECUTIVE OFFICES)

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 whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes þ No o
APPLICABLE ONLY TO CORPORATE ISSUERS:
As of July 29, 2005 registrant had outstanding 77,273,819 shares of Common Stock.

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SPECIAL NOTE ON FORWARD-LOOKING STATEMENTS

This Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 which are subject to the safe harbor created by those sections. These forward-looking statements include, but are not limited to: statements related to industry trends and future growth in the markets for cable modem systems; our strategies for reducing the cost of our products; our product development efforts; our future research and development; the timing of our introduction of new products; the timing and extent of deployment of our products by our customers; the future sales of our products; and our future revenues and profitability. We usually use words such as may, will, should, expect, plan, anticipate, estimate, predict, future, intend, or certain or the negative of these terms or similar expressions to identify forward-looking statements. Discussions containing such forward-looking statements may be found throughout the document. These forward-looking statements involve certain risks and uncertainties that could cause actual results to differ materially from those in such forward-looking statements. We disclaim any obligation to update these forward-looking statements as a result of subsequent events. The business risks discussed in Part 1, Item 2 of this Report on Form 10-Q, among other things, should be considered in evaluating our prospects and future financial performance.

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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

TERAYON COMMUNICATION SYSTEMS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands)

	June 30, 2005 (unaudited)	December 31, 2004
ASSETS		
Current assets:		
Cash and cash equivalents	$ 38,605	$ 43,218
Short-term investments	66,383	54,517
Accounts receivable, net	17,645	16,554
Accounts receivable from related parties	2,312	3,106
Other current receivables	1,758	1,044
Inventory	12,759	17,144
Other current assets	2,100	2,042
Total current assets	141,562	137,625
Property and equipment, net	4,538	5,760
Restricted cash	8,763	8,827
Other assets	633	1,522
Total assets	$ 155,496	$ 153,734
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 4,572	$ 7,845
Accrued payroll and related expenses	3,147	3,936
Deferred revenues	5,427	2,579
Deferred gain on sale of semiconductor assets	8,578	
Accrued warranty expenses	2,722	3,870
Current portion of accrued restructuring and executive severance	1,991	3,902
Accrued vendor cancellation charges	374	521
Accrued other liabilities	3,609	4,562
Interest payable	1,356	1,356
Total current liabilities	31,776	28,571
Other long-term obligations	1,720	2,077
Long term portion of accrued restructuring and executive severance	1,721	1,664
Convertible subordinated notes	65,081	65,081
Commitments and contingencies		
Stockholders equity:		
Common stock	77	76

Additional paid in capital	1,085,820	1,083,711
Accumulated deficit	(1,027,203)	(1,024,091)
Treasury stock, at cost	(773)	(773)
Accumulated other comprehensive loss	(2,723)	(2,582)
Total stockholders equity	55,198	56,341
Total liabilities and stockholders equity	$ 155,496	$ 153,734

See accompanying notes.

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TERAYON COMMUNICATION SYSTEMS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(unaudited)

	Three months ended June 30,		Six months ended June 30,	
	2005	**2004**	**2005**	**2004**
Revenues	$24,692	$40,138	$42,228	$ 80,560
Related party revenues	4,841	2,644	13,668	3,389
Total revenues	29,533	42,782	55,896	83,949
Cost of revenues	14,024	27,046	25,379	55,605
Cost of related party revenues	2,677	614	4,364	825
Total cost of revenues	16,701	27,660	29,743	56,430
Gross profit	12,832	15,122	26,153	27,519
Operating expenses:				
Research and development	4,427	8,516	10,371	17,984
Sales and marketing	5,611	5,411	11,285	12,632
General and administrative	2,878	2,953	5,673	5,388
Restructuring charges, executive severance and asset write-offs	282	3,579	1,564	6,946
Total operating expenses	13,198	20,459	28,893	42,950
Loss from operations	(366)	(5,337)	(2,740)	(15,431)
Interest income	672	460	1,240	912
Interest expense	(814)	(826)	(1,627)	(1,643)
Other income (expense), net	(50)	921	15	1,200
Loss before income tax benefit (provision)	558	(4,782)	(3,112)	(14,962)
Income tax benefit (provision)	50	(79)		(146)
Net loss	$ (508)	$ (4,861)	$ (3,112)	$(15,108)
Net loss per share, basic and diluted	$ (0.01)	$ (0.06)	$ (0.04)	$ (0.20)
Shares used in per share calculation, basic and diluted	77,057	75,551	76,898	75,534

See accompanying notes.

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TERAYON COMMUNICATION SYSTEMS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Six Months Ended June 30,	
	2005	**2004**
Operating activities:		
Net loss	$ (3,112)	$ (15,108)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,708	3,319
Reduction of accounts receivable allowance	(675)	
Amortization of deferred compensation		17
Inventory reserves	858	969
Impairment and write-off of fixed assets	330	130
Net changes in operating assets and liabilities:		
Accounts receivable	(416)	2,420
Accounts receivable from related parties	794	(505)
Inventory	3,527	(6,008)
Other assets	181	2,813
Accounts payable	(3,273)	(9,569)
Accrued payroll and related expenses	(789)	(1,618)
Deferred revenues	2,848	1,668
Accrued warranty expenses	(1,148)	(1,318)
Accrued restructuring and executive severance	(1,853)	4,570
Accrued vendor cancellation charges	(147)	(2,156)
Other accrued liabilities	(1,311)	(806)
Net cash used in operating activities	(2,478)	(21,182)
Investing activities:		
Purchases of short-term investments	(48,938)	(78,000)
Proceeds from sales and maturities of short-term investments	36,941	117,429
Proceeds from sale of semiconductor assets, net	8,578	
Purchases of property and equipment	(816)	(1,623)
Net cash provided by (used in) investing activities	(4,235)	37,806
Financing activities:		
Principal payments on capital leases		(178)
Proceeds from issuance of common stock	2,109	781
Net cash provided by financing activities	2,109	603
Effect of foreign currency exchange rate changes	(9)	368

Net increase (decrease) in cash and cash equivalents	(4,613)	17,595
Cash and cash equivalents at beginning of period	43,218	30,188
Cash and cash equivalents at end of period	$ 38,605	$ 47,783

See accompanying notes.

TERAYON COMMUNICATION SYSTEMS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Organization

Description of Business

Terayon Communication Systems, Inc. (Company) was incorporated under the laws of the State of California on January 20, 1993. In June 1998, the Company reincorporated in the State of Delaware.

The Company develops, markets and sells equipment to broadband service providers who use the Company s products to deliver broadband voice, digital video solutions (DVS) and data services to residential and business subscribers.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of the condensed consolidated financial statements at June 30, 2005 and for the three and six months ended June 30, 2005 and 2004 have been included.

Results for the three and six months ended June 30, 2005 are not necessarily indicative of results for the entire fiscal year or future periods. These financial statements should be read in conjunction with the consolidated financial statements and the accompanying notes included in the Company s Form 10-K dated March 15, 2005, as filed with the U.S. Securities and Exchange Commission. The accompanying condensed consolidated balance sheet at December 31, 2004 is derived from audited consolidated financial statements at that date.

Reclassifications

Certain amounts such as cost of related party revenues in the 2004 financial statements have been reclassified to conform to the 2005 presentation.

Basis of Consolidation

The condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All intercompany balances and transactions have been eliminated.

Use of Estimates

The preparation of the condensed consolidated 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. Estimates are based on historical experience, input from sources outside of the Company, and other relevant facts and circumstances. Areas that are particularly significant include the Company s valuation of its accounts receivable and inventory, the assessment of recoverability and the measurement of impairment of fixed assets, and the recognition of restructuring liabilities.

Net Loss Per Share

The numerator and denominator of basic and diluted net loss per share is provided as follows (in thousands, except per share amounts):

	Three months ended June 30,		Six months ended June 30,	
	2005	2004	2005	2004
Net loss	$ (508)	$ (4,861)	$ (3,112)	$ (15,108)
Shares used in computing basic and diluted net loss per share	77,057	75,551	76,898	75,534

Basic and diluted net loss per share	$ (0.01)	$ (0.06)	$ (0.04)	$ (0.20)

Options to purchase 13,844,360 and 15,836,009 shares of common stock were outstanding at June 30, 2005 and June 30, 2004, respectively, but were not included in the computation of diluted net loss per share since the effect would have been anti-dilutive.

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Stock-based Compensation

The Company accounts for stock-based compensation for its employees using the intrinsic value method presented in Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, (APB 25), and includes the disclosure-only provisions as required under Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation (SFAS 123). The Company provides additional pro forma disclosures as required under SFAS 123 and SFAS 148, Accounting for Stock-Based Compensation, Transition and Disclosure .

For purposes of pro forma disclosures, the estimated fair value of the options granted and employee stock purchase plan shares to be issued is amortized to expense over their respective vesting periods. Had compensation cost for the Company s stock-based compensation plans been determined based on the fair value at the grant dates for awards under those plans consistent with the method of SFAS 123, the Company s net loss and net loss per share would have been increased to the pro forma amounts indicated below (in thousands, except per share data):

		Three months ended June 30,		Six months ended June 30,	
		2005	2004	2005	2004
Net loss, as reported		$ (508)	$ (4,861)	$ (3,112)	$(15,108)
Add:	Stock-based compensation under APB 25		17		17
Deduct:	Stock option compensation expense determined under fair value-based method	(1,051)	(3,703)	(2,367)	(8,213)
	Employee stock purchase plan compensation expense determined under fair value-based method		(357)		(713)
Pro forma net loss		$ (1,559)	$ (8,904)	$ (5,479)	$(24,017)
Net loss per share, basic and diluted, as reported		$ (0.01)	$ (0.06)	$ (0.04)	$ (0.20)
Pro forma net loss per share, basic and diluted		$ (0.02)	$ (0.12)	$ (0.07)	$ (0.32)
Shares used in computing net loss per share , as reported, and pro forma net loss per share, as reported, basic and diluted		77,057	75,551	76,898	75,534

Inventory

Inventory is stated at the lower of cost (first-in, first-out) or market. The components of inventory are as follows (in thousands):

	June 30, 2005	December 31, 2004
Raw materials	$ 473	$ 1,880
Work-in-process	23	1,501
Finished goods	12,263	13,763
Inventory	$12,759	$17,144

Purchase Obligations

The Company has purchase obligations to certain of its suppliers that support the Company s ability to manufacture its products. The obligations consist of purchase orders placed with vendors for goods and services and require the Company to purchase minimum quantities of the suppliers products at a specified price. As of June 30, 2005, $21.8 million of purchase obligations were outstanding. The Company accrued for vendor cancellation charges in an amount, which represented management s estimate of the Company s exposure to vendors for its inventory commitments that will not be consumed in the ordinary course of business. At June 30, 2005, accrued vendor cancellation charges were $0.4 million and the remaining $21.4 million was attributable to open purchase orders that are expected to be utilized in the normal course of business. The remaining obligations are expected to become payable at various times throughout 2005.

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Changes in Accounting Estimates

For the three and six months ended June 30, 2005, the Company s gross margins were benefited by the reversal of approximately $0.2 million and $0.4 million, respectively of accrued vendor cancellation charges, which were previously recorded as cost of goods sold. Additionally, for the three and six months ended June 30, 2004, the Company reversed approximately $0.8 million and $2.1 million, respectively, of accrued vendor cancellation charges, which were previously recorded as cost of goods sold. The Company reversed these charges as it was able to negotiate downward certain vendor cancellation to more favorable terms. During the three and six months ended June 30, 2005, the Company s gross margins were benefited by the sale of previously reserved inventory of approximately $1.9 million and $2.6 million, respectively, of inventory provisions, which were previously recorded as cost of goods sold. Additionally, during the three and six months ended June 30, 2004, the Company reversed approximately $0.3 million and $0.8 million, respectively, of inventory provisions, which were previously recorded as cost of goods sold. The Company reversed these provisions as it was able to sell inventory originally considered to be excess or obsolete.

In the first quarter of 2005, the Company reversed approximately $0.6 million of accounts receivable allowances as the Company was able to collect accounts which had previously been specifically reserved.

Accumulated Other Comprehensive Loss

Accumulated other comprehensive loss presented in the accompanying condensed consolidated balance sheets consists of net unrealized gains or losses on short-term investments and accumulated net foreign currency translation gains or losses.

The following are the components of comprehensive loss (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2005	2004	2005	2004
Net loss	$(508)	$(4,861)	$(3,112)	$(15,108)
Cumulative translation adjustments	22	444	(9)	368
Change in unrealized gain (loss) on available-for-sale investments	174	(537)	(131)	(534)
Total comprehensive loss	$(312)	$(4,954)	$(3,252)	$(15,274)

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Impact of Recently Issued Accounting Standards

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued SFAS 123 (revised 2004), (SFAS 123(R)), Share-Based Payment, which replaces SFAS 123, Accounting for Stock-Based Compensation, and supersedes APB 25, Accounting for Stock Issued to Employees. Generally, the approach in SFAS 123(R) is similar to the approach described in SFAS 123. SFAS 123(R) eliminates the alternative to use APB 25 s intrinsic value method of accounting that was provided in SFAS 123 as originally issued. The Company s effective date for implementation of SFAS 123(R) is January 1, 2006. The Company has not yet determined which phase-in method it will adopt. In the first quarter of 2005, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 107, which provided further clarification on the implementation of SFAS 123(R).

As permitted by SFAS 123, the Company currently accounts for share-based payments to employees using APB 25 s intrinsic value method and, as such, generally recognizes no compensation expense for employee stock options. Accordingly, the adoption of SFAS 123(R) s fair value method will likely have a material impact on the Company s results of operations, although it will have no impact on its overall financial position. See *Stock Based Compensation*, above for information related to the pro forma effects on the Company s reported net loss and net loss per common share of applying the fair value recognition provisions of the previous SFAS 123 to stock-based employee compensation.

In November 2004, the FASB issued SFAS 151, Inventory Costs, which revised Accounting Research Bulletin No. 43 (ARB 43), relating to inventory costs. This revision is to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material (spoilage). SFAS 151 requires that these items be recognized as a current period charge regardless of whether they meet the criterion specified in ARB 43. In addition, SFAS 151 requires the allocation of fixed production overheads to the costs of conversion be based on normal capacity of the production facilities. SFAS 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of SFAS 151 is not expected to have a material impact on the Company s financial statements.

3. Contingencies

Beginning in April 2000, several plaintiffs filed class action lawsuits in federal court against the Company and certain of the Company s officers and directors. Later that year, the cases were consolidated in the United States District Court, Northern District of California as In re Terayon Communication Systems, Inc. Securities Litigation. The Court then appointed lead plaintiffs who filed an amended complaint. In 2001, the Court granted in part and denied in part defendants motion to dismiss, and plaintiffs filed a new complaint. In 2002, the Court denied defendants motion to dismiss that complaint, which, like the earlier complaints, alleges that the defendants violated the federal securities laws by issuing materially false and misleading statements and failing to disclose material information regarding the Company s technology. On February 24, 2003, the Court certified a plaintiff class consisting of those who purchased or otherwise acquired the Company s securities between November 15, 1999 and April 11, 2000.

On September 8, 2003, the Court heard defendants motion to disqualify two of the lead plaintiffs and to modify the definition of the plaintiff class. On September 10, 2003, the Court issued an order vacating the hearing date for the parties summary judgment motions, and, on September 22, 2003, the Court issued another order staying all discovery until further notice and vacating the trial date, which had been November 4, 2003.

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On February 23, 2004, the Court issued an order disqualifying two of the lead plaintiffs. The order also states that plaintiffs counsel must provide certain information to the Court about counsel s relationship with the disqualified lead plaintiffs, and it provides that defendants may serve certain additional discovery. On March 24, 2004, plaintiffs submitted certain documents to the Court in response to its order, and, on April 16, 2004, the Company responded to this submission. The Company has also initiated discovery pursuant to the Court s February 23, 2004 order. Were an unfavorable ruling to occur in this legal matter, there exists the possibility of a material adverse impact on the Company s results of operations for the period in which the ruling occurs.

On October 16, 2000, a lawsuit was filed against the Company and the individual defendants (Zaki Rakib, Selim Rakib and Raymond Fritz) in the California Superior Court, San Luis Obispo County. This lawsuit is titled Bertram v. Terayon Communications Systems, Inc. The factual allegations in the Bertram complaint were similar to those in the federal class action, but the Bertram complaint sought remedies under state law. Defendants removed the Bertram case to the United States District Court, Central District of California, which dismissed the complaint and transferred the case to the United States District Court, Northern District of California. That Court eventually issued an order dismissing the case. Plaintiffs have appealed this order, and their appeal was heard on April 16, 2004. On June 9, 2004, the United States Court of Appeals for the Ninth Circuit affirmed the order dismissing the Bertram case.

The Court of Appeals opinion affirming dismissal of the Bertram case does not end the class action. The Company believes that the allegations in the class action are without merit, and intends to contest this matter vigorously. This matter, however, could prove costly and time consuming to defend, and there can be no assurances about the eventual outcome.

In 2002, two shareholders filed derivative cases purportedly on behalf of the Company against certain of its current and former directors, officers, and investors. (The defendants differed somewhat in the two cases.) Since the cases were filed, the investor defendants have been dismissed without prejudice, and the lawsuits have been consolidated as Campbell v. Rakib in the California Superior Court, Santa Clara County. The Company is a nominal defendant in these lawsuits, which allege claims relating to essentially the same purportedly misleading statements that are at issue in the pending securities class action. In the securities class action, the Company disputes making any misleading statements. The derivative complaints also allege claims relating to stock sales by certain of the director and officer defendants.

The Company believes that there are many defects in the derivative complaints. However, were an unfavorable ruling to occur in this legal matter, there exists the possibility of a material adverse impact on the Company s results of operations for the period in which the ruling occurs.

In January 2005, Adelphia Corporation (Adelphia) sued the Company in the District Court of the City and County of Denver, Colorado. Adelphia s complaint alleges, among other things, breach of contract and misrepresentation in connection with the Company s sale of CMTS products to Adelphia and the Company s announcement to cease future investment in the CMTS market. Adelphia seeks damages in excess of $25.0 million and declaratory relief. The Company moved to dismiss the complaint seeking an order blocking the case from going forward at a preliminary stage. The court denied the Company s motion to dismiss the complaint, thereby permitting the case and discovery to go forward. The Company filed its response to Adelphia s complaint and discovery has begun. The case is currently set for trial to commence on May 15, 2006. As the Company believes that Adelphia s allegations are without merit, it intends to contest this matter vigorously. This matter, however, could prove costly and time consuming to defend, and there can be no assurances about the eventual outcome. Were an unfavorable ruling to occur in this legal matter, there exists the possibility of a material adverse impact on the Company s results of operations for the period in which the ruling occurs.

The Company has received letters claiming that its technology infringes the intellectual property rights of others. The Company has consulted with its patent counsel and is in the process of reviewing the allegations made by such third parties. If these allegations were submitted to a court, the court could find that the Company s products infringe third party intellectual property rights. If the Company is found to have infringed third party rights, the Company could be subject to substantial damages and/or an injunction preventing the Company from conducting its business. In addition, other third parties may assert infringement claims against the Company in the future. A claim of infringement, whether meritorious or

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not, could be time-consuming, result in costly litigation, divert the Company s management s resources cause product shipment delays or require the Company to enter into royalty or licensing arrangements. These royalty or licensing arrangements may not be available on terms acceptable to the Company, if at all.

Furthermore, the Company has in the past agreed to, and may from time to time in the future agree to, indemnify a customer of its technology or products for claims against the customer by a third party based on claims that its technology or products infringe intellectual property rights of that third party. These types of claims, meritorious or not, can result in costly and time-consuming litigation; divert management s attention and other resources; require the Company to enter into royalty arrangements; subject the Company to damages or injunctions restricting the sale of its products; require the Company to indemnify its customers for the use of the allegedly infringing products; require the Company to refund payment of allegedly infringing products to its customers or to forgo future payments; require the Company to redesign certain of its products; or damage its reputation, any one of which could materially and adversely affect the Company s business, results of operations and financial condition.

The Company may, in the future, take legal action to enforce its patents and other intellectual property rights, to protect its trade secrets, to determine the validity and scope of the proprietary rights of others, or to defend against claims of infringement or invalidity. Such litigation could result in substantial costs and diversion of resources and could negatively affect the Company s business, operating results, financial position and liquidity.

The Company is currently a party to various other legal proceedings, in addition to those noted above, and may become involved from time to time in other legal proceedings in the future. While the Company currently believes that the ultimate outcome of these proceedings, individually and in the aggregate, will not have a material adverse effect on its financial position or overall results of operations, litigation is subject to inherent uncertainties. Were an unfavorable ruling to occur in any of the Company s legal proceedings, there exists the possibility of a material adverse impact on the Company s financial condition and results of operations for the period in which the ruling occurs. The estimate of the potential impact on the Company s financial position and overall results of operations for any of the above legal proceedings could change in the future.

4. Operating Segment Information

The Company operates as one business segment.

	Three months ended June 30,		Six months ended June 30,	
(in thousands)	2005	2004	2005	2004
Revenues by product:				
Digital Video Solutions (DVS)	$17,339	$ 7,508	$30,385	$13,579
Home Access Solutions (HAS)	10,590	24,983	22,160	48,597
Cable Modem Termination Systems (CMTS)	1,506	10,291	3,157	21,588
Other	98		194	185
Total revenues	$29,533	$42,782	$55,896	$83,949
Revenues by geographic areas:				
United States	$20,223	$21,226	$35,490	$43,058
Americas, excluding United States	431	224	568	1,838
Europe, Middle East and Africa, (EMEA), excluding Israel	2,288	7,041	6,474	14,965
Israel	2,797	5,931	3,984	9,215
Asia, excluding Japan	3,400	5,037	8,965	9,132
Japan	394	3,294	394	5,688
Other		29	21	53
Total	$29,533	$42,782	$55,896	$83,949

	June 30, 2005	December 31, 2004
Long-lived assets:		
United States	$ 4,079	$ 4,423
Americas, excluding United States		402
EMEA, excluding Israel	96	131
Israel	273	687
Asia	90	117
Total long-lived assets	4,538	5,760
Total current assets	141,562	137,625
Other assets	9,396	10,349
Total assets	$155,496	$153,734

Two customers, Comcast Corporation (Comcast) and Harmonic, Inc. (Harmonic), accounted for 10% or more of total revenues (24% and 16%) for the three months ended June 30, 2005. Two customers, Harmonic and Comcast, accounted for 10% or more of total revenues (24% and 17%) for the six months ended June 30, 2005. Two customers, Adelphia Communications Corporation (Adelphia) and Telenet, accounted for 10% or more of total revenues (25% and 12%) for the three months ended June 30, 2004. Two customers, Adelphia and Telenet, accounted for 10% or more of total revenues (23% and 10%) for the six months ended June 30, 2004. One of these customers is Harmonic which is a related party (see Note 6). For the three and six months ended June 30, 2005, Harmonic accounted for 16% and 24% respectively of the Company s total revenues. For the three and six months ended June 30, 2004, Harmonic accounted for 6% and 4% respectively of the Company s total revenues.

At June 30, 2005, Comcast, Harmonic, Adelphia, and Telenet accounted for $4.3 million, $2.3 million, $1.5 million, and $0.1 million, respectively of the accounts receivable. At June 30, 2004, Comcast, Harmonic, Adelphia, and Telenet accounted for $0.9 million, $1.1 million, $5.3 million, and $4.7 million, respectively of the accounts receivable.

5. Restructuring Charges and Asset Write-offs

Restructuring

The Company accrues for termination costs in accordance with SFAS 146, *Accounting for Costs Associated with Exit or Disposal Activities,* and SFAS 112, "*Employers Accounting for Post Employment Benefits* . Liabilities are initially measured at their fair value on the date in which they are incurred based on plans approved by the Company s Board of Directors. Accrued employee termination costs principally consist of three components: 1) a lump-sum severance payment based upon the years of service; 2) COBRA insurance based on years of service; and 3) an estimate of costs for outplacement services provided to the affected employees. Most employees are terminated on the date of notification so there is no additional service period required to be included in the determination of accrued termination costs. Where services are required for a period over 60 days, the Company ratably amortizes termination costs over the required service period.

2004 Restructurings

During the first quarter of 2004, the Company initiated a Board of Director s approved restructuring plan to bring operating expenses in line with revenue levels. The Company incurred restructuring charges in the amount of $3.3 million of which $1.0 million related to employee termination costs, $0.9 million related to termination costs for an aircraft lease, and $1.4 million related to costs for excess leased facilities in the first quarter of 2004. The Company incurred additional restructuring charges in the amount of $1.1 million in the second quarter of 2004 related to additional costs for excess leased facilities resulting in a second restructuring plan. In the fourth quarter of 2004, to further conform the Company s expenses to its revenue and to cease investment in the CMTS product line, the

Company s Board of Directors approved a third restructuring plan that resulted in a charge in the amount of $1.3 million related to employee terminations.

Each quarter, the Company re-evaluates the 2004 restructuring charges for the employee severance, excess leased facilities and the aircraft lease. Based on market conditions, new assumptions provided by its real-estate broker, and the terms of an aircraft sublease agreement, which the Company entered into in the third quarter of 2004, the Company revalues the restructuring liability. During the first six months of 2005, the Company re-evaluated the 2004 restructuring liability estimates. Based on new

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assumptions provided by its real-estate broker, the Company increased the 2004 restructuring accrual by $0.9 million in the first six months of 2005. Additionally, the Company increased its estimated 2004 restructuring liability for employee severance in the first six months of 2005 by $1.0 million.

As of June 30, 2005, $3.2 million of 2004 restructuring charges remained accrued. In the six months ended June 30, 2005, the Company had paid $1.1 million in employee termination costs, $0.1 million of costs related to the aircraft lease, and $0.7 million of costs related to excess leased facilities.

The Company anticipates the remaining restructuring accrual related to the aircraft lease to be substantially utilized for servicing operating lease payments, through January 2007. The remaining restructuring accrual related to excess leased facilities is expected to be utilized for servicing operating lease payments or negotiating a buyout of operating lease commitments through October 2009.

The accrual for the aircraft lease approximates the difference between the Company s current costs for the aircraft lease and the estimated income derived from the sublease of the aircraft.

The amount of net charges accrued under the 2004 restructuring plans assumes that the Company will successfully sublease excess leased facilities. The accrual for the excess leased facilities includes the estimated income derived from subleasing, which is based on information from the Company s real-estate brokers, who provide estimates based on assumptions relevant to the real estate market conditions. Even though it is the Company s intent to sublease its interests in the excess facility at the earliest possible time, the Company cannot determine with certainty a fixed date by which such events will occur, if at all. In light of this uncertainty, the Company will continue to periodically re-evaluate and adjust the accrual, as necessary.

This table summarizes the accrued restructuring balances related to the 2004 restructurings as of June 30, 2005 (in thousands):

	Involuntary Employee Terminations	Aircraft Lease Termination	Excess Leased Facilities and Cancelled Contracts,	Total
Balance at December 31, 2004	$ 592	$ 692	$ 1,998	$ 3,282
Cash payments	(1,121)	(125)	(679)	(1,925)
Charges	965			965
Changes in estimate			907	907
Balance at June 30, 2005	$ 436	$ 567	$ 2,226	$ 3,229

2002 Restructuring

During 2002, a restructuring plan (2002 Plan) was approved by the Board of Directors and the Company incurred restructuring charges in the amount of $3.6 million, of which none remained accrued at June 30, 2005, for excess leased facilities in Israel. During 2004, improving real estate market conditions in Israel gave rise to the Company s improved tenant sublease assumptions and, as a result, the Company revalued the accrual for excess leased facilities in Israel and decreased the accrual by $0.1 million. Additionally, the Company reclassified $1.1 million between the 2002 Plan and 2001 Plan in the fourth quarter of 2004.

This table summarizes the accrued restructuring balances related to the 2002 Plan as of June 30, 2005 (in thousands):

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	Involuntary Employee Terminations	Excess Leased Facilities and Cancelled Contracts	Total
Balance at December 31, 2004	$	$ 15	$ 15
Changes in estimate		(15)	(15)
Balance at June 30, 2005	$	$	$

2001 Restructuring

During 2001, the Board of Directors approved a restructuring plan (2001 Plan) and the Company incurred restructuring charges in the amount of $12.7 million, of which $0.5 million remained accrued at June 30, 2005, primarily for excess leased facilities in Israel. During 2004, improving real estate market conditions in Israel gave rise to the Company s improved tenant sublease assumptions thereby resulting in a change in estimate of $1.4 million. Additionally, a reclassification between the 2002 Plan and 2001 Plan increased the 2001 Plan by $1.1 million in the fourth quarter of 2004. The Company currently anticipates the remaining restructuring accrual relating to excess leased facilities will be utilized for servicing operating lease payments through 2005.

During the first half of 2005, the Company re-evaluated the 2001 restructuring accrual estimates for the excess facilities in Israel. Based on actual sublease income and new assumptions provided by its real-estate broker, the Company decreased the restructuring charge by $0.4 million for the six months ended June 30, 2005.

This table summarizes the accrued restructuring balances related to the 2001 Plan as of June 30, 2005 (in thousands):

	Involuntary Employee Terminations	Excess Leased Facilities and Cancelled Contracts	Total
Balance at December 31, 2004	$ 50	$ 1,788	$ 1,838
Cash payments	(50)	(957)	(1,007)
Changes in estimate		(361)	(361)
Balance at June 30, 2005	$	$ (470)	$ (470)

Executive Severance

In 2003 and 2004, the Company entered into employment agreements with four executive officers who subsequently resigned from the Company. The Company recorded a severance provision of $1.7 million related to termination costs for these officers in the six months ended June 30, 2004. Most of the severance costs related to these officers were paid in 2004. Approximately $13,000 of employee benefits for the executive officers remained accrued at June 30, 2005, which is expected to be paid through 2005.

Asset Write-offs

The Company wrote off $0.1 million and $0.1 million in the six months ended June 30, 2005 and June 30, 2004, respectively, of fixed assets related to restructuring activities, which were determined to have no remaining useful life.

6. Related Party Transactions

Lewis Solomon, a member of the Company s Board of Directors is also a member of the Board of Directors of Harmonic, Inc. (Harmonic). Harmonic is an authorized, non-exclusive reseller of certain of the Company s video products. For the six months ended June 30, 2005 and June 30, 2004, related party revenue from Harmonic was $13.7 million and $3.4 million, respectively.

Cost of related party revenues in the Company s consolidated statements of operations consists of direct and indirect costs. Accounts receivable from Harmonic totaled approximately $2.3 million at June 30, 2005. Harmonic is not a supplier to the Company.

7. Product Warranties

The Company provides for estimated product warranty expenses when it sells the related products. The Company has comprehensive processes that it uses to estimate accruals for warranty exposure. The processes include specific evaluation by product type, estimated failure rates and costs to repair or replace. Although the Company believes it has the continued ability to reasonably estimate warranty expenses, unforeseeable changes in factors used to estimate the accrual for warranty could occur. These unforeseeable changes could cause a material change in the Company s warranty accrual estimate. Such a change would be recorded in the period in which the change was identified.

An analysis of changes in the liability for product warranties for the six months ended June 30, 2005 and 2004, is as follows (in thousands):

	Balance at beginning of period	Additions charged to expenses	Expiration of accrued warranty	Charges for warranty services provided	Balance at end of period
Six months ended June 30, 2004					
Accrued warranty expenses	$5,509	1,922	(1,300)	(1,940)	$4,191
Six months ended June 30, 2005					
Accrued warranty expenses	$3,870	830	(475)	(1,503)	$2,722

8. Sale of Certain Assets

ATI

On February 7, 2005, the Company entered into an agreement with ATI Technologies, Inc (ATI) to sell certain cable modem semiconductor assets to ATI for a total purchase price of up to $13.8 million if the Company achieves all the milestones specified in the agreement. Under the terms of the agreement, ATI acquired the Company s cable modem silicon intellectual property and related software, assumed a lease and hired approximately twenty-five employees from the Company s design team. Upon closing on March 9, 2005, the Company received $8.6 million in cash, which was comprised of a $6.95 million initial payment and $1.65 million of the $1.9 million for having met the first milestone. In May 2005, the Company received an additional $2.5 million upon completion of two additional milestones. As of June 30, 2005, the Company had deferred the net gain of $8.6 million, which represented the cash receipt of $11.1 million, less transaction related costs of $2.5 million. The balance of up to $2.7 million of the purchase price will be paid to the Company in the event the Company meets the two remaining milestones over the subsequent 15 months following the closing, and upon the release of the escrow. The agreement also sets forth representations and warranties made by the Company that may cause it to incur liabilities and penalties arising out of its failure to meet certain conditions and milestones. The maximum liability for the Company is the greater of $11.5 million or the total amount of the purchase price paid by ATI plus $1.5 million. The gain on the sale of the assets, if any, will be recognized upon completion of all milestones or when the contingencies related to the sale are resolved.

Israel Subsidiaries

On April 2, 2004, the Company sold all of its ownership in Radwiz, Ltd., Ultracom Communications Holdings Ltd. and Combox Ltd. to a third party for a cash payment of $150,000. In connection with this disposition, the acquirer received obsolete inventories with no book value, $0.2 million of selected net assets, and assumed $1.35 million of net

liabilities related to these subsidiaries. The Company recorded a net gain of $1.3 million on this transaction in the second quarter of 2004, which is included as an element of other income (expense) in the accompanying condensed consolidated statement of operations.

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

The following discussion and analysis should be read in conjunction with our condensed consolidated financial statements and notes thereto.

Overview

We sell our digital video solution (DVS) products to cable operators, satellite providers and television broadcasters. Additionally, we sell our home access solution (HAS) products, including cable modems, embedded multimedia terminal adapters (eMTA), home networking devices, and to a lesser extent cable modem termination system (CMTS) product line to cable operators.

On February 7, 2005, we entered into an agreement with ATI Technologies, Inc (ATI) to sell certain cable modem semiconductor assets to ATI for a total purchase price of up to $13.8 million if we achieve all the milestones specified in the agreement. Under the terms of the agreement, ATI acquired our cable modem silicon intellectual property and related software, assumed a lease and hired approximately twenty-five employees from our design team. Upon closing on March 9, 2005, we received $8.6 million in cash, which was comprised of a $6.95 million initial payment and $1.65 million of the $1.9 million for having met the first milestone. In May 2005, we received an additional $2.5 million upon completion of two additional milestones. As of June 30, 2005, we had deferred the net gain of $8.6 million, which represented the cash receipt of $11.1 million, less transaction related costs of $2.5 million. The balance of up to $2.7 million of the purchase price will be paid to us in the event we meet the two remaining milestones over the subsequent 15 months following the closing, and upon the release of the escrow. The agreement also sets forth representations and warranties made by us that may cause us to incur liabilities and penalties arising out of our failure to meet certain conditions and milestones. The maximum liability for us is the greater of $11.5 million or the total amount of the purchase price paid by ATI plus $1.5 million. The gain on the sale of the assets, if any, will be recognized upon completion of all milestones or when the contingencies related to the sale are resolved.

We have not been profitable since our inception. We had a net loss of $0.5 million or $0.01 per share for the quarter ended June 30, 2005. Our ability to grow our business and attain profitability is dependent on our ability to effectively compete in the marketplace with our current products and services, develop and introduce new products and services, contain operating expenses and improve our gross margins, as well as continued investment in equipment by the broadband provider industry.

At June 30, 2005, we had approximately $105.0 million in unrestricted cash, cash equivalents and short-term investments as compared to approximately $97.7 million at December 31, 2004. This increase in the first six months of 2005 primarily resulted from the ATI transaction, offset by the use of cash for operating activities.

A more detailed description of the risks to our business can be found in the section captioned Risk Factors in this quarterly report.

Critical Accounting Policies

There have been no material changes to any of our critical accounting policies and estimates as disclosed in our report on Form 10-K for the year ended December 31, 2004.

Results of Operations
Three and Six months ended June 30, 2005 and June 30, 2004
Revenues

(in thousands)	For the three months ended June 30, 2005	2004	For the six months ended June 30, 2005	2004	% Change for the three months ended June 30, 2005/2004	% Change for the six months ended June 30, 2005/2004
Revenues	$29,533	$42,782	$55,896	$83,949	(31%)	(33%)

Our revenues decreased 31% for the quarter ended June 30, 2005 compared to the quarter ended June 30, 2004 and decreased 33% for the six months ended June 30, 2005 compared to the six months ended June 30, 2004. While sales of our DVS products increased, the overall decrease was primarily due to decreased sales of our HAS and CMTS products. We expect overall revenues to remain flat or increase slightly on a sequential basis in 2005.

Revenues by Groups of Similar Products

(in thousands)	For the three months ended June 30, 2005	2004	For the six months ended June 30, 2005	2004	% Change for the three months ended June 30, 2005/2004	% Change for the six months ended June 30, 2005/2004
Revenues by product:						
DVS	$17,339	$ 7,508	$30,385	$13,579	131%	124%
HAS	10,590	24,983	22,160	48,597	(58%)	(54%)
CMTS	1,506	10,291	3,157	21,588	(85%)	(85%)
Other	98		194	185	100%	5%
Total revenues	$29,533	$42,782	$55,896	$83,949	(31%)	(33%)

Revenues from DVS products increased in 2005 compared to 2004, due to significant shipments of the CP 7600G edge decoder, primarily in the second quarter of 2005, as well as continued sales of our DM 6400 CherryPickers. We are encouraged by the prospects for the DVS business to grow and believe that we will continue to see increased demand of DVS products resulting from more high definition television (HDTV) programming and other digital video services, including digital ad insertion.

HAS revenues decreased in 2005 compared to 2004, primarily due to an overall decrease in modem sales. The number of modems sold decreased from 0.5 million in the second quarter of 2004 to 0.2 million in the same period in 2005. The intensely competitive nature of the market for broadband products has resulted in significant price erosion of Average Selling Prices (ASP). While we continue to see a decrease in ASPs in the second quarter of 2005, the overall ASP of all modems we sold in the second quarter of 2005 increased due to increased sales of our higher priced eMTA modems. We expect HAS revenues to remain relatively flat or increase slightly in the remainder of 2005.

CMTS revenues continued to decline in 2005 compared to 2004, due to our decision to cease investment in the CMTS product line as announced in the third quarter of 2004. We expect CMTS revenues to continue to decrease in 2005.

Revenues by Geographic Region

(in thousands)	For the three months ended June 30, 2005	For the three months ended June 30, 2004	For the six months ended June 30, 2005	For the six months ended June 30, 2004	% Change for the three months ended June 30, 2005/2004	% Change for the six months ended June 30, 2005/2004
Revenues by geographic areas:						
United States	$20,223	$21,226	$35,490	$43,058	(5%)	(18%)
Americas, excluding United States	431	224	568	1,838	92%	(69%)
Europe, Middle East and Africa, (EMEA), excluding Israel	2,288	7,041	6,474	14,965	(68%)	(57%)
Israel	2,797	5,931	3,984	9,215	(53%)	(57%)
Asia excluding Japan	3,400	5,037	8,965	9,132	(32%)	(2%)
Japan	394	3,294	394	5,688	(88%)	(93%)
Other		29	21	53	(100%)	(60%)
Total	$29,533	$42,782	$55,896	$83,949	(31%)	(33%)

Revenues in the United States decreased in the three and six months ended June 30, 2005 compared to the same periods in 2004, primarily due to decreased sales of CMTSs and HAS products to United States Major Systems Operators (MSOs). Revenues in EMEA, Israel, and Asia also decreased in the same period due to decreased sales of our CMTS and HAS products. During the second quarter of 2005, we continued to emphasize sales to our United States, Israel, and Asian customers while placing a lower emphasis on other locations such as Canada, South America and Japan. In the remainder of 2005, we expect revenues to remain flat or slightly increase in the United States and EMEA markets. Two customers, Comcast Corporation (Comcast) and Harmonic, Inc. (Harmonic), accounted for 10% or more of total revenues (24% and 16%) for the three months ended June 30, 2005. Two customers, Harmonic and Comcast, accounted for 10% or more of total revenues (24% and 17%) for the six months ended June 30, 2005. Two customers, Adelphia Communications Corporation (Adelphia) and Telenet, accounted for 10% or more of total revenues (25% and 12%) for the three months ended June 30, 2004. Two customers, Adelphia and Telenet, accounted for 10% or more of total revenues (23% and 10%) for the six months ended June 30, 2004. At June 30, 2005, Comcast, Harmonic, Adelphia, and Telenet accounted for $4.3 million, $2.3 million, $1.5 million, and $0.1 million, respectively of the accounts receivable. At June 30, 2004, Comcast, Harmonic, Adelphia, and Telenet accounted for $0.9 million, $1.1 million, $5.3 million, and $4.7 million, respectively of the accounts receivable.

Related Party Revenues

	For the three months ended June 30,	For the six months ended June 30,	% Change for the three months ended June 30,	% Change for the six months ended June 30,

(in thousands)	2005	2004	2005	2004	2005/2004	2005/2004
Related party revenues	$4,841	$2,644	$13,668	$3,389	83%	303%

Related party revenues increased in 2005 compared to 2004. Lewis Solomon, a member of our board of directors, is a member of the board of directors of Harmonic. All related party revenues are attributable to Harmonic and are included in related party revenues in 2005 and 2004. The increase in related party revenues was primarily due to an increase of sales of our DVS products to Harmonic in 2005 as compared to 2004. Harmonic is not a supplier to us.

Cost of Goods Sold and Gross Profit

	For the three months ended June 30,		For the six months ended June 30,		% Change for the three months ended June 30,	% Change for the six months ended June 30,
(in thousands)	2005	2004	2005	2004	2005/2004	2005/2004
Cost of revenues	$14,024	$27,046	$25,379	$55,605	(48%)	(54%)
Cost of related party revenues	2,677	614	4,364	825	336%	429%
Total cost of goods sold	$16,701	$27,660	$29,743	$56,430	(40%)	(47%)
Gross profit	$12,832	$15,122	$26,153	$27,519	(15%)	(5%)

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Cost of goods sold consists of direct product costs as well as the cost of our manufacturing operations. The cost of manufacturing includes contract manufacturing, test and quality assurance for products, warranty costs and associated costs of personnel and equipment. In the three and six months ended June 30, 2005, cost of goods sold was approximately 57% and 53% of revenues, respectively, compared to 65% and 67% of revenues, respectively, in the same periods in 2004. For the three and six months ended June 30, 2005, our gross margins were benefited by the reversal of approximately $0.2 million and $0.4 million, respectively of accrued vendor cancellation charges, which were previously recorded as cost of goods sold. Additionally, for the three and six months ended June 30, 2004, we reversed approximately $0.8 million and $2.1 million, respectively, of accrued vendor cancellation charges, which were previously recorded as cost of goods sold. During the three and six months ended June 30, 2005, our gross margins were benefited primarily by reversal of inventory provisions, which were previously recorded as cost of goods sold, upon the sale of previously reserved CMTS inventory of approximately $1.9 million and $2.6 million. We reversed these provisions as we were able to sell inventory originally considered to be excess or obsolete. Additionally, during the three and six months ended June 30, 2004, we reversed approximately $0.3 million and $0.8 million, respectively, of inventory provisions, which were previously recorded as cost of goods sold. We reversed these provisions as we were able to sell inventory originally considered to be excess or obsolete.

In 2005, related party cost of revenues increased compared to 2004 due to increased sales of our DVS products to Harmonic in 2005 as compared to sales in 2004.

Our gross profit decreased in the three and six months ended June 30, 2005 compared to the same period in 2004. The decrease in our gross profit was primarily related to a decrease in revenues from our HAS and CMTS products.

During 2005, we will continue to focus on improving sales of higher margin products and reducing product manufacturing costs. We are now partnering with contract manufacturers in Asia and the U.S. for our HAS and DVS products, which may provide us with more competitive component pricing, economies of scale, and improved manufacturing capabilities. We may be able to increase our margins by obtaining a product mix that is expected to shift to higher margin DVS products. Additionally, We expect HAS product mix to shift to higher margin priced eMTA products. However, there are no assurances that we will succeed in selling a greater percentage of higher margin products or reducing our product manufacturing costs.

Operating Expenses

(in thousands)	For the three months ended June 30, 2005	For the three months ended June 30, 2004	For the six months ended June 30, 2005	For the six months ended June 30, 2004	% Change for the three months ended June 30, 2005/2004	% Change for the six months ended June 30, 2005/2004
Research and development	$4,427	$8,516	$10,371	$17,984	(48%)	(42%)
Sales and marketing	$5,611	$5,411	$11,285	$12,632	4%	(11%)
General and administrative	$2,878	$2,953	$ 5,673	$ 5,388	(3%)	5%

Research and Development. Research and development expenses consist primarily of personnel costs, internally designed prototype material expenditures, and expenditures for outside engineering consultants, and testing equipment and supplies required to develop and enhance our products. Research and development expenses decreased 48% to $4.4 million or 15% of sales in the second quarter of 2005 from $8.5 million or 20% of sales in the same period in 2004. The $4.1 million decrease in research and development expenses was attributable to $2.5 million of reductions in employee related expenses primarily related to our decision to cease investment in the CMTS product line as announced in the third quarter of 2004, $0.6 million decrease in allocations of facility and overhead related support costs, and $1.1 reduction of other expenses, partially offset by an increase of $0.1 million of outside engineering

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consultants. Research and development expenses decreased 42% to $10.4 million or 19% of sales in the six months ended June 30, 2005 from $18.0 million or 21% of sales in the same period in 2004. The $7.6 million decrease in research and development expenses was attributable to $4.5 million of reductions in employee related expenses primarily related to our decision to cease investment in the CMTS product line as announced in the third quarter of 2004, $1.8 million decrease in allocations of facility and overhead related support costs, and $1.7 reduction of other expenses, partially offset by an increase of $0.4 million of outside engineering consultants. We believe it is critical for the Company to continue to make significant investments in research and development to create innovative technologies and products that meet the current and future requirements of our customers. Accordingly, we intend to continue our investment in research and development in 2005 primarily in our DVS products.

Sales and Marketing. Sales and marketing expenses consist primarily of salaries and commissions for sales personnel, and marketing and support personnel, and costs related to marketing communications, consulting and travel. Sales and marketing expenses increased by $0.2 million to $5.6 million or 19% of sales in the second quarter of 2005 from $5.4 million or 13% of sales in the same period in 2004. The $0.2 million increase in sales and marketing expenses was primarily due $0.4 million of increased cost for trade shows, $0.2 million of increased spending for outside consultants, and $0.3 million of overall sales and marketing costs, partially offset by $0.7 million in decreased employee expenses due to decreased headcount. Sales and marketing expenses decreased by $1.3 million to $11.3 million or 20% of sales in the six months ended June 30, 2005 from $12.6 million or 15% of sales in the same period in 2004. The $1.3 million decrease in sales and marketing expenses was primarily due to $1.1 million in decreased employee expenses due to decreased headcount and $0.8 million of decreased corporate aircraft expenses, offset by $0.6 million of overall sales and marketing cost increases. We currently expect sales and marketing expenses to be relatively flat to slightly lower in 2005 when compared to 2004.

General and Administrative. General and administrative expenses consist primarily of salary and benefits for administrative officers and support personnel, travel expenses and legal, and accounting and consulting fees. General and administrative expenses decreased by $0.1 million to $2.9 million or 10% of sales in the quarter ended June 30, 2005 from $3.0 million or 7% of sales in the same period in 2004. The $0.1 million decrease was primarily due to $0.2 million in reduced employee expenses and $0.4 million in decreased facilities costs, offset by $0.5 million increase in allocations of facility and overhead related support costs. General and administrative expenses increased by $0.3 million to $5.7 million or 10% of sales in the six months ended June 30, 2005 from $5.4 million or 6% of sales in the same period in 2004. The $0.3 million increase was primarily due to $0.3 million of increased spending for outside consultants and a $2.2 million increase in allocations of facility and overhead related support costs, partially offset by a $0.6 million reduction in our allowance for doubtful accounts credited to general and administrative expense, $0.5 million in reduced employee expenses due to lower headcount, and $1.1 million of overall general and administrative cost decreases. We currently expect general and administrative expenses to be relatively flat in 2005 when compared to 2004.

Restructuring Charges and Asset Write-offs

	For the three months ended June 30,		For the six months ended June 30,	
(in thousands)	2005	2004	2005	2004
Executive severance charges	$	$1,682	$	$1,682
Restructuring charges, net	282	1,897	1,479	5,158
Long-lived assets written-off			85	106
Restructuring costs and asset write-offs	$282	$3,579	$1,564	$6,946

Restructuring Costs During the first quarter of 2004, we initiated a Board of Directors approved restructuring plan to bring operating expenses in line with revenue levels. We incurred restructuring charges in the amount of $3.3 million of which $1.0 million related to employee termination costs, $0.9 million related to termination costs for an aircraft lease, and $1.4 million related to costs for excess leased facilities in the first quarter of 2004. We incurred additional restructuring charges in the amount of

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$1.1 million in the second quarter of 2004 related to additional costs for excess leased facilities resulting in a second restructuring plan. In the fourth quarter of 2004, to further conform our expenses to our revenue and to cease investment in the CMTS product line, our Board of Directors approved a third restructuring plan that resulted in a charge in the amount of $1.3 million related to employee terminations. The remaining restructuring accrual related to the aircraft lease is expected to be substantially utilized for servicing operating lease payments through January 2007, and the remaining restructuring accrual related to excess leased facilities, is expected to be utilized for servicing operating lease payments or negotiating a buyout of operating lease commitments, through October 2009.

The reserve for the aircraft lease and excess leased facilities was based on information provided by our brokers that estimated, based on assumptions relevant to the aircraft and real estate market conditions as of the date of our restructuring plan, the time it would be likely to take until the aircraft and excess leased facilities would be fully sub-leased. Even though it is our intent to sublease, assign or sell our interests in the excess facilities at the earliest possible time, we cannot determine with certainty a fixed date by which such events will occur. In light of this uncertainty, we will periodically re-evaluate and adjust the reserve, as necessary.

In the third quarter of 2002, we initiated a restructuring program. As part of this program, we restructured our worldwide operations including a worldwide reduction in workforce and the consolidation of excess leased facilities. We incurred restructuring charges of $3.6 million related to the 2002 restructuring. Of the total restructuring charge, $2.3 million was related to employee termination costs. The remaining $1.3 million related primarily to costs for excess leased facilities. At June 30, 2005, no 2002 restructuring charges remained accrued.

In 2001 we incurred restructuring charges of $12.7 million. Of the total restructuring charges recorded, $3.2 million related to employee termination costs covering 293 technical, production, and administrative employees. The remaining $9.5 million of restructuring charges related primarily to costs for excess leased facilities. As of June 30, 2005, restructuring charges of $0.5 million remained accrued. We anticipate utilizing the remaining restructuring accrual, which relates to servicing operating lease payments of operating lease commitments, through 2005.

Executive Severance In 2003 and 2004, we entered into employment agreements with four executive officers who subsequently resigned. Most of the severance costs related to these officers were paid in 2004. Approximately $13,000 of employee benefits for the executive officers remain accrued, which are expected to be paid through 2005.

Asset Write-offs We wrote off $0.1 million and $0.1 million in the six months ended June 30, 2005 and June 30, 2004, respectively, of fixed assets related to restructuring activities, which were determined to have no remaining useful life.

Non-operating Expenses

(in thousands)	For the three months ended June 30, 2005	For the three months ended June 30, 2004	For the six months ended June 30, 2005	For the six months ended June 30, 2004	% Change for the three months ended June 30, 2005/2004	% Change for the six months ended June 30, 2005/2004
Interest income	$ 672	$ 460	$ 1,240	$ 912	46%	36%
Interest expense	$(814)	$(826)	$(1,627)	$(1,643)	(1%)	(1%)
Other income expense	$ (50)	$ 921	$ 15	$ 1,200	(106%)	(99%)

Interest Income. Interest income increased in the three and six months ended June 30, 2005 compared to the same periods in 2004. The increase in interest income was primarily due to slightly higher interest rates.

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Interest Expense. Interest expense, which related primarily to interest on our Convertible Subordinated Notes (Notes) due in 2007, remained relatively flat in the three and six months ended June 30, 2005 compared to the same periods in 2004.

Other Income. Other income is generally comprised of realization of foreign currency gains and losses, realized gains or losses on investments, and non-operational gains and losses. In the second quarter of 2004, we sold all of our ownership in Radwiz, Ltd., Ultracom Communication Holdings Ltd. and Combox Ltd. to a third party for a cash payment of $150,000. In connection with this disposition, the acquirer received obsolete inventories with no book value, $0.2 million of selected net assets, and $1.35 million of net liabilities related to these subsidiaries. We recorded other income of $1.3 million on this transaction in the second quarter of 2004.

Income Taxes

	For the three months ended June 30,		For the six months ended June 30,	
(in thousands)	2005	2004	2005	2004
Income tax expense	$ 50	$ (79)		$ (146)

We have generated losses since our inception. Tax expense for the three and six months ended June 30, 2005 and 2004 primarily relates to foreign taxes. In the second quarter of 2005, we reversed approximately $50,000 of foreign income tax expense, which had previously been recorded in the first quarter of 2005, due to a revaluation of estimated tax expense in the second quarter of 2005 recorded in a prior period that is no longer required by the foreign jurisdiction.

Litigation

See Part II, Item 1 Legal Proceedings.

Off-Balance Sheet Financings and Liabilities

Other than lease commitments and unconditional purchase obligations incurred in the normal course of business, we do not have any off-balance sheet financing arrangements or liabilities, guarantee contracts, retained or contingent interests in transferred assets or any obligation arising out of a material variable interest in an unconsolidated entity. We do not have any majority-owned subsidiaries that are not included in the consolidated financial statements.

Liquidity and Capital Resources

At June 30, 2005, we had approximately $38.6 million in unrestricted cash and cash equivalents and $66.4 million in short-term investments.

In July 2000, we issued $500.0 million of Notes, resulting in net proceeds to us of approximately $484.4 million. The Notes are a general unsecured obligation and are subordinated in right of payment to all of our existing and future senior indebtedness and to all of the liabilities of our subsidiaries. The Notes are convertible into shares of our common stock at a conversion price of $84.01 per share at any time on or after October 24, 2000 through maturity, unless previously redeemed or repurchased. Interest is payable semi-annually. Debt issuance costs related to the Notes were approximately $15.6 million. The Notes mature in August 2007.

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Through June 30, 2005, we had repurchased approximately $434.9 million of the Notes for $171.0 million in cash and $17.9 million in stock, resulting in a gain on early retirement of debt of approximately $234.4 million net of related unamortized issuance costs of $11.6 million in prior periods. No Notes were repurchased in 2003, 2004, or 2005.

Cash used in operating activities for the six months ended June 30, 2005 was $2.5 million compared to $21.2 million in the same period in 2004. In 2005, significant uses of cash from operating activities included a $3.1 million loss and a $3.3 million reduction of accounts payable partially offset by $3.5 million net decrease in gross inventory. Inventory levels decreased at June 30, 2005 when compared to December 31, 2004. In the six months ended June 30, 2004, significant uses of cash from operating activities included a $15.1 million loss, $9.6 million decrease in accounts payable, and $6.0 million for purchases of inventory.

Cash used in investing activities for the six months ended June 30, 2005 was $4.2 million compared to cash provided by investing activities of $37.8 million in the same period in 2004. Investing activities consisted primarily of net purchases and sales of short-term investments. Net cash used in investment activities during 2005 also included proceeds from the sale of our semiconductor assets to ATI described below.

On February 7, 2005, we entered into an agreement with ATI Technologies, Inc (ATI) to sell certain cable modem semiconductor assets to ATI for a total purchase price of up to $13.8 million if we achieve all the milestones specified in the agreement. Under the terms of the agreement, ATI acquired our cable modem silicon intellectual property and related software, assumed a lease and hired approximately twenty-five employees from our design team. Upon closing on March 9, 2005, we received $8.6 million in cash, which was comprised of a $6.95 million initial payment, and $1.65 million of the $1.9 million for having met the first milestone. In May 2005, we received an additional $2.5 million upon completion of two additional milestones. As of June 30, 2005, we had deferred the net gain of $8.6 million, which represented the cash receipt of $11.1 million, less transaction related costs of $2.5 million. The balance of up to $2.7 million of the purchase price will be paid to us in the event we meet the two remaining milestones over the subsequent 15 months following the closing, and upon the release of the escrow. The agreement also sets forth representations and warranties made by us that may cause us to incur liabilities and penalties arising out of our failure to meet certain conditions and milestones. The maximum liability for us is the greater of $11.5 million or the total amount of the purchase price paid by ATI plus $1.5 million. The gain on the sale of the assets, if any, will be recognized upon completion of all milestones or when the contingencies related to the sale are resolved.

Cash provided by financing activities was $2.1 million in 2005 primarily due to proceeds from the exercise of stock options. Cash provided by financing activities was $0.6 million in 2004 primarily due to proceeds from the exercise of stock options and the sale of shares of common stock through our Employee Stock Purchase Plan in 2004.

We currently believe that our current unrestricted cash, cash equivalents, and short term investment balances will be sufficient to satisfy our cash requirements for at least the next 12 months. In order to achieve profitability in the future, we will need to increase revenues, primarily through sales of more profitable products, and decrease costs. These statements are forward-looking in nature and involve risks and uncertainties. Actual results may vary as a result of a number of factors, including those discussed under the risk factor Our Operating Results May Fluctuate below and elsewhere. We may need to raise additional funds in order to support more rapid expansion, develop new or enhanced services, respond to competitive pressures, acquire complementary businesses or technologies or respond to unanticipated cash requirements. We may seek to raise additional funds through private or public sales of securities, strategic relationships, bank debt, and financing under leasing arrangements or otherwise. If additional funds are raised through the issuance of equity securities, the percentage ownership of our current stockholders will be reduced, stockholders may experience additional dilution or such equity

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securities may have rights, preferences or privileges senior to those of the holders of our common stock. We cannot assure you that additional financing will be available on acceptable terms, if at all. If adequate funds are not available or are not available on acceptable terms, we may be unable to continue operations, develop our products, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements, which could have a material adverse effect on our business, financial condition and operating results.

Contractual Obligations

The following summarizes our contractual obligations at June 30, 2005, and the effect such obligations are expected to have on our liquidity and cash flows in future periods (in millions):

		Payments Due by Period			
	Total	Less than 1 year	1-3 years	4-5 years	After 5 years
Unconditional Purchase Obligations	$ 21.8	$21.8	$	$	$
Long Term Debt	65.1		65.1		
Operating Lease Obligations	14.3	3.8	6.3	4.1	0.1
Aircraft Lease Obligations	2.3	1.5	0.8		
Total Contractual Commitments	$103.5	$27.1	$72.2	$4.1	$0.1

We have unconditional purchase obligations to certain of our suppliers that support our ability to manufacture our products. The obligations require us to purchase minimum quantities of the suppliers products at a specified price. As of June 30, 2005, we had approximately $21.8 million of purchase obligations, of which $0.4 million is included in the Condensed Consolidated Balance Sheet as accrued vendor cancellation charges, and the remaining $21.4 is attributable to open purchase orders. The remaining obligations are expected to become payable at various times through 2005.

Other commercial commitments, primarily required to support operating leases, are as follows (in millions):

		Amount of Commitment Expiration Per Period			
	Total Amounts Committed	Less than 1 year	1-3 years	4-5 years	Over 5 years
Deposits	$7.5	$	$7.5	$	$
Standby Letters of Credit	1.2	0.9		0.3	
Total Commercial Commitments	$8.7	$0.9	$7.5	$0.3	$

In 2002, we entered into an operating lease arrangement to lease a corporate aircraft. This lease arrangement was secured by a $9.0 million letter of credit. The letter of credit was reduced to $7.5 million in February 2003. During 2004 the $7.5 million letter of credit was converted to a cash deposit. This lease commitment is included in the table above. In March 2004, in connection with our worldwide restructuring, we notified the lessor of our intentions to locate a purchaser for our remaining obligations under this lease. In August 2004, we entered into an agreement with a third party to sublease the corporate aircraft through December 31, 2006.

Impact of Recently Issued Accounting Standards

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued SFAS 123 (revised 2004), (SFAS 123(R)), Share-Based Payment, which replaces SFAS 123, Accounting for Stock-Based Compensation, and supersedes APB 25, Accounting for Stock Issued to Employees. Generally, the approach in SFAS 123(R) is similar to the approach described in SFAS 123. SFAS 123(R) eliminates the alternative to use APB 25 s intrinsic value method of accounting that was provided in SFAS

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123 as originally issued. After a phase-in period for SFAS 123(R), pro forma disclosure will no longer be allowed. The SEC announced in the second quarter of 2005 that it would extend this phase-in period and, therefore, our effective date for implementation of SFAS 123(R) is January 1, 2006. We have not yet determined which phase-in method it will adopt. In the first quarter of 2005 the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 107, which provided further clarification on the implementation of SFAS 123(R).

As permitted by SFAS 123, we currently account for share-based payments to employees using APB 25 s intrinsic value method and, as such, generally recognize no compensation expense for employee stock options. Accordingly, the adoption of SFAS 123(R) s fair value method will likely have a material impact on our results of operations, although it will have no impact on our overall financial position. See *Stock Based Compensation*, above for information related to the pro forma effects on our reported net loss and net loss per common share of applying the fair value recognition provisions of the previous SFAS 123 to stock-based employee compensation.

In November 2004, the FASB issued SFAS 151, Inventory Costs, which revised Accounting Research Bulletin No. 43 (ARB 43), relating to inventory costs. This revision is to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material (spoilage). SFAS 151 requires that these items be recognized as a current period charge regardless of whether they meet the criterion specified in ARB 43. In addition, SFAS 151 requires the allocation of fixed production overheads to the costs of conversion be based on normal capacity of the production facilities. SFAS 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of SFAS 151 is not expected to have a material impact on our financial statements.

RISK FACTORS

You should carefully consider the risks described below before making an investment decision. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties not presently known to us or that we currently deem immaterial also may impair our business operations. If any of the following risks actually occur, our business could be harmed. In such case, the trading price of our common stock could decline, and you may lose all or part of your investment.

Risks Related to Our Business

We have a history of losses and may continue to incur losses in the future

It is difficult to predict our future operating results. We began shipping products commercially in June 1997, and we have been shipping products in volume since the first quarter of 1998. As of June 30, 2005, we had an accumulated deficit of approximately $1.0 billion. We believe that we will continue to experience challenges in selling our products at a profit and may continue to operate with net losses for the foreseeable future. In the past few years, we experienced a decrease in revenues compared to 2001 and 2000, in large part, due to the erosion of average selling prices (ASPs) of our products due to our transition from a proprietary platform to the Data Over Cable System Interface (DOCSIS) standards platform and a drop in sales volume of cable modem termination systems (CMTS). Additionally, we are experiencing a decline in revenues from 2004 to 2005 primarily because of our decision to cease investment in our CMTS product line, which has resulted in a significant decline in sales, and a decline in the sale of our HAS products. Our revenue decreased for the six months ended June 30, 2005 to $55.9 million from $83.9 million in the same period in 2004, and to $29.5 million from $42.8 million for the three months ended June 30, 2005 and 2004, respectively. We incurred losses of $0.5 million and $3.1 million in the three and six months ended June 30, 2005. As a result of our losses, we have had to use available cash and cash equivalents to supplement the operation of our business. Additionally, we generally have been unable to significantly reduce our short-term expenses in order to compensate for unexpected decreases in anticipated revenues or delays in generating anticipated revenues. For example, we have fixed commitments with some of our suppliers that require us to purchase minimum quantities of their products at a specified price irrespective of whether we can subsequently use such quantities in our products. Further, we have experienced and will likely continue to experience declining ASPs of our products. In addition, we have significant operating lease commitments for facilities and equipment that generally cannot be cancelled in the short-term without substantial penalties, if at all.

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We may continue to experience fluctuations in our operating results and face unpredictability in our future revenues

Our quarterly revenues have fluctuated and are likely to continue to fluctuate significantly in the future due to a number of factors, many of which we cannot control. Factors that affect our revenues include, among others, the following:

- variations in the timing of orders and shipments of our products;
- variations in the size of the orders by our customers and pricing concessions on volume sales;
- competitive market conditions;
- unpredictable sales cycles;
- new product introductions by competitors or by us;
- delays in our introduction of new products;
- delays in our introduction of added features to our products;
- delays in the commercialization of products that are competitive in the marketplace;
- delays in our receipt of and cancellation of orders forecasted by customers;
- variations in capital spending budgets of cable operators and other broadband service providers;
- international conflicts, including the continuing conflict in Iraq, and acts of terrorism and the impact of adverse economic, market and political conditions worldwide; and
- ability of our products to be qualified or certified as meeting industry standards.

Our quarterly results are affected by the gross margin we achieve for the quarter relative to our gross revenues. A variety of factors influence our gross margin for a particular quarter, including, among others, the following:

- the sales mix of our products;
- the volume of products manufactured;
- the type of distribution channel through which we sell our products;
- the ASPs of our products;
- our ability to manage excess and obsolete inventory;
- delays in reducing the cost of our products;
- the costs of manufacturing our products; and
- the effectiveness of our cost reduction measures.

We often recognize a substantial portion of our revenues in the last month of the quarter. We establish our expenditure levels for product development and other operating expenses based on projected sales levels, and expenses are relatively fixed, particularly in the short term. For example, a significant percentage of these operating expenses are fixed due to operating leases for our facilities and equipment. Also, we have fixed commitments with some of our suppliers that require us to purchase minimum quantities of their products at a specified price. Because in the past, we have been unable to use all of the products that we purchased from our suppliers, we have taken vendor cancellation charges as a result of these fixed commitments, and we may have to take additional charges in the future if we are unable to use all of the products that we purchase from our suppliers. As of June 30, 2005, $21.8 million of purchase obligations were outstanding. The obligations are generally expected to become payable at various times throughout 2005. Accordingly, variations in timing of sales can cause significant fluctuations in operating results. In addition, because a significant portion of our business is derived from orders placed by a limited number of large customers, the timing of such orders can also cause significant fluctuations in our operating results. Our expenses for any given quarter are typically based on expected sales and if sales are below expectations; our operating results may be adversely impacted by our inability to adjust spending to compensate for the shortfall. Moreover, our research and development expenses fluctuate in response to new product development, and changing industry requirements and customer demands.

Additionally, the unit ASPs of our HAS products declined considerably in 2004, 2003, and 2002, and to a lesser extent, in 2005. We anticipate that unit ASPs of our HAS products will continue to decline in the future. This has caused and will continue to cause a decrease in our gross margins if we are unable to offset the decline in ASPs of our HAS products with cost reduction measures. In addition, the gross margins we realize from the sale of our products are affected by the mix of product sales between higher margin, lower volume digital video solutions (DVS) products and applications and lower margin, higher volume HAS products. We are attempting to increase our gross margin by increasing the sale of our DVS products, cost-reducing the HAS products, and ceasing investment in our CMTS product line. However, there are no assurances that we will succeed. For 2005, we expect that sales of our low-margin HAS products will continue to make up a significant portion of our revenues. If we do not continue to generate a greater percentage of total revenues from our DVS product revenues, we will not succeed in greatly improving our gross margin.

We are dependent on a small number of customers and resellers and our business could be harmed by the loss of any of these customers or reductions in their purchasing volumes

Our customers have undergone and continue to undergo significant consolidation in both North America and internationally, as a limited number of cable operators control an increasing number of systems. For example, the top nine cable operators in the United States operate systems that service approximately 90% of homes that receive cable services in the United States. As a result of the consolidation among cable operators, our revenue has been and will continue to be dependent on sales to the few leading cable operators worldwide. Two customers, Comcast Corporation (Comcast) and Harmonic, Inc. (Harmonic), accounted for 10% or more of total revenues (24% and 16%) for the three months ended June 30, 2005. Two customers, Harmonic and Comcast, accounted for 10% or more of total revenues (24% and 17%) for the six months ended June 30, 2005. Two customers, Adelphia Communications Corporation (Adelphia) and Telenet, accounted for 10% or more of total revenues (25% and 12%) for the three months ended June 30, 2004. Two customers, Adelphia and Telenet, accounted for 10% or more of total revenues (23% and 10%) for the six months ended June 30, 2004. At June 30, 2005, Comcast, Harmonic, Adelphia, and Telenet accounted for $4.3 million, $2.3 million, $1.5 million, and $0.1 million, respectively of the accounts receivable. At June 30, 2004, Comcast, Harmonic, Adelphia, and Telenet accounted for $0.9 million, $1.1 million, $5.3 million, and $4.7 million, respectively of the accounts receivable. Adelphia is not expected to be a customer in 2005 due to our decision to cease investment in our CMTS product line, which may continue to have a material adverse effect on our business or results of operations in 2005. As is common in our industry, we typically do not enter into contracts with our customers in which they commit to purchase products from us. Typically, our sales are made on a purchase order or system contract basis, and none of our customers has entered into a long-term agreement requiring it to purchase our products. Moreover, we do not typically require our customers to purchase a minimum quantity of our products, and our customers can generally cancel or significantly reduce their orders on short notice without significant penalties. The loss of any of our customers can have a material adverse effect on our results of operations. Further, any reduction in orders from a given customer also may have a material adverse affect on our results of operations.

Significant sales of our DVS products are made to a small number of resellers, who often incorporate our DVS products and applications in systems that are sold to an end-user customer, which is typically a cable operator, satellite provider or broadcast operator. If one or more of these resellers develop their own products or elect to purchase similar products from another vendor, our revenue and results of operations may suffer.

Also, we may not succeed in attracting new customers as many of our potential customers have pre-existing relationships with our current or potential competitors and the continued consolidation of the cable industry reduces the number of potential customers. To attract new customers, we may be faced with intense price competition, which may affect our gross margins.

We may also lose existing customers or experience declining business in our DVS and HAS products from our existing customers because of our decision to cease investment in our CMTS product line. For example, Adelphia, one of our largest CMTS customers, indicated that it will no longer purchase HAS or DVS products from us. The loss of Adelphia and the loss of any additional CMTS customers that decrease or cease their purchases of DVS and HAS products could continue to materially adversely affect our business and results of operations.

Recent changes in senior management and the reductions in workforce associated with our restructuring efforts could disrupt the operation of our business, distract our management from focusing on revenue- generating efforts, result in the erosion of employee morale, and impair our ability to respond rapidly to growth opportunities in the future

We have experienced a number of recent changes in senior management and other key personnel. Our Chief Executive Officer, President and Chief Technology Officer, Chief Operating Officer, Chief Financial Officer and General Counsel all resigned within the latter half of 2004. Our new Chief Executive Officer was appointed in September 2004 and our new Chief Financial Officer was appointed in late November 2004. We also have recently experienced increased turnover in our video engineering group and finance organization. The recruitment and retention of a new senior management staff and turnover in key personnel has created and could continue to create a number of transitional challenges for us. These transitional issues have caused, and may cause, disruptions to our business. We cannot be assured that a smooth transition of our senior management staff has occurred, or that we have

taken the necessary steps to

effect an orderly continuation of our operations during the transitional period. Further, the process of locating personnel with the combination of skills and attributes required to carry out our goals and integrating such personnel once they are recruited is often lengthy. We cannot be assured that the integration of our new senior management staff will occur in a timely manner, or that such integration will not present additional transitional challenges for us or adversely affect the operation of our business.

Moreover, we have implemented a number of restructuring plans since 2001, including the most recent restructuring activities in 2004 that resulted in personnel reduction of 40%. The employee reductions and changes in connection with our restructuring activities, as well as future changes in senior management and key personnel, could result in an erosion of morale, and affect the focus and productivity of our remaining employees, including those directly responsible for revenue generation and the management and administration of our finances, which in turn may adversely affect our revenue in the future or cause other administrative deficiencies. Additionally, employees directly affected by the reductions may seek future employment with our business partners, customers or competitors. Although all employees are required to sign a proprietary information agreement with us at the time of hire, there can be no assurances that the confidential nature of our proprietary information will be maintained in the course of such future employment. Additionally, we may face wrongful termination, discrimination, or other claims from employees affected by the reduction related to their employment and termination. We could incur substantial costs in defending ourselves or our employees against such claims, regardless of the merits of such actions. Furthermore, such matters could divert the attention of our employees, including management, away from our operations, harm productivity, harm our reputation and increase our expenses. We cannot assure you that our restructuring efforts will be successful, and we may need to take additional restructuring efforts, including additional personnel reduction, in the future.

We are dependent on key personnel

Due to the specialized nature of our business, we are highly dependent on the continued service of, and on our ability to attract and retain qualified senior management, engineering, sales and marketing personnel and employees with significant experience and expertise in video, data networking and radio frequency design. The competition for some of these personnel is intense, particularly for engineers with Moving Picture Experts Group (MPEG) experience. We may incur additional expenses to attract and retain key personnel. There can be no assurances that the additional expenses we may incur, or our efforts to recruit such individuals, will be successful, and if they are not, our business may experience significant disruption or adverse effects. In addition, if we are unable to hire qualified personnel as needed in a timely manner, we may be unable to adequately manage and grow our business.

We do not have key person insurance coverage for the loss of any of our employees. Any officer or employee can terminate his or her relationship with us at any time. Our employees generally are not bound by non-competition agreements.

There are many risks associated with our participation in industry standards

In connection with the development of the DOCSIS 2.0 specification by CableLabs, a cable industry consortium that establishes cable technology standards and administers compliance testing, we entered into an agreement with CableLabs whereby we licensed to CableLabs on a royalty-free basis any of our intellectual property rights, including rights to our proprietary S-CDMA technology, to the extent that such rights may be asserted against a party desiring to design, manufacture or sell DOCSIS based products, including DOCSIS 2.0 based products. This license agreement grants to CableLabs the right to sublicense our intellectual property, including our intellectual property rights in our S-CDMA patents, to manufacturers that compete with us in the marketplace for DOCSIS based products. As a result of this license to CableLabs, our competitors that produce DOCSIS-based products have access to our technology without having to pay us any royalties or other compensation for the use of our technology. As a result of our contribution of technology to the DOCSIS intellectual property pool, we may have foregone significant revenue from the potential licensing of our proprietary technology, and we may be unable to recoup the investment in the research and development of intellectual property contributed to the DOCSIS technology pool.

Additionally, the agreement that we signed with CableLabs to participate in the DOCSIS intellectual property pool may make it difficult for us to enforce our intellectual property rights against other companies. Certain cable equipment vendors manufacture and sell DOCSIS based and DOCSIS certified and qualified products without sublicensing from CableLabs the technology in the CableLabs intellectual property pool. Due to the interests of cable operators in having as many equipment vendors as possible, we may feel constrained by competitive pressures from pursuing the enforcement of our intellectual property rights against our competitors that have not entered into sublicenses with CableLabs. Moreover, if we seek to enforce our intellectual property rights against other equipment manufacturers that access technology from the CableLabs intellectual property pool, our license to the technology in the pool may be jeopardized. Certain contributors of technology to the CableLabs intellectual property pool are our competitors and may elect to revoke our license to their technology if we attempt to enforce our intellectual property rights against them.

We may have lost any competitive advantage that our proprietary S-CDMA technology may have provided us in the marketplace by licensing it to CableLabs and we may lose any competitive advantage that any other proprietary technology that is licensed to CableLabs. Additionally, we may face increased competition because our competitors have the ability to incorporate our technology into their products. We believe that this increased competition could come from existing competitors or from new competitors who enter the market and that such competition is likely to result in lower product ASPs, which could harm our revenues and gross margins. Additionally, because our competitors will be able to incorporate our technology into their products, our current customers may choose alternate suppliers or choose to purchase DOCSIS-compliant products from multiple suppliers. We may be unable to effectively compete with the other vendors if we cannot produce DOCSIS compliant cable products more quickly or at lower cost than our competitors.

DOCSIS specifications have not yet been accepted in Asia, although an increasing number of Asian cable operators are requiring product to be DOCSIS qualified or certified. A related specification for cable products, called the Euro-DOCSIS specification, has been formalized by TComLabs, a cable technology consortium of European cable operators, and European and some Asian cable operators have embraced it. We have contributed certain of our technologies, including our proprietary S-CDMA technology, to the Euro-DOCSIS specification. We may develop and sell products that comply with the Euro-DOCSIS specification, and we may be unsuccessful in these efforts. Even if we are successful in our efforts, we may face some of the same risks associated with our contribution of intellectual property to the CableLabs DOCSIS intellectual property pool.

We need to certify and qualify our new and existing products to meet industry specifications in order to remain competitive

Major cable operators worldwide have endorsed the DOCSIS, Euro-DOCSIS and PacketCable specifications and rarely purchase data and voice equipment that is not certified or qualified as compliant with these specifications. Although there are currently no specifications for DVS products, if such specifications are adopted, then we will not only need to certify our video products with such specifications, but we may experience more intense price competition for our DVS products and erosion in ASPs. In addition, we currently need to certify our HAS products. Traditionally, cable operators have chosen to purchase only products meeting industry specifications because the specifications enable interoperability among products from multiple vendors, which leads to increased competition among equipment manufacturers and consequently lowers product ASPs. As a result, our future success depends on our ability to compete effectively in this marketplace by developing, marketing and selling products that are certified and qualified to industry standards in a timely and cost effective manner.

The DOCSIS and PacketCable specifications are promulgated by CableLabs. Currently these specifications have been widely adopted by cable operators in North America and by some cable operators in Asia, Latin America and Europe. The Euro-DOCSIS specifications have been developed by TComLabs specifically to meet the requirements of European operators, and have found some acceptance in China as well. There is no guarantee that our products will continue to be DOCSIS, EuroDOCSIS or PacketCable

certified or qualified, or will be certified for any new standards that may emerge. If we are unable to certify or qualify our products as compliant with DOCSIS, EuroDOCSIS or PacketCable or other applicable standards in a timely manner, we may be unable to sell our products and may lose some or all of any advantage we might otherwise have had, and our future operating results may be adversely affected.

Although we sell certified and qualified data and voice products, there have been and may continue to be instances where our existing customers and potential new customers elect to purchase products from one or more of our competitors rather than from us. In response, we have reduced our prices and continue to experience customer demand to further reduce our prices in order to promote sales of our current products. This has had and may continue to have an adverse impact on our revenues, operating results and gross margin.

Developing products to meet these various industry specifications has several risks. The first is the cost and effort to engineer standards-based products and to then prepare them for compliance testing. Not only do we have to certify or qualify new products, but any of our currently certified or qualified products must be re-certified or re-qualified should they be changed in any way. Second, there is no guarantee that these products will be certified or qualified as meeting these specifications in a timely fashion, if ever. Because most cable operators purchase only those products that have been certified or qualified as meeting these specifications, it is highly unlikely that we will be able to sell our products until they achieve certification or qualification, which can be a lengthy process. As a result, we may incur significant research and development expenses to develop new products that may not receive certification or qualification and we cannot recoup the costs of these research and development expenses by marketing uncertified or unqualified products. Moreover, a consequence of cable operators only purchasing products certified or qualified as meeting industry specifications is the increased competition between equipment vendors, which has resulted in a steady and ongoing decline in equipment prices as vendors compete for cable operators business. Third, there is no guarantee that we will be able to support all future cable industry specifications, which will likely have an adverse impact on our future revenues.

Our video products and applications must achieve widespread market acceptance to advance the growth of our digital video solutions business

Our success depends upon the widespread acceptance of our video products and applications by broadband providers. Traditionally, we have had success selling our DVS products to cable operators and satellite providers; however, there is no guarantee that this success will continue as the products and applications evolve and as new competitors enter the market. In 2004, we introduced a new DVS product which is geared towards television broadcasters. Currently, we have had one large deployment of this product and have had limited sales of this product through resale channels. We are currently developing technology for the deployment of video for the telecom carriers; however, there is no guarantee that we will continue to pursue that development, that our product will work or that our product will find widespread acceptance among the telecom carriers.

The emerging market trend to standardize the digital video technology may challenge our ability to continue to grow our digital video business

Comcast Corporation, Time-Warner, Inc. and Cox Communications, Inc., the three largest cable operators in the United States, started their Next-Generation Network Architecture (NGNA) initiative in 2003 to develop a common approach to transform their cable systems into all-digital networks. This initiative could potentially impact video technology, including our video technology and products. As a group, the operators can work more effectively with equipment vendors in defining the products and product capabilities required for the migration. In 2004, the participating operators commissioned CableLabs to manage the NGNA initiative and to develop a set of standards to which equipment vendors can build their products. The NGNA initiative is so far following the model successfully proven with the earlier DOCSIS initiative, which enabled the development of interoperable cable modems, CMTSs and other associated equipment that allowed United States operators to rollout broadband cable modem service much faster, more broadly and with greater success than telecom carriers could offer their competing DSL service. As it has with data services, CableLabs may request companies to contribute their video

technologies to a DOCSIS-like technology pool on a royalty-free basis. If we contribute any of our video technology to a DOCSIS-like technology pool, our video technology is subject to the same risks as those associated with the standards-based technology for our data services, which are discussed above.

Subject to the success of the initiative, cable operators may want to purchase only video products that have been certified or qualified by CableLabs, in which case we will not be able to sell our video products until they achieve certification or qualification, which, based on our experience with our data services, can be a lengthy process. As a result, we may incur significant research and development expenses to develop new video products that may not receive certification or qualification and we may not be able to recoup the costs of these research and development expenses by marketing uncertified or unqualified products. Moreover, there is no guarantee that we will be able to support all future specifications relating to video products, which would likely have an adverse impact on our future revenues. Furthermore, a consequence of cable operators purchasing only certified or qualified products, based on our experience with the data services, is the increased competition between equipment vendors, which would result in a steady and ongoing decline in equipment prices as vendors compete for cable operators business. Consequently, our future success may depend on our ability to compete effectively in the video marketplace by developing, marketing and selling products that are certified and qualified to industry standards in a timely fashion and in a cost effective manner.

We depend on broadband providers capital spending for a substantial portion of our revenue and any decrease or delay in capital spending would negatively impact our operating results and financial condition

Historically, almost all of our sales had been derived from sales to broadband providers and, more specifically, cable operators, and we expect these sales to constitute a significant portion of net sales for the foreseeable future. Demand for our products will depend on the magnitude and timing of capital spending by broadband providers. These capital spending patterns depend on a variety of factors including:

- the availability of financing;
- annual budget cycles, as well as the typical reduction in upgrade projects during the winter months;
- the status of federal, local and foreign government regulation and deregulation of the telecommunications industry;
- overall demand for broadband services and the acceptance of new data, video and voice services;
- evolving industry standards and network architectures;
- competitive pressures (including the availability of alternative data transmission and access technologies);
- discretionary consumer spending patterns; and
- general economic conditions.

Average selling prices of broadband equipment may continue to decline, decreasing our gross margins

The broadband equipment market has been characterized by erosion of product ASPs, particularly for HAS products, which declined considerably in 2004, 2003, and 2002, and to a lesser extent in 2005. This erosion may continue. The ASPs for our products are likely to continue to decline due to competitive pricing pressures, promotional programs and customers possessing strong negotiating positions which require price reductions as a condition of purchase. In addition, we believe that the widespread adoption of industry specifications, such as the DOCSIS and EuroDOCSIS specifications, is further eroding ASPs as cable modems and other similar HAS products become commodity products. If a specification is adopted for video technology, our DVS products may experience the same ASP erosion. Decreasing ASPs could result in decreased revenues even if the number of units sold increases. Decreasing ASPs may also require us to sell our products at much lower gross margin than in the past, and in fact, we may sell products at a loss. The primary reason that our gross profits have generally declined in recent years is the decline in product ASPs. As a result, we may experience substantial period-to-period fluctuations in future revenue, gross margin and operating results due to ASP erosion. Therefore, we must continue to develop and introduce on a timely basis and a cost- effective manner new products or next-generation products with enhanced functionalities that can be sold at higher gross margins. If we fail to do so our revenues and gross margins may decline further.

In addition, the gross margins we realize from the sale of our products are affected by the mix of product sales between higher margin, lower volume digital video solutions (DVS) products, and applications and lower margin, higher volume HAS products. We are attempting to increase our gross margin by increasing the sale of our DVS products, reducing the manufacturing costs associated with the HAS products, and ceasing investment in our CMTS product line. However, there are no assurances that we will succeed. For 2005, we expect that sales of our low-margin HAS products will continue to represent a significant portion of our revenues. If we do not generate a greater percentage of total revenues from our DVS product revenues, we will not succeed in greatly improving our gross margin.

We must achieve cost reductions or increase revenues to attain profitability

In prior years, we experienced revenue declines, which were, in large part, due to declining product ASPs due to our transition from a proprietary platform to the DOCSIS standards platform. In order to achieve profitability, we must significantly increase our revenues, reduce the cost of our products, and maintain or reduce our operating expenses.

Although we have implemented expense reduction and restructuring plans in the past, including the latest restructurings in the fourth quarter of 2004, that have focused on cost reductions and operating efficiencies, we still operate at a loss. A large portion of our expenses, including rent, and operating lease expenditures, is fixed and difficult to reduce or change. Accordingly, if our revenue does not meet our expectations, we may not be able to adjust our expenses quickly enough to compensate for the shortfall in revenue, which, in turn, could materially and adversely impact our business, financial condition and results of operations.

As product ASPs decline, we need to reduce the cost of our products through design and engineering changes. We may not be successful in redesigning our products, and, even if we are successful, our efforts may be delayed or our redesigned products may contain significant errors and product defects. In addition, any redesign may not result in sufficient cost reductions to allow us to reduce significantly the prices of our products or improve our gross margins. Reductions in our product costs may require us to use lower-priced components that are highly integrated in future products and may require us to enter into high volume or long-term purchase or manufacturing agreements. Volume purchase or manufacturing agreements may not be available on acceptable terms, if at all, and we could incur significant expenses without related revenues if we cannot use the products or services offered by such agreements. We have incurred significant vendor cancellation charges related to volume purchase and manufacturing agreements in the past and may incur such charges in the future.

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We may not be able to raise additional funds to continue operating our business

Our main source of liquidity continues to be our unrestricted cash and cash equivalents on hand. As a result of our history of operating losses, we expect to continue to use our unrestricted cash to fund operating losses in the future. Our unrestricted cash, cash equivalents and short-term investments increased to $105.0 million at June 30, 2005, from $97.7 million at December 31, 2004. If our operating losses are more severe than expected or continue longer than expected, we may find it necessary to seek other sources of financing to support our capital needs and provide available funds for working capital. Furthermore, as of June 30, 2005, we had $65.1 million of notes outstanding that mature in August 2007 and may need to seek additional financing to repay the notes at maturity.

There may be few sources of financing available to us. Commercial bank financing may not be available to us on acceptable terms. Accordingly, any plan to raise additional capital, if available to us, would likely involve an equity-based or equity-linked financing, such as the issuance of convertible debt, common stock or preferred stock, which would be dilutive to our stockholders. On October 7, 2003, we filed a registration statement on Form S-3 with the SEC. This shelf registration statement will allow us to issue various types of securities, including common stock, preferred stock, debt securities and warrants to purchase common stock, from time to time up to an aggregate of $125.0 million, subject to market conditions and our capital needs. However, we may not be able to sell securities on terms acceptable to us. If we are unable to procure additional working capital, as necessary, we may be unable to continue operations.

We may dispose of or discontinue existing product lines, which may adversely impact our future results

On an ongoing basis, we evaluate our various product offerings in order to determine whether any should be discontinued or, to the extent possible, divested. Moreover, the worldwide downturn in the telecommunications industry led us to reassess our business strategy, which in turn caused us to discontinue investment in certain product lines. We have ceased investment in the telecom and satellite businesses and largely sold or discontinued the various businesses we acquired in 1999 and 2000. In October 2004, we also announced our decision to cease investment in the CMTS product line. In March 2005, we sold to ATI Technologies Inc. certain of our cable modem semiconductor assets.

We cannot guarantee that we have correctly forecasted, or will correctly forecast in the future, the right product lines to dispose or discontinue or that our decision to dispose of or discontinue various investments and product lines is prudent if market conditions change. In addition, there are no assurances that the discontinuance of various product lines will reduce our operating expenses or will not cause us to incur material charges associated with such decision. Furthermore, the discontinuance of existing product lines entails various risks, including the risks that we will not be able to find a buyer for a product line or the purchase price obtained will not be equal to the book value of the assets for the product line. Other risks include managing the expectations of, and maintaining good relations with, our customers who previously purchased products from our disposed or discontinued product lines, which could prevent us from selling other products to them in the future. We may also incur other liabilities and costs associated with our disposal or discontinuance of product lines.

We may be unable to provide adequate customer support

Our ability to achieve our planned sales growth and retain current and future customers will depend in part upon the quality of our customer support operations. Our customers generally require significant support and training with respect to our products, particularly in the initial deployment and implementation stages. Spikes in demand of our support services may cause us to be unable to serve our customers adequately. We may not have sufficient personnel to provide the levels of support that our customers may require during initial product deployment or on an ongoing basis especially during peak periods. Our inability to provide sufficient support to our customers could delay or prevent the successful deployment of our products. In addition, our failure to provide adequate support could harm our reputation and relationships with our customers and could prevent us from selling products to existing customers or gaining new customers.

Furthermore, we may experience transitional issues relating to customer support in connection with our decision to dispose of or discontinue various investments and product lines. We may incur liability associated with customers dissatisfaction with the level of customer support maintained for discontinued product lines.

We may have financial exposure to litigation

We and/or our directors and officers are defendants in a number of lawsuits, including securities litigation lawsuits and the lawsuit with Adelphia discussed above (See Part II Item 1 Legal Proceedings for more information regarding our litigation). As a result, we may have financial exposure to litigation as a defendant and because we are obligated to indemnify our officers and members of our board of directors for certain actions taken by our officers and directors on our behalf.

In order to limit financial exposure arising from litigation and/or our obligation to indemnify our officers and directors, we have historically purchased directors and officers insurance (D&O Insurance). There can be no assurance that D&O Insurance will be available to us in the future or, if D&O Insurance is available, that it will not be prohibitively expensive. Additionally, some insurance underwriters who offered D&O Insurance in the past have been placed into liquidation or may be, at some future point, placed into liquidation.

If there is no insurance coverage for the litigation or, even if there is insurance coverage, if a carrier is subsequently liquidated or placed into liquidation, we will be responsible for the attorney fees and costs resulting from the litigation. The incurrence of significant fees and expenses in connection with the litigation could have a material adverse effect on our results of operations.

The sales cycle for certain of our products is lengthy, which makes forecasting of our customer orders and revenues difficult

The sales cycle for certain of our products is lengthy, often lasting nine months to more than a year. Our customers generally conduct significant technical evaluations, including customer trials, of our products as well as competing products prior to making a purchasing decision. In addition, purchasing decisions may also be delayed because of a customer s internal budget approval processes. Because of the lengthy sales cycle and the size of customer orders, if orders forecasted for a specific customer for a particular period do not occur in that period, our revenues and operating results for that particular quarter could suffer. Moreover, a portion of our expenses related to an anticipated order is fixed and difficult to reduce or change, which may further impact our revenues and operating results for a particular period.

We need to develop additional distribution channels to market and sell our products

The vast majority of our data and voice product sales have traditionally been to large cable operators. Our DVS products have been traditionally sold to large cable operators and satellite operators with recent, limited sales to television broadcasters. Although we intend to establish strategic relationships with leading distributors worldwide to new customers, we may not succeed in establishing these relationships. Even if we do establish these relationships, the distributors may not succeed in marketing our products to their customers. Some of our competitors have established long-standing relationships with these cable operators that may limit our and our distributors ability to sell our products to those customers. Even if we were to sell our products to those customers, it would likely not be based on long-term commitments, and those customers would be able to terminate their relationships with us at any time without significant penalties.

We may fail to accurately forecast customer demand for our products

The nature of the broadband industry makes it difficult for us to accurately forecast demand for our products. Our inability to forecast accurately the actual demand for our products may result in too much or too little supply of products or an over/under capacity of manufacturing or testing resources at any given point in time. The existence of any one or more of these situations could have a negative impact on our

business, operating results or financial condition. We have incurred significant vendor cancellation charges related to volume purchase and manufacturing agreements in the past and may incur such charges in the future. We had purchase obligations of approximately $21.8 million as of June 30, 2005, primarily to purchase minimum quantities of materials and components used to manufacture our products. We may be obligated to fulfill these purchase obligations even if demand for our products is lower than we anticipate.

We may not be able to manage expenses and inventory risks associated with meeting the demand of our customers

From time to time, we receive indications from our customers as to their future plans and requirements to ensure that we will be prepared to meet their demand for our products. If actual orders differ materially from these indications, our ability to manage inventory and expenses may be affected. In addition, if we fail to meet customers supply expectations, we may lose business from such customers. If we enter into purchase commitments to acquire materials, or expend resources to manufacture products and such products are not purchased by our customers, our business and operating results could suffer.

We are dependent on key third-party suppliers and any failure by them to deliver components could limit our ability to satisfy customer demand

We manufacture all of our products using components or subassemblies procured from third-party suppliers, including semiconductors. Some of these components are available from a sole source and others are available from limited sources. A majority of our sales are from products containing one or more components that are available only from sole source suppliers. For example, our video equipment is single sourced from a manufacturer in San Jose, California. Our modems are sourced from a manufacturer in China. Additionally, some of our components are custom parts that are produced to our specifications, and it may be difficult to move the manufacturing of such components from one vendor to another vendor.

Any interruption in the operations of our vendors of sole source or custom product parts could adversely affect our ability to meet our scheduled product deliveries to customers. If we are unable to obtain a sufficient supply of components, including semiconductors, from our current sources, we could experience difficulties in obtaining alternative sources or in altering product designs to use alternative components. Resulting delays or reductions in product shipments could damage customer relationships and expose us to potential damages that may arise from our inability to supply our customers with products. Further, a significant increase in the price of one or more of these components, such as our semiconductor components, could harm our gross margin or operating results. Additionally, we attempt to limit this risk by maintaining safety stocks of these components, subassemblies and modules. As a result of this investment in inventories, we have in the past and in the future may be subject to risk of excess and obsolete inventories, which could harm our business. In this regard, our gross margins and operating results could be adversely affected by excess and obsolete inventory.

We may be unable to migrate to new semiconductor process technologies successfully or on a timely basis

Our future success will depend in part upon our ability to develop products that utilize new semiconductor process technologies. These technologies change rapidly and require us to spend significant amounts on research and development. We continuously evaluate the benefits of redesigning our integrated circuits using smaller geometry process technologies to improve performance and reduce costs. The transition of our products to integrated circuits with increasingly smaller geometries will be important to our competitive position. Other companies have experienced difficulty in migrating to new semiconductor processes and, consequently, have suffered reduced yields, delays in product deliveries and increased expense levels. Moreover, we depend on our relationship with our third-party manufacturers to migrate to smaller geometry processes successfully.

Our ability to directly control product delivery schedules and product quality is dependent on third-party contract manufacturers

Most of our products are assembled and tested by contract manufacturers using testing equipment that we provide. As a result of our dependence on these contract manufacturers for the assembly and testing of our products, we do not directly control product delivery schedules or product quality. Any product shortages or quality assurance problems could increase the costs of manufacturing, assembling or testing our products. In addition, as manufacturing volume increases, we will need to procure and assemble additional testing equipment and provide it to our contract manufacturers. The production and assembly of testing equipment typically requires significant lead times. We could experience significant delays in the shipment of our products if we are unable to provide this testing equipment to our contract manufacturers in a timely manner.

We are dependent upon international sales and there are many risks associated with international operations

We expect sales to customers outside of the United States to continue to represent a significant percentage of our revenues for the foreseeable future. For the six months ended June 30, 2005 and the twelve months ended December 31, 2004, 2003 and 2002, approximately 37%, 45%, 44% and 68%, respectively, of our net revenues were from customers outside of the U.S. International sales are subject to a number of risks, including the following:

- changes in foreign government regulations and communications standards;
- import and export license requirements, tariffs and taxes;
- trade barriers and trade disputes;
- difficulty in protecting intellectual property;
- difficulty in collecting accounts receivable;
- currency fluctuations;
- the burden of complying with a wide variety of foreign laws, treaties and technical standards;
- difficulty in staffing and managing foreign operations; and
- political and economic instability.

If our customers are affected by currency devaluations or general economic downturns their ability to purchase our products could be reduced significantly. Payment cycles for international customers typically are longer than those for customers in North America.

Our international operations are subject to certain risks common to foreign operations in general, such as governmental regulations and import restrictions. In addition, there are social, political, labor and economic conditions in specific countries or regions as well as difficulties in staffing and managing foreign operations, and potential adverse foreign tax consequences, among other factors that could also have an impact on our business and results of operations outside of the United States.

Furthermore, foreign countries may decide to prohibit, terminate or delay the construction of new broadband infrastructures for a variety of reasons. These reasons include environmental issues, economic downturns and availability of favorable pricing for other communications services or the availability and cost of related equipment. Any such action by foreign countries would reduce the market for our products.

Like other companies operating or selling internationally, we are subject to the Foreign Corrupt Practices Act (FCPA) and other laws which prohibit improper payments or offers of payments to foreign governments and their officials and political parties by U.S. and other business entities for the purpose of obtaining or retaining business. We make sales in countries known to experience corruption. Our sales

activities in such countries create the risk of an unauthorized payments or offers of payments by one of our employees, consultants, sales agents or distributors which could be in violation of various laws including the FCPA, even though such parties are not always subject to our control. We have attempted to implement safeguards to prevent losses from such practices and to discourage such practices by our employees, consultants, sales agents and distributors. However, our safeguards may prove to be less than effective and our employees, consultants, sales agents or distributors may engage in conduct for which we might be held responsible. Violations of the FCPA may result in severe criminal or civil sanctions, and we may be subject to other liabilities, which could negatively affect our business, financial condition and results of operations.

The deployment process for our equipment may be lengthy and may delay the receipt of new orders and cause fluctuations in our revenues

The timing of deployment of our equipment can be subject to a number of other risks, including the availability of skilled engineering and technical personnel, the availability of other equipment such as fiber optic cable, and the need for local zoning and licensing approvals. We believe that changes in our customers deployment plans have delayed, and may in the future delay the receipt of new orders. Since the majority of our sales have been to relatively few customers, a delay in equipment deployment with any one customer has in the past had, and could in the future, have a material adverse effect on our sales for a particular quarter.

Our industry is highly competitive with many larger and more established competitors

The market for our products is extremely competitive and is characterized by rapid technological change. Our direct competitors include Ambit Microsystems Corporation, Cisco Systems, BigBand Networks, Motorola, Scientific-Atlanta and RGB Networks. Additionally, we face competition from early stage companies with access to significant financial backing that improve existing technologies or develop new technologies. The principal competitive factors in our market include the following:

- product performance, features and reliability;
- price;
- size and stability of operations;
- breadth of product line;
- sales and distribution capabilities;
- technical support and service;
- relationships with providers of service providers; and
- compliance with industry standards.

Some of these factors are outside of our control. Conditions in the market could change rapidly and significantly as a result of technological advancements. The development and market acceptance of alternative technologies could decrease the demand for our products or render them obsolete. Our competitors may introduce products that are less costly, provide superior performance or achieve greater market acceptance than our products.

Many of our current and potential competitors have greater financial, technical, marketing, distribution, customer support and other resources, as well as better name recognition and access to customers than we do. The widespread adoption of DOCSIS and other industry standards has and is likely to continue to cause increased price competition. We believe that the adoption of these standards have resulted in and are likely to continue to result in lower ASPs for our products. Any increased price competition or reduction in sales of our products, particularly our higher margin head-end products, has resulted and will continue to result in decreased revenue and downward pressure on our gross margin. These competitive pressures have and are likely to continue to have an adverse impact on our business.

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Our business is subject to the risks of warranty returns, product liability and product defects

Products like ours are very complex and can frequently contain undetected errors or failures, especially when first introduced or when new versions are released. Despite testing, errors may occur. Product errors could affect the performance or interoperability of our products, delay the development or release of new products or new versions of products, adversely affect our reputation and our customers willingness to buy products from us and adversely affect market acceptance or perception of our products. Any such errors or delays in releasing new products or new versions of products or allegations of unsatisfactory performance could cause us to lose revenue or market share, increase our service costs, cause us to incur substantial costs in redesigning the products, subject us to liability for damages and divert our resources from other tasks, any one of which could materially and adversely affect our business, results of operations and financial condition. Although we have limitation of liability provisions in our standard terms and conditions of sale, they may not be effective as a result of federal, state or local laws or ordinances or unfavorable judicial decisions in the United States or other countries. The sale and support of our products also entails the risk of product liability claims. We maintain insurance to protect against certain claims associated with the use of our products, but our insurance coverage may not adequately cover any claim asserted against us. In addition, even claims that ultimately are unsuccessful could result in our expenditure of funds in litigation and divert management s time and other resources.

We may be unable to adequately protect or enforce our intellectual property rights

We rely on a combination of patent, trade secret, copyright and trademark laws and contractual restrictions to establish and protect proprietary rights in our products. Even though we seek to establish and protect proprietary rights in our products, there are risks. There are no assurances that any patent, trademark, copyright or other intellectual property rights owned by us will not be invalidated, circumvented or challenged, that such intellectual property rights will provide competitive advantages to us or that any of our pending or future patent applications will be issued with the scope of the claims sought by us, if at all. There are no assurances that others will not develop technologies that are similar or superior to our technology, duplicate our technology or design around the patents that we own. In addition, effective patent, copyright and trade secret protection may be unavailable or limited in certain foreign countries in which we do business or may do business in the future.

Our pending patent applications may not be granted. Even if they are granted, the claims covered by any patent may be reduced from those included in our applications. Any patent might be subject to challenge in court and, whether or not challenged, might not be broad enough to prevent third parties from developing equivalent technologies or products without a license from us.

We believe that the future success of our business will depend on our ability to translate the technological expertise and innovation of our employees into new and enhanced products. We have entered into confidentiality and invention assignment agreements with our employees, and we enter into non-disclosure agreements with many of our suppliers, distributors and appropriate customers so as to limit access to and disclosure of our proprietary information. These contractual arrangements, as well as statutory protections, may not prove sufficient to prevent misappropriation of our trade secrets or technology or deter independent third-party development of similar technologies. In addition, the laws of some foreign countries may not protect our intellectual property rights to the same extent as do the laws of the United States. We may, in the future, take legal action to enforce our patents and other intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others, or to defend against claims of infringement or invalidity. Such litigation could result in substantial costs and diversion of resources and could negatively affect our business, operating results, financial position and liquidity.

CableLabs DOCSIS 2.0 specification includes two advanced physical layer technologies, S-CDMA and A-TDMA. In connection with the development of the DOCSIS 2.0 specification by CableLabs, we entered into an agreement with CableLabs, on a royalty-free basis, whereby we licensed to CableLabs many of our intellectual property rights to the extent that such rights may be asserted against a party desiring to design, manufacture or sell DOCSIS-based products, including DOCSIS 2.0-based products. This license agreement grants to CableLabs the right to sublicense our intellectual property, including our intellectual property rights in our S-CDMA patents, to manufacturers that compete with us in the marketplace for DOCSIS based products.

We pursue the registration of our trademarks in the United States and have applications pending to register several of our trademarks throughout the world. However, the laws of certain foreign countries might not protect our products or intellectual property rights to the same extent as the laws of the United States. Effective trademark, copyright, trade secret and patent protection may not be available in every country in which our products may be manufactured, marketed or sold.

Third party claims of infringement or other claims against us could adversely affect our ability to market our products, require us to redesign our products or seek licenses from third parties, and seriously harm our operating results and disrupt our business

As is typical in our industry, we have been and may from time to time be notified of claims asserting that we are infringing intellectual property rights owned by third parties. We also have in the past agreed to, and may from time to time in the future agree to, indemnify customers of our technology or products for claims against such customers by a third party based on claims that our technology or products infringe patents of that third party. We further believe that companies may be increasingly subject to infringement claims as distressed companies and individuals attempt to generate cash by enforcing their patent portfolio against a wide range of products. These types of claims, meritorious or not, can result in costly and time-consuming litigation; divert management s attention and other resources; require us to enter into royalty arrangements; subject us to damages or injunctions restricting the sale of our products, require us to indemnify our customers for the use of the allegedly infringing products; require us to refund payment of allegedly infringing products to our customers or to forgo future payments; require us to redesign certain of our products; or damage our reputation. Our failure to obtain a license for key intellectual property rights from a third party for technology used by us could cause us to incur substantial liabilities and to suspend the manufacturing of products utilizing the technology. Alternatively, we could be required to expend significant resources to develop non-infringing technology with no assurances that we would be successful in such endeavors. The occurrence of any of the above events could materially and adversely affect our business, results of operations and financial condition.

Our indebtedness could adversely affect our financial condition and we may incur substantially more debt

As of June 30, 2005, we had approximately $68.5 million of long-term obligations of which $65.1 million is long-term debt associated with our Notes. This level of indebtedness may adversely affect our stockholders by:

- making it more difficult for us to satisfy our obligations with respect to our indebtedness;
- increasing our vulnerability to general adverse economic and industry conditions;
- limiting our ability to obtain additional financing;
- requiring the dedication of a substantial portion of our cash flow from operations to the payment of principal of, and interest on, our indebtedness, thereby reducing the availability of our cash flow to fund our growth strategy, working capital, capital expenditures and other general corporate purposes;
- limiting our flexibility in planning for, or reacting to, changes in our business and the industry; and
- placing us at a competitive disadvantage relative to our competitors with less debt.

We may incur substantial additional debt in the future. If new debt is added to our current levels, the related risks described above could intensify.

We need to develop and introduce new and enhanced products in a timely manner to remain competitive

The markets in which we operate are characterized by rapidly changing technologies, evolving industry standards, frequent new product introductions and relatively short product life. The pursuit of necessary technological advances and the development of new products require substantial time and expense. For example, we acquired ten businesses during the period between 1999 and 2000. Due to various economic conditions, none of the products from our acquired businesses, other than the CherryPicker products, have achieved the level of market acceptance that was forecasted at the time of their acquisitions. Additionally, certain product groups have not achieved the level of technological development needed to be marketable or to expand the market. As a result, we recorded an aggregate of approximately $576.8 million related to impairment charges and write-down of in- process research and development related to the acquired technologies, both of which negatively impacted our operating results in 2001 and 2002.

To compete successfully in the markets in which we operate, we must design, develop, manufacture and sell new or enhanced products that provide increasingly higher levels of performance and reliability. However, we may not be able to successfully develop or introduce these products, if our products are not:

- cost effective;
- brought to market in a timely manner;
- in accordance with evolving industry standards and architecture; or
- fail to achieve market acceptance.

There is no assurance that the technologies we are currently developing or intend to develop will achieve feasibility or that even if we are successful, the developed product will be accepted by the market. We may not be able to recover the costs of existing and future product developments and our failure to do so may materially and adversely impact our business, financial condition and results of operations.

We are exposed to the credit risk of our customers and to credit exposures in weakened markets, which could result in material losses

Most of our sales are on an open credit basis, with payment terms of 30 to 60 days typically in the United States, and because of local customs or conditions, longer in some markets outside the United States. Beyond our open credit arrangements, we have also experienced a request for customer financing and facilitation of leasing arrangements, which we have not provided to date and do not expect to provide in the future. We expect demand for enhanced open credit terms, for example, longer payment terms, customer financing and leasing arrangements to continue and believe that such arrangements are a competitive factor in obtaining business. Our decision not to provide these types of financing arrangements may adversely affect our ability to sell products, and therefore, our revenue, operations and business.

Because of the current condition in the global economy, our exposure to credit risks relating to sales on an open-credit basis has increased. Although we monitor and attempt to mitigate the associated risk, there can be no assurance that our efforts will be effective in reducing credit risk. Additionally, there have been significant insolvencies and bankruptcies among our customers, which have and may continue to cause us to incur economic and financial losses. There can be no assurance that additional losses would not be incurred and that such losses would not be material. Although these losses have generally not been material to date, future losses, if incurred, could harm our business and have a material adverse effect on our operating results and financial condition.

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We have and we may seek to expand our business through acquisitions which could disrupt our business operations and harm our operating results

In order to expand our business, we may make strategic acquisitions of other companies or certain assets. We plan to continue to evaluate opportunities for strategic acquisitions from time to time, and may make an acquisition at some future point. However, the current volatility in the stock market and the current price of our common stock may adversely affect our ability to make such acquisitions. Any acquisition that we make involves substantial risks, including the following:

difficulties in integrating the operations, technologies, products and personnel of an acquired company;

DILUTED EARNINGS PER COMMON SHARE	$	1.78	$ 1.37	$ 1.13
WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING - BASIC		37,518	36,118	34,592
WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING - DILUTED		38,127	36,779	36,339

See notes to consolidated financial statements.

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LIFE TIME FITNESS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

	Common Stock		Additional		Accumulated Other		
	Shares	Amount	Paid-In Capital	Deferred Compensation	Comprehensive Loss	Retained Earnings	Total
	(In thousands, except share data)						
BALANCE December 31, 2004	33,791,61	$ 676	$ 209,931	$ (66)	$	$ 40,093	$ 250,634
Common stock issued upon exercise of stock options	1,698,714	34	6,149				6,183
Grant of restricted stock	80,243	2	2,625	(2,627)			
Compensation related to stock options and restricted stock			255	387			642
Tax benefit upon exercise of stock options			9,172				9,172
Net income						41,213	41,213
BALANCE December 31, 2005	35,570,567	712	228,132	(2,306)		81,306	307,844
Reclassification of deferred compensation to additional paid-in capital			(2,306)	2,306			
Common stock issued upon exercise of stock options	1,090,788	22	15,242				15,264
Grant of restricted stock	156,164	3	(3)				
Forfeiture of restricted stock	(320)						
Compensation related to stock options and restricted stock			7,556				7,556
Capitalized compensation related to stock options and			1,055				1,055

restricted stock							
Tax benefit upon exercise of stock options			10,229				10,229
Net income						50,565	50,565
BALANCE December 31, 2006	36,817,199	737	259,905			131,871	392,513
Common stock issued upon common stock offering	1,675,000	33	92,469				92,502
Common stock issued upon exercise of stock options	487,075	10	8,444				8,454
Grant of restricted stock	162,393	3	(3)				
Forfeiture of restricted stock	(3,720)						
Compensation related to stock options and restricted stock			7,746				7,746
Capitalized compensation related to stock options and restricted stock			744				744
Tax benefit upon exercise of stock options			4,605				4,605
Interest rate swap contract					(2,026)		(2,026)
Net income						68,019	68,019
BALANCE December 31, 2007	39,137,947	$ 783	$ 373,910	$	$ (2,026)	$ 199,890	$ 572,557

See notes to consolidated financial statements.

LIFE TIME FITNESS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the Year Ended December 31,		
	2007	2006	2005
		(In thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	$ 68,019	$ 50,565	$ 41,213
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	59,014	47,560	38,346
Deferred income taxes	11,505	3,165	3,315
Loss on disposal of property and equipment, net	354	946	539
Amortization of deferred financing costs	853	696	1,025
Share-based compensation	7,746	7,556	388
Excess tax benefit from stock option exercises	(4,605)	(10,229)	
Changes in operating assets and liabilities	(544)	25,425	22,870
Other	(136)	168	256
Net cash provided by operating activities	142,206	125,852	107,952
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchases of property and equipment (excluding non-cash purchases supplementally noted below)	(415,822)	(261,767)	(190,355)
Proceeds from sale of property and equipment	5,054	6,629	4,411
Proceeds from property insurance settlement	78	581	
Increase in other assets	(4,488)	(7,803)	(3,083)
Decrease (increase) in restricted cash	(2,029)	(823)	8,177
Net cash used in investing activities	(417,207)	(263,183)	(180,850)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from long-term borrowings	113,455		5,652
Repayments on long-term borrowings	(11,181)	(19,120)	(23,971)
Proceeds from revolving credit facility, net	67,800	134,000	80,678
Increase in deferred financing costs	(2,160)	(842)	(1,175)
Proceeds from common stock offering, net of underwriting discount and offering costs	92,502		
Excess tax benefit from exercise of stock options	4,605	10,229	
Proceeds from exercise of stock options	8,454	15,264	6,183
Net cash provided by financing activities	273,475	139,531	67,367
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(1,526)	2,200	(5,531)
CASH AND CASH EQUIVALENTS Beginning of period	6,880	4,680	10,211
CASH AND CASH EQUIVALENTS End of period	$ 5,354	$ 6,880	$ 4,680
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:			

Cash payments for interest, net of capitalized interest of $8,425, $5,308 and $3,965, respectively	$	30,621	$	22,183	$	17,212
Cash payments for income taxes	$	33,746	$	17,005	$	13,227
SUPPLEMENTAL SCHEDULE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:						
Purchases of property and equipment purchases financed through capital lease obligations	$	1,445	$		$	96
Purchases of property purchase financed through notes payable	$	95	$	1,620	$	
Purchases of property and equipment in accounts payable	$	10,218	$	22,594	$	8,773
Non-cash share-based compensation capitalized to projects under development	$	744	$	1,055	$	

See notes to consolidated financial statements.

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LIFE TIME FITNESS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Table amounts in thousands, except share and per share data)

1. Nature of Business

Life Time Fitness, Inc., a Minnesota corporation, and our subsidiaries are primarily engaged in designing, building and operating sports and athletic, professional fitness, family recreation and resort/spa centers, principally in residential locations of major metropolitan areas. As of December 31, 2007, we operated 70 centers and one satellite center, including 25 in Minnesota, 14 in Texas, eight in Illinois, six in Michigan, four in Arizona, three in Ohio, two each in Virginia and Georgia and one each in Florida, Indiana, Kansas, Maryland, Nebraska, North Carolina and Utah.

2. Significant Accounting Policies

Principles of Consolidation The consolidated financial statements include the accounts of Life Time Fitness, Inc. and our wholly owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

Revenue Recognition We receive a one-time enrollment fee at the time a member joins and monthly membership dues for usage from our members. The enrollment fees are nonrefundable after 30 days. Enrollment fees and related direct expenses, primarily sales commissions, are deferred and recognized on a straight-line basis over an estimated membership period of 36 months, which is based on historical membership experience. In addition, monthly membership dues paid in advance of a center s opening are deferred until the center opens. We offer members month-to-month memberships and recognize as revenue the monthly membership dues in the month to which they pertain.

We provide service at each of our centers, including personal training, spa, cafe and other member services. The revenue associated with these services is recognized at the time the service is performed. Personal training revenue received in advance of training sessions and the related commissions are deferred and recognized when services are performed. Other revenue includes revenue from our media, athletic events and restaurant. Media advertising revenue is recognized over the duration of the advertising placement. For athletic events, revenue is generated primarily through sponsorship sales and registration fees. Athletic event revenue is recognized upon the completion of the event. In limited instances in our media and athletic events businesses, we recognize revenue on barter transactions. We recognize barter revenue equal to the lesser of the value of the advertising or promotion given up or the value of the asset received. Restaurant revenue is recognized at the point of sale to the customer.

Pre-Opening Operations We generally operate a preview center up to nine months prior to the planned opening of a center during which time memberships are sold as construction of the center is being completed. The revenue and direct membership acquisition costs, primarily sales commissions and related benefits, incurred during the period prior to a center opening are deferred until the center opens and are then recognized on a straight-line basis over a period of 36 months beginning when the center opens; however, the related advertising, office, rent and other expenses incurred during this period are expensed as incurred.

Cash and Cash Equivalents We classify all unrestricted cash accounts and highly liquid debt instruments purchased with original maturities of three months or less to be cash and cash equivalents.

Restricted Cash We are required to keep funds on deposit at certain financial institutions related to certain of our credit facilities. Our lender or lenders, as the case may be, may access the restricted cash after the occurrence of an event of default, as defined under their respective credit facilities.

Accounts Receivable Accounts receivable is presented net of allowance for doubtful accounts and sales returns and allowances.

LIFE TIME FITNESS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Table amounts in thousands, except share and per share data)

The rollforward of these allowances are as follows:

	December 31,		
	2007	**2006**	**2005**
Allowance for Doubtful Accounts:			
Balance, beginning of period	$ 616	$ 187	$ 435
Provisions	345	542	126
Write-offs against allowance	(206)	(113)	(374)
Balance, end of period	$ 755	$ 616	$ 187
Sales Returns and Allowances:			
Balance, beginning of period	$	$ 134	$ 289
Provisions		(52)	255
Write-offs against allowance		(82)	(410)
Balance, end of period	$	$	$ 134

We no longer carry sales returns and allowances as a result of our discontinuation of the sale of our nutritional products through independent retailers during 2006. We continue to sell our nutritional products through LifeCafe.

Inventories Inventories consist primarily of operational supplies, nutritional products and uniforms. These inventories are stated at the lower of cost or market value.

Inventories consist of the following:

	December 31,	
	2007	**2006**
Center operations inventory	$ 4,232	$ 3,815
In-center businesses inventory	7,144	3,452
Apparel and uniforms	2,693	1,250
Other	255	256
	$ 14,324	$ 8,773

Prepaid Expenses and Other Current Assets Prepaid expenses and other current assets consist primarily of prepaid insurance, other prepaid operating expenses and deposits and two properties held for sale.

Prepaid expenses and other current assets consist of the following:

	December 31,	
	2007	**2006**
Land held for sale	$ 5,390	$
Insurance deposits	2,664	2,578
Deferred costs	1,928	1,480
Prepaid lease obligations	1,232	1,489
Due from affiliate	490	233
Other prepaid expenses and current assets	4,259	3,421

	$ 15,963	$ 9,201

LIFE TIME FITNESS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Table amounts in thousands, except share and per share data)

Property and Equipment Property, equipment and leasehold improvements are recorded at cost. Improvements are capitalized, while repair and maintenance costs are charged to operations when incurred. The cost and accumulated depreciation of property and equipment retired and other items disposed of are removed from the related accounts, and any residual values are charged or credited to income.

Depreciation is computed primarily using the straight-line method over estimated useful lives of the assets. Leasehold improvements are amortized using the straight-line method over the shorter of the lease term or the estimated useful life of the improvement. Accelerated depreciation methods are used for tax reporting purposes.

Property and equipment consist of the following:

	Depreciable Lives	December 31, 2007	December 31, 2006
Land		$ 219,347	$ 154,680
Buildings	3-40 years	869,365	630,565
Leasehold improvements	1-20 years	36,253	34,695
Construction in progress		137,335	82,589
		1,262,300	902,529
Equipment:			
Fitness	5-7 years	76,620	59,559
Computer and telephone	3-5 years	35,792	32,335
Capitalized software	5 years	21,884	17,345
Decor and signage	5 years	8,962	7,018
Audio/visual	3-5 years	15,319	11,349
Furniture and fixtures	7 years	9,300	7,579
Other equipment	3-7 years	48,135	33,965
		216,012	169,150
Property and equipment, gross		1,478,312	1,071,679
Less accumulated depreciation		219,041	169,557
Property and equipment, net		$ 1,259,271	$ 902,122

At December 31, 2007, we had eleven centers under construction: three in Texas, two in Georgia and one each in Colorado, Illinois, Missouri, Maryland, New Jersey and Virginia. Construction in progress, including land purchased for future development totaled $206.3 million at December 31, 2007 and $116.9 million at December 31, 2006.

Capitalized software is our internally developed Web-based systems to facilitate member enrollment and management, as well as point of sale system enhancements. Costs related to these projects have been capitalized in accordance with Statement of Position No. 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use.*

Other equipment consists primarily of cafe, spa and playground and laundry equipment.

LIFE TIME FITNESS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Table amounts in thousands, except share and per share data)

Impairment of Long-lived Assets The carrying value of long-lived assets is reviewed annually and whenever events or changes in circumstances indicate that such carrying values may not be recoverable. We consider a history of consistent and significant operating losses to be our primary indicator of potential impairment. Assets are grouped and evaluated for impairment at the lowest level for which there are identifiable cash flows, which is generally at an individual center level or corporate business. The determination of whether impairment has occurred is based on an estimate of undiscounted future cash flows directly related to that center or corporate business, compared to the carrying value of these assets. If an impairment has occurred, the amount of impairment recognized is determined by estimating the fair value of these assets and recording a loss if the carrying value is greater than the fair value. Based upon our review and analysis, no impairments were deemed to have occurred during 2007, 2006 or 2005.

Derivative Instruments and Hedging Activities. As part of our risk management program, we may periodically use interest rate swaps to manage known market exposures. Terms of derivative instruments are structured to match the terms of the risk being managed and are generally held to maturity. We do not hold or issue derivative financial instruments for trading purposes. All other contracts that contain provisions meeting the definition of a derivative also meet the requirements of, and have been designated as normal purchases or sales. Our policy is to not enter into contracts with terms that cannot be designated as normal purchases or sales.

In 2007, we entered into an interest rate swap contract that effectively fixed the rates paid on a total of $125.0 million of variable rate borrowings. The contract fixed the rate on $125.0 million of borrowings at 4.825% plus the applicable spread (depending on cash flow leverage ratio) until October 2010. The contract has been designated a hedge against interest rate volatility. In accordance with Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities, changes in the fair market value of the swap contract are recorded in accumulated other comprehensive income (loss). As of December 31, 2007, the $2.0 million, net of tax, fair market value of the swap contract was recorded as accumulated other comprehensive loss in the shareholder equity section and the $3.3 million gross fair market value of the swap contract was included in long-term debt.

Other Assets We record other assets at cost. Amortization of financing costs is computed over the periods of the related debt financing. Other assets consist of the following:

	December 31,	
	2007	**2006**
Financing costs, net	$ 5,399	$ 4,093
Investment in unconsolidated affiliate (see Note 3)	2,636	2,400
Site development costs	2,669	2,371
Lease deposits	3,867	2,340
Earnest money deposits	9,632	8,984
Intangible assets	5,505	4,252
Land held for sale	10,592	5,655
Other	2,505	
	$ 42,805	$ 30,095

Site development costs consist of legal, engineering, architectural, environmental, feasibility and other direct expenditures incurred for certain new center projects. Capitalization commences when acquisition of a particular property is deemed probable by management. Should a specific project be deemed not viable for construction, any capitalized costs related to that project are charged to operations at the time of that determination. Costs incurred prior to the point at which the acquisition is deemed probable are expensed as incurred. Site development costs capitalized in the years ended December 31, 2007 and 2006 were approximately $10.3 million and $6.1 million, respectively. Upon completion of a project, the site development costs are classified as property and equipment and depreciated

over the useful life of the asset.

LIFE TIME FITNESS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Table amounts in thousands, except share and per share data)

Intangible assets are comprised principally of goodwill, leasehold rights at our Highland Park, Minnesota office building and trade names. In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets,* intangible assets determined to have an indefinite useful life, which consist of all our intangible assets, are not amortized but instead tested for impairment at least annually.

We are required to test our intangible assets for impairment on an annual basis. We are also required to evaluate these assets for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of the intangible asset below its carrying amount. An indicator of potential impairment that could impact our intangible asset values include, but is not limited to, a significant loss of occupancy at our rental property located in Highland Park, Minnesota. We tested to determine if the fair values of each of our intangible assets were in excess of their respective carrying values at December 31, 2007 and December 31, 2006, for purposes of the annual impairment test.

The following table summarizes the changes in our net intangible balance during the years ended December 31, 2007, 2006 and 2005:

Balance at December 31, 2004	$ 241
Leasehold rights acquired	2,318
Trade name acquired	321
Balance at December 31, 2005	2,880
Goodwill acquired	1,272
Trade name acquired	100
Balance at December 31, 2006	4,252
Purchase price adjustment (1)	(1,346)
Goodwill acquired	2,599
Balance at December 31, 2007	$ 5,505

(1) Includes adjustments related to the finalization of the purchase price allocation of 2006 acquisition transactions.

The following table summarizes the carrying amounts of our intangible assets:

	December 31,	
	2007	**2006**
Goodwill	$ 2,599	$ 1,346
Leasehold rights	2,318	2,318
Trade names	588	588
	$ 5,505	$ 4,252

LIFE TIME FITNESS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Table amounts in thousands, except share and per share data)

Accrued Expenses Accrued expenses consist of the following:

	December 31,	
	2007	**2006**
Payroll related	$ 8,129	$ 7,092
Real estate taxes	9,395	8,120
Center operating costs	17,032	14,126
Insurance	2,692	2,112
Interest	3,185	376
Other	6,619	5,365
	$ 47,052	$ 37,191

Income Taxes We account for income taxes under the asset and liability method, which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements. Under this method, deferred tax assets and liabilities are determined based on the differences between the financial statements and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. The effect of a change in tax rates on deferred tax assets and liabilities is recognized in income in the period that includes the enactment date.

We record net deferred tax assets to the extent we believe these assets will more likely than not be realized. In making such determination, we consider all available positive and negative evidence, including scheduled reversals of deferred tax liabilities, projected future taxable income, tax planning strategies and recent financial operations. In the event we were to determine that we would be able to realize our deferred income tax assets in the future in excess of their net recorded amount, we would record a valuation allowance, which would reduce the provision for income taxes.

In July 2006, the FASB issued Financial Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), which clarifies the accounting for uncertainty in income taxes recognized in the financial statements in accordance with SFAS 109, Accounting for Income Taxes. FIN 48 provides that a tax benefit from an uncertain tax position may be recognized when it is more likely than not that the position will be sustained upon examination, including resolutions of any related appeals or litigation processes, based on the technical merits. Income tax positions must meet a more-likely-than-not recognition threshold at the effective date to be recognized upon the adoption of FIN 48 and in subsequent periods. This interpretation also provides guidance on measurement, derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

We adopted the provisions of FIN 48*,* on January 1, 2007. No cumulative effect upon adoption of FIN 48 was recorded; however, certain amounts have been presented in the consolidated balance sheet in conformance with the requirements of the statement.

We recognize interest and penalties related to unrecognized tax benefits within the income tax expense line in the accompanying consolidated statement of operations. Accrued interest and penalties are included within the related tax liability line in the consolidated balance sheet.

Earnings per Common Share Basic earnings per common share (EPS) is computed by dividing net income applicable to common shareholders by the weighted average number of shares of common stock outstanding for each year. Diluted EPS is computed similarly to basic EPS, except that the numerator is adjusted to add back any redeemable preferred stock accretion and the denominator is increased for the conversion of any dilutive common stock equivalents, such as redeemable preferred stock, the assumed exercise of dilutive stock options using the treasury stock method and unvested restricted stock awards using the treasury stock method.

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LIFE TIME FITNESS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Table amounts in thousands, except share and per share data)

The basic and diluted earnings per share calculations are shown below:

	For the Year Ended December 31,		
	2007	**2006**	**2005**
Net income	$ 68,019	$ 50,565	$ 41,213
Weighted average number of common shares outstanding basic	37,518	36,118	34,592
Effect of dilutive stock options	476	509	1,739
Effect of dilutive restricted stock awards	133	152	8
Weighted average number of common shares outstanding diluted	38,127	36,779	36,339
Basic earnings per common share	$ 1.81	$ 1.40	$ 1.19
Diluted earnings per common share	$ 1.78	$ 1.37	$ 1.13

The number of total common shares outstanding at December 31, 2007 was 39,137,947.

Share-Based Compensation We have stock option plans for employees and accounts for these option plans in accordance with Statement of Financial Accounting Standards No. 123, Share-Based Payment (SFAS 123(R)). Prior to January 1, 2006, we applied Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees. On January 1, 2006, we adopted the fair value recognition provisions of SFAS 123(R), requiring us to recognize expense related to the fair value of our share-based compensation awards. We elected to use the modified prospective transition method as permitted by SFAS 123(R). Under this method, share-based compensation expense for the year ended December 31, 2006 included compensation expense for all share-based compensation awards granted prior to, but not yet vested, as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, Accounting for Stock-Based Compensation. In accordance with the modified prospective transition method of SFAS 123(R), financial results for the prior periods have not been restated. Had compensation cost for these plans been determined consistent with SFAS 123(R) for the year ended December 31, 2005, our net income applicable to common shareholders, basic EPS and diluted EPS would have been reduced to the following pro forma amounts:

Net income applicable to common shareholders basic:	
As reported	$ 41,213
Pro forma	$ 35,870
Basic earnings per common share:	
As reported	$ 1.19
Pro forma	$ 1.04
Net income applicable to common shareholders diluted:	
As reported	$ 41,213
Pro forma	$ 35,870

Diluted earnings per common share:	
As reported	$ 1.13
Pro forma	$ 0.99

LIFE TIME FITNESS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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The pro forma net income applicable to common shareholders, basic and diluted, for the year ended December 31, 2005, includes the compensation cost related to the vesting of certain stock options that were granted to certain members of management at or around the time of our initial public offering. Upon meeting specific market performance criteria governing these stock options, sixty percent of these shares had vested as of December 31, 2005. The remaining forty percent of the shares, upon meeting additional specific market performance criteria, vested during the second quarter of 2006.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used:

	December 31,		
	2007	**2006**	**2005**
Risk-free interest rate	4.7%	4.8%	4.0%
Expected dividend yield			
Expected life in years	5	5	6
Volatility	36.9%	35.9%	42.7%

The volatility and expected life assumptions presented are based on an average of the volatility assumptions reported by a peer group of publicly traded companies.

For more information on our share-based compensation plans, see Note 8.

Dividends We have not declared or paid any cash dividends on our common stock in the past. As discussed in Note 4, the terms of our revolving credit facility and certain debt financing agreements prohibit us from paying dividends without the consent of the lenders.

Fair Value of Financial Instruments The carrying amounts related to cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities approximate fair value due to the relatively short maturities of such instruments. The fair value of the term notes payable and capital leases approximated $245.1 million and $11.8 million, respectively, as of December 31, 2007. The fair value of our other long-term debt approximates the carrying value and is based on variable rates or interest rates for the same or similar debt offered to us having the same or similar remaining maturities and collateral requirements.

Use of Estimates The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Ultimate results could differ from those estimates. In recording transactions and balances resulting from business operations, we use estimates based on the best information available. We use estimates for such items as depreciable lives, volatility factors and expected life in determining fair value of option grants, tax provisions and provisions for uncollectible receivables. We also use estimates for calculating the amortization period for deferred enrollment fee revenue and associated direct costs, which are based on the historical average expected life of center memberships. We revise the recorded estimates when better information is available, facts change or we can determine actual amounts. These revisions can affect operating results.

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LIFE TIME FITNESS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Table amounts in thousands, except share and per share data)

Supplemental Cash Flow Information Decreases (increases) in operating assets and increases (decreases) in operating liabilities are as follows:

	For the Year Ended December 31,		
	2007	**2006**	**2005**
Accounts receivable	$ (2,155)	$ 1,947	$ (3,080)
Income tax receivable	(1,112)	13,643	1,068
Inventories	(5,551)	(3,104)	(698)
Prepaid expenses and other current assets	(6,762)	(2,014)	88
Deferred membership origination costs	(7,122)	(4,958)	(3,159)
Accounts payable	4,895	(132)	12,623
Accrued expenses	9,861	9,329	8,711
Deferred revenue	6,690	7,904	5,503
Deferred rent	(190)	2,546	1,814
Other liabilities	902	264	
	$ (544)	$ 25,425	$ 22,870

Our capital expenditures were as follows:

	For the Year Ended December 31,		
	2007	**2006**	**2005**
Purchases of property and equipment	$ 415,822	$ 261,767	$ 190,355
Non-cash property and equipment purchases financed through capital lease obligations	1,445		96
Non-cash property purchases financed through notes payable obligations	95	1,620	
Non-cash property purchases in accounts payable	10,218	22,594	8,773
Non-cash share-based compensation capitalized to projects under development	744	1,055	
Total capital expenditures	$ 428,324	$ 287,036	$ 199,224

New Accounting Pronouncements In July 2006, the FASB issued Financial Interpretation No. 48 (FIN 48). FIN 48 clarifies the application of SFAS No. 109 by defining a criterion that an individual tax position must meet for any part of the benefit of that position to be recognized in an enterprise s financial statements. The criterion allows for recognition in the financial statements of a tax position when it is more likely than not that the position will be sustained upon examination. FIN 48 was effective for us on January 1, 2007. For more information on the adoption of FIN 48, see Note 6.

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS 157). This accounting standard defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. The standard applies under other accounting pronouncements that require or permit fair value measurements with certain exceptions. SFAS 157 was effective for us January 1, 2008. The adoption of SFAS 157 is not expected to have a material effect on our financial position or results of operations.

LIFE TIME FITNESS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159). This accounting standard permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The standard also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. We currently do not plan to adopt any of the provisions of SFAS 159.

In December 2007, the FASB issued a revision of SFAS No. 141, Business Combinations (SFAS 141(R)). This accounting standard requires an acquirer to recognize and measure the assets acquired, liabilities assumed and any noncontrolling interests in the acquiree at the acquisition date, measured at their fair values as of that date, with limited exception. In addition, SFAS 141(R) requires that acquisition-related costs will be generally expensed as incurred. SFAS 141(R) also expands the disclosure requirements for business combinations. SFAS 141(R) will be effective for us on January 1, 2009. We are currently evaluating the effects of the adoption of SFAS 141(R).

Comprehensive Income We follow the provisions of SFAS No. 130 Reporting Comprehensive Income, which established standards for reporting and displaying of comprehensive income (loss) and its components. Comprehensive income (loss) reflects the change in equity of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. For us, the difference between net income as reported on the consolidated statements of operations and comprehensive income is a loss of $2.0 million, net of tax, related to our outstanding interest rate swap contract. For more information, see Note 4.

3. Investment in Unconsolidated Affiliate

In December 1999, we, together with two unrelated organizations, formed an Illinois limited liability company named LIFE TIME Fitness Bloomingdale L.L.C. (Bloomingdale LLC) for the purpose of constructing and operating a center in Bloomingdale, Illinois. The center opened for business in February 2001. Each of the three members maintains an equal interest in Bloomingdale LLC. Pursuant to the terms of the agreement that governs the formation and operation of Bloomingdale LLC (the Operating Agreement), each of the three members contributed $2.0 million to Bloomingdale LLC. We have no unilateral control of the center, as all decisions essential to the accomplishments of the purpose of Bloomingdale LLC require the consent of the other members of Bloomingdale LLC. The Operating Agreement expires on the earlier of December 2039 or the liquidation of Bloomingdale LLC. We account for our interest in Bloomingdale LLC using the equity method.

Bloomingdale LLC issued indebtedness in June 2000 in a taxable bond financing that is secured by a letter of credit in an amount not to exceed $14.7 million. All of the members separately guaranteed one-third of these obligations to the bank for the letter of credit and pledged their membership interest to the bank as security for the guarantee. The guarantee runs through June 7, 2010. As of December 31, 2007, the maximum amount of future payments under our one-third of the guarantee was $3.4 million. We have the right to recover from Bloomingdale LLC any amounts paid under the terms of the guarantee, but only after Bloomingdale LLC s obligations to the bank have been satisfied.

Pursuant to the terms of the Operating Agreement, beginning in March 2002 and continuing throughout the term of such agreement, the members are entitled to receive monthly cash distributions from Bloomingdale LLC. The amount of this monthly distribution is, and will continue to be throughout the term of the agreement, approximately $0.1 million per member. In the event that Bloomingdale LLC does not generate sufficient cash flow through its own operations to make the required monthly distributions, we are obligated to make such payments to each of the other two members. To date, Bloomingdale LLC has generated cash flows sufficient to make all such payments. Each of the three members had the right to receive distributions from Bloomingdale LLC in the amount of $0.7 million for each of the three years 2007, 2006 and 2005.

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4. Long-Term Debt

Long-term debt consists of the following:

	December 31,	
	2007	**2006**
Term notes payable to insurance company, monthly interest and principal payments totaling $1,273 including interest at 8.25% to June 2011, collateralized by certain related real estate and buildings	$ 117,597	$ 122,498
Revolving credit facility, interest only due monthly at interest rates ranging from LIBOR plus 0.625% to 1.50% or base plus 0.0%, facility expires May 2012, collateralized by certain personal property	312,800	245,000
Term notes payable with monthly interest and principal payments totaling $632 including interest at 6.03% to February 2017, collateralized by certain related real estate and buildings	103,990	
Mortgage notes payable to bank, due in monthly installments of $52 through October 2012, including interest at approximately 6.4%, collateralized by certain interests in related two centers	4,461	4,707
Promissory note payable to a municipality, collateralized by a mortgage on the underlying property, due in two equal payments through June 2013, including interest of 0.0%, (balances shown net of imputed interest of $450 and $533, respectively)	1,201	1,118
Unsecured promissory note, due in various unequal installments, expiring December 2010, including interest at 5.6% (balances shown net of imputed interest of $36 and $48, respectively)	514	502
Promissory note payable to lender, monthly interest and principal payments totaling $80 including interest at 5.78% to January 2015, collateralized by a certain interest in secured property	8,455	
Interest rate swap on notional amount of $125,000 at a fixed annual rate of 4.825%, expiring October 2010	3,252	
Special assessments payable, due in variable semiannual installments through September 2028, including interest at 4.25% to 7.00%, secured by the related real estate and buildings	3,053	2,870
Total debt (excluding obligations under capital leases)	555,323	376,695
Obligations under capital leases (see below)	9,282	12,860
Total debt	564,605	389,555
Less current maturities	9,568	15,228
Total long-term debt	$ 555,037	$ 374,327

On April 15, 2005, we entered into a Credit Agreement, with U.S. Bank National Association, as administrative agent and lead arranger, J.P. Morgan Securities, Inc., as syndication agent, and the banks party thereto from time to time (the U.S. Bank Facility). On May 31, 2007, we entered into a Second Amended and Restated Credit Agreement effective May 31, 2007 to amend and restate our U.S. Bank Facility. The material changes to the U.S. Bank Facility increase the amount of the facility from $300.0 million to $400.0 million, which may be increased by an additional

$25.0 million upon the exercise of an accordion feature, and extend the term of the facility by a little

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over one year to May 31, 2012. Interest on the amounts borrowed under the U.S. Bank Facility continues to be based on (i) a base rate, which is the greater of (a) U.S. Bank s prime rate and (b) the federal funds rate plus 50 basis points, or (ii) an adjusted Eurodollar rate, plus, in either case (i) or (ii), the applicable margin within a range based on our consolidated leverage ratio. In connection with the amendment and restatement of the U.S. Bank Facility, the applicable margin ranges were reduced to zero at all times (from zero to 25 basis points) for base rate borrowings and decreased to 62.5 to 150 basis points (from 75 to 175 basis points) for Eurodollar borrowings. As of December 31, 2007, $312.8 million was outstanding on the U.S. Bank Facility, plus $20.5 million related to letters of credit.

The weighted average interest rate and debt outstanding under the revolving credit facility for the year ended December 31, 2007 was 6.7% and $230.2 million, respectively. The weighted average interest rate and debt outstanding under the revolving credit facility for the year ended December 31, 2006 was 6.8% and $140.0 million, respectively.

On January 24, 2008, we amended the facility to increase the amount of the accordion feature from $25.0 million to $200.0 million and increase the senior secured operating company leverage ratio from not more than 2.50 to 1.00 to not more than 3.25 to 1.00. The amendment also allows for the issuance of additional senior debt and sharing of related collateral with lenders other than the existing bank syndicate.

On January 24, 2007, LTF CMBS I, LLC, a wholly owned subsidiary, obtained a commercial mortgage-backed loan in the original principal amount of $105.0 million from Goldman Sachs Commercial Mortgage Capital, L.P. pursuant to a loan agreement dated January 24, 2007. The mortgage financing is secured by six properties owned by the subsidiary and operated as Life Time Fitness centers located in Tempe, Arizona, Commerce Township, Michigan, and Garland, Flower Mound, Willowbrook and Sugar Land, Texas. The mortgage financing matures in February 2017. Interest on the amounts borrowed under the mortgage financing referenced above is 6.03% per annum, with a constant monthly debt service payment of $0.6 million. Our subsidiary LTF CMBS I, LLC, as landlord, and LTF Club Operations Company, Inc., another wholly owned subsidiary as tenant, entered into a lease agreement dated January 24, 2007 with respect to the properties. The initial term of the lease ends in February 2022, but the lease term may be extended at the option of LTF Club Operations Company, Inc. for two additional periods of five years each. Our subsidiaries may not transfer any of the properties except as permitted under the loan agreement. We guarantee the obligations of our subsidiary as tenant under the lease.

As additional security for LTF CMBS I, LLC s obligations under the mortgage financing, the subsidiary granted a security interest in all assets owned from time to time by the subsidiary including the properties which had a net book value of $99.1 million on January 24, 2007, the revenues from the properties and all other tangible and intangible property, and certain bank accounts belonging to the subsidiary that the lender has required pursuant to the mortgage financing. As of December 31, 2007, $104.0 million remained outstanding on the loan.

On September 17, 2007, we entered into a three-year floating-to-fixed interest rate swap contract, effective October 10, 2007, with J.P. Morgan Chase Bank, N.A. that effectively fixed the rates paid on $125.0 million of variable rate borrowings. Under the terms of the agreement we pay J.P. Morgan interest on a notional amount of $125.0 million at a fixed annual rate of 4.825%. In return we receive interest payments on the same notional amount at the 90 day LIBOR rate resetting every three months. The contract has been designated a hedge against interest rate volatility. Consequently, changes in the fair market value of the swap contract are recorded in accumulated other comprehensive income (loss). As of December 31, 2007, the $2.0 million, net of tax, fair market value of the swap contract was recorded as accumulated other comprehensive loss in the shareholder equity section and the $3.3 million gross fair market value of the swap contract was included in long-term debt.

On December 31, 2007, we borrowed $8.5 million. The loan is evidenced by a promissory note that matures in January 2015, bears interest at 5.78% and is secured by an interest in certain personal property.

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In May 2001, we financed one of our Minnesota centers pursuant to the terms of a sale-leaseback transaction that qualified as a capital lease. Pursuant to the terms of the lease, we agreed to lease the center for a period of 20 years. At December 31, 2007, the present value of future minimum lease payments due under the lease amounted to $6.6 million.

We were in compliance in all material respects with all restrictive and financial covenants under our various credit facilities as of December 31, 2007.

Aggregate annual future maturities of long-term debt (excluding capital leases) at December 31, 2007 are as follows:

2008	$ 7,985
2009	8,722
2010	13,551
2011	101,282
2012	317,970
Thereafter	105,813
	$ 555,323

We are a party to capital equipment leases with third parties which include monthly rental payments of approximately $0.2 million as of December 31, 2007. Amortization recorded for these capital leased assets totaled $3.7 million and $4.7 million for the years ended December 31, 2007 and 2006, respectively. The following is a summary of property and equipment recorded under capital leases:

	December 31,	
	2007	**2006**
Land and buildings	$ 6,622	$ 6,622
Equipment	26,078	35,863
	32,700	42,485
Less accumulated amortization	21,937	27,548
	$ 10,763	$ 14,937

Future minimum lease payments and the present value of net minimum lease payments on capital leases at December 31, 2007 are as follows:

2008	$ 2,464
2009	1,172
2010	1,169
2011	1,226
2012	1,648
Thereafter	7,480
	15,159
Less amounts representing interest	5,877
Present value of net minimum lease payments	9,282

Current portion	1,583
	$ 7,699

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5. Subsequent Event

On January 24, 2008, we amended our credit facility with U.S. Bank National Association to increase the amount of the accordion feature from $25.0 million to $200.0 million and increase the senior secured operating company leverage ratio from not more than 2.50 to 1.00 to not more than 3.25 to 1.00. The amendment also allows for the issuance of additional senior debt and sharing of related collateral with lenders other than the existing bank syndicate.

6. Income Taxes

The provision for income taxes is comprised of:

	December 31,		
	2007	**2006**	**2005**
Current tax expense	$ 33,358	$ 30,348	$ 23,443
Deferred tax expense	8,297	3,165	3,315
Non-current tax expense	3,565		
Income tax provision	$ 45,220	$ 33,513	$ 26,758

The amount of deferred tax expense does not reconcile to the change in the deferred tax year end balances due to the separate noncurrent tax liability created pursuant to the requirement of FIN 48 and the tax effect of Other Comprehensive Income items.

The reconciliation between our effective tax rate on income from continuing operations and the statutory tax rate is as follows:

	December 31,		
	2007	**2006**	**2005**
Income tax provision at federal statutory rate	$ 39,634	$ 29,428	$ 23,790
State and local income taxes, net of federal tax benefit	4,837	3,268	3,495
Other, net	749	817	(527)
Income tax provision	$ 45,220	$ 33,513	$ 26,758

Deferred income taxes are the result of provisions of the tax laws that either require or permit certain items of income or expense to be reported for tax purposes in different periods than they are reported for financial reporting. The tax effect of temporary differences that gives rise to the deferred tax liability are as follows:

	December 31,	
	2007	**2006**
Property and equipment	$ (32,274)	$ (43,088)
Partnership interest	(8,967)	
Accrued rent expense	2,618	5,612
Other comprehensive income	1,226	
Costs related to deferred revenue	(3,280)	(1,904)
Other, net	3,258	796
Net deferred tax liability	$ (37,419)	$ (38,584)

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The following is a reconciliation of the total amounts of unrecognized tax benefits for the year:

Unrecognized tax benefit beginning balance	$ 9,228
Gross increases tax positions in current period	4,329
Settlements	(161)
Lapse of statute of limitations	(504)
Unrecognized tax benefit ending balance	$ 12,892

Included in the balance of unrecognized tax benefits at December 31, 2007 are $1.4 million of benefits that, if recognized, would affect the effective tax rate.

We recognize interest accrued related to unrecognized tax benefits and penalties as income tax expense. Related to the uncertain tax benefits noted above, we accrued penalties and interest of $0.4 million during 2007 and in total, as of December 31, 2007, has recognized a liability for penalties and interest of $0.8 million.

In addition, we believe that it is reasonably possible that approximately $3.6 million of our currently remaining unrecognized tax positions, of which $3.1 million relates to depreciation related to property and equipment lives, may be recognized by the end of 2008 as a result of a lapse of the statute of limitations. The balance of $12.9 million is included in other long-term liabilities on our consolidated balance sheet.

We are subject to taxation in the U.S. and various states. Our tax years 2004, 2005 and 2006 are subject to examination by the tax authorities. With few exceptions, we are no longer subject to U.S. federal, state or local examinations by tax authorities for years before 2004.

7. Offering of Capital Stock

On August 29, 2007, we closed on the public offering, issuance and sale of 1,500,000 shares of our common stock, and on September 7, 2007, we closed on the issuance and sale of 175,000 shares of our common stock pursuant to exercise of the underwriters over-allotment option. The shares were sold pursuant to an underwriting agreement with Credit Suisse Securities (USA) LLC that was entered into on August 24, 2007. The shares were sold to the public at $55.40 per share, and the resulting proceeds totaled $92.5 million, net of underwriting discounts and commissions and offering expenses of $0.3 million. We used the net proceeds to repay a portion of the amounts outstanding under our revolving credit facility.

8. Share-Based Compensation

The FCA, Ltd. 1996 Stock Option Plan (the 1996 Plan) reserved up to 2,000,000 shares of our common stock for issuance. Under the 1996 Plan, the Board of Directors had the authority to grant incentive and nonqualified options to purchase shares of the our common stock to eligible employees, directors, and contractors at a price of not less than 100% of the fair market value at the time of the grant. Incentive stock options expire no later than 10 years from the date of grant, and nonqualified stock options expire no later than 15 years from the date of grant. As of December 31, 2007, we had granted a total of 1,700,000 options to purchase common stock under the 1996 Plan, of which 12,000 were outstanding. In connection with approval of the Life Time Fitness, Inc. 2004 Long-Term Incentive Plan (the 2004 Plan), as discussed below, our Board of Directors approved a resolution to cease making additional grants under the 1996 Plan.

The LIFE TIME FITNESS, Inc. 1998 Stock Option Plan (the 1998 Plan), reserved up to 1,600,000 shares of our common stock for issuance. Under the 1998 Plan, the Board of Directors had the authority to grant incentive and nonqualified options to purchase shares of our common stock to eligible employees, directors and contractors at a price of not less than 100% of the fair market value at the time of the grant. Incentive stock options expire no later than 10 years from the date of grant, and nonqualified stock options expire no later than 15 years from the date of grant. The 1998 Plan was amended in December 2003 by our Board of Directors and shareholders to reserve an

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additional 1,500,000 shares of our common stock for issuance. As of December 31, 2007, we had granted a total of 1,957,500 options to purchase common stock under the 1998 Plan, of which 304,905 were outstanding. In connection with approval of the 2004 Plan, as discussed below, our Board of Directors approved a resolution to cease making additional grants under the 1998 Plan.

The 2004 Plan reserved up to 3,500,000 shares of our common stock for issuance. Under the 2004 Plan, the Compensation Committee of our Board of Directors administers the 2004 Plan and has the power to select the persons to receive awards and determine the type, size and terms of awards and establish objectives and conditions for earning awards. The types of awards that may be granted under the 2004 Plan include incentive and non-qualified options to purchase shares of common stock, stock appreciation rights, restricted shares, restricted share units, performance awards and other types of stock-based awards. We use the term restricted shares to define nonvested shares granted to employees, whereas SFAS 123(R) reserves that term for fully vested and outstanding shares whose sale is contractually or governmentally prohibited for a specified period of time. Eligible participants under the 2004 Plan include our officers, employees, non-employee directors and consultants. Each award agreement will specify the number and type of award, together with any other terms and conditions as determined by the Compensation Committee of the Board of Directors or its designees. In connection with approval of the 2004 Plan, our Board of Directors approved a resolution to cease making additional grants under the 1996 Plan and 1998 Plan. During 2007, we issued 162,393 shares of restricted stock. The value of the restricted shares was based upon the closing price of our stock on the dates of issue which ranged from $49.06 to $53.95 during 2007. The restricted stock generally vests over periods ranging from one to five years. As of December 31, 2007, we had granted a total of 1,929,665 options to purchase common stock under the 2004 Plan, of which options to purchase 891,362 shares were outstanding, and a total of 405,828 restricted shares under the 2004 Plan, of which 302,345 restricted shares were unvested. As of December 31, 2007, 1,276,686 shares remain available for grant under the 2004 Plan.

Total share-based compensation expense, which includes stock option expense from the adoption of SFAS 123(R) and restricted stock expense, included in our consolidated statements of operations for the years ended December 31, 2007 and 2006, was as follows:

	For the Year Ended December 31,	
	2007	2006
Share-based compensation expense related to stock options	$ 3,206	$ 5,671
Share-based compensation expense related to restricted shares	4,410	1,833
Share-based compensation expense related to employee stock purchase program (ESPP)	130	52
Total share-based compensation expense	$ 7,746	$ 7,556

A summary of restricted stock activity follows:

	Restricted Shares Outstanding	Range of Market Price Per Share on Grant Date
Balance December 31, 2005	83,634	$24.75-33.14
Granted	156,164	42.72-50.82
Canceled	(320)	46.51
Vested	(28,584)	24.75-42.72

Balance December 31, 2006	210,894	24.75-50.82
Granted	162,393	49.06-53.95
Canceled	(3,720)	46.51-53.95
Vested	(67,222)	24.75-50.85
Balance December 31, 2007	302,345	$24.75-53.95

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During the years ended December 31, 2007 and 2006, we issued 162,393 and 156,164 shares of restricted stock, respectively, with an aggregate fair value of $8.0 million and $7.8 million, respectively. The fair market value of restricted shares that became vested during the year ended December 31, 2007 was $2.8 million. The total value of each restricted stock grant, based on the fair market value of the stock on the date of grant, is amortized to compensation expense on a straight-line basis over the related vesting period.

A summary of option activity is as follows:

Options	Shares	Weighted-Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Outstanding at December 31, 2004	3,831,108			
Granted	758,900			
Exercised	(1,698,714)			
Canceled	(133,628)			
Outstanding at December 31, 2005	2,757,666	$17.01		
Granted	71,954	46.57		
Exercised	(1,090,788)	14.00		
Canceled	(14,233)	16.41		
Outstanding at December 31, 2006	1,724,599	$20.15		
Granted	2,477	50.85		
Exercised	(487,075)	17.34		
Canceled	(31,734)	26.82		
Outstanding at December 31, 2007	1,208,267	$21.17	6.5	$34,441
Vested or Expected to Vest at December 31, 2007	1,155,351	$20.99	6.5	$33,145
Exercisable at December 31, 2007	651,253	$17.74	6.0	$20,799

The weighted average grant date fair value of stock options granted during the years ended December 31, 2007 and 2006, was $20.35 and $18.41, respectively. The aggregate intrinsic value of options (the amount by which the market price of the stock on the date of exercise exceeded the exercise price of the option) exercised during the years ended December 31, 2007 and 2006 was $17.3 million and $34.8 million, respectively. As of December 31, 2007, there was $4.2 million of unrecognized compensation expense to be recognized over a weighted-average period of 1.2 years.

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The options granted generally vest over a period of four to five years from the date of grant. The following table summarizes information concerning options outstanding and exercisable as of December 31, 2007:

Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$1.66 to $8.00	202,165	4.1	$ 7.68	145,965	$ 7.55
$12.00 to $18.50	439,397	6.4	16.80	342,097	16.79
$22.15 to $25.47	366,601	7.2	25.43	99,325	25.47
$26.15 to $48.59	200,104	7.9	36.62	63,866	34.09
$1.66 to $48.59	1,208,267	6.5	$ 21.17	651,253	$17.74

Our net cash proceeds from the exercise of stock options were $8.5 million and $15.3 million for the years ended December 31, 2007 and 2006, respectively. The actual income tax benefit realized from stock option exercises was $4.6 million and $10.2 million, respectively, for those same periods. Prior to the adoption of SFAS 123(R), we reported all tax benefits resulting from the exercise of stock options as cash flows from operating activities in our consolidated statements of cash flows. In accordance with SFAS 123(R), for the years ended December 31, 2007 and 2006, the excess tax benefits from the exercise of stock options are presented as cash flows from financing activities.

Our employee stock purchase program (ESPP) provides for the sale of up to 1,500,000 share of our common stock to our employees at discounted purchase prices. The cost per share under this plan is currently 90% of the fair market value of our common stock on the last day of the purchase period, as defined. The first purchase period during 2007 under the ESPP began January 1, 2007 and ended June 30, 2007. The second purchase period began July 1, 2007 and ended December 31, 2007. Compensation expense under the ESPP, which was $0.1 million for 2007, is based on the discount of 10% at the end of the purchase period. $1.2 million was withheld from employees for the purpose of purchasing shares under the ESPP. There were 1,478,865 shares of common stock available for purchase under the ESPP as of December 31, 2007.

In June 2006, our Board of Directors authorized the repurchase of up to 500,000 shares of our common stock from time to time in the open market or otherwise for the primary purpose of offsetting the dilutive effect of shares pursuant to our Employee Stock Purchase Plan. During 2007, we repurchased 12,635 shares for approximately $0.7 million. As of December 31, 2007, there were 478,865 remaining shares authorized to be repurchased for this purpose. The shares repurchased to date have been purchased in the open market and, upon repurchase, became authorized, but unissued shares of our common stock.

9. Operating Segments

Our operations are conducted mainly through our sports and athletic, professional fitness, family recreation and resort/spa centers. We aggregate the activities of our centers and other ancillary businesses into one reportable segment as none of the centers or other ancillary businesses meet the quantitative thresholds for separate disclosure under SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information. Each of the centers has similar expected economic characteristics, service and product offerings, customers and design. Each of the other ancillary businesses either directly or indirectly, through advertising or branding, compliment the operations of the centers. Our chief operating decision maker uses EBITDA as the primary measure of operating segment performance.

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The following table presents revenue for the years ended December 31, 2007, 2006 and 2005:

	For the Year Ended December 31,		
	2007	2006	2005
Membership dues	$ 434,138	$ 339,623	$ 262,989
Enrollment fees	24,741	22,438	20,341
Personal training	88,278	65,191	45,272
Other in-center	93,937	73,141	52,438
Other	14,692	11,504	9,076
Total revenue	$ 655,786	$ 511,897	$ 390,116

10. Commitments and Contingencies

Lease Commitments We lease certain property under operating leases, which require us to pay maintenance, insurance and other expenses in addition to annual rentals. The minimum annual payments under all noncancelable operating leases at December 31, 2007 are as follows:

2008	$ 17,336
2009	18,679
2010	18,710
2011	18,578
2012	19,429
Thereafter	278,266
	$ 370,998

Rent expense under operating leases was $19.4 million, $13.7 million and $10.2 million for the years ended December 31, 2007, 2006 and 2005, respectively. Certain lease agreements call for escalating lease payments over the term of the lease, which result in a deferred rent liability due to recognizing the expense on the straight-line basis over the life of the lease.

In October 2003, we financed two of our Michigan centers pursuant to the terms of a sale-leaseback transaction that qualified as an operating lease. Pursuant to the terms of the lease, we agreed to lease the centers for a period of 20 years. At December 31, 2007, the future minimum lease payments due under the lease amounted to $80.9 million.

Purchase Commitments We contract in advance for land purchases and construction services and materials, among other things. The purchase commitments were $156.4 million, $164.5 million and $82.7 million at December 31, 2007, 2006, and 2005, respectively.

Litigation We are engaged in legal proceedings incidental to the normal course of business. Due to their nature, such legal proceedings involve inherent uncertainties, including but not limited to, court rulings, negotiations between affected parties and governmental intervention. We have established reserves for matters that are probable and estimable in amounts we believe are adequate to cover reasonable adverse judgments not covered by insurance. Based upon the information available to us and discussions with legal counsel, it is our opinion that the outcome of the various legal actions and claims that are incidental to the our business will not have a material adverse impact on the consolidated financial position, results of operations or cash flows; however, such matters are subject to many uncertainties, and the outcome of individual matters are not predictable with assurance.

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401(k) Savings and Investment Plan We offer a 401(k) savings and investment plan (the 401(k) Plan) to substantially all full-time employees who have at least six months of service and are at least 21 years of age. We made discretionary contributions to the 401(k) Plan in the amount of $1.5 million, $1.1 million and $0.8 million for the years ended December 31, 2007, 2006 and 2005, respectively.

11. Related Party Transactions

We reimburse a general contractor that is primarily owned by the former president of a wholly owned subsidiary for a car allowance, car insurance premiums, executive medical benefits and life insurance premiums provided by the general contractor to such person. Such former president incurred expenses totaling less than $0.1 million for each of the years ended December 31, 2007, 2006 and 2005. We made payments to the general contractor in the amounts of less than $0.1 million during each of the years ended December 31, 2007, 2006 and 2005 for expenses incurred during these and certain prior years.

We lease various fitness and office equipment from third party equipment vendors for use at the center in Bloomingdale, Illinois. We then sublease this equipment to Bloomingdale LLC. The terms of the sublease are such that Bloomingdale LLC is charged the equivalent of the debt service for the use of the equipment. We charged $0.4 million, $0.4 million and $0.5 million for the years ended December 31, 2007, 2006 and 2005, respectively.

In May 2001, we completed a transaction to sell and simultaneously lease back one of our Minnesota centers. We did not recognize any material gain or loss on the sale of the center. The purchaser and landlord in such transaction is an entity composed of four individuals, one of whom was the president of a wholly owned subsidiary. We paid rent pursuant to the lease of $0.9 million for each of the years ended December 31, 2007, 2006 and 2005.

In October 2003, we leased a center located within a shopping center that is owned by a general partnership in which our chief executive officer has a 50% interest. In December 2003, we and the general partnership executed an addendum to this lease whereby we leased an additional 5,000 square feet of office space on a month-to-month basis within the shopping center, which we terminated effective January 1, 2007. We paid rent pursuant to this lease of $0.5 million for each of the years ended December 31, 2007, 2006 and 2005.

12. Executive Nonqualified Plan

During fiscal 2006, we implemented the Executive Nonqualified Excess Plan of Life Time Fitness, a non-qualified deferred compensation plan. This plan was established for the benefit of our highly compensated employees, which our plan defines as our employees whose projected compensation for the upcoming plan year would meet or exceed the IRS limit for determining highly compensated employees. This unfunded, non-qualified deferred compensation plan allows participants the ability to defer and grow income for retirement and significant expenses in addition to contributions made to our company s 401(k) plan.

All highly compensated employees eligible to participate in the Executive Nonqualified Excess Plan of Life Time Fitness, including but not limited to our executives, may elect to defer up to 50% of their annual base salary and/or annual bonus earnings to be paid in any coming year. The investment choices available to participants under the non-qualified deferred compensation plan are of the same type and risk categories as those offered under our company s 401(k) plan and may be modified or changed by the participant or our company at any time. Distributions can be paid out as in-service payments or at retirement. Retirement benefits can be paid out as a lump sum or in annual installments over a term of up to 10 years. Our company may, but does not currently plan to, make matching contributions and/or discretionary contributions to this plan. If our company did desire to make contributions to this plan, the contributions would vest to each participant according to their years of service with our company. At December 31, 2007, $0.8 million had been deferred and is being held on behalf of the employees. This amount is reflected as an other liability on the balance sheet.

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LIFE TIME FITNESS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Table amounts in thousands, except share and per share data)

13. Quarterly Financial Data (Unaudited)

The following is a condensed summary of actual quarterly results of operations for 2007 and 2006:

	2006				2007			
	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
Total revenue	$115,425	$122,455	$134,741	$139,276	$153,101	$162,137	$169,450	$171,098
Income from operations	21,172	23,530	27,794	28,019	28,741	33,500	37,543	37,626
Net income	10,433	12,385	13,639	14,108	14,134	16,485	18,350	19,050
Earnings per share (1)								
Basic	$ 0.29	$ 0.34	$ 0.38	$ 0.39	$ 0.39	$ 0.45	$ 0.49	$ 0.48
Diluted	0.28	0.33	0.37	0.39	0.38	0.44	0.48	0.48

(1) See Note 2 for discussion on the computation of earnings per share.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Life Time Fitness, Inc.:

We have audited the accompanying consolidated balance sheets of Life Time Fitness, Inc. (a Minnesota corporation) and subsidiaries (the Company) as of December 31, 2007 and 2006, and the related consolidated statements of operations, stockholders equity, and cash flows for each of the three years in the period ended December 31, 2007. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on the consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Life Time Fitness, Inc. and subsidiaries as of December 31, 2007 and 2006, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2007, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 2 to the consolidated financial statements, the Company changed its method of accounting for share-based compensation in 2006.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company s internal control over financial reporting as of December 31, 2007, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 25, 2008 expressed an unqualified opinion on the Company s internal control over financial reporting.

DELOITTE & TOUCHE LLP
Minneapolis, Minnesota
February 25, 2008

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Life Time Fitness, Inc.:

We have audited the internal control over financial reporting of Life Time Fitness, Inc. (a Minnesota corporation) and subsidiaries (the Company) as of December 31, 2007, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying *Management s Annual Report on Internal Control Over Financial Reporting*. Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed by, or under the supervision of, the company s principal executive and principal financial officers, or persons performing similar functions, and effected by the company s board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended December 31, 2007 of the Company and our report dated February 25, 2008 expressed an unqualified opinion on those consolidated financial statements and included an explanatory paragraph regarding the Company s change in the method of accounting for share-based compensation in 2006 as described in Note 2.

DELOITTE & TOUCHE LLP
Minneapolis, Minnesota
February 25, 2008

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Quarterly Results (Unaudited)

Our quarterly operating results may fluctuate significantly because of several factors, including the timing of new center openings and related expenses, timing of price increases for enrollment fees and membership dues and general economic conditions.

In the past, our pre-opening costs, which primarily consist of compensation and related expenses, as well as marketing, have varied significantly from quarter to quarter, primarily due to the timing of center openings. In addition, our compensation and related expenses as well as our operating costs in the beginning of a center s operations are greater than what can be expected in the future, both in aggregate dollars and as a percentage of membership revenue. Accordingly, the volume and timing of new center openings in any quarter have had, and are expected to continue to have, an impact on quarterly pre-opening costs, compensation and related expenses and occupancy and real estate costs. Due to these factors, results for a quarter may not indicate results to be expected for any other quarter or for a full fiscal year.

	2006				2007			
	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
	(In thousands, except for number of centers and per share data)							
Total revenue	$115,425	$122,455	$134,741	$139,276	$153,101	$ 162,137	$ 169,450	$ 171,098
Income from operations	21,172	23,530	27,794	28,019	28,741	33,500	37,543	37,626
Net income	10,433	12,385	13,639	14,108	14,134	16,485	18,350	19,050
Earnings per share								
Basic	$ 0.29	$ 0.34	$ 0.38	$ 0.39	$ 0.39	$ 0.45	$ 0.49	$ 0.48
Diluted	0.28	0.33	0.37	0.39	0.38	0.44	0.48	0.48
Cash Flow Data:								
Net cash provided by (used in):								
Operating activities	33,813	27,168	42,028	22,843	39,027	27,150	41,167	34,862
Investing activities	(48,149)	(56,464)	(70,877)	(87,693)	(85,189)	(125,727)	(103,671)	(102,620)
Financing activities	12,204	26,748	35,419	65,160	45,197	100,925	55,014	72,339
EBITDA (1)	$ 32,934	$ 35,927	$ 39,698	$ 40,435	$ 42,744	$ 48,463	$ 52,776	$ 53,713
Centers open at end of quarter (2)	48	49	56	60	60	64	67	70

(1) EBITDA consists of net income plus interest expense, net, provision for income taxes and depreciation

and amortization. This term, as we define it, may not be comparable to a similarly titled measure used by other companies and is not a measure of performance presented in accordance with GAAP. We use EBITDA as a measure of operating performance. EBITDA should not be considered as a substitute for net income, cash flows provided by operating activities, or other income or cash flow data prepared in accordance with GAAP. The funds depicted by EBITDA are not necessarily available for discretionary use if they are reserved for particular capital purposes, to maintain debt covenants, to service debt or to pay taxes. Additional details related to EBITDA are provided in Management s

Discussion and Analysis of Financial Condition and Results of Operations Non-GAAP Financial Measures.

(2) The data being presented include the center owned by Bloomingdale LLC.

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The following table provides a reconciliation of net income to EBITDA:

	2006				2007			
	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
	(In thousands, except for number of centers and per share data)							
Net income	10,433	12,385	13,639	14,108	14,134	16,485	18,350	19,050
Interest expense, net	4,117	4,140	4,204	4,895	5,528	6,369	7,135	6,411
Provision for income taxes	6,865	7,256	10,139	9,253	9,395	10,931	12,374	12,520
Depreciation and amortization	11,519	12,146	11,716	12,179	13,687	14,678	14,917	15,732
EBITDA	$ 32,934	$ 35,927	$ 39,698	$ 40,435	$ 42,744	$ 48,463	$ 52,776	$ 53,713

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

None.

Item 9A. Controls and Procedures.

Disclosure Controls and Procedures. As of December 31, 2007, an evaluation was carried out under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act). Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that the design and operation of these disclosure controls and procedures were effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in applicable rules and forms, and is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Management s Annual Report on Internal Control Over Financial Reporting. Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a and 15d 15f under the Exchange Act. Our internal control system is designed to provide reasonable assurance to our management and board of directors regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Our internal control over financial reporting includes those policies and procedures that:

Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;

Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and

Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of our internal control over financial reporting as of December 31, 2007. In making this assessment, we used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control Integrated Framework. Based on management s assessment

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and those criteria, they believe that, as of December 31, 2007, we maintained effective internal control over financial reporting.

Our independent registered public accounting firm has audited the effectiveness of our internal control over financial reporting as of December 31, 2007, as stated in the Report of Independent Registered Public Accounting Firm, appearing under Item 8, which expresses an unqualified opinion on the effectiveness of our internal control over financial reporting as of December 31, 2007.

Changes in Internal Control Over Financial Reporting. There was no change in our internal control over financial reporting identified in connection with the evaluation required by Rule 13a-15(d) and 15d-15(d) of the Exchange Act that occurred during the period covered by this report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. Other Information.

None.

PART III

Certain information required by Part III is incorporated by reference from our definitive Proxy Statement for the Annual Meeting of Shareholders to be held on April 24, 2008 (the Proxy Statement), which will be filed with the SEC pursuant to Regulation 14A within 120 days after December 31, 2007. Except for those portions specifically incorporated in this Form 10-K by reference to our Proxy Statement, no other portions of the Proxy Statement are deemed to be filed as part of this Form 10-K.

Item 10. Directors, Executive Officers and Corporate Governance.

Incorporated into this item by reference is the information under Election of Directors - Directors and Director Nominees, Election of Directors Committees of Our Board of Directors, Election of Directors Code of Business Conduct and Ethics and Section 16(a) Beneficial Ownership Reporting Compliance in our Proxy Statement.

The following table sets forth the name, age and positions of each of our executive officers as of February 29, 2008:

Name	Age	Position
Bahram Akradi	46	Chairman of the Board of Directors and Chief Executive Officer
Michael J. Gerend	43	President and Chief Operating Officer
Michael R. Robinson	48	Executive Vice President and Chief Financial Officer
Eric J. Buss	41	Executive Vice President, General Counsel and Secretary
Mark L. Zaebst	48	Executive Vice President
Jeffrey G. Zwiefel	45	Senior Vice President, Life Time University

Bahram Akradi founded our company in 1992 and has been a director since our inception. Mr. Akradi was elected Chief Executive Officer and Chairman of the Board of Directors in May 1996. Mr. Akradi has over 24 years of experience in healthy way of life initiatives. From 1984 to 1989, he led U.S. Swim & Fitness Corporation as its co-founder and Executive Vice President. Mr. Akradi was a founder of the health and fitness Industry Leadership Council.

Michael J. Gerend was elected Executive Vice President and Chief Operating Officer upon joining our company in March 2003, and was promoted to President in December 2007. Prior to joining our company, Mr. Gerend was President and Chief Executive Officer of Grand Holdings, Inc., doing business as Champion Air, the largest dedicated provider of charter airlift in the airline industry, from July 1998 to January 2003. Mr. Gerend also held senior management positions at Northwest Airlines, Inc. from April 1991 to December 1997.

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Michael R. Robinson was elected Executive Vice President and Chief Financial Officer upon joining our company in March 2002. Prior to joining our company, Mr. Robinson was most recently Executive Vice President and Chief Financial Officer of Next Generation Network, Inc., a digital video advertising company, from April 2000 to March 2002. Prior to April 2000, Mr. Robinson spent approximately 17 years with Honeywell International, Inc., a diversified technology and manufacturing company, where he held senior management positions from 1994 to March 2000. From 1995 to 1997, Mr. Robinson held the position of Vice President of Investor Relations and he was responsible for financial communications with investors and other third parties. From 1997 to 2000, he was the Vice President of Finance, Logistics and Supply for Europe, the Middle East and Africa where he managed accounting, finance, tax and treasury functions.

Eric J. Buss joined our company in September 1999 as Vice President of Finance and General Counsel. Mr. Buss was elected Secretary in September 2001 and was named Senior Vice President of Corporate Development in December 2001 and Executive Vice President in August 2005. Prior to joining our company, Mr. Buss was an associate with the law firm of Faegre & Benson LLP from 1996 to August 1999. Prior to beginning his legal career, Mr. Buss was employed by Arthur Andersen LLP.

Mark L. Zaebst joined our company in January 1996 as Director, Real Estate, and was named Senior Vice President of Real Estate and Development, in December 2001 and Executive Vice President in March 2006. Mr. Zaebst has over 20 years of experience in the health and fitness industry. Mr. Zaebst was instrumental in assisting Mr. Akradi in the creation, expansion and day-to-day operations of U.S. Swim & Fitness Corporation until 1991, at which time he started a career in real estate.

Jeffrey G. Zwiefel joined our company in December 1998 as Vice President, Health Enhancement Division and became Vice President of Fitness, Training and New Program Development in January 2004. Mr. Zwiefel was named Senior Vice President, Life Time University in March 2005. Mr. Zwiefel has 23 years of comprehensive and diverse experience in the health, fitness and wellness industry. Prior to joining our company in 1999, Mr. Zwiefel worked for over nine years with NordicTrack, Inc. where he served most recently as Vice President, Product Development. Mr. Zwiefel has a M.S. in exercise physiology and is certified by the American College of Sports Medicine and National Strength and Conditioning Association.

Item 11. Executive Compensation.

Incorporated into this item by reference is the information under Election of Directors and Executive Compensation in our Proxy Statement.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

Incorporated into this item by reference is the information under Equity Compensation Plan Information and Security Ownership of Principal Shareholders and Management in our Proxy Statement.

Item 13. Certain Relationships and Related Transactions, and Director Independence.

Incorporated into this item by reference is the information under Certain Relationships and Related Party Transactions and Election of Directors Director Independence in our Proxy Statement.

Item 14. Principal Accountant Fees and Services.

Incorporated into this item by reference is the information under Ratification of Independent Public Accounting Firm Fees in our Proxy Statement.

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PART IV

Item 15. Exhibits and Financial Statement Schedules.

(a) Documents filed as Part of this Annual Report on Form 10-K:

1. Consolidated Financial Statements: Consolidated Balance Sheets as of December 31, 2007 and 2006 Consolidated Statements of Operations for the years ended December 31, 2007, 2006 and 2005 Consolidated Statements of Shareholders Equity for the years ended December 31, 2007, 2006 and 2005 Consolidated Statements of Cash Flows for the years ended December 31, 2007, 2006 and 2005 Notes to Consolidated Financial Statements Reports of Independent Registered Public Accounting Firm
2. Financial Statement Schedules: The information required by Schedule II Valuation and Qualifying Accounts is provided in Note 2 to the Consolidated Financial Statements. Other schedules are omitted because they are not required.

(b) Exhibits:

3.1	Amended and Restated Articles of Incorporation of the Registrant.	Incorporated by reference to Exhibit 3.1 to the Registrant s Form 10-Q for the quarter ended June 30, 2004 (File No. 001-32230)
3.2	Amended and Restated Bylaws of the Registrant.	Incorporated by reference to Exhibit 3.4 to Amendment No. 2 to the Registrant s Form S-1 (File No. 333-113764), filed with the Commission on May 21, 2004.
4	Specimen of common stock certificate.	Incorporated by reference to Exhibit 4 to Amendment No. 4 to the Registrant s Registration Statement of Form S-1 (File No. 333-113764), filed with the Commission on June 23, 2004.
10.1#	FCA, Ltd. 1996 Stock Option Plan.	Incorporated by reference to Exhibit 10.1 to the Registrant s Registration Statement of Form S-1 (File No. 333-113764), filed with the Commission on March 19, 2004.
10.2#	LIFE TIME FITNESS, Inc. 1998 Stock Option Plan, as amended and restated.	Incorporated by reference to Exhibit 10.2 to the Registrant s Registration Statement of Form S-1 (File No. 333-113764), filed with the Commission on March 19, 2004.
10.3	Form of Promissory Note made in favor of Teachers Insurance and Annuity Association of America.	Incorporated by reference to Exhibit 10.16 to the Registrant s Registration Statement of Form S-1 (File No. 333-113764), filed with the Commission on March 19, 2004.
10.4	Schedule of terms to Form of Promissory Note made in favor of Teachers Insurance and Annuity Association of America.	Incorporated by reference to Exhibit 10.17 to the Registrant s Registration Statement of Form S-1 (File No. 333-113764), filed with the Commission on March 19, 2004.
10.5	Open-End Leasehold Mortgage, Assignment of Leases and Rents, Security Agreement and	Incorporated by reference to Exhibit 10.18 to the Registrant s Registration Statement of Form S-1

Fixtures Filing Statement made by LTF USA Real Estate, LLC for the benefit of Teachers Insurance and Annuity Association of America.	(File No. 333-113764), filed with the Commission on March 19, 2004.

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10.6	Form of Mortgage, Assignment of Leases and Rents, Security Agreement and Fixture Filing Statement made for the benefit of Teachers Insurance and Annuity Association of America.	Incorporated by reference to Exhibit 10.19 to the Registrant s Registration Statement of Form S-1 (File No. 333-113764), filed with the Commission on March 19, 2004.
10.7	Schedule of terms to Form of Mortgage, Assignment of Leases and Rents, Security Agreement and Fixture Filing Statement made for the benefit of Teachers Insurance and Annuity Association of America.	Incorporated by reference to Exhibit 10.20 to the Registrant s Registration Statement of Form S-1 (File No. 333-113764), filed with the Commission on March 19, 2004.
10.8	Form of Second Mortgage, Assignment of Leases and Rents, Security Agreement and Fixture Filing Statement made for the benefit of Teachers Insurance and Annuity Association of America.	Incorporated by reference to Exhibit 10.21 to the Registrant s Registration Statement of Form S-1 (File No. 333-113764), filed with the Commission on March 19, 2004.
10.9	Schedule of terms to Form of Second Mortgage, Assignment of Leases and Rents, Security Agreement and Fixture Filing Statement made for the benefit of Teachers Insurance and Annuity Association of America.	Incorporated by reference to Exhibit 10.22 to the Registrant s Registration Statement of Form S-1 (File No. 333-113764), filed with the Commission on March 19, 2004.
10.10	Lease Agreement dated as of September 30, 2003, by and between LT Fitness (DE) QRS 15-53, Inc., as landlord, and Life Time Fitness, Inc., as tenant.	Incorporated by reference to Exhibit 10.23 to the Registrant s Registration Statement of Form S-1 (File No. 333-113764), filed with the Commission on March 19, 2004.
10.11	Series A Stock Purchase Agreement dated May 7, 1996, including amendments thereto.	Incorporated by reference to Exhibit 10.25 to the Registrant s Registration Statement of Form S-1 (File No. 333-113764), filed with the Commission on March 19, 2004.
10.12	Series B Stock Purchase Agreement dated December 8, 1998, including amendments thereto.	Incorporated by reference to Exhibit 10.26 to the Registrant s Registration Statement of Form S-1 (File No. 333-113764), filed with the Commission on March 19, 2004.
10.13	Series C Stock Purchase Agreement dated August 16, 2000, including amendments thereto.	Incorporated by reference to Exhibit 10.27 to the Registrant s Registration Statement of Form S-1 (File No. 333-113764), filed with the Commission on March 19, 2004.
10.14	Series D Stock Purchase Agreement dated July 19, 2001, including amendments thereto.	Incorporated by reference to Exhibit 10.28 to the Registrant s Registration Statement of Form S-1 (File No. 333-113764), filed with the Commission on March 19, 2004.
10.15		

	Operating Agreement of Life Time, BSC Land, DuPage Health Services Fitness Center Bloomingdale L.L.C. dated December 1, 1999 by and between the Registrant, Bloomingdale Sports Center Land Company and Central DuPage Health.	Incorporated by reference to Exhibit 10.29 to Amendment No. 2 to the Registrant s Form S-1 (File No. 333-113764), filed with the Commission on May 21, 2004.
10.16#	Life Time Fitness, Inc. 2004 Long-Term Incentive Plan.	Incorporated by reference to Exhibit 10.30 to Amendment No. 2 to the Registrant s Form S-1 (File No. 333-113764), filed with the Commission on May 21, 2004.
10.17#	Form of Executive Employment Agreement.	Incorporated by reference to Exhibit 10.32 to Amendment No. 3 to the Registrant s Registration Statement of Form S-1 (File No. 333-113764), filed with the Commission on June 9, 2004.

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10.18	Schedule of parties to Executive Employment Agreements.	Filed Electronically.
10.19#	Form of Incentive Stock Option for 2004 Long-Term Incentive Plan.	Incorporated by reference to Exhibit 10.19 to the Registrant s Form10-K for the year ended December 31, 2006 (File No. 001-32230).
10.20#	Form of Non-Incentive Stock Option Agreement for 2004 Long-Term Incentive Plan.	Incorporated by reference to Exhibit 10.20 to the Registrant s Form10-K for the year ended December 31, 2006 (File No. 001-32230).
10.21#	Summary of Non-Employee Director Compensation.	Incorporated by reference to Exhibit 10.1 to the Registrant s Form 8-K dated October 24, 2006 (File No. 001-32230).
10.22#	2007 Key Executive Incentive Compensation Plan.	Incorporated by reference to Exhibit 10.1 to the Registrant s Form 8-K dated March 14, 2007 (File No. 001-32230).
10.23	Second Amended and Restated Credit Agreement, dated as of May 31, 2007, among the Company, U.S. Bank National Association, as administrative agent and lead arranger, J.P. Morgan Securities, Inc. and Royal Bank of Canada, as co-syndication agents, BMO Capital Markets, as documentation agent, and the banks party thereto from time to time.	Incorporated by reference to Exhibit 10.1 to the Registrant s Form10-Q for the quarter ended June 30, 2007 (File No. 001-32230).
10.24	Security Agreement, dated as of April 15, 2005, among the Company and U.S. Bank National Association, as administrative agent.	Incorporated by reference to Exhibit 10.2 to the Registrant s Form 8-K dated April 15, 2005 (File No. 001-32230).
10.25#	Form of Restricted Stock Agreement (Employee) for 2004 Long-Term Incentive Plan.	Incorporated by reference to Exhibit 10.26 to the Registrant s Form10-K for the year ended December 31, 2006 (File No. 001-32230).
10.26#	Form of Restricted Stock Agreement (Non-Employee Director) for 2004 Long-Term Incentive Plan.	Incorporated by reference to Exhibit 10.27 to the Registrant s Form10-K for the year ended December 31, 2006 (File No. 001-32230).
10.27	Lease Agreement with Well-Prop (Multi) LLC dated July 26, 2006.	Incorporated by reference to Exhibit 10.1 to the Registrant s Form 10-Q for the quarter ended September 30, 2006 (File No. 001-32230).
10.28	Guaranty and Suretyship Agreement with Well-Prop (Multi) LLC dated July 26, 2006.	Incorporated by reference to Exhibit 10.2 to the Registrant s Form 10-Q for the quarter ended September 30, 2006 (File No. 001-32230).

10.29	Purchase and Sale Agreement with Well-Prop (Multi) LLC dated July 26, 2006.	Incorporated by reference to Exhibit 10.3 to the Registrant s Form 10-Q for the quarter ended September 30, 2006 (File No. 001-32230).
10.30#	Form of 2006 Restricted Stock Agreement (Executive) for 2004 Long-Term Incentive Plan with performance-based vesting component.	Incorporated by reference to Exhibit 10.31 to the Registrant s Form 10-K for the year ended December 31, 2006 (File No. 001-32230).

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10.31#	Form of 2007 Restricted Stock Agreement (Executive) for 2004 Long-Term Incentive Plan with performance-based vesting component.	Incorporated by reference to Exhibit 10.2 to the Registrant s Form 8-K dated March 14, 2007 (File No. 001-32230).
10.32#	Executive Nonqualified Excess Plan.	Incorporated by reference to Exhibit 10.32to the Registrant s Form 10-K for the year ended December 31, 2006 (File No. 001-32230).
10.33	Loan Agreement dated January 24, 2007 among LTF CMBS I, LLC, the Company and Goldman Sachs Commercial Mortgage Capital, L.P.	Incorporated by reference to Exhibit 10.1 to the Registrant s Form 8-K dated January 24, 2007 (File No. 001-32230).
10.34	Lease Agreement dated January 24, 2007 among LTF CMBS I, LLC and LTF Club Operations Company, Inc.	Incorporated by reference to Exhibit 10.2 to the Registrant s Form 8-K dated January 24, 2007 (File No. 001-32230).
10.35	Guaranty of the Loan Agreement dated January 24, 2007 for the benefit of Goldman Sachs Commercial Mortgage Capital, L.P. executed by the Company.	Incorporated by reference to Exhibit 10.3 to the Registrant s Form 8-K dated January 24, 2007 (File No. 001-32230).
10.36	Lease Guaranty dated January 24, 2007 for the benefit of LTF CMBS I, LLC executed by the Company.	Incorporated by reference to Exhibit 10.4 to the Registrant s Form 8-K dated January 24, 2007 (File No. 001-32230).
10.37	Amendment No. 1 to Second Amended and Restated Credit Agreement, dated as of January 24, 2008, among the Company, U.S. Bank National Association, as administrative agent and lead arranger, J.P. Morgan Securities, Inc. and Royal Bank of Canada, as co-syndication agents, BMO Capital Markets, as documentation agent, and the banks party thereto from time to time.	Filed Electronically.
21	Subsidiaries of the Registrant.	Filed Electronically.
23	Consent of Deloitte & Touche LLP.	Filed Electronically.
31.1	Rule 13a-14(a)/15d-14(a) Certification by Principal Executive Officer.	Filed Electronically.
31.2	Rule 13a-14(a)/15d-14(a) Certification by Principal Financial and Officer.	Filed Electronically.
32	Section 1350 Certifications.	Filed Electronically.

Management contract,

compensatory
plan or
arrangement
required to be
filed as an
exhibit to this
Annual Report
on Form 10-K.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, Life Time Fitness, Inc. has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on February 29, 2008.

LIFE TIME FITNESS, INC.

By: /s/ Bahram Akradi
Name: Bahram Akradi
Title: Chairman of the Board of Directors and Chief Executive Officer
(Principal Executive Officer and Director)

By: /s/ Michael R. Robinson
Name: Michael R. Robinson
Title: Executive Vice President and Chief Financial Officer
(Principal Financial Officer)

By: /s/ John M. Hugo
Name: John M. Hugo
Title: Controller
(Principal Accounting Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed on February 29, 2008 by the following persons on behalf of the Registrant in the capacities indicated.

Signature	Title
/s/ Giles H. Bateman *	Director
Giles H. Bateman	
/s/ James F. Halpin*	Director
James F. Halpin	
/s/ Guy C. Jackson *	Director
Guy C. Jackson	
/s/ John B. Richards*	Director
John B. Richards	
/s/ Stephen R. Sefton*	Director
Stephen R. Sefton	

/s/ Joseph S. Vassalluzzo*	Director
Joseph S. Vassalluzzo	

* Michael R. Robinson, by signing his name hereto, does hereby sign this document on behalf of each of the above-named officers and/or directors of the Registrant pursuant to powers of attorney duly executed by such persons.

By /s/ Michael R. Robinson

Michael R. Robinson,
Attorney-in-Fact

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