POPULAR INC
Form 10-Q
November 09, 2007

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UNITED STATES
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 September 30, 2007
Commission File Number: 000-13818
POPULAR, INC.

(Exact name of registrant as specified in its charter)

Puerto Rico	**66-0667416**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification Number)
Popular Center Building **209 Muñoz Rivera Avenue, Hato Rey** **San Juan, Puerto Rico**	**00918**
(Address of principal executive offices)	(Zip code)

(787) 765-9800

(Registrant s telephone number, including area code)

NOT APPLICABLE

(Former name, former address and former fiscal year, if changed since last report)

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.

þ Yes o No

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

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

o Yes þ No

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: Common Stock $6.00 par value 280,286,329 shares outstanding as of October 31, 2007.

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Forward-Looking Information

The information included in this Form 10-Q contains certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements may relate to the Corporation s financial condition, results of operations, plans, objectives, future performance and business, including, but not limited to, statements with respect to the adequacy of the allowance for loan losses, market risk and the impact of interest rate changes, capital markets conditions, capital adequacy and liquidity, and the effect of legal proceedings and new accounting standards on the Corporation s financial condition and results of operations. All statements contained herein that are not clearly historical in nature are forward-looking, and the words anticipate, believe, continues, expect, estimate, intend, project and similar expressions and future or conditional verbs such as will, would, could, might, can, may, or similar expressions are generally intended to identify forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties, estimates and assumptions by management that are difficult to predict. Various factors, some of which are beyond the Corporation s control, could cause actual results to differ materially from those expressed in, or implied by, such forward-looking statements. Factors that might cause such a difference include, but are not limited to: the rate of growth in the economy, as well as general business and economic conditions; changes in interest rates, as well as the magnitude of such changes; the fiscal and monetary policies of the federal government and its agencies; the relative strength or weakness of the consumer and commercial credit sectors and of the real estate markets; the performance of the stock and bond markets; competition in the financial services industry; possible legislative, tax or regulatory changes; and difficulties in combining the operations of acquired entities.

Moreover, the outcome of legal proceedings, as discussed in Part II, Item I. Legal Proceedings, is inherently uncertain and depends on judicial interpretations of law and the findings of regulators, judges and juries.

All forward-looking statements included in this document are based upon information available to the Corporation as of the date of this document, and we assume no obligation to update or revise any such forward-looking statements to reflect occurrences or unanticipated events or circumstances after the date of such statements.

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ITEM 1. FINANCIAL STATEMENTS
POPULAR, INC.
CONSOLIDATED STATEMENTS OF CONDITION
(UNAUDITED)

(In thousands, except share information)	September 30, 2007	December 31, 2006	September 30, 2006
ASSETS			
Cash and due from banks	$ 709,056	$ 950,158	$ 736,669
Money market investments:			
Federal funds sold	430,000	84,350	323,980
Securities purchased under agreements to resell	180,394	202,181	211,439
Time deposits with other banks	24,703	15,177	9,830
	635,097	301,708	545,249
Investment securities available-for-sale, at fair value:			
Pledged securities with creditors right to repledge	4,742,127	3,743,924	4,463,023
Other investment securities available-for-sale	4,136,368	6,106,938	5,695,302
Investment securities held-to-maturity, at amortized cost (market value at September 30, 2007 - $280,072; December 31, 2006 - $92,764; September 30, 2006 $358,849)	279,267	91,340	357,430
Other investment securities, at lower of cost or realizable value (realizable value at September 30, 2007 - $179,598; December 31, 2006 - $412,593; September 30, 2006 - $407,849)	179,376	297,394	297,472
Trading account securities, at fair value:			
Pledged securities with creditors right to repledge	569,357	193,619	211,942
Other trading securities	92,801	188,706	239,720
Loans held-for-sale, at lower of cost or market value	423,303	719,922	447,314
Loans held-in-portfolio:			
Loans held-in-portfolio pledged with creditors right to repledge	160,923	306,320	51,260
Other loans held-in-portfolio	33,067,301	32,019,044	31,563,499
Less Unearned income	330,723	308,347	305,114
Allowance for loan losses	600,273	522,232	487,339
	32,297,228	31,494,785	30,822,306
Premises and equipment, net	580,768	595,140	588,282
Other real estate	133,508	84,816	83,636
Accrued income receivable	290,916	248,240	288,342
Other assets	1,441,681	1,611,890	1,374,900
Goodwill	668,807	667,853	678,666
Other intangible assets	100,471	107,554	104,497

	$47,280,131	$47,403,987	$46,934,750
LIABILITIES AND STOCKHOLDERS EQUITY			
Liabilities:			
Deposits:			
Non-interest bearing	$ 3,975,383	$ 4,222,133	$ 3,822,584
Interest bearing	22,626,132	20,216,198	19,314,861
	26,601,515	24,438,331	23,137,445
Federal funds purchased and assets sold under agreements to repurchase	6,287,303	5,762,445	7,045,466
Other short-term borrowings	1,414,897	4,034,125	2,709,511
Notes payable	8,314,791	8,737,246	9,681,897
Other liabilities	857,795	811,424	724,296
	43,476,301	43,783,571	43,298,615
Commitments and contingencies (See Note 12)			
Minority interest in consolidated subsidiaries	109	110	111
Stockholders equity:			
Preferred stock, $25 liquidation value; 30,000,000 shares authorized; 7,475,000 shares issued and outstanding in all periods presented	186,875	186,875	186,875
Common stock, $6 par value; 470,000,000 shares authorized in all periods presented; 292,993,474 shares issued (December 31, 2006 292,190,924; September 30, 2006 291,977,949) and 279,597,529 outstanding (December 31, 2006 278,741,547; September 30, 2006 278,553,152)	1,757,961	1,753,146	1,751,868
Surplus	536,129	526,856	494,398
Retained earnings	1,689,384	1,594,144	1,611,103
Accumulated other comprehensive loss, net of tax of ($56,551) (December 31, 2006 ($84,143); September 30, 2006 ($61,834))	(161,061)	(233,728)	(201,687)
Treasury stock at cost, 13,395,945 shares (December 31, 2006 13,449,377; September 30, 2006 13,424,797)	(205,567)	(206,987)	(206,533)
	3,803,721	3,620,306	3,636,024
	$47,280,131	$47,403,987	$46,934,750

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

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POPULAR, INC.
CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)

(In thousands, except per share information)	Quarter ended September 30, 2007	Quarter ended September 30, 2006	Nine months ended September 30, 2007	Nine months ended September 30, 2006
INTEREST INCOME:				
Loans	$662,973	$637,246	$1,963,572	$1,842,873
Money market investments	6,807	7,038	17,168	22,926
Investment securities	109,793	129,323	338,347	396,130
Trading account securities	10,653	7,724	29,645	23,649
	790,226	781,331	2,348,732	2,285,578
INTEREST EXPENSE:				
Deposits	196,825	151,008	552,657	411,380
Short-term borrowings	113,832	141,727	358,107	393,604
Long-term debt	119,453	146,558	351,453	413,013
	430,110	439,293	1,262,217	1,217,997
Net interest income	360,116	342,038	1,086,515	1,067,581
Provision for loan losses	148,093	63,445	359,606	179,488
Net interest income after provision for loan losses	212,023	278,593	726,909	888,093
Service charges on deposit accounts	49,704	47,484	146,567	142,277
Other service fees (See Note 13)	93,364	79,637	270,803	240,000
Net (loss) gain on sale and valuation adjustments of investment securities	(3,089)	7,123	79,857	5,039
Trading account (loss) profit	(2,867)	10,019	(6,654)	23,324
Gain on sale of loans and valuation adjustments on loans held-for-sale	5,991	20,113	37,719	96,428
Other operating income	23,902	26,973	94,264	97,100
	379,028	469,942	1,349,465	1,492,261
OPERATING EXPENSES:				
Personnel costs:				
Salaries	120,810	130,613	384,239	392,845
Pension, profit sharing and other benefits	31,430	34,083	110,664	116,386
	152,240	164,696	494,903	509,231
Net occupancy expenses	29,436	31,573	87,951	88,840
Equipment expenses	30,688	34,346	95,329	101,516
Other taxes	13,227	11,770	36,909	32,940
Professional fees	37,103	29,618	111,732	105,184
Communications	16,846	17,343	50,881	51,936
Business promotion	28,560	33,855	87,301	98,669
Printing and supplies	4,131	4,408	12,956	13,331

Other operating expenses	32,508	28,706	97,362	85,609
Impact of change in fiscal period of certain subsidiaries				9,741
Amortization of intangibles	2,234	3,608	8,030	9,160
	346,973	359,923	1,083,354	1,106,157
Income before income tax	32,055	110,019	266,111	386,104
Income tax	(3,948)	27,859	36,511	88,060
NET INCOME	$ 36,003	$ 82,160	$ 229,600	$ 298,044
NET INCOME APPLICABLE TO COMMON STOCK	$ 33,024	$ 79,181	$ 220,665	$ 289,109
BASIC EARNINGS PER COMMON SHARE (EPS)	$ 0.12	$ 0.28	$ 0.79	$ 1.04
DILUTED EPS	$ 0.12	$ 0.28	$ 0.79	$ 1.04
DIVIDENDS DECLARED PER COMMON SHARE	$ 0.16	$ 0.16	$ 0.48	$ 0.48

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

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POPULAR, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY
(UNAUDITED)

(In thousands)	Nine months ended September 30, 2007	2006
Preferred stock:		
Balance at beginning and end of year	$ 186,875	$ 186,875
Common stock:		
Balance at beginning of year	1,753,146	1,736,443
Common stock issued under the Dividend Reinvestment Plan	4,755	3,919
Issuance of common stock		11,312
Stock options exercised	60	194
Balance at end of period	1,757,961	1,751,868
Surplus:		
Balance at beginning of year	526,856	452,398
Common stock issued under the Dividend Reinvestment Plan	7,835	8,634
Issuance of common stock		28,281
Issuance cost of common stock		1,462
Stock options expense on unexercised options, net of forfeitures	1,289	2,160
Stock options exercised	149	463
Transfer from retained earnings		1,000
Balance at end of period	536,129	494,398
Retained earnings:		
Balance at beginning of year	1,594,144	1,456,612
Net income	229,600	298,044
Cumulative effect of accounting change (adoption of SFAS No. 156 and EITF 06-5)	8,667	
Cash dividends declared on common stock	(134,092)	(133,618)
Cash dividends declared on preferred stock	(8,935)	(8,935)
Transfer to surplus		(1,000)
Balance at end of period	1,689,384	1,611,103
Accumulated other comprehensive loss:		
Balance at beginning of year	(233,728)	(176,000)
Other comprehensive income (loss), net of tax	72,667	(25,687)
Balance at end of period	(161,061)	(201,687)
Treasury stock at cost:		
Balance at beginning of year	(206,987)	(207,081)

Purchase of common stock	(352)	
Reissuance of common stock	1,772	548
Balance at end of period	(205,567)	(206,533)
Total stockholders equity	$3,803,721	$3,636,024

Disclosure of changes in number of shares:

	September 30, 2007	December 31, 2006	September 30, 2006
Preferred Stock:			
Balance at beginning and end of period	7,475,000	7,475,000	7,475,000
Common Stock Issued:			
Balance at beginning of year	292,190,924	289,407,190	289,407,190
Issued under the Dividend Reinvestment Plan	792,486	858,905	653,142
Issuance of common stock		1,885,380	1,885,380
Stock options exercised	10,064	39,449	32,237
Balance at end of period	292,993,474	292,190,924	291,977,949
Treasury stock	(13,395,945)	(13,449,377)	(13,424,797)
Common Stock outstanding	279,597,529	278,741,547	278,553,152

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

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POPULAR, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(UNAUDITED)

	Quarter ended September 30,		Nine months ended September 30,	
(In thousands)	2007	2006	2007	2006
Net income	$ 36,003	$ 82,160	$ 229,600	$ 298,044
Other comprehensive income (loss), before tax:				
Foreign currency translation adjustment	(966)	(150)	2,014	(467)
Adjustment of pension and postretirement benefit plans			(519)	
Unrealized gains (losses) on securities available-for-sale arising during the period	156,462	192,674	100,493	(23,150)
Reclassification adjustment for losses (gains) included in net income	3	(7,123)	(80)	(5,039)
Unrealized net losses on cash flows hedges	(2,065)	(4,992)	(1,117)	(1,082)
Reclassification adjustment for (gains) losses included in net income	(164)	1,126	(289)	509
Cumulative effect of accounting change			(243)	
	153,270	181,535	100,259	(29,229)
Income tax (expense) benefit	(39,514)	(48,433)	(27,592)	3,542
Total other comprehensive income (loss), net of tax	113,756	133,102	72,667	(25,687)
Comprehensive income	$ 149,759	$ 215,262	$ 302,267	$ 272,357

Tax Effects Allocated to Each Component of Other Comprehensive Income:

	Quarter ended September 30,		Nine months ended September 30,	
(In thousands)	2007	2006	2007	2006
Underfunding of pension and postretirement benefit plans			$ 180	
Unrealized gains (losses) on securities available-for-sale arising during the period	($40,302)	($49,801)	(28,280)	$ 3,348
Reclassification adjustment for losses (gains) included in net income	(1)	3	13	(3)
Unrealized net losses on cash flows hedges	723	1,807	371	425
Reclassification adjustment for (gains) losses included in net income	66	(442)	124	(228)
Income tax (expense) benefit	($39,514)	($48,433)	($27,592)	$ 3,542

Disclosure of accumulated other comprehensive loss:

(In thousands)	September 30, 2007	December 31, 2006	September 30, 2006
Foreign currency translation adjustment	($34,687)	($36,701)	($36,782)
Minimum pension liability adjustment		(3,893)	(2,354)
Tax effect		1,518	918
Adoption of SFAS No. 158		3,893	
Tax effect		(1,518)	
Net of tax amount			(1,436)
Underfunding of pension and postretirement benefit plans	(69,779)	(69,260)	
Tax effect	27,214	27,034	
Net of tax amount	(42,565)	(42,226)	
Unrealized losses on securities available-for-sale	(111,830)	(212,243)	(223,879)
Tax effect	28,879	57,146	60,642
Net of tax amount	(82,951)	(155,097)	(163,237)
Unrealized (losses) gains on cash flows hedges	(1,316)	90	(749)
Tax effect	458	(37)	274
Net of tax amount	(858)	53	(475)
Cumulative effect of accounting change, net of tax		243	243
Accumulated other comprehensive loss, net of tax	($161,061)	($233,728)	($201,687)

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

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POPULAR, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(In thousands)	Nine months ended September 30, 2007	2006
Cash flows from operating activities:		
Net income	$ 229,600	$ 298,044
Less: Impact of change in fiscal period of certain subsidiaries, net of tax		(6,129)
Net income before change in fiscal period	229,600	304,173
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of premises and equipment	59,558	63,805
Provision for loan losses	359,606	179,488
Amortization of intangibles	8,030	9,160
Amortization and fair value adjustments of servicing assets	34,941	43,309
Net gain on sale and valuation adjustments of investment securities	(79,857)	(5,039)
Net gain on disposition of premises and equipment	(5,293)	(7,177)
Net gain on sale of loans and valuation adjustments on loans held-for-sale	(37,719)	(96,428)
Net amortization of premiums and accretion of discounts on investments	15,801	19,060
Net amortization of premiums and deferred loan origination fees and costs	70,645	99,065
Earnings from investments under the equity method	(19,514)	(9,081)
Stock options expense	1,339	2,308
Deferred income taxes	(94,581)	(19,630)
Net disbursements on loans held-for-sale	(4,007,301)	(4,963,647)
Acquisitions of loans held-for-sale	(474,269)	(1,188,844)
Proceeds from sale of loans held-for-sale	3,475,817	5,559,968
Net decrease in trading securities	1,003,078	1,195,639
Net increase in accrued income receivable	(42,675)	(44,311)
Net decrease in other assets	30,507	67,881
Net increase in interest payable	4,586	41,257
Net increase in postretirement benefit obligation	2,407	3,028
Net increase (decrease) in other liabilities	18,645	(88,160)
Total adjustments	323,751	861,651
Net cash provided by operating activities	553,351	1,165,824
Cash flows from investing activities:		
Net (increase) decrease in money market investments	(266,954)	204,322
Purchases of investment securities:		
Available-for-sale	(67,920)	(243,481)
Held-to-maturity	(17,026,831)	(20,847,771)
Other	(47,786)	(50,980)

Proceeds from calls, paydowns, maturities and redemptions of investment securities:		
Available-for-sale	1,066,304	1,560,612
Held-to-maturity	16,844,551	20,644,100
Other	17,071	72,611
Proceeds from sale of investment securities available-for-sale	37,352	198,191
Proceeds from sale of other investment securities	246,352	
Net disbursements on loans	(1,137,982)	(877,628)
Proceeds from sale of loans	16,367	759,518
Acquisition of loan portfolios	(22,312)	(291,330)
Assets acquired, net of cash	(2,378)	(2,752)
Mortgage servicing rights purchased	(25,596)	(18,723)
Acquisition of premises and equipment	(69,607)	(85,415)
Proceeds from sale of premises and equipment	29,501	39,031
Proceeds from sale of foreclosed assets	113,776	99,928
Net cash (used in) provided by investing activities	(296,092)	1,160,233
Cash flows from financing activities:		
Net increase in deposits	2,150,668	494,091
Net increase (decrease) in federal funds purchased and assets sold under agreements to repurchase	524,858	(1,770,146)
Net decrease in other short-term borrowings	(2,619,228)	(97,642)
Payments of notes payable	(1,245,332)	(1,822,303)
Proceeds from issuance of notes payable	821,087	777,171
Dividends paid	(142,898)	(140,765)
Proceeds from issuance of common stock	12,836	51,895
Treasury stock acquired	(352)	
Net cash used in financing activities	(498,361)	(2,507,699)
Cash effect of change in fiscal period of certain subsidiaries		11,914
Net decrease in cash and due from banks	(241,102)	(169,728)
Cash and due from banks at beginning of period	950,158	906,397
Cash and due from banks at end of period	$ 709,056	$ 736,669

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

Notes to Unaudited Consolidated Financial Statements

Note 1 Nature of Operations and Basis of Presentation

Popular, Inc. (the Corporation or Popular) is a diversified, publicly-owned financial holding company subject to the supervision and regulation of the Board of Governors of the Federal Reserve System. The Corporation is a full service financial services provider based in Puerto Rico with operations in Puerto Rico, the United States, the Caribbean and Latin America. As the leading financial institution in Puerto Rico, the Corporation offers retail and commercial banking services through its principal banking subsidiary, Banco Popular de Puerto Rico (BPPR), as well as auto and equipment leasing and financing, mortgage loans, consumer lending, investment banking, broker-dealer and insurance services through specialized subsidiaries. In the United States, the Corporation has established a community banking franchise providing a broad range of financial services and products to the communities it serves. Banco Popular North America (BPNA) operates branches in New York, California, Illinois, New Jersey, Florida and Texas, while E-LOAN provides online consumer direct lending for obtaining mortgage, auto and home equity loans, and provides an online platform to raise deposits for BPNA. Popular Financial Holdings (PFH) offers mortgage and personal loans and provides mortgage loan servicing. The Corporation, through its transaction processing company, EVERTEC, continues to use its expertise in technology as a competitive advantage in its expansion throughout the United States, the Caribbean and Latin America, as well as internally servicing many of its subsidiaries system infrastructures and transactional processing businesses. Note 21 to the consolidated financial statements presents further information about the Corporation s business segments.

The unaudited consolidated financial statements include the accounts of Popular, Inc. and its majority-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. The Corporation also consolidates the variable interest entities for which it is the primary beneficiary and, therefore, will absorb the majority of the entity s expected losses, receive a majority of the entity s expected returns, or both. These unaudited statements are, in the opinion of management, a fair statement of the results for the periods reported and include all necessary adjustments, all of a normal recurring nature, for a fair statement of such results. Certain reclassifications have been made to the prior period consolidated financial statements to conform to the 2007 presentation.

The statement of condition data as of December 31, 2006 was derived from audited financial statements. Certain information and note disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States of America have been condensed or omitted from the statements presented as of September 30, 2007, December 31, 2006 and September 30, 2006 pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, these financial statements should be read in conjunction with the audited consolidated financial statements of the Corporation for the year ended December 31, 2006, included in the Corporation s 2006 Annual Report. The Corporation s Form 10-K filed on March 1, 2007 incorporates by reference the 2006 Annual Report.

SUBSEQUENT EVENTS

Sale of BPNA s Retail Bank Branches in Houston

On October 22, 2007, the Corporation announced the signing of a definitive agreement to sell the six Houston retail bank branches of BPNA to Prosperity Bank. Prosperity Bank has agreed to pay a premium of 10.10% for approximately $140 million in deposits, as well as purchase certain loans and other assets attributable to the branches. Prosperity Bank also agreed to retain all branch-based employees of BPNA s Houston locations as part of the transaction. BPNA will continue to operate its mortgage business based in Houston as well as its franchise and small business lending activities in Texas. BPNA will also continue to maintain a retail branch in Arlington, Texas. The agreement was approved by the Boards of Directors of both banks and is expected to close during the fourth quarter of 2007. The transaction is subject to certain customary closing conditions, including receipt of regulatory approvals.

E-LOAN Restructuring Plan

On November 5, 2007, the Board of Directors of Popular adopted a Restructuring Plan for its internet financial services subsidiary E-LOAN (the E-LOAN s Restructuring Plan).

Considering the losses in the operation of E-LOAN, market conditions and other factors, the Board of Directors approved a substantial reduction of marketing and personnel costs at E-LOAN. This change will include concentrating marketing investment toward the internet and the origination of first mortgage loans that are actually being sold to Government Sponsored Entities (GSEs). The E-LOAN Restructuring Plan continues to promote the expansion of the Internet deposit gathering initiative with BPNA.

The cost-control plan initiative at the E-LOAN subsidiary will result in the elimination of approximately 513 positions out of a total of 771 and will be substantially accomplished in the fourth quarter of 2007. As a result of the E-LOAN Restructuring Plan, operating expenses are expected to be reduced by approximately $79 million for 2008. E-LOAN s estimated net losses for the year ended December 31, 2008 are expected to decline by $28 million, resulting principally from the reduction in operating expenses, partially offset by the related tax impact and by lower volume of loan originations in certain business channels that are impacted by this plan.

It is expected that this Plan will result in estimated restructuring charges as follows:

(In millions)		Fourth Quarter 2007
Severance	$	4.4
Stay and retention bonuses		0.2
Lease terminations		4.2
Total restructuring charges		8.8
Impairment of long-lived assets		12.3
Impairment charges on definite-life intangible assets		3.1
Total estimated charges	$	24.2

These estimates are preliminary as management continues to work on the E-LOAN Restructuring Plan. Further, the Corporation is currently evaluating whether this change in E-LOAN s business model could result in impairment in the value of its recorded goodwill and trademark. As of September 30, 2007, E-LOAN s accounting records reflect $164 million in goodwill and $64 million in trademark. The impairment valuation analysis is to be completed in the fourth quarter of 2007. Any impairment charge will not impact the regulatory capital ratios of the Corporation or its liquidity since it would be a non-cash transaction.

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Note 2 Recent Accounting Developments

SFAS No. 155 Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140. SFAS No. 155 permits companies to elect, on a transaction-by-transaction basis, to apply a fair value measurement to hybrid financial instruments that contain an embedded derivative that would otherwise require bifurcation under SFAS No. 133. This statement also clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS No. 133, establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and amends SFAS No. 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. The adoption of SFAS No. 155 in 2007 did not have a material impact on the Corporation s consolidated financial statements during the nine months ended September 30, 2007.

SFAS No. 156 Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140

SFAS No. 156 requires that all separately recognized servicing assets and liabilities be initially measured at fair value, if practicable. For subsequent measurements, SFAS No. 156 permits companies to choose between using an amortization method or a fair value measurement method for reporting purposes by class of servicing asset or liability. The Corporation adopted SFAS No. 156 in January 2007. The Corporation elected the fair value measurement for mortgage servicing rights (MSRs). Servicing rights associated with Small Business Administration (SBA) commercial loans will continue to be accounted for at the lower of cost or market method. The initial impact of adoption of the fair value measurement for MSRs during the first quarter of 2007 was included as a cumulative effect of a change in accounting principle directly in stockholders equity and resulted in a net increase in stockholders equity of approximately $9.6 million, net of deferred taxes. Refer to Note 7 to the consolidated financial statements for required SFAS No. 156 disclosures.

FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48)

In 2006, the FASB issued FIN 48, which clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition related to income taxes. The accounting provisions of FIN 48 were effective for the Corporation beginning in the first quarter of 2007. Based on management s assessment, there was no impact on retained earnings as of January 1, 2007 due to the initial application of the provisions of FIN 48. Also, as a result of the implementation, the Corporation did not recognize any change in the liability for unrecognized tax benefits. Refer to Note 14 to the consolidated financial statements for further information on the impact of FIN 48.

EITF Issue No. 06-03 How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation) (EITF 06-03)

EITF 06-03 provides that the presentation of taxes assessed by a governmental authority that is directly imposed on a revenue-producing transaction between a seller and a customer on either a gross basis (included in revenues and costs) or on a net basis (excluded from revenues) is an accounting policy decision that should be disclosed. The Corporation adopted the EITF 06-03 guidance in the first quarter of 2007. The Corporation s accounting policy is to account on a net basis for the taxes collected from customers and remitted to governmental authorities on a net basis. The corresponding amounts recognized in the consolidated financial statements are not significant.

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EITF Issue No. 06-5 Accounting for Purchases of Life Insurance Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance (EITF 06-5)

EITF 06-5 focuses on how an entity should determine the amount that could be realized under the insurance contract at the balance sheet date in applying FTB 85-4, and whether the determination should be on an individual or group policy basis. At the September 2006 meeting, the Task Force affirmed as a final consensus that the cash surrender value and any additional amounts provided by the contractual terms of the insurance policy that are realizable at the balance sheet date should be considered in determining the amount that could be realized under FTB 85-4, and any amounts that are not immediately payable in cash to the policyholder should be discounted to their present value. Additionally, the Task Force affirmed as a final consensus the tentative conclusion that in determining the amount that could be realized, companies should assume that policies will be surrendered on an individual-by-individual basis, rather than surrendering the entire group policy. Also, the Task Force reached a consensus that contractual limitations on the ability to surrender a policy do not affect the amount to be reflected under FTB 85-4, but, if significant, the nature of those restrictions should be disclosed. The Corporation adopted the EITF 06-5 guidance in the first quarter of 2007 and as a result recorded a $0.9 million cumulative effect adjustment to beginning retained earnings (reduction of capital) for the existing bank-owned life insurance arrangement.

SFAS No. 157 Fair Value Measurements

SFAS No. 157, issued in September 2006, defines fair value, establishes a framework for measuring fair value and requires enhanced disclosures about fair value measurements. SFAS No. 157 requires companies to disclose the fair value of their financial instruments according to a fair value hierarchy. The fair value hierarchy ranks the quality and reliability of the information used to determine fair values. Financial assets carried at fair value will be classified and disclosed in one of the three categories in accordance with the hierarchy. The three levels of the fair value hierarchy are: (1) quoted market prices for identical assets or liabilities in active markets; (2) observable market-based inputs or unobservable inputs that are corroborated by market data; and (3) unobservable inputs that are not corroborated by market data. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Corporation will adopt the provisions of SFAS No. 157 commencing with the first quarter of 2008. The Corporation is evaluating the impact that this accounting pronouncement may have on its consolidated financial statements and disclosures.

SFAS No. 159 Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities

In February 2007, the FASB issued SFAS No. 159, which provides companies with an option to report selected financial assets and liabilities at fair value. The election to measure a financial asset or liability at fair value can be made on an instrument-by-instrument basis and is irrevocable. The difference between the carrying amount and the fair value at the election date is recorded as a transition adjustment to opening retained earnings. Subsequent changes in fair value are recognized in earnings. The statement also establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. The new statement does not eliminate disclosure requirements included in other accounting standards, including requirements for disclosures about fair value measurements included in FASB Statements No. 157, *Fair Value Measurements,* and No. 107, *Disclosures about Fair Value of Financial Instrument.* SFAS No. 159 is effective as of the beginning of an entity s first fiscal year beginning after November 15, 2007. Early adoption is permitted as of the beginning of the previous fiscal year provided that the entity makes that choice in the first 120 days of that fiscal year and also elects to apply the provisions of SFAS No. 157. The Corporation will adopt the provisions of SFAS No. 159 commencing in January 2008. Management is evaluating the impact that this accounting standard may have on its consolidated financial statements and disclosures.

FSP FIN No. 39-1 Amendment of FASB Interpretation No. 39

In April 2007, the FASB issued Staff Position FSP FIN No. 39-1 which defines right of setoff and specifies what conditions must be met for a derivative contract to qualify for this right of setoff. It also addresses the applicability of a right of setoff to derivative instruments and clarifies the circumstances in which it is appropriate to offset amounts recognized for those instruments in the statement of financial position. In addition, this FSP permits the offsetting of fair value amounts recognized for multiple derivative instruments executed with the same counterparty under a master netting arrangement and fair value amounts recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) arising from the same master netting arrangement as

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the derivative instruments. This interpretation is effective for fiscal years beginning after November 15, 2007, with early application permitted. The adoption of FSP FIN No. 39-1 is not expected to have a material impact on the Corporation s consolidated financial statements and disclosures.

SOP 07-01 Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies

The Statement of Position (SOP) 07-01 issued in June 2007 provides guidance for determining whether an entity is within the scope of the American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide for Investment Companies (the AICPA Guide). Additionally, it provides guidance as to whether a parent company or an equity method investor can apply the specialized industry accounting principles of the AICPA Guide. SOP 07-01 is effective for fiscal years beginning on or after December 15, 2007. On October 17, 2007, the FASB agreed to propose an indefinite delay of the effective dates of SOP 07-01 and, for entities that meet the definition of an investment company in SOP 07-01, of *FSP FIN 46(R)-7, Application of FASB Interpretation No. 46(R) to Investment Companies* . The proposed delays, which will be exposed for comment for 30 days, will enable the FASB to add a project to its technical agenda to address the implementation issues that have arisen and possibly revise SOP 07-01. Until that occurs, affected entities should continue to follow existing guidance. Nevertheless, management is evaluating the impact, if any, that the adoption of SOP 07-01 may have on its consolidated financial statements and disclosures.

FSP FIN No. 46(R) 7 Application of FASB Interpretation No. 46(R) to Investment Companies

In May 2007, the FASB issued Staff Position FSP FIN No. 46 (R) 7 , which amends the scope of the exception to FIN No. 46 (R) to indicate that investments accounted for at fair value in accordance with the specialized accounting guidance in the AICPA Guide, are not subject to consolidation under FIN No. 46 (R). This interpretation is effective for fiscal years beginning on or after December 15, 2007. Management is evaluating the impact, if any, that the adoption of this interpretation may have on its consolidated financial statements and disclosures. Also, management is considering the guidance of SOP 07-01 which was previously described that considers an indefinite delay on its implementation until further notification by the FASB.

Note 3 Restrictions on Cash and Due from Banks and Highly-Liquid Securities

The Corporation s subsidiary banks are required by federal and state regulatory agencies to maintain average reserve balances with the Federal Reserve Bank or with a correspondent bank. Those required average reserve balances were approximately $588 million at September 30, 2007 (December 31, 2006 $621 million; September 30, 2006 $591 million). Cash and due from banks as well as other short-term, highly-liquid securities are used to cover the required average reserve balances.

In compliance with rules and regulations of the Securities and Exchange Commission, at September 30, 2007, the Corporation had securities with a market value of $397 thousand (December 31, 2006 - $445 thousand; September 30, 2006 $445 thousand) segregated in a special reserve bank account for the benefit of brokerage customers of its broker-dealer subsidiary. These securities are classified in the consolidated statement of condition within the other trading securities category.

As required by the Puerto Rico International Banking Center Law, at September 30, 2007, December 31, 2006, and September 30, 2006, the Corporation maintained separately for its two international banking entities (IBEs), $600 thousand in time deposits, equally divided for the two IBEs, which were considered restricted assets.

As part of a line of credit facility with a financial institution, at September 30, 2007, the Corporation maintained restricted cash of $1.9 million as collateral (December 31, 2006 $1.9 million; September 30, 2006 $1.9 million). The cash is being held in certificates of deposits which mature in less than 90 days. The line of credit is used to support letters of credit.

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Note 4 Pledged Assets

Certain securities and loans were pledged to secure public and trust deposits, assets sold under agreements to repurchase, borrowings and other available credit facilities. The classification and carrying amount of the Corporation s pledged assets, in which the secured parties are not permitted to sell or repledge the collateral, were as follows:

(In thousands)	September 30, 2007	December 31, 2006	September 30, 2006
Investment securities available-for-sale	$ 3,222,644	$ 2,645,272	$ 2,882,589
Investment securities held-to-maturity	340	658	659
Loans held-for-sale	41,266	332,058	20,838
Loans held-in-portfolio	11,482,585	10,260,198	10,642,884
	$14,746,835	$13,238,186	$13,546,970

Pledged securities and loans in which the creditor has the right by custom or contract to repledge are presented separately in the consolidated statements of condition.

Note 5 Investment Securities Available-For-Sale

The amortized cost, gross unrealized gains and losses and approximate market value (or fair value for certain investment securities where no market quotations are available) of investment securities available-for-sale as of September 30, 2007, December 31, 2006 and September 30, 2006 were as follows:

	AS OF SEPTEMBER 30, 2007			
(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
U.S. Treasury securities	$ 497,893	$ 41	$ 22,114	$ 475,820
Obligations of U.S. Government sponsored entities	5,871,339	2,628	55,613	5,818,354
Obligations of Puerto Rico, States and political subdivisions	109,289	420	2,871	106,838
Collateralized mortgage obligations	1,479,951	3,216	13,798	1,469,369
Mortgage-backed securities	969,023	3,190	22,738	949,475
Equity securities	46,100	1,780	6,598	41,282
Others	16,730	627		17,357
	$8,990,325	$11,902	$123,732	$8,878,495

	AS OF DECEMBER 31, 2006			
(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
U.S. Treasury securities	$ 504,653		$ 29,818	$ 474,835
Obligations of U.S. Government sponsored entities	6,603,252	$ 57	147,524	6,455,785

Obligations of Puerto Rico, States and political subdivisions	118,214	265	3,537	114,942
Collateralized mortgage obligations	1,657,613	4,904	17,191	1,645,326
Mortgage-backed securities	1,061,850	1,458	26,492	1,036,816
Equity securities	70,954	6,692	3,901	73,745
Others	46,326	3,087		49,413
	$10,062,862	$16,463	$228,463	$9,850,862

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	AS OF SEPTEMBER 30, 2006			
(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
U.S. Treasury securities	$ 521,885		$ 28,418	$ 493,467
Obligations of U.S. Government sponsored entities	6,776,956	$ 178	154,923	6,622,211
Obligations of Puerto Rico, States and political subdivisions	119,999	308	3,927	116,380
Collateralized mortgage obligations	1,725,068	5,031	17,198	1,712,901
Mortgage-backed securities	1,099,321	1,412	29,535	1,071,198
Equity securities	70,987	4,938	3,109	72,816
Others	67,745	2,289	682	69,352
	$10,381,961	$14,156	$237,792	$10,158,325

The table below shows the Corporation s gross unrealized losses and market value of investment securities available-for-sale, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2007, December 31, 2006 and September 30, 2006.

	AS OF SEPTEMBER 30, 2007 Less than 12 Months		
(In thousands)	Amortized Cost	Gross Unrealized Losses	Market Value
Obligations of U.S. Government sponsored entities	$106,914	$ 3,960	$102,954
Obligations of Puerto Rico, States and political subdivisions	22,680	411	22,269
Collateralized mortgage obligations	283,814	1,869	281,945
Mortgage-backed securities	22,328	399	21,929
Equity securities	22,638	6,572	16,066
	$458,374	$13,211	$445,163

	12 months or more		
(In thousands)	Amortized Cost	Gross Unrealized Losses	Market Value
U.S. Treasury securities	$ 478,436	$ 22,114	$ 456,322
Obligations of U.S. Government sponsored entities	5,212,523	51,653	5,160,870
Obligations of Puerto Rico, States and political subdivisions	50,235	2,460	47,775
Collateralized mortgage obligations	576,852	11,929	564,923
Mortgage-backed securities	818,782	22,339	796,443
Equity securities	300	26	274

	$7,137,128	$110,521	$7,026,607

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(In thousands)	Amortized Cost	Total Gross Unrealized Losses	Market Value
U.S. Treasury securities	$ 478,436	$ 22,114	$ 456,322
Obligations of U.S. Government sponsored entities	5,319,437	55,613	5,263,824
Obligations of Puerto Rico, States and political subdivisions	72,915	2,871	70,044
Collateralized mortgage obligations	860,666	13,798	846,868
Mortgage-backed securities	841,110	22,738	818,372
Equity securities	22,938	6,598	16,340
	$7,595,502	$123,732	$7,471,770

	AS OF DECEMBER 31, 2006		
	Less than 12 Months		
(In thousands)	Amortized Cost	Gross Unrealized Losses	Market Value
U.S. Treasury securities	$ 19,421	$ 134	$ 19,287
Obligations of U.S. Government sponsored entities	425,076	4,345	420,731
Obligations of Puerto Rico, States and political subdivisions	21,426	259	21,167
Collateralized mortgage obligations	501,705	4,299	497,406
Mortgage-backed securities	28,958	484	28,474
Equity securities	11,180	3,699	7,481
	$1,007,766	$13,220	$994,546

	12 months or more		
(In thousands)	Amortized Cost	Gross Unrealized Losses	Market Value
U.S. Treasury securities	$ 485,232	$ 29,684	$ 455,548
Obligations of U.S. Government sponsored entities	6,097,274	143,179	5,954,095
Obligations of Puerto Rico, States and political subdivisions	55,238	3,278	51,960
Collateralized mortgage obligations	564,217	12,892	551,325
Mortgage-backed securities	954,293	26,008	928,285
Equity securities	300	202	98
	$8,156,554	$215,243	$7,941,311

(In thousands)	Amortized Cost	Total Gross Unrealized Losses	Market Value
U.S. Treasury securities	$ 504,653	$ 29,818	$ 474,835
Obligations of U.S. Government sponsored entities	6,522,350	147,524	6,374,826
Obligations of Puerto Rico, States and political subdivisions	76,664	3,537	73,127
Collateralized mortgage obligations	1,065,922	17,191	1,048,731
Mortgage-backed securities	983,251	26,492	956,759
Equity securities	11,480	3,901	7,579
	$9,164,320	$228,463	$8,935,857

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(In thousands)	AS OF SEPTEMBER 30, 2006 Less than 12 Months Amortized Cost	Gross Unrealized Losses	Market Value
U.S. Treasury securities	$ 19,410	$ 91	$ 19,319
Obligations of U.S. Government sponsored entities	443,593	4,348	439,245
Obligations of Puerto Rico, States and political subdivisions	26,398	375	26,023
Collateralized mortgage obligations	507,121	4,037	503,084
Mortgage-backed securities	165,200	2,363	162,837
Equity securities	46,811	2,811	44,000
Others	10,360	682	9,678
	$1,218,893	$14,707	$1,204,186

(In thousands)	12 months or more Amortized Cost	Gross Unrealized Losses	Market Value
U.S. Treasury securities	$ 502,475	$ 28,327	$ 474,148
Obligations of U.S. Government sponsored entities	6,254,447	150,575	6,103,872
Obligations of Puerto Rico, States and political subdivisions	53,305	3,552	49,753
Collateralized mortgage obligations	576,660	13,161	563,499
Mortgage-backed securities	858,717	27,172	831,545
Equity securities	300	298	2
	$8,245,904	$223,085	$8,022,819

(In thousands)	Total Amortized Cost	Gross Unrealized Losses	Market Value
U.S. Treasury securities	$ 521,885	$ 28,418	$ 493,467
Obligations of U.S. Government sponsored entities	6,698,040	154,923	6,543,117
Obligations of Puerto Rico, States and political subdivisions	79,703	3,927	75,776
Collateralized mortgage obligations	1,083,781	17,198	1,066,583
Mortgage-backed securities	1,023,917	29,535	994,382
Equity securities	47,111	3,109	44,002
Others	10,360	682	9,678

	$9,464,797	$237,792	$9,227,005

At September 30, 2007, Obligations of Puerto Rico, States and political subdivisions include approximately $55 million in Commonwealth of Puerto Rico Appropriation Bonds (Appropriation Bonds) the rating on which was downgraded in May 2006 by Moody s Investors Service (Moody s) to Ba1, one notch below investment grade. Standard & Poor s (S&P), another nationally-recognized credit rating agency, rated the Appropriation Bonds BBB-, which is still considered investment grade. As of September 30, 2007, these Appropriation Bonds represented approximately $2.2 million in unrealized losses in the Corporation s available-for-sale investment securities portfolio. The Corporation is closely monitoring the political and economic situation of the Island as part of its evaluation of its available-for-sale portfolio for any declines in value that management may consider being other-than-temporary.

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Management has the intent and ability to hold these investments for a reasonable period of time for a forecasted recovery of fair value up to (or beyond) the cost of these investments.

The unrealized loss positions of available-for-sale securities at September 30, 2007, except for the obligations of the Puerto Rico government described above are primarily associated with U.S. government sponsored entities, and to a lesser extent, U.S. Treasury obligations and U.S. Agency and government sponsored-issued mortgage-backed securities and collateralized mortgage obligations. The vast majority of these securities are rated the equivalent of AAA by the major rating agencies. The investment portfolio is structured primarily with highly-liquid securities, which possess a large and efficient secondary market. Valuations are performed at least on a quarterly basis using third party providers and dealer quotes. Management believes that the unrealized losses in these available-for-sale securities at September 30, 2007 are temporary and are substantially related to market interest rate fluctuations and not to the deterioration in the creditworthiness of the issuers. Also, management has the intent and ability to hold these investments for a reasonable period of time for a forecasted recovery of fair value up to (or beyond) the cost of these investments.

During the nine months ended September 30, 2007, the Corporation recognized through earnings approximately $32.7 million in losses on residual interests classified as available-for-sale ($2.0 million for the third quarter of 2007) and $7.6 million in losses on equity securities that management considered to be other-than-temporarily impaired. The equity securities that generated this other-than-temporary impairment in the first quarter of 2007 were sold in the second quarter of 2007.

The following table states the names of issuers and the aggregate amortized cost and market value of the securities of such issuer (includes available-for-sale and held-to-maturity securities), when the aggregate amortized cost of such securities exceeds 10% of stockholders equity. This information excludes securities of the U.S. Government agencies and corporations. Investments in obligations issued by a state of the U.S. and its political subdivisions and agencies, which are payable and secured by the same source of revenue or taxing authority, other than the U.S. Government, are considered securities of a single issuer.

	September 30, 2007		December 31, 2006		September 30, 2006	
(In thousands)	Amortized Cost	Market Value	Amortized Cost	Market Value	Amortized Cost	Market Value
FNMA	$1,184,225	$1,169,857	$1,539,651	$1,517,525	$1,594,165	$1,570,842
FHLB	5,841,614	5,788,544	6,230,841	6,086,885	6,621,836	6,470,786
Freddie Mac	954,598	944,533	1,149,185	1,134,853	1,195,093	1,178,715

Note 6 Investment Securities Held-to-Maturity

The amortized cost, gross unrealized gains and losses and approximate market value (or fair value for certain investment securities where no market quotations are available) of investment securities held-to-maturity as of September 30, 2007, December 31, 2006 and September 30, 2006 were as follows:

	AS OF SEPTEMBER 30, 2007			
(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
Obligations of U.S. Government sponsored entities	$196,190		$ 71	$196,119
Obligations of Puerto Rico, States and political subdivisions	71,465	$1,400	148	72,717
Collateralized mortgage obligations	331		18	313
Others	11,281		358	10,923

$279,267	$1,400	$595	$280,072

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	AS OF DECEMBER 31, 2006			
(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
Obligations of U.S. Government sponsored entities	$ 3,017			$ 3,017
Obligations of Puerto Rico, States and political subdivisions	72,152	$1,559	$161	73,550
Collateralized mortgage obligations	381		21	360
Others	15,790	60	13	15,837
	$91,340	$1,619	$195	$92,764

	AS OF SEPTEMBER 30, 2006			
(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
Obligations of U.S. Government sponsored entities	$269,683		$ 34	$269,649
Obligations of Puerto Rico, States and political subdivisions	72,154	$1,605	158	73,601
Collateralized mortgage obligations	409		22	387
Others	15,184	43	15	15,212
	$357,430	$1,648	$229	$358,849

The following table shows the Corporation s gross unrealized losses and fair value of investment securities held-to-maturity, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2007, December 31, 2006 and September 30, 2006:

	AS OF SEPTEMBER 30, 2007 Less than 12 months		
(In thousands)	Amortized Cost	Gross Unrealized Losses	Market Value
Obligations of U.S. Government sponsored entities	$196,190	$ 71	$196,119
Obligations of Puerto Rico, States and political subdivisions	1,545	24	1,521
Others	6,225	354	5,871
	$203,960	$449	$203,511

	12 months or more		
	Amortized	Gross Unrealized	Market

(In thousands)	Cost	Losses	Value
Obligations of Puerto Rico, States and political subdivisions	$23,460	$124	$23,336
Collateralized mortgage obligations	331	18	313
Others	1,250	4	1,246
	$25,041	$146	$24,895

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(In thousands)	Amortized Cost	Total Gross Unrealized Losses	Market Value
Obligations of U.S. Government sponsored entities	$ 196,190	$ 71	$ 196,119
Obligations of Puerto Rico, States and political subdivisions	25,005	148	24,857
Collateralized mortgage obligations	331	18	313
Others	7,475	358	7,117
	$ 229,001	$ 595	$ 228,406

	AS OF DECEMBER 31, 2006 12 months or more and Total		
(In thousands)	Amortized Cost	Gross Unrealized Losses	Market Value
Obligations of Puerto Rico, States and political subdivisions	$26,623	$161	$26,462
Collateralized mortgage obligations	381	21	360
Others	1,250	13	1,237
	$28,254	$195	$28,059

	AS OF SEPTEMBER 30, 2006 Less than 12 months		
(In thousands)	Amortized Cost	Gross Unrealized Losses	Market Value
Obligations of U.S. Government sponsored entities	$269,683	$ 34	$269,649
Obligations of Puerto Rico, States and political subdivisions	2,110	3	2,107
	$271,793	$ 37	$271,756

	12 months or more		
(In thousands)	Amortized Cost	Gross Unrealized Losses	Market Value
Obligations of Puerto Rico, States and political subdivisions	$2,534	$155	$2,379
Collateralized mortgage obligations	409	22	387
Others	1,250	15	1,235
	$4,193	$192	$4,001

(In thousands)	Amortized Cost	Total Gross Unrealized Losses	Market Value
Obligations of U.S. Government sponsored entities	$269,683	$ 34	$269,649
Obligations of Puerto Rico, States and political subdivisions	4,644	158	4,486
Collateralized mortgage obligations	409	22	387
Others	1,250	15	1,235
	$275,986	$229	$275,757

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Management believes that the unrealized losses in the held-to-maturity portfolio at September 30, 2007 are temporary and are substantially related to market interest rate fluctuations and not to deterioration in the creditworthiness of the issuers. Management has the intent and ability to hold these investments until maturity.

Note 7 Mortgage Servicing Rights

The Corporation recognizes as assets the rights to service loans for others, whether these rights are purchased or result from asset transfers (sales and securitizations). Commencing in 2007 and in accordance with SFAS No. 156, the Corporation no longer records servicing rights in connection with on-balance sheet mortgage loan securitizations.

Effective January 1, 2007, under SFAS No. 156, the Corporation identified servicing rights related to residential mortgage loans as a class of servicing rights and elected to apply fair value accounting to these mortgage servicing rights (MSRs). These MSRs are segregated between loans serviced by PFH and by the Corporation s banking subsidiaries. Fair value determination is performed on a subsidiary basis, with assumptions varying in accordance with the types of assets or markets served (i.e. PFH primarily subprime mortgage loans Vs. banking subsidiaries primarily conforming loans). Servicing rights associated with Small Business Administration (SBA) commercial loans, the other class of servicing assets held by the Corporation, will continue to be accounted for at the lower of cost or market method.

Classes of servicing rights were determined based on the different markets or types of assets served. Management also considered trends in the markets and elections by other major participants in the industries served in determining the accounting methodology to be followed for the different types of servicing rights.

Under the fair value accounting method of SFAS No. 156, purchased MSRs and MSRs resulting from asset transfers are capitalized and carried at fair value. Prior to the adoption of SFAS No. 156, the Corporation capitalized purchased residential MSRs at cost, and MSRs from asset transfers based on the relative fair value of the servicing right and the residential mortgage loan at the time of sale. Prior to SFAS No. 156, both purchased MSRs and MSRs from asset transfers were accounted for at quarter-end at the lower of cost or market value.

Effective January 1, 2007, upon the remeasurement of the MSRs at fair value in accordance with SFAS No. 156, the Corporation recorded a cumulative effect adjustment to increase the 2007 beginning balance of MSRs by $15.3 million, which resulted in a $9.6 million, net of tax, increase in the retained earnings account of stockholders equity. The table below reconciles the balance of MSRs as of December 31, 2006 and January 1, 2007.

	Banking subsidiaries	PFH	Total

(a) The remeasurement effect, net of deferred taxes, amounted to $9.6 million on a consolidated basis.

At the end of each quarter, the Corporation uses a discounted cash flow model to estimate the fair value of MSRs, which is benchmarked against third party opinions of fair value. The discounted cash flow model incorporates assumptions that market participants would use in estimating future net servicing income, including estimates of prepayment speeds, discount rate, cost to service, escrow account earnings, contractual servicing fee income, prepayment and late fees, among other considerations. The Corporation uses assumptions in the model that it believes are comparable to those used by brokers or other service providers. Refer to Note 8 Retained Interests on Sales of Mortgage Loans for information on assumptions used in the valuation model of MSRs as of September 30, 2007.

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The change in MSRs measured using the fair value method for the nine months ended September 30, 2007 was:

(In thousands)	Banking subsidiaries Residential MSRs	PFH Residential MSRs	Total
Fair value at January 1, 2007	$ 91,431	$ 84,038	$175,469
Purchases	3,345	22,251	25,596
Servicing from securitizations or asset transfers	17,682	8,040	25,722
Changes due to payments on loans (1)	(6,821)	(29,285)	(36,106)
Changes in fair value due to changes in valuation model inputs or assumptions	4,276	(1,636)	2,640
Other changes		(66)	(66)
Fair value at September 30, 2007	$ 109,913	$ 83,342	$193,255

(1) Represents changes due to collection / realization of expected cash flows over time.

The changes in amortized MSRs for the nine months ended September 30, 2006 were:

(In thousands)	Residential MSRs
Balance at January 1, 2006	$ 137,701
Rights originated	58,497
Rights purchased	18,723
Amortization	(46,842)
Balance at September 30, 2006	168,079
Less: Valuation allowance	316
Balance at September 30, 2006, net of valuation allowance	$ 167,763
Fair value at September 30, 2006	$ 185,923

Residential mortgage loans serviced for others were $18.1 billion at September 30, 2007 (December 31, 2006 $13.3 billion; September 30, 2006 $13.0 billion).

Net mortgage servicing fees, a component of other service fees in the consolidated statement of income, include the changes from period to period in fair value of the MSRs, which may result from changes in the valuation model inputs or assumptions (principally reflecting changes in discount rates and prepayment speed assumptions) and other changes, representing changes due to collection / realization of expected cash flows. Prior to the adoption of SFAS No. 156, the Corporation carried residential MSRs at the lower of cost or market, with amortization of MSRs and changes in the MSRs valuation allowance recognized in net mortgage servicing fees.

Note 8 Retained Interests on Sales of Mortgage Loans

Popular Financial Holdings

The Corporation, through its consumer lending subsidiary PFH, has retained mortgage servicing rights and residual interests in connection with securitizations of subprime mortgage loans.

The Corporation accounts for the residual interests derived from PFH s off-balance sheet securitizations that took place prior to 2006 as investment securities available-for-sale. Under SFAS No. 140, interest-only strips, retained interests in securitizations or other financial assets that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its investment shall be subsequently measured like investments in debt securities classified as available-for-sale or trading under SFAS No. 115. In 2006, as permitted by SFAS No. 115, management determined, on a prospective basis, to begin classifying PFH s new residual interests as trading securities and as such, account for any changes in fair value through earnings (recorded as part of trading account profit (loss) in the consolidated statements of income).

PFH s residual interests classified as available-for-sale as of September 30, 2007 amounted to $17 million. In the quarter and nine-month periods ended September 30, 2007, the Corporation recognized other-than-temporary impairment losses of $2.0 million and $32.7 million, respectively, on these residual interests.

Residual interests accounted for as trading securities from PFH s securitizations approximated $5 million at

September 30, 2007. For the third quarter and nine-month periods ended September 30, 2007, the Corporation recognized trading losses of $12.1 million and $36.4 million, respectively, on these residual interests.

During 2007, the Corporation conducted one off-balance sheet asset securitization that involved the transfer of mortgage loans to a qualifying special purpose entity (QSPE), which in turn transferred these assets and their titles to a different trust, thus isolating those loans from the Corporation s assets. Approximately, $461 million in adjustable (ARM) and fixed-rate loans were securitized and sold by PFH as part of this transaction, with a gain on sale of approximately $13.5 million.

Key economic assumptions used in measuring the retained interests at the date of this off-balance sheet securitization were:

		MSRs	
	Residual Interests	Fixed-rate loans	ARM Loans
Average prepayment speed	28% (Fixed-rate loans) 35% (ARM loans)	28%	35%
Weighted average life of collateral (in years)	4.2 years	4.8 years	2.2 years
Cumulative credit losses	4.75% (Fixed-rate loans) 8.40% (ARM loans)		
Discount rate (annual rate)	25%	17%	17%

Key economic assumptions used to estimate the fair value of residual interests and MSRs derived from PFH s securitizations and the sensitivity of residual cash flows to immediate changes in those assumptions were as follows:

	September 30, 2007			December 31, 2006		
		MSRs			MSRs	
(In thousands)	Residual Interests	Fixed-rate loans	ARM loans	Residual Interests	Fixed-rate loans	ARM loans
Carrying amount of retained interests	$22,469	$32,069	$21,343	$85,965	$38,017	$29,838
Fair value of retained interests	$22,469	$32,069	$21,343	$85,965	$37,815	$32,212
Weighted average life of collateral (in years)	3.0 years	3.8 years	2.0 years	3.2 years	3.1 years	2.1 years
Weighted average prepayment speed (annual rate)	23% (Fixed-rate loans) 35% (ARM loans)	23%	35%	28% (Fixed-rate loans) 35% (ARM loans)	28%	35%
Impact on fair value of 10% increase in prepayment rate	($ 563)	($ 316)	($ 268)	($ 5,543)	$ 210	($ 149)
Impact on fair value of 20% increase in prepayment rate	($ 1,489)	($ 372)	($ 493)	($ 9,284)	$ 234	($ 200)

Weighted average discount rate (annual rate)	30%	17%	17%	17%	16%	16%
Impact on fair value of 10% adverse change	($ 2,132)	($ 913)	($ 408)	($ 4,172)	($ 901)	($ 542)
Impact on fair value of 20% adverse change	($ 4,056)	($ 1,777)	($ 800)	($ 8,081)	($ 1,761)	($ 1,060)
Cumulative credit losses	3.17% to 8.50%			1.28% to 3.19%		
Impact on fair value of 10% adverse change	($10,268)			($ 4,792)		
Impact on fair value of 20% adverse change	($18,327)			($ 9,558)		

PFH, as servicer, collects prepayment penalties on a substantial portion of the underlying serviced loans; as such, an adverse change in the prepayment assumptions with respect to the MSRs could be partially offset by the benefit derived from the prepayment penalties estimated to be collected.

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The amounts included in the tables above exclude any purchased MSRs since these assets were not derived from securitizations or loan sales executed by the Corporation.

Banking subsidiaries

The Corporation s banking subsidiaries also retain servicing responsibilities in connection with the sale of mortgage loans to third parties. Also, servicing responsibilities are retained under securitization arrangements of mortgage loans into mortgage-backed securities, primarily GNMA and FNMA securities. Substantially all mortgage loans securitized by the Corporation s banking subsidiaries, in which the Corporation retains a servicing right, have fixed rates. Under the servicing agreements, the banking subsidiaries do not earn significant prepayment penalties on the underlying loans serviced.

Key economic assumptions used in measuring the MSRs at the date of the securitizations and whole loan sales by the banking subsidiaries performed during the quarter ended September 30, 2007 were:

	MSRs
Prepayment speed	8.8%
Weighted average life (in years)	11.3 years
Discount rate (annual rate)	10.7%

Key economic assumptions used to estimate the fair value of MSRs derived from transactions performed by the banking subsidiaries and the sensitivity of residual cash flows to immediate changes in those assumptions were as follows:

	September 30, 2007	December 31, 2006
(In thousands)	MSRs	MSRs
Fair value of retained interests	$ 86,550	$ 73,332
Weighted average life (in years)	12.4 years	9.2 years
Weighted average prepayment speed (annual rate)	8.1%	14.0%
Impact on fair value of 10% adverse change	($ 2,536)	($ 1,868)
Impact on fair value of 20% adverse change	($ 4,544)	($ 4,151)
Weighted average discount rate (annual rate)	10.7%	10.3%
Impact on fair value of 10% adverse change	($ 3,513)	($ 2,142)
Impact on fair value of 20% adverse change	($ 6,394)	($ 4,200)

The amounts of MSRs presented in the table above exclude purchased MSRs.

The sensitivity analyses presented above for residual interests and MSRs are hypothetical and should be used with caution. As the figures indicate, changes in fair value based on a 10 and 20 percent variation in assumptions generally cannot be extrapolated because the relationship of the change in assumption to the change in fair value may not be linear. Also, in the sensitivity tables included herein, the effect of a variation in a particular assumption on the fair value of the retained interest is calculated without changing any other assumption; in reality, changes in one factor may result in changes in another (for example, increases in market interest rates may result in lower prepayments and increased credit losses), which might magnify or counteract the sensitivities.

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Note 9 Derivative Instruments and Hedging Activities
Refer to Note 28 to the consolidated financial statements included in the 2006 Annual Report for a complete description of the Corporation s derivative activities. The following represents the major changes that occurred in the Corporation s derivative activities in the third quarter of 2007:
Cash Flow Hedges
Derivative financial instruments designated as cash flow hedges outstanding as of September 30, 2007 and December 31, 2006 were as follows:

	As of September 30, 2007				
(In thousands)	Notional amount	Derivative assets	Derivative liabilities	Equity OCI	Ineffectiveness
Asset Hedges					
Forward commitments	$155,000	$ 181	$ 105	$ 46	
Liability Hedges					
Interest rate swaps	$390,000	$ 439	$ 1,665	($797)	

	As of December 31, 2006				
(In thousands)	Notional amount	Derivative assets	Derivative liabilities	Equity OCI	Ineffectiveness
Asset Hedges					
Forward commitments	$190,000	$ 175	$ 2	$106	
Liability Hedges					
Interest rate swaps	$390,000	$ 887	$ 523	$237	

The Corporation utilizes forward contracts to hedge the sale of mortgage-backed securities with duration terms over one month. Interest rate forward contracts are contracts for the delayed delivery of securities which the seller agrees to deliver on a specified future date at a specified price or yield. These forward contracts are used to hedge a forecasted transaction and thus qualify for cash flow hedge accounting in accordance with SFAS No. 133, as amended. Changes in the fair value of the derivatives are recorded in other comprehensive income. The amount included in accumulated other comprehensive income corresponding to these forward contracts is expected to be reclassified to earnings in the next twelve months. The contracts outstanding at September 30, 2007 have a maximum remaining maturity of 78 days.
The Corporation also has designated as cash flow hedges, interest rate swap contracts that convert floating rate debt into fixed rate debt by minimizing the exposure to changes in cash flows due to higher interest rates. These interest rate swap contracts have a maximum remaining maturity of 1.5 years.

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Non-Hedging Activities

Financial instruments designated as non-hedging derivatives outstanding at September 30, 2007 and December 31, 2006 were as follows:

September 30, 2007

(In thousands)	Notional amount	Fair Values Derivative assets	Fair Values Derivative liabilities
Forward contracts	$ 730,700	$ 424	$ 1,801
Call options and put options	38,000	41	85
Interest rate swaps associated with:			
- short-term borrowings	400,000	392	
- bond certificates offered in an on-balance sheet securitization	406,347		2,924
- financing of auto loans held-in-portfolio	344,066		1,485
- swaps with corporate clients	583,744		5,039
- swaps offsetting position of corporate client swaps	583,744	5,039	
Credit default swap	33,463		
Interest rate caps	836,883	1,260	
Interest rate caps for benefit of corporate clients	50,000		45
Indexed options on deposits	211,267	50,200	
Indexed options on S&P Notes	31,152	7,439	
Bifurcated embedded options	222,732		56,124
Mortgage rate lock commitments	177,791		266
Total	$ 4,649,889	$64,795	$ 67,769

As of December 31, 2006

(In thousands)	Notional amount	Fair Values Derivative assets	Fair Values Derivative liabilities
Forward contracts	$ 400,572	$ 1,277	$ 125
Call options and put options	37,500	83	46
Interest rate swaps associated with:			
- short-term borrowings	400,000	2,153	
- bond certificates offered in an on-balance sheet securitization	516,495	90	1,168
- financing of auto loans held-in-portfolio	470,146	728	
- auto loans approvals locked interest rates	17,442	22	
- swaps with corporate clients	410,533		2,146
- swaps offsetting position of corporate client swaps	410,533	2,146	
- investment securities	89,385		1,645
- mortgage loan portfolio prior to securitization	75,000	302	
Credit default swap	33,463		
Foreign currency and exchange rate commitments w/ clients	103		2

Foreign currency and exchange rate commitments w/ counterparty	103	2	
Interest rate caps	889,417	4,099	
Interest rate caps for benefit of corporate clients	50,000		90
Indexed options on deposits	204,946	38,323	
Indexed options on S&P Notes	31,152	5,648	
Bifurcated embedded options	229,455		43,844
Mortgage rate lock commitments	215,676	13	635
Total	$ 4,481,921	$54,886	$ 49,701

Interest Rates Swaps

The Corporation has an interest rate swap outstanding to economically hedge the payments of certificates issued as part of a securitization. This swap is marked-to-market quarterly and recognized as part of interest expense. The Corporation recognized losses of $3.8 million for the third quarter and $1.8 million for the nine months ended September 30, 2007 due to changes in its fair value. During the quarter and nine-month periods ended September 30, 2006, the Corporation recognized losses of $2.4 million.

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The Corporation has interest rate swaps to economically hedge the cost of short-term debt. For the third quarter of 2007, the Corporation recognized a loss of $1.6 million, and for the nine months ended September 30, 2007, recognized losses of $1.8 million due to changes in their fair value, which were included as part of short-term interest expense. During the third quarter and nine months ended September 30, 2006, the Corporation recognized losses of $3.4 million and $2.0 million, respectively, associated with changes in the fair value of these interest rate swaps. Additionally, the Corporation entered into amortizing swap contracts to economically convert to a fixed rate the cost of funds associated with auto loans held-in-portfolio. Losses of $3.0 million and $2.2 million for the quarter and nine months ended September 30, 2007, respectively, were recognized as part of long-term interest expense related to these swaps. During the quarter and nine-month periods ended September 30, 2006, the Corporation recognized losses of $3.5 million and $572 thousand, respectively, associated with changes in the fair value of these swaps.

Interest Rate Caps

During the quarter ended June 30, 2007, the Corporation entered into a $100 million interest rate cap to mitigate its exposure to rising interest rates on short-term borrowings.

The Corporation has interest rate caps in conjunction with a series of mortgage loan securitizations that are used to limit the interest rate payable to the security holders. These interest rate caps are designated as non-hedging derivative instruments and are marked-to-market currently in the consolidated statements of income. Losses of $1.2 million and $2.6 million for the quarter and nine months ended September 30, 2007, respectively, were recognized as part of long-term interest expense related to these interest rate cap contracts. For the quarter and nine months ended September 30, 2006, losses on these contracts amounted to $3.5 million and $6.6 million, respectively.

Forward Contracts

The Corporation has loan sales commitments to economically hedge the changes in fair value of mortgage loans held-for-sale associated with interest rate lock commitments through both mandatory and best efforts forward sales agreements. These contracts are entered into in order to optimize the gain on sales of loans. These contracts are recognized at fair market value with changes directly reported in income as part of gain on sale of loans. For the quarter and nine months ended September 30, 2007, losses of $3.7 million and $2.1 million, respectively, were recognized due to changes in fair value of these forward sales commitments. During the third quarter and nine months ended September 30, 2006, the Corporation recognized losses of $1.9 million and $112 thousand, respectively, related to these forward contracts.

Mortgage Rate Lock Commitments

The Corporation has mortgage rate lock commitments to fund mortgage loans at interest rates previously agreed for a specified period of time. These contracts are recognized at fair value with changes directly reported in income as part of gain on sale of loans. For the quarter and nine months ended September 30, 2007, gains of $1.9 million and $356 thousand, respectively, were recognized due to changes in fair value of these commitments. During the third quarter and nine months ended September 30, 2006, the Corporation recognized gains of $464 thousand and losses of $10 thousand, respectively, related to these commitments.

Credit Default Swap

The Corporation s credit default swap guarantees a third-party performance under an interest rate swap with the counterparty. The interest rate swap was in the money in favor of the third-party . The credit default swap matures in April 2008. The credit default swap is marked-to-market through earnings. Its fair value has historically been zero because of the credit standing of the third-party .

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Note 10 Goodwill and Other Intangible Assets

The changes in the carrying amount of goodwill for the nine months ended September 30, 2007 and 2006, allocated by reportable segment, were as follows (refer to Note 21 for the definition of the Corporation s reportable segments):

2007

(In thousands)	Balance at January 1, 2007	Goodwill acquired	Other	Balance at September 30, 2007
Banco Popular de Puerto Rico:				
Commercial Banking	$ 14,674			$ 14,674
Consumer and Retail Banking	34,999			34,999
Other Financial Services	4,391			4,391
Popular North America:				
Banco Popular North America	568,647			568,647
Popular Financial Holdings				
EVERTEC	45,142	$1,137	($183)	46,096
Total Popular, Inc.	$ 667,853	$1,137	($183)	$ 668,807

2006

(In thousands)	Balance at January 1, 2006	Goodwill acquired	Purchase accounting adjustments	Other	Balance at September 30, 2006
Banco Popular de Puerto Rico:					
Commercial Banking	$ 14,674				$ 14,674
Consumer and Retail Banking	34,999				34,999
Other Financial Services	4,110				4,110
Popular North America:					
Banco Popular North America	542,834		$23,378	($210)	566,002
Popular Financial Holdings	14,236		3		14,239
EVERTEC	43,131	$1,511			44,642
Total Popular, Inc.	$ 653,984	$1,511	$23,381	($210)	$ 678,666

Purchase accounting adjustments consist of adjustments to the value of the assets acquired and liabilities assumed resulting from the completion of appraisals or other valuations, adjustments to initial estimates recorded for transaction costs, if any, and contingent consideration paid during a contractual contingency period. The purchase accounting adjustments during the first nine months of 2006 at the PNA reportable segment were mostly related to the E-LOAN acquisition.

The Corporation performed the annual impairment test required by SFAS No. 142, Goodwill and Other Intangible Assets. This test did not result in impairment of the Corporation s recorded goodwill.

At September 30, 2007 and December 31, 2006, other than goodwill, the Corporation had $65 million of identifiable intangibles with indefinite useful lives, mostly associated with E-LOAN s trademark (September 30, 2006

$59 million).

The following table reflects the components of other intangible assets subject to amortization:

	September 30, 2007		December 31, 2006		September 30, 2006	
(In thousands)	Gross Amount	Accumulated Amortization	Gross Amount	Accumulated Amortization	Gross Amount	Accumulated Amortization
Core deposits	$46,302	$22,836	$76,708	$48,367	$76,956	$46,688
Other customer relationships	11,925	3,609	11,156	2,171	10,028	1,703
Other intangibles	9,170	5,092	9,099	3,426	10,808	4,003
Total	$67,397	$31,537	$96,963	$53,964	$97,792	$52,394

Certain core deposits intangibles with a gross amount of $30.4 million became fully amortized during 2007 and, as such, their gross amount and accumulated amortization were eliminated from the tabular disclosure presented above. During the quarter and nine months ended September 30, 2007, the Corporation recognized $2.2 million and $8.0 million, respectively, in amortization expense related to other intangible assets with definite lives (September 30, 2006 $3.6 million and $9.2 million, respectively).

The following table presents the estimated aggregate annual amortization expense of the intangible assets with definite lives for each of the following fiscal years:

	(In thousands)
2007	$10,259
2008	8,454
2009	6,632
2010	5,674
2011	4,016

No significant events or circumstances have occurred that would reduce the fair value of any reporting unit below its carrying amount.

Note 11 Borrowings

The composition of federal funds purchased and assets sold under agreements to repurchase was as follows:

(In thousands)	September 30, 2007	December 31, 2006	September 30, 2006
Federal funds purchased	$ 690,332	$1,276,818	$2,056,610
Assets sold under agreements to repurchase	5,596,971	4,485,627	4,988,856
	$6,287,303	$5,762,445	$7,045,466

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Other short-term borrowings consisted of:

(In thousands)	September 30, 2007	December 31, 2006	September 30, 2006
Advances with FHLB paying interest at:			
-fixed rates ranging from 5.14% to 5.17% (September 30, 2006 5.40% to 5.42%)	$ 172,000	$ 230,000	$ 230,000
-floating rate with a spread over the fed funds rate (Fed funds rate at September 30, 2006 was 5.38%)			55,000
Advances under credit facilities with other institutions at:			
-fixed rates ranging from 5.25% to 5.96% (September 30, 2006 5.38% to 5.52%)	210,000	386,000	23,385
-floating rates ranging from 0.45% to 0.75% over the 1-month LIBOR rate (1-month LIBOR rate at September 30, 2006 was 5.32%)		481,062	112,915
-a floating rate of 0.20% over the 3-month LIBOR rate (3-month LIBOR rate at September 30, 2006 5.37%)		10,000	10,000
Commercial paper at rates ranging from 5.05% to 5.92% (September 30, 2006 4.85% to 5.33%)	249,041	193,383	97,172
Term funds purchased at:			
-fixed rates ranging from 5.13% to 5.82% (September 30, 2006 5.28% to 5.39%)	749,000	2,140,900	1,487,162
-a floating rate of 0.08% over the fed funds rate (Fed funds rate at September 30, 2006 was 5.38%)		500,000	600,000
Others	34,856	92,780	93,877
	$1,414,897	$4,034,125	$2,709,511

Note: Refer to the Corporation s Form 10-K for the year ended December 31, 2006, for rates and maturity information corresponding to the borrowings outstanding as of such date.

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Notes payable consisted of:

(In thousands)	September 30, 2007	December 31, 2006	September 30, 2006
Advances with FHLB:			
-with maturities ranging from 2007 through 2018 paying interest at fixed rates ranging from 2.51% to 6.98% (September 30, 2006 2.44% to 6.98%)	$ 738,099	$ 289,881	$ 414,403
-maturing in 2008 paying interest monthly at a floating rate of 0.0075% over the 1-month LIBOR rate (1-month LIBOR rate at September 30, 2007 was 5.12%; September 30, 2006 5.32%)	250,000	250,000	250,000
-maturing in 2007 paying interest monthly at the 1-month LIBOR rate plus 0.02% (1-month LIBOR rate at September 30, 2006 5.32%)		5,000	5,000
-maturing in 2007 paying interest quarterly at the 3-month LIBOR rate less 0.04% (3-month LIBOR rate at September 30, 2006 was 5.37%)		6,000	6,000
Advances under revolving lines of credit maturing in 2008 paying interest monthly at a floating rate of 0.75% (September 30, 2006 0.90%) over the 1-month LIBOR rate (1-month LIBOR rate at September 30, 2007 was 5.12%; September 30, 2006 5.32%)	317,926	426,687	388,432
Advances under revolving lines of credit with maturities ranging from 2007 to 2009 paying interest quarterly at a floating rate of 0.20% to 0.35% over the 3-month LIBOR rate (3-month LIBOR rate at September 30, 2007 was 5.23%)	154,999	69,994	
Term notes maturing in 2030 paying interest monthly at fixed rates ranging from 3.00% to 6.00%	3,100	3,100	3,100
Term notes with maturities ranging from 2008 to 2013 paying interest monthly at a floating rate of 3.00% over the 10-year U.S. Treasury note rate (10-year U.S. Treasury note rate at September 30, 2007 was 4.59%; September 30, 2006 4.63%)	7,502	10,428	11,029
Term notes with maturities ranging from 2007 to 2009 paying interest quarterly at floating rates ranging from 0.35% to 0.40% (September 30, 2006 0.35% to 0.45%) over the 3-month LIBOR rate (3-month LIBOR rate at September 30, 2007 was 5.23%, September 30, 2006 5.37%)	349,610	349,295	469,182
	2,014,323	2,014,928	2,713,078

Term notes with maturities ranging from 2007 through 2011 paying interest semiannually at fixed rates ranging from 3.60% to 5.65% (September 30, 2006 3.25% to 6.39%)			
Secured borrowings with maturities ranging from 2007 to 2012 paying interest monthly at fixed rates ranging from 4.00% to 7.12% (September 30, 2006 3.05% to 7.12%)	2,381,081	2,695,916	2,914,523
Secured borrowings with maturities ranging from 2007 to 2012 paying interest monthly ranging from 0.06% to 3.51% (September 30, 2006 0.05% to 4.75%) over the 1-month LIBOR rate (1-month LIBOR rate at September 30, 2007 was 5.12%; September 30, 2006 5.32%)	1,189,286	1,708,650	1,623,142
Notes linked to the S&P 500 Index maturing in 2008	37,876	36,112	34,136
Junior subordinated deferrable interest debentures with maturities ranging from 2027 to 2034 with fixed interest rates ranging from 6.13% to 8.33% (Refer to Note 17)	849,672	849,672	849,672
Other	21,317	21,583	200
	$8,314,791	$8,737,246	$9,681,897

Note: Refer to the Corporation s Form 10-K for the year ended December 31, 2006, for rates and maturity information corresponding to the borrowings outstanding as of such date.

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Note 12 Commitments and Contingencies

Commercial letters of credit and stand-by letters of credit amounted to $18 million and $196 million, respectively, at September 30, 2007 (December 31, 2006 $21 million and $181 million; September 30, 2006 $21 million and $169 million). There were also other commitments outstanding and contingent liabilities, such as commitments to extend credit.

At September 30, 2007, the Corporation recorded a liability of $721 thousand (December 31, 2006 - $658 thousand; September 30, 2006 $574 thousand), which represents the fair value of the obligations undertaken in issuing the guarantees under stand-by letters of credit. The fair value approximates the fee received from the customer for issuing such commitments. These fees are deferred and are recognized over the commitment period. The liability was included as part of other liabilities in the consolidated statements of condition. The stand-by letters of credit were issued to guarantee the performance of various customers to third parties. The contract amounts in stand-by letters of credit outstanding represent the maximum potential amount of future payments the Corporation could be required to make under the guarantees in the event of nonperformance by the customers. These stand-by letters of credit are used by the customer as a credit enhancement and typically expire without being drawn upon. The Corporation s stand-by letters of credit are generally secured, and in the event of nonperformance by the customers, the Corporation has rights to the underlying collateral provided, which normally includes cash and marketable securities, real estate, receivables and others. Management does not anticipate any material losses related to these instruments.

Popular, Inc. Holding Company (PIHC) fully and unconditionally guarantees certain borrowing obligations issued by certain of its wholly-owned consolidated subsidiaries, which aggregated to $3.3 billion at September 30, 2007 (December 31, 2006 $3.3 billion and September 30, 2006 $3.9 billion). In addition, at September 30, 2007, PIHC fully and unconditionally guaranteed $824 million of capital securities (December 31, 2006 and September 30, 2006 $824 million) issued by four wholly-owned issuing trust entities that have been deconsolidated pursuant to FIN No. 46R.

The Corporation is a defendant in a number of legal proceedings arising in the normal course of business. Based on the opinion of legal counsel, management believes that the final disposition of these matters will not have a material adverse effect on the Corporation s financial position or results of operations.

Note 13 Other Service Fees

The caption of other service fees in the consolidated statements of income consists of the following major categories:

	Quarter ended September 30,		Nine months ended September 30,	
(In thousands)	2007	2006	2007	2006
Credit card fees and discounts	$25,975	$22,035	$ 74,498	$ 66,979
Debit card fees	16,228	15,345	49,184	45,349
Insurance fees	15,024	13,327	42,693	39,879
Processing fees	11,674	11,164	35,463	32,382
Sale and administration of investment products	8,043	7,345	22,614	21,451
Mortgage servicing fees, net of amortization and fair value adjustments	7,400	(1,756)	18,269	(2,423)
Other	9,020	12,177	28,082	36,383
Total	$93,364	$79,637	$270,803	$240,000

Note 14 Income Taxes

As indicated in Note 2, the Corporation adopted FIN 48 effective January 1, 2007. The initial adoption of FIN 48 had no impact on the Corporation s financial statements since management determined that there was no need to recognize changes in the liability for unrecognized tax benefits.

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The reconciliation of unrecognized tax benefits, including accrued interest, was as follows:

(In millions)	
Balance as of January 1, 2007	$20.4
Additions for tax positions Jan March 2007	1.7
Balance as of March 31, 2007	$22.1
Additions for tax positions April June 2007	2.3
Balance as of June 30, 2007	$24.4
Additions for tax positions July Sept 2007	2.9
Balance as of September 30, 2007	$27.3

As of September 30, 2007, the related accrued interest approximated $3.2 million. Management has determined that as of September 30, 2007 there is no need to accrue for the payment of penalties. The Corporation s policy is to report interest related to unrecognized tax benefits in income tax expense, while the penalties, if any, are reported in other operating expenses in the consolidated statements of income.

After consideration of the effect on U.S. federal tax of unrecognized U.S. state tax benefits, the total amount of unrecognized tax benefits, including U.S. and Puerto Rico that, if recognized, would affect the Corporation s effective tax rate, was approximately $26 million as of September 30, 2007.

The amount of unrecognized tax benefits may increase or decrease in the future for various reasons including adding amounts for current tax year positions, expiration of open income tax returns due to the statutes of limitation, changes in management s judgment about the level of uncertainty, status of examinations, litigation and legislative activity and the addition or elimination of uncertain tax positions.

The Corporation and its subsidiaries file income tax returns in Puerto Rico, the U.S. federal jurisdiction, various U.S. states and political subdivisions, and foreign jurisdictions. As of September 30, 2007, the following years remain subject to examination: U.S. Federal jurisdiction 2005 and 2006 and Puerto Rico 2003 through 2006. The U.S. Internal Revenue Service (IRS) commenced an examination of the Corporation s U.S. operations tax return for 2005 that is anticipated to be finished by the end of 2007. As of September 30, 2007, the IRS has not proposed any adjustment as a result of the audit. Although the outcome of tax audits is uncertain, the Corporation believes that adequate amounts of tax, interest and penalties have been provided for any adjustments that are expected to result from open years. The Corporation does not anticipate a significant change to the total amount of unrecognized tax benefits within the next 12 months.

Note 15 Stock-Based Compensation

The Corporation maintained a Stock Option Plan (the Stock Option Plan), which permitted the granting of incentive awards in the form of qualified stock options, incentive stock options, or non-statutory stock options of the Corporation. In April 2004, the Corporation s shareholders adopted the Popular, Inc. 2004 Omnibus Incentive Plan (the Incentive Plan), which replaced and superseded the Stock Option Plan. Nevertheless, all outstanding award grants under the Stock Option Plan continue to remain in effect at September 30, 2007 under the original terms of the Stock Option Plan.

Stock Option Plan

Employees and directors of the Corporation or any of its subsidiaries were eligible to participate in the Stock Option Plan. The Board of Directors or the Compensation Committee of the Board had the absolute discretion to determine the individuals that were eligible to participate in the Stock Option Plan. This plan provides for the issuance of Popular, Inc. s common stock at a price equal to its fair market value at the grant date, subject to certain plan provisions. The shares are to be made available from authorized but unissued shares of common stock or treasury stock. The Corporation s policy has been to use authorized but unissued shares of common stock to cover each grant.

The maximum option term is ten years from the date of grant. Unless an option agreement provides otherwise, all options granted are 20% exercisable after the first year and an additional 20% is exercisable after each subsequent year, subject to an acceleration clause at termination of employment due to retirement.

The following table presents information on stock options outstanding as of September 30, 2007:

(Not in thousands)

Exercise Price Range per Share	Options Outstanding	Weighted Average Exercise Price of Options Outstanding	Weighted Average Remaining Life of Options Outstanding (in years)	Options Exercisable (fully vested)	Weighted Average Exercise Price of Options Exercisable
$14.39 - $18.50	1,513,582	$ 15.81	4.98	1,382,319	$ 15.72
$19.25 - $27.20	1,586,035	$ 25.27	6.75	1,012,839	$ 25.02
$14.39 - $27.20	3,099,617	$ 20.65	5.89	2,395,158	$ 19.65

The aggregate intrinsic value of options outstanding as of September 30, 2007 was $8.7 million. There was no intrinsic value of options exercisable as of September 30, 2007.

The following table summarizes the stock option activity and related information:

(Not in thousands)	Options Outstanding	Weighted-Average Exercise Price
Outstanding at January 1, 2006	3,223,703	$ 20.63
Granted		
Exercised	(39,449)	15.78
Forfeited	(37,818)	23.75
Expired	(1,637)	24.05
Outstanding at December 31, 2006	3,144,799	$ 20.65
Granted		
Exercised	(10,064)	15.83
Forfeited	(19,063)	25.50
Expired	(16,055)	19.14
Outstanding at September 30, 2007	3,099,617	$ 20.65

The stock options exercisable at September 30, 2007 totaled 2,395,158 (September 30, 2006 1,953,606). There were no stock options exercised during the quarter ended September 30, 2007. For the nine months ended September 30, 2007, the cash received from stock options exercised amounted to $159 thousand. The total intrinsic value of options exercised during the quarter ended September 30, 2006 was $60 thousand. The total intrinsic value of options exercised during the nine-month period ended September 30, 2007 was $28 thousand (September 30, 2006 $127 thousand).

There were no new stock option grants issued by the Corporation under the Stock Option Plan during 2006 or the nine months ended September 30, 2007.

The Corporation recognized $432 thousand of stock option expense, with a tax benefit of $165 thousand, for the quarter ended September 30, 2007 (September 30, 2006 $724 thousand, with a tax benefit of $293 thousand). For the nine months ended September 30, 2007, the Corporation recognized $1.3 million of stock option expense, with a tax benefit of $515 thousand (September 30, 2006 - $2.3 million, with a tax benefit of $899 thousand). The total unrecognized compensation cost at September 30, 2007 related to non-vested stock option awards was $2.1 million and is expected to be recognized over a weighted-average period of 1.3 years.

Incentive Plan

The Incentive Plan permits the granting of incentive awards in the form of Annual Incentive Awards, Long-term

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Performance Unit Awards, Options, Stock Appreciation Rights, Restricted Stock, Restricted Units or Performance Shares. Participants in the Incentive Plan are designated by the Compensation Committee of the Board of Directors (or its delegate as determined by the Board). Employees and directors of the Corporation and / or any of its subsidiaries are eligible to participate in the Incentive Plan. The shares may be made available from common stock purchased by the Corporation for such purpose, authorized but unissued shares of common stock or treasury stock. The Corporation s policy with respect to the shares of restricted stock has been to purchase such shares in the open market to cover each grant.

Under the Incentive Plan, the Corporation has issued only restricted shares, which become vested based on the employees continued service with Popular. The compensation cost associated with the shares of restricted stock is estimated based on a two-prong vesting schedule, unless otherwise stated in an agreement. The first part is vested ratably over five years commencing at the date of grant and the second part is vested at termination of employment after attainment of 55 years of age and 10 years of service. The five-year vesting part is accelerated at termination of employment after attaining 55 years of age and 10 years of service.

Beginning in 2007, the Corporation authorized the issuance of performance shares, in addition to restricted shares, under a long-term incentive plan. The performance shares award consists of the opportunity to receive shares of Popular, Inc. s common stock provided the Corporation achieves certain performance goals during a 3-year performance cycle. The compensation cost associated with the performance shares will be recorded ratably over a three-year performance period. The performance shares will be granted at the end of the three-year period and will be vested at grant date. As of September 30, 2007, no shares have been granted under this plan.

The following table summarizes the restricted stock activity under the Incentive Plan and related information to members of management:

(Not in thousands)	Restricted Stock	Weighted-Average Grant Date Fair Value
Non-vested at January 1, 2006	172,622	$ 27.65
Granted	444,036	20.54
Vested		
Forfeited	(5,188)	19.95
Non-vested at December 31, 2006	611,470	$ 22.55
Granted		
Vested	(69,471)	20.56
Forfeited	(3,781)	19.95
Non-vested at September 30, 2007	538,218	$ 22.83

During the quarters ended September 30, 2007 and 2006, no shares of restricted stock were awarded to management under the Incentive Plan. During the nine-month period ended September 30, 2007, no shares of restricted stock were awarded to management under the Incentive Plan (September 30, 2006 444,036).

During the quarter ended September 30, 2007, the Corporation recognized $33 thousand of restricted stock expense related to management incentive awards, with a tax benefit of $14 thousand (September 30, 2006 ($433) thousand, with a tax impact of $160 thousand). For the nine-month period ended September 30, 2007, the Corporation recognized $1.9 million of restricted stock expense related to management incentive awards, with a tax benefit of $718 thousand (September 30, 2006 $1.7 million, with a tax benefit of $663 thousand). The fair market value of the restricted stock vested was $1.2 million. The total unrecognized compensation cost related to non-vested restricted stock awards to members of management at September 30, 2007 was $4.5 million and is expected to be recognized over a weighted-average period of 2.7 years. During the nine-month period ended September 30, 2007, there was a vesting of restricted stock that triggered a shortfall of $194 thousand, which was recorded as an additional income tax expense.

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The following table summarizes the restricted stock under Incentive Award and related information to members of the Board of Directors:

(Not in thousands)	Restricted Stock	Weighted-Average Grant Date Fair Value
Non-vested at January 1, 2006	46,948	$ 23.61
Granted	32,267	19.82
Vested	(2,601)	23.54
Forfeited		
Non-vested at December 31, 2006	76,614	$ 22.02
Granted	32,381	16.96
Vested	(22,486)	22.03
Forfeited		
Non-vested at September 30, 2007	86,509	$ 20.12

During the quarter ended September 30, 2007, the Corporation granted 3,018 (September 30, 2006 1,038) shares of restricted stock to members of the Board of Directors of Popular, Inc. During this period, the Corporation recognized $115 thousand of restricted stock expense related to these restricted stock grants, with a tax benefit of $45 thousand (September 30, 2006 $150 thousand, with a tax benefit of $59 thousand). For the nine-month period ended September 30, 2007, the Corporation granted 32,381 (September 30, 2006 30,897) shares of restricted stock to members of the Board of Directors of Popular, Inc. The fair market value of the restricted stock vested was $394 thousand. During this period, the Corporation recognized $423 thousand of restricted stock expense related to these restricted stock grants, with a tax benefit of $165 thousand (September 30, 2006 $430 thousand, with a tax benefit of $168 thousand).

Note 16 Pension and Postretirement Benefits

The Corporation has noncontributory defined benefit pension plans and supplementary pension plans for regular employees of certain of its subsidiaries.

The components of net periodic pension cost for the quarters and nine months ended September 30, 2007 and 2006 were as follows:

	Pension Plans				Benefit Restoration Plans			
	Quarters ended September 30,		Nine months ended September 30,		Quarters ended September 30,		Nine months ended September 30,	
(In thousands)	2007	2006	2007	2006	2007	2006	2007	2006
Service cost	$ 2,639	$ 3,135	$ 8,384	$ 9,405	$ 221	$ 262	$ 678	$ 786
Interest cost	7,958	7,641	23,890	22,923	419	400	1,258	1,200
Expected return on plan assets	(10,532)	(10,009)	(31,589)	(29,918)	(369)	(264)	(1,105)	(792)
Amortization of prior service cost	52	44	156	132	(13)	(13)	(39)	(39)
Amortization of net loss		488		1,464	248	276	743	828
Net periodic cost	$ 117	$ 1,299	$ 841	$ 4,006	$ 506	$ 661	$ 1,535	$1,983

Curtailment gain			(246)				(258)	
Total cost	$ 117	$ 1,299	$ 595	$ 4,006	$ 506	$ 661	$ 1,277	$1,983

During the first quarter of 2007, the Corporation adopted an amendment to freeze the benefits for all employees under the U.S. Retirement and Restoration plans. These plans were remeasured at January 31, 2007 to account for the freeze. The discount rate of the U.S. Retirement plan was changed to 4.5% to reflect the expected plan termination. The remeasurement and curtailment effects were considered for these plans in the first quarter of 2007 and are included as part of the year-to-date disclosures.
For the nine months ended September 30, 2007, contributions made to the pension and restoration plans approximated $1.9 million. The total contributions expected to be paid during 2007 for the pension and restoration plans approximate $2.2 million.

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The Corporation also provides certain health care benefits for retired employees of certain subsidiaries. The components of net periodic postretirement benefit cost for the quarters and nine months ended September 30, 2007 and 2006 were as follows:

	Quarters ended September 30,		Nine months ended September 30,	
(In thousands)	2007	2006	2007	2006
Service cost	$ 578	$ 696	$1,734	$2,095
Interest cost	1,889	1,927	5,667	5,781
Amortization of prior service cost	(261)	(262)	(784)	(786)
Amortization of net loss		240		720
Total net periodic cost	$2,206	$2,601	$6,617	$7,810

For the nine months ended September 30, 2007, contributions made to the postretirement benefit plan approximated $4.9 million. The total contributions expected to be paid during 2007 for the postretirement benefit plan approximate $6.4 million.

Note 17 Trust Preferred Securities

At September 30, 2007 and 2006, the Corporation had established four trusts for the purpose of issuing trust preferred securities (the capital securities) to the public. The proceeds from such issuances, together with the proceeds of the related issuances of common securities of the trusts (the common securities), were used by the trusts to purchase junior subordinated deferrable interest debentures (the junior subordinated debentures) issued by the Corporation. The sole assets of the trusts consisted of the junior subordinated debentures of the Corporation and the related accrued interest receivable. These trusts are not consolidated by the Corporation under the provisions of FIN No. 46(R).

The junior subordinated debentures are included by the Corporation as notes payable in the consolidated statements of condition, while the common securities issued by the issuer trusts are included as other investment securities. The common securities of each trust are wholly-owned, or indirectly wholly-owned, by the Corporation.

Financial data pertaining to the trusts follows:

(In thousands, including reference notes)

Issuer	BanPonce Trust I	Popular Capital Trust I	Popular North America Capital Trust I	Popular Capital Trust II
Issuance date	February 1997	October 2003	September 2004	November 2004
Capital securities	$ 144,000	$ 300,000	$ 250,000	$ 130,000
Distribution rate	8.327%	6.700%	6.564%	6.125%
Common securities	$ 4,640	$ 9,279	$ 7,732	$ 4,021
Junior subordinated debentures aggregate liquidation amount	$ 148,640	$ 309,279	$ 257,732	$ 134,021
Stated maturity date	February 2027	November 2033	September 2034	December 2034
Reference notes	(a),(c),(e),(f),(g)	(b),(d),(f)	(a),(c),(f)	(b),(d),(f)

(a)

Statutory business trust that is wholly-owned by Popular North America (PNA) and indirectly wholly-owned by the Corporation.

(b) Statutory business trust that is wholly-owned by the Corporation.

(c) The obligations of PNA under the junior subordinated debentures and its guarantees of the capital securities under the trust are fully and unconditionally guaranteed on a subordinated basis by the Corporation to the extent set forth in the applicable guarantee agreement.

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(d) These capital securities are fully and unconditionally guaranteed on a subordinated basis by the Corporation to the extent set forth in the applicable guarantee agreement.

(e) The original issuance was for $150,000. In 2003, the Corporation reacquired $6,000 of the 8.327% capital securities.

(f) The Corporation has the right, subject to any required prior approval from the Federal Reserve, to redeem after certain dates or upon the occurrence of certain events mentioned below, the junior subordinated debentures at a redemption price equal to 100% of the principal amount, plus accrued and unpaid interest to the date of redemption. The maturity of the junior subordinated debentures may be shortened at the option of the Corporation prior to their stated maturity dates (i) on or after the stated optional redemption dates stipulated in the agreements, in whole at any time or in part from time to time, or (ii) in whole, but not in part, at any time within 90 days following the occurrence and during the continuation of a tax event, an investment company event or a capital treatment event as set forth in the indentures relating to the capital securities, in each case subject to regulatory approval. A capital treatment event would include a change in the regulatory capital treatment of the capital securities as a result of the recent accounting changes affecting the criteria for consolidation of variable interest entities such as the trust under FIN 46(R).

(g) Same as (f) above, except that the investment company event does not apply for early redemption.

The capital securities of Popular Capital Trust I and Popular Capital Trust II are traded on the NASDAQ under the symbols BPOPN and BPOPM , respectively.
Under the Federal Reserve Board s risk-based capital guidelines, the capital securities are included as part of the Corporation s Tier I capital.

Note 18 Stockholders Equity

During the fourth quarter of 2005, existing shareholders of record of the Corporation s common stock at November 7, 2005 fully subscribed to an offering of 10,500,000 newly issued shares of Popular, Inc. s common stock at a price of $21.00 per share under a subscription rights offering. This offering resulted in approximately $216 million in additional capital, of which approximately $175 million impacted stockholders equity at December 31, 2005 and the remainder impacted the Corporation s financial condition in the first quarter of 2006. As of December 31, 2005, this subscription rights offering resulted in 8,614,620 newly issued shares of common stock; the remaining 1,885,380 were issued during the first quarter of 2006.
The Corporation has a dividend reinvestment and stock purchase plan under which stockholders may reinvest their quarterly dividends in shares of common stock at a 5% discount from the average market price at the time of issuance, as well as purchase shares of common stock directly from the Corporation by making optional cash payments at prevailing market prices.
The Corporation s authorized preferred stock may be issued in one or more series, and the shares of each series shall have such rights and preferences as shall be fixed by the Board of Directors when authorizing the issuance of that particular series. The Corporation s only outstanding class of preferred stock is its 6.375% noncumulative monthly income preferred stock, 2003 Series A. These shares of preferred stock are perpetual, nonconvertible and are redeemable solely at the option of the Corporation beginning on March 31, 2008. The redemption price per share is $25.50 from March 31, 2008 through March 30, 2009, $25.25 from March 31, 2009 through March 30, 2010 and $25.00 from March 31, 2010 and thereafter.
The Banking Act of the Commonwealth of Puerto Rico requires that a minimum of 10% of BPPR s net income for the year be transferred to a statutory reserve account until such statutory reserve equals the total of paid-in capital on common and preferred stock. Any losses incurred by a bank must first be charged to retained earnings and then to the reserve fund. Amounts credited to the reserve fund may not be used to pay dividends without the prior consent of the Puerto Rico Commissioner of Financial Institutions. The failure to maintain sufficient statutory reserves would preclude BPPR from paying dividends. BPPR s statutory reserve fund totaled $346 million at September 30, 2007 (December 31, 2006 $346 million; September 30, 2006 $317 million). During the nine months ended September 30,

2006, BPPR transferred $1 million to the statutory reserve account. There were no transfers between the statutory reserve account and the retained earnings account during the nine months ended September 30, 2007.

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Note 19 Earnings per Common Share

The computation of earnings per common share (EPS) follows:

(In thousands, except share information)	Quarter ended September 30, 2007	Quarter ended September 30, 2006	Nine months ended September 30, 2007	Nine months ended September 30, 2006
Net income	$ 36,003	$ 82,160	$ 229,600	$ 298,044
Less: Preferred stock dividends	2,979	2,979	8,935	8,935
Net income applicable to common stock	$ 33,024	$ 79,181	$ 220,665	$ 289,109
Average common shares outstanding	279,625,715	278,602,482	279,355,496	278,349,354
Average potential common shares		210,465	78,016	255,751
Average common shares outstanding assuming dilution	279,625,715	278,812,947	279,433,512	278,605,105
Basic and diluted EPS	$ 0.12	$ 0.28	$ 0.79	$ 1.04

Potential common shares consist of common stock issuable under the assumed exercise of stock options and under restricted stock awards using the treasury stock method. This method assumes that the potential common shares are issued and the proceeds from exercise, in addition to the amount of compensation cost attributed to future services, are used to purchase common stock at the exercise date. The difference between the number of potential shares issued and the shares purchased is added as incremental shares to the actual number of shares outstanding to compute diluted earnings per share. Stock options that result in lower potential shares issued than shares purchased under the treasury stock method are not included in the computation of dilutive earnings per share since their inclusion would have an antidilutive effect in earnings per share. For the quarter and nine-month period ended September 30, 2007, there were 3,099,617 and 2,209,290 weighted average antidilutive stock options outstanding, respectively (September 30, 2006 1,895,081 and 1,897,983).

Note 20 Supplemental Disclosure on the Consolidated Statements of Cash Flows

As mentioned in Note 1 of the Corporation s 2006 Annual Report, as of the end of the first quarter of 2006, all subsidiaries of the Corporation had changed the reporting period to a December 31st calendar period. The impact of this change corresponds to the financial results for the month of December 2005 for those subsidiaries which implemented the change in the first reporting period of 2006.

The following table reflects the effect in the Consolidated Statements of Cash Flows of the change in reporting period mentioned above.

(In thousands)	Nine months ended September 30, 2006
Net cash used in operating activities	($ 80,906)
Net cash used in investing activities	(104,732)
Net cash provided by financing activities	197,552

Net increase in cash and due from banks	$	11,914

Loans receivable transferred to other real estate and other property for the nine months ended September 30, 2007 amounted to $134 million and $27 million, respectively (September 30, 2006 $92 million and $24 million, respectively).

During the nine months ended September 30, 2006, $613 million in non-conforming loans classified as held-in-portfolio were pooled into trading securities and subsequently sold. The cash inflow from this sale was reflected as operating activities in the consolidated statement of cash flows. In addition, the consolidated statements of cash flows exclude the effect of $1 billion and $519 million in non-cash reclassifications of loans held-for-sale securitized into trading securities for the nine months ended September 30, 2007 and 2006, respectively.

The Corporation recognized mortgage servicing rights of $26 million during the nine months ended September 30, 2007 as a result of the securitization and sale of mortgage loans with servicing retained (nine months ended September 30, 2006 $58 million).

Note 21 Segment Reporting

Commencing in the first quarter of 2007, the Corporation s corporate structure consists of three reportable segments Banco Popular de Puerto Rico, Popular North America and EVERTEC. Also, a corporate group has been defined to support the reportable segments.

Management determined the reportable segments based on the internal reporting used to evaluate performance and to assess where to allocate resources. The segments were determined based on the organizational structure, which focuses primarily on the markets the segments serve, as well as on the products and services offered by the segments.

As indicated in the 2006 Annual Report, in January 2007, the Corporation announced a restructuring and integration plan (the Restructuring Plan) for PFH s businesses. The Restructuring Plan, which is being implemented throughout 2007, has the following four basic components:

- o exiting the wholesale subprime mortgage origination business during the first quarter of 2007, which entailed shutting down the wholesale broker, retail and call center business divisions;

- o consolidating support activities at PFH (Finance, Credit Risk, Compliance, Human Resources, Facilities) within BPNA to reduce expenses;

- o integrating PFH s existing commercial lending businesses (mortgage warehouse, mixed use, and construction lending) into BPNA s business lending groups; and

- o focusing on the core Equity One network of 132 consumer finance branches in 15 states.

As part of the Restructuring Plan, the Corporation also executed an internal corporate reorganization of its U.S. subsidiaries. In January 2007, E-LOAN, as well as all of its direct and indirect subsidiaries, with the exception of E-LOAN Insurance Services, Inc. and E-LOAN International, Inc., became operating subsidiaries of BPNA. Prior to the consummation of this U.S. reorganization, E-LOAN was a direct wholly-owned subsidiary of PFH. E-LOAN continues to offer its broad range of products and conducts its direct activities through its online platform. Management will be leveraging the E-LOAN brand, technology and internet financial services platform over the next several years to complement BPNA s community banking growth strategy.

This reorganization and the Restructuring Plan led management to redefine its business reportable segments. Commencing in 2007, the U.S. operations are defined as one reportable segment defined as Popular North America . This segment includes the operations of BPNA and PFH, including all of its wholly-owned subsidiaries.

The reportable segment disclosures for periods prior to 2007 were restated to reflect the new segmentation.

<u>Banco Popular de Puerto Rico:</u>

Given that Banco Popular de Puerto Rico constitutes a significant portion of the Corporation s net income and total assets as of September 30, 2007, additional disclosures are provided for the business areas included in this reportable segment, as described below:

Commercial banking represents the Corporation s banking operations conducted at BPPR, which are targeted mainly to corporate, small and middle size businesses. It includes aspects of the lending and depository businesses, as well as other finance and advisory services. BPPR allocates funds across segments based on duration matched transfer pricing at market rates. This area also incorporates income related with the investment of excess funds as well as a proportionate share of the investment function of BPPR.

Consumer and retail banking represents the branch banking operations of BPPR which focus on retail clients. It includes the consumer lending business operations of BPPR, as well as the lending operations of

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Popular Auto, Popular Finance, and Popular Mortgage. These three subsidiaries focus respectively on auto and lease financing, small personal loans and mortgage loan originations. This area also incorporates income related with the investment of excess funds from the branch network, as well as a proportionate share of the investment function of BPPR.

Other financial services include the trust and asset management service units of BPPR, the brokerage and investment banking operations of Popular Securities, and the insurance agency and reinsurance businesses of Popular Insurance, Popular Insurance V.I. and Popular Life Re. Most of the services that are provided by these subsidiaries generate profits based on fee income.

Popular North America:

Popular North America, which includes the Corporation s U.S. operations, consists of:

BPNA, including its subsidiaries E-LOAN, Popular Leasing, U.S.A. (name being changed to Popular Equipment Finance, Inc.) and Popular Insurance Agency, U.S.A. BPNA operates through a branch network of over 135 branches in 6 states, while E-LOAN provides online consumer direct lending and supports BPNA s deposit gathering through its online platform. Popular Insurance Agency, U.S.A. offers investment and insurance services across the BPNA branch network. Popular Equipment Finance, Inc. provides mainly small to mid-ticket commercial and medical equipment financing. The U.S. operations also include the mortgage business unit of Banco Popular, National Association.

PFH, which activities are described above.

All of Popular s U.S. operations now report to the same president. The PNA segment is disaggregated for additional disclosures between BPNA and PFH. The results of E-LOAN are included as part of BPNA for the quarters ended September 30, 2007 and 2006. PNA Holding Company only is included as part of the Corporate group.

EVERTEC:

This reportable segment includes the financial transaction processing and technology functions of the Corporation, including EVERTEC with offices in Puerto Rico, Florida, the Dominican Republic and Venezuela; EVERTEC USA, Inc. incorporated in the United States; and ATH Costa Rica, S.A., EVERTEC Centroamérica S.A. and T.I.I. Smart Solutions Inc. located in Costa Rica. In addition, this reportable segment includes the equity investments in CONTADO and Servicios Financieros, S.A. de C.V. (Serfinsa), which operate in the Dominican Republic and El Salvador, respectively. This segment provides processing and technology services to other units of the Corporation as well as to third parties, principally other financial institutions in Puerto Rico, the Caribbean and Central America.

Corporate:

The Corporate group consists primarily of the holding companies: Popular, Inc., Popular North America and Popular International Bank, excluding the equity investments in CONTADO and Serfinsa, which due to the nature of their operations, are included as part of the processing segment. The holding companies obtain funding in the capital markets to finance the Corporation s growth, including acquisitions. The Corporate group also includes the expenses of the four administrative corporate areas that are identified as critical for the organization: Finance, Risk Management, Legal and People, Communications and Planning. These corporate administrative areas have the responsibility of establishing policy, setting up controls and coordinating the activities of their corresponding groups in each of the business circles.

The Corporation may periodically reclassify business segment results based on modifications to its management reporting and profitability measurement methodologies and changes in organizational alignment. The accounting policies of the individual operating segments are the same as those of the Corporation described in Note 1. Transactions between operating segments are primarily conducted at market rates, resulting in profits that are eliminated for reporting consolidated results of operations.

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2007
For the quarter ended September 30, 2007

(In thousands)	Banco Popular de Puerto Rico	Popular North America	EVERTEC	Intersegment Eliminations	Total Reportable Segments
Net interest income (expense)	$ 241,725	$ 122,467	($ 74)		$ 364,118
Provision for loan losses	66,077	82,016			148,093
Non-interest income	116,522	25,948	59,585	($ 34,840)	167,215
Amortization of intangibles	190	1,810	234		2,234
Depreciation expense	10,290	4,678	4,035	(19)	18,984
Other operating expenses	172,267	134,310	43,157	(34,696)	315,038
Income tax	29,247	(29,700)	3,987	(48)	3,486
Net income (loss)	$ 80,176	($ 44,699)	$ 8,098	($ 77)	$ 43,498
Segment Assets	$26,137,863	$21,153,471	$224,834	($508,032)	$47,008,136

For the quarter ended September 30, 2007

(In thousands)	Total Reportable Segments	Corporate	Eliminations	Total Popular, Inc.
Net interest income (expense)	$ 364,118	($ 4,300)	$ 298	$ 360,116
Provision for loan losses	148,093			148,093
Non-interest income	167,215	945	(1,155)	167,005
Amortization of intangibles	2,234			2,234
Depreciation expense	18,984	601		19,585
Other operating expenses	315,038	11,670	(1,554)	325,154
Income tax	3,486	(7,709)	275	(3,948)
Net income (loss)	$ 43,498	($ 7,917)	$ 422	$ 36,003
Segment Assets	$ 47,008,136	$ 6,550,633	($ 6,278,638)	$ 47,280,131

For the nine months ended September 30, 2007

(In thousands)	Banco Popular de Puerto Rico	Popular North America	EVERTEC	Intersegment Eliminations	Total Reportable Segments

Net interest income (expense)	$ 711,103	$ 394,138	($ 547)		$ 1,104,694
Provision for loan losses	176,557	183,042			359,599
Non-interest income	358,364	64,783	179,060	($ 103,974)	498,233
Amortization of intangibles	1,508	5,821	701		8,030
Depreciation expense	31,455	14,020	12,355	(55)	57,775
Other operating expenses	525,259	427,777	131,782	(103,892)	980,926
Income tax	87,629	(64,016)	11,736	(10)	35,339
Net income (loss)	$ 247,059	($ 107,723)	$ 21,939	($ 17)	$ 161,258

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For the nine months ended September 30, 2007

(In thousands)	Total Reportable Segments	Corporate	Eliminations	Total Popular, Inc.
Net interest income (expense)	$1,104,694	($ 19,076)	$ 897	$1,086,515
Provision for loan losses	359,599	7		359,606
Non-interest income	498,233	128,994	(4,671)	622,556
Amortization of intangibles	8,030			8,030
Depreciation expense	57,775	1,783		59,558
Other operating expenses	980,926	39,831	(4,991)	1,015,766
Income tax	35,339	677	495	36,511
Net income	$ 161,258	$ 67,620	$ 722	$ 229,600

2006
For the quarter ended September 30, 2006

(In thousands)	Banco Popular de Puerto Rico	Popular North America	EVERTEC	Intersegment Eliminations	Total Reportable Segments
Net interest income (expense)	$ 227,245	$ 124,659	($ 501)		$ 351,403
Provision for loan losses	31,930	31,515			63,445
Non-interest income	101,827	69,166	57,481	($ 33,264)	195,210
Amortization of intangibles	634	2,851	123		3,608
Depreciation expense	10,871	5,687	4,173	(18)	20,713
Other operating expenses	169,356	149,275	40,793	(33,277)	326,147
Income tax	28,342	2,663	4,168	12	35,185
Net income	$ 87,939	$ 1,834	$ 7,723	$ 19	$ 97,515
Segment Assets	$25,124,056	$21,029,460	$217,658	($121,252)	$46,249,922

For the quarter ended September 30, 2006

(In thousands)	Total Reportable Segments	Corporate	Eliminations	Total Popular, Inc.
Net interest income (expense)	$ 351,403	($ 9,664)	$ 299	$ 342,038
Provision for loan losses	63,445			63,445
Non-interest income (loss)	195,210	(1,571)	(2,290)	191,349
Amortization of intangibles	3,608			3,608
Depreciation expense	20,713	586		21,299
Other operating expenses	326,147	11,481	(2,612)	335,016

Income tax	35,185	(7,575)	249	27,859
Net income (loss)	$ 97,515	($ 15,727)	$ 372	$ 82,160
Segment Assets	$46,249,922	$6,579,170	($5,894,342)	$46,934,750

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For the nine months ended September 30, 2006

(In thousands)	Banco Popular de Puerto Rico	Popular North America	EVERTEC	Intersegment Eliminations	Total Reportable Segments
Net interest income (expense)	$ 682,046	$416,321	($ 1,568)		$1,096,799
Provision for loan losses	89,395	90,093			179,488
Non-interest income	318,551	189,874	169,523	($ 103,731)	574,217
Amortization of intangibles	1,900	6,915	345		9,160
Depreciation expense	32,915	16,812	12,411	(57)	62,081
Other operating expenses	508,032	451,496	126,515	(103,772)	982,271
Impact of change in fiscal period	(2,072)	6,181			4,109
Income tax	92,066	14,397	10,441	38	116,942
Net income	$ 278,361	$ 20,301	$ 18,243	$ 60	$ 316,965

For the nine months ended September 30, 2006

(In thousands)	Total Reportable Segments	Corporate	Eliminations	Total Popular, Inc.
Net interest income (expense)	$1,096,799	($ 30,047)	$ 829	$1,067,581
Provision for loan losses	179,488			179,488
Non-interest income	574,217	33,260	(3,309)	604,168
Amortization of intangibles	9,160			9,160
Depreciation expense	62,081	1,724		63,805
Other operating expenses	982,271	44,229	(3,049)	1,023,451
Impact of change in fiscal period	4,109	3,495	2,137	9,741
Income tax	116,942	(28,176)	(706)	88,060
Net income (loss)	$ 316,965	($ 18,059)	($ 862)	$ 298,044

During the nine months ended September 30, 2007, the holding companies realized net gains on sale and valuation adjustments of investment securities (before tax) of approximately $107.3 million, compared with $14.2 million for the nine months ended September 30, 2006. These net gains are included in non-interest income within the Corporate group.

Additional disclosures with respect to the Banco Popular de Puerto Rico reportable segment are as follows:

2007

For the quarter ended September 30, 2007

(In thousands)	Commercial Banking	Consumer and Retail Banking	Other Financial Services	Eliminations	Total Banco Popular de Puerto Rico

Net interest income	$ 95,607	$ 143,108	$ 2,842	$ 168	$ 241,725
Provision for loan losses	21,248	44,829			66,077
Non-interest income	22,200	70,807	23,633	(118)	116,522
Amortization of intangibles	30	47	113		190
Depreciation expense	3,563	6,395	332		10,290
Other operating expenses	42,556	113,365	16,424	(78)	172,267
Income tax	14,728	11,061	3,403	55	29,247
Net income	$ 35,682	$ 38,218	$ 6,203	$ 73	$ 80,176
Segment Assets	$11,729,908	$18,651,108	$508,838	($4,751,991)	$26,137,863

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For the nine months ended September 30, 2007

(In thousands)	Commercial Banking	Consumer and Retail Banking	Other Financial Services	Eliminations	Total Banco Popular de Puerto Rico
Net interest income	$279,789	$422,844	$ 8,022	$ 448	$711,103
Provision for loan losses	57,070	119,487			176,557
Non-interest income	67,307	225,382	66,440	(765)	358,364
Amortization of intangibles	470	705	333		1,508
Depreciation expense	10,941	19,609	905		31,455
Other operating expenses	130,909	345,292	49,315	(257)	525,259
Income tax	42,128	37,783	7,731	(13)	87,629
Net income	$105,578	$125,350	$ 16,178	($ 47)	$247,059

2006

For the quarter ended September 30, 2006

(In thousands)	Commercial Banking	Consumer and Retail Banking	Other Financial Services	Eliminations	Total Banco Popular de Puerto Rico
Net interest income	$ 86,563	$ 137,998	$ 2,640	$ 44	$ 227,245
Provision for loan losses	9,007	22,923			31,930
Non-interest income	26,589	48,961	26,596	(319)	101,827
Amortization of intangibles	220	335	79		634
Depreciation expense	3,599	6,967	305		10,871
Other operating expenses	43,105	109,965	16,421	(135)	169,356
Income tax	17,944	5,733	4,685	(20)	28,342
Net income	$ 39,277	$ 41,036	$ 7,746	($ 120)	$ 87,939
Segment Assets	$10,821,963	$17,798,620	$564,088	($4,060,615)	$25,124,056

For the nine months ended September 30, 2006

(In thousands)	Commercial Banking	Consumer and Retail Banking	Other Financial Services	Eliminations	Total Banco Popular de Puerto Rico

Net interest income		$252,786	$421,234	$7,695	$;"> 139,357	128,236	111,823
	Less net income attributable to noncontrolling interests	1,880	1,927	4,616			
Net income attributable to Bally Technologies, Inc.		$ 137,477	$ 126,309	$ 107,207			
Basic earnings per share attributable to Bally Technologies, Inc.:							
	Income from continuing operations	$ 2.00	$ 2.19	$ 1.78			
	Discontinued operations	0.11	0.13	0.19			
	Gain on sale of discontinued operations	0.41					
Basic earnings per share		$ 2.52	$ 2.32	$ 1.97			
Diluted earnings per share attributable to Bally Technologies, Inc.:							
	Income from continuing operations	$ 1.89	$ 2.10	$ 1.67			
	Discontinued operations	0.11	0.12	0.18			
	Gain on sale of discontinued operations	0.38					
Diluted earnings per share		$ 2.38	$ 2.22	$ 1.85			
Weighted average shares outstanding:							
	Basic	54,576	54,449	54,428			
	Diluted	57,675	57,058	58,157			
Amounts attributable to Bally Technologies, Inc.:							
	Income from continuing operations, net of tax	$ 109,223	$ 119,439	$ 96,972			
	Income from discontinued operations, net of tax	6,175	6,870	10,235			
	Gain on sale of discontinued operations, net of tax	22,079					
	Net income	$ 137,477	$ 126,309	$ 107,207			

(1) Cost of gaming equipment and systems exclude amortization related to certain intangibles, including core technology and license rights, which are included in depreciation and amortization.

See accompanying notes to consolidated financial statements.

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

FOR THE THREE YEARS ENDED JUNE 30, 2010

	Common Stock Shares	Common Stock Dollars	Series E Special Stock	Treasury Stock	Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss) ("OCI")	Retained Earnings	Noncontrolling Interests	Total Stockholders' Equity
					(in 000s)				
Balances at June 30, 2007	54,612	$ 5,455	$ 12	$ (1,894)	$ 253,809	$ 1,119	$ (59,047)	$ 948	$ 200,402
Net income from continuing operations, net of tax							96,972	2,731	99,703
Net income from discontinued operations, net of tax							10,235	1,885	12,120
Foreign currency translation adjustment						149			149
Total comprehensive income									$ 111,972
Distributions to noncontrolling interests								(3,782)	(3,782)
Cumulative effect of adoption of ASC Topic 740							(8,846)		(8,846)
Issuance and receipt of restricted stock, ESPP shares, stock options and related tax and tax benefit	1,706	171		(38)	35,320				35,453
Purchase of common stock for treasury				(23,109)					(23,109)
Share-based compensation					13,017				13,017
Balances at June 30, 2008	56,318	$ 5,626	$ 12	$ (25,041)	$ 302,146	$ 1,268	$ 39,314	$ 1,782	$ 325,107
Net income from continuing operations, net of tax							119,439	740	120,179
Net income from discontinued operations, net of tax							6,870	1,187	8,057
Foreign currency translation adjustment						(2,293)			(2,293)
Unrealized gain on derivative financial instruments, net of tax						255			255
Total comprehensive income									$ 126,198
Distributions to noncontrolling interests								(1,266)	(1,266)
Issuance and receipt of restricted stock, ESPP shares, stock options and related tax and tax benefit	773	77		(1,411)	11,914				10,580
Purchase of common stock for treasury				(38,275)					(38,275)
Share-based compensation					16,405				16,405
Balances at June 30, 2009	57,091	$ 5,703	$ 12	$ (64,727)	$ 330,465	$ (770)	$ 165,623	$ 2,443	$ 438,749
Net income from continuing operations, net of tax							109,223	874	110,097
Net income from discontinued operations, net of tax							6,175	1,006	7,181
Gain on sale of discontinued operations, net of tax							22,079		22,079
Foreign currency translation adjustment						(266)			(266)
Unrealized loss on derivative financial instruments, net of tax						(2,008)			(2,008)
Total comprehensive income									$ 137,083
Distributions to noncontrolling interests								(1,942)	(1,942)
Issuance and receipt of restricted stock, ESPP shares, stock options and related tax and tax benefit	2,364	236		(1,105)	48,462				47,593
Purchase of common stock for treasury				(91,221)					(91,221)
Shares issued upon exercise of warrants	40	4			(4)				
Share-based compensation					13,930				13,930
Balances at June 30, 2010	59,495	$ 5,943	$ 12	$ (157,053)	$ 392,853	$ (3,044)	$ 303,100	$ 2,381	$ 544,192

See accompanying notes to consolidated financial statements.

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE THREE YEARS ENDED JUNE 30, 2010

	2010	2009	2008
		(in 000s)	
Cash flows from operating activities:			
Net income	$ 139,357	$ 128,236	$ 111,823
Adjustments to net income to net cash provided by operating activities:			
Income from discontinued operations, net of tax	(7,181)	(8,057)	(12,120)
Gain on sale of discontinued operations, net of tax	(22,079)		
Depreciation and amortization	73,900	68,772	58,978
Impairment charges	11,379		
Share-based compensation	13,793	16,259	12,876
Amortization of deferred debt issuance costs	2,984	2,108	
Income tax (benefit) expense	(19,927)	28,602	1,752
Provision for doubtful accounts	2,927	(42)	5,234
Write-off of debt issuance costs		786	
Inventory write-downs	2,025	4,536	9,238
Excess tax benefit of stock option exercises	(15,355)	(270)	(12,341)
Other	(1,089)	1,945	3,176
Change in operating assets and liabilities:			
Accounts and notes receivable	(49,816)	41,180	(48,880)
Inventories	(36,553)	5,638	(92,673)
Prepaid and refundable income tax and income tax payable	48,026	(31,098)	(9,452)
Other current assets	3,890	5,628	(7,519)
Accounts payable	3,763	(26,826)	358
Accrued liabilities, customer deposits and jackpot liabilities	(3,437)	(38,748)	10,298
Deferred revenue and deferred cost of revenue	(17,482)	(45,341)	25,527
Net cash provided by operating activities	129,125	153,308	56,275
Cash flows from investing activities:			
Capital expenditures	(11,611)	(27,555)	(14,981)
Restricted cash and investments	(205)	4,110	4,076
Financing arrangements with customers	(15,750)		
Additions to other long-term assets	(4,758)	(5,521)	(12,326)
Net cash used in investing activities	(32,324)	(28,966)	(23,231)
Cash flows from financing activities:			
Proceeds from revolving credit facility		25,000	
Payments on revolving credit facility		(75,000)	
Capitalized debt issuance costs	(2,906)	(10,728)	
Pay-off of debt from refinancing		(14,553)	
Reduction of long-term debt and capital leases	(35,337)	(27,961)	(28,150)
Distributions to noncontrolling interests	(675)	105	(1,851)
Purchase of treasury stock	(92,326)	(39,686)	(23,147)
Excess tax benefit of stock option exercises	15,355	270	12,341
Proceeds from exercise of stock options and employee stock purchases	31,968	11,303	21,798
Net cash used in financing activities	(83,921)	(131,250)	(19,009)
Effect of exchange rate changes on cash	(396)	(71)	1,159
Net cash provided by (used in) operating activities of discontinued operations	(9,483)	8,868	15,645

Net cash provided by (used in) investing activities of discontinued operations	78,757	(6,756)	(3,211)
Net cash used in financing activities of discontinued operations	(1,267)	(1,371)	(1,930)
Decrease in cash and cash equivalents of discontinued operations	8,712	2,133	15
	76,719	2,874	10,519
Cash and cash equivalents:			
Increase (decrease) for year	89,203	(4,105)	25,713
Balance, beginning of year	55,886	59,991	34,278
Balance, end of year	$ 145,089	$ 55,886	$ 59,991

See accompanying notes to consolidated financial statements.

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

FOR THE THREE YEARS ENDED JUNE 30, 2010

The following supplemental information is related to the consolidated statements of cash flows:

	Year Ended June 30,		
	2010	2009	2008
		(in 000s)	
Cash paid for interest	$ 12,982	$ 23,824	$ 27,899
Cash paid for income taxes	42,306	64,957	66,879
Non-cash investing and financing transactions:			
Pay-off of debt from refinancing	$	$ 275,000	$
Transfer of inventory to leased gaming equipment(1)	51,952	43,938	79,140
Reclassify property, plant and equipment to inventory(1)	8,931	12,869	9,471
Acquisition of Bally trademark	7,500		
Accrual of core technology investments			5,625

(1) As a result of the inability to separately identify the cash flows associated with the construction of leased gaming equipment, the Company has included all additions to leased gaming equipment as an increase in inventory under cash used in operating activities in the consolidated statement of cash flows. In addition, cash generated from the sale of used gaming equipment classified as leased gaming equipment is also included in cash provided by operating activities in the consolidated statement of cash flows. The Company has one process to procure raw materials for the assembly of both inventory and leased gaming equipment. The materials requisition planning process considers the number of devices the Company expects to build for sale and for use in its gaming operations division during a particular period, but it does not separately earmark purchases for leased gaming equipment. Without such an earmarking process, the Company is unable to determine whether the parts used to construct leased gaming equipment during a particular period came from inventory on hand at the beginning of the period or was constructed from inventory procured during the period of deployment, thus requiring the expenditure of cash.

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. DESCRIPTION OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Bally Technologies, Inc. ("Bally" or the "Company"), a Nevada corporation, is a diversified, worldwide gaming company that innovates, designs, manufactures, operates and distributes advanced technology-based gaming devices, systems and server-based solutions. As a global gaming-systems provider, the Company offers technology solutions which provide gaming operators with a wide range of marketing, data management and analysis, accounting, player tracking, security and other software applications and tools to more effectively manage their operations. The Company's primary hardware technologies include spinning-reel and video gaming devices, specialty gaming devices and wide-area progressive systems for traditional land-based, riverboat and Native American casinos, video lottery and central determination markets and specialized system-based hardware products. In addition to selling its gaming devices, the Company also offers its customers a wide range of rental options.

Principles of presentation and consolidation

The accompanying consolidated financial statements include the accounts of Bally Technologies, Inc., and its wholly owned and partially owned subsidiaries and have been prepared in accordance with accounting principles generally accepted in the United States of America and, pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC"), include all adjustments necessary to fairly present the Company's consolidated financial position, results of operations and cash flows for each period presented.

All intercompany accounts and transactions have been eliminated in consolidation.

Discontinued Operations

The Company was the general partner of Rainbow Casino Vicksburg Partnership ("RCVP"), which operated the Rainbow Casino, a dockside riverboat casino in Vicksburg, Mississippi. On April 5, 2010, the Company entered into a definitive purchase agreement to sell the Rainbow Casino which closed on June 8, 2010. Under the terms of the agreement, the Company was paid approximately $80.0 million in an all-cash transaction. The sale of Rainbow resulted in a gain of $22.1 million, net of tax. The Company's Casino Operations have been classified as discontinued operations in the accompanying financial statements. See Note 3 to consolidated financial statements, *Assets Held For Sale and Discontinued Operations*.

Expense classification

The classification of certain costs within the Consolidated Statement of Operations for the years ended June 30, 2009 and 2008 has been corrected to conform to the current year presentation. The reclassification reflects certain costs of services associated with revenue presented in *Cost of gaming equipment and systems* of $4.8 million and $5.5 million for the years ended June 30, 2009 and 2008, respectively, that had previously been presented as a component of *Selling, general and administrative expenses*. This correction was not material to the previously issued financial statements and did not have any impact on income from continuing operations, earnings per share, retained earnings, or cash flows.

Use of estimates

The preparation of the consolidated 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

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Fair value of financial instruments

The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced sale or liquidation. The carrying amounts reflected in the accompanying consolidated balance sheets for cash equivalents, accounts and notes receivable, investment securities to fund jackpot liabilities, accounts payable, jackpot liabilities and long-term debt approximate their respective fair values.

All financial assets and liabilities are recognized or disclosed at fair value using a fair value hierarchy that maximizes the use of observable inputs and minimizes the use of unobservable inputs when measuring fair value. A financial instrument's categorization within the fair value hierarchy is based upon the lowest level of input that is significant to the fair value measurement. There are three levels of inputs that may be used to measure fair value:

Level 1: quoted prices in active markets for identical assets or liabilities;

Level 2: inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices in active markets for similar assets or liabilities, quoted prices for identical or similar assets or liabilities in markets that are not active, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities; or

Level 3: unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The Company's only significant financial asset or liability measured at fair value on a recurring basis, excluding accrued interest components, consisted of a cash flow hedge related to a variable rate debt instrument as of June 30, 2010 and 2009 (which is included in accrued and other liabilities and other current assets, respectively, in the consolidated balance sheets):

	Fair Value Measurements Using Input Type		
	Level 1	**Level 2**	**Total**
		(in 000s)	
As of June 30, 2010:			
Liability:			
Derivative financial instrument	$	$ 2,698	$
As of June 30, 2009:			
Assets:			
Derivative financial instrument asset	$	$ 255	$

The valuation techniques used to measure the fair value of the derivative financial instrument above in which the counterparties have high credit ratings, were derived from pricing models, such as discounted cash flow techniques, with all significant inputs derived from or corroborated by observable market data. The Company's discounted cash flow techniques use observable market inputs, such as LIBOR-based yield curves. See Note 9 to consolidated financial statements, *Long-Term Debt*.

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Accounting for Derivative Instruments and Hedging Activity

The Company assesses, both at the inception of each hedge and on an on-going basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in cash flows of the hedged items. Such highly effective derivatives are granted hedge accounting treatment. The derivative financial instrument meets these requirements and is accounted for as a cash flow hedge.

The impact of the cash flow hedge on the consolidated financial statements is depicted below:

Cash Flow Hedging Relationship	Amount of Gain (Loss) Recognized in OCI on Derivative (Effective Portion)	Location of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	Amount of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)
		(in 000s)	
For the year ended June 30, 2010:			
Interest rate swap agreement	$ (5,978)	Interest expense	$ (3,024)
For the year ended June 30, 2009:			
Interest rate swap agreement	$ (341)	Interest expense	$ (596)

Cash and cash equivalents

Cash and cash equivalents consist of highly liquid debt instruments purchased with an original maturity of three months or less at the date of purchase and are carried at cost, which approximates fair value.

Restricted cash

The Company maintains jackpot funds totaling approximately $8.3 million and $9.1 million at June 30, 2010 and 2009, respectively, to ensure availability of funds to pay wide-area progressive jackpot awards.

Accounts and notes receivable and allowance for doubtful accounts

Accounts and notes receivable are stated at face value less an allowance for doubtful accounts. The Company evaluates its receivables and establishes an allowance for doubtful accounts based on a combination of factors including, but not limited to, historical customer collection experience, economic conditions, and customers' financial condition.

The Company grants customers credit terms for periods of 30 to 120 days or may grant extended credit terms to some customers for periods up to three years, with interest at prevailing rates, which are generally collateralized by the related equipment sold, although the value of such equipment, if repossessed, may be less than the receivable balance outstanding.

The Company also provides development financing loans to select customers to assist in funding new or expanding gaming opportunities, generally under terms of three to five years with interest recognized at prevailing rates. Certain agreements may also include provisions for the facility to reserve a percentage of its total gaming footprint for the placement of the Company's gaming devices.

The fair value of accounts and notes receivable, net, is estimated by discounting expected future cash flows using current interest rates at which similar loans would be made to borrowers, with similar credit ratings and remaining maturities. As of June 30, 2010 and 2009, respectively, the fair value of the accounts and notes receivable, net, approximate the carrying value.

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Inventories

Inventories are stated at the lower of cost, determined on a first in, first out basis, or market. Cost elements included in work-in-process and finished goods include raw materials, direct labor and manufacturing overhead. Inventories consist of the following:

	June 30,	
	2010	2009
	(in 000s)	
Raw materials	$ 34,221	$ 40,662
Work-in-process	1,101	1,432
Finished goods	7,484	10,793
Total	$ 42,806	$ 52,887

The Company regularly reviews inventory quantities and updates estimates for the net realizable value of inventories. This process includes examining the carrying values of new and used gaming devices, parts and ancillary equipment in comparison to the current fair market values for such equipment (less costs to sell or dispose). Some of the factors involved in this analysis include the overall levels of inventories, current and projected sales levels and markets for such products, the costs required to sell the products, including refurbishment costs and importation costs for international shipments, and the overall projected demand for products once the next generation of products are scheduled for release.

The Company recorded inventory write-downs totaling approximately $2.0 million, $4.5 million and $9.2 million during the years ended June 30, 2010, 2009 and 2008, respectively. These charges are classified in cost of gaming equipment and systems in the consolidated statements of operations.

Hurricane damage insurance recoveries

During fiscal 2009, the Company negotiated an insurance settlement related to the 2005 U.S. Gulf Coast hurricane damages which destroyed or temporarily shut down certain gaming operations in the Gulf Coast region. The Company received a final payment of $3.0 million for business interruption, which was included in selling, general and administrative expenses.

Deferred revenue and deferred cost of revenue

Deferred revenue arises from the timing differences between the shipment or installation of gaming equipment and systems products and the satisfaction of all revenue recognition criteria consistent with the Company's revenue recognition policy. Deferred cost of revenue consists of the direct costs associated with the manufacture of gaming equipment and systems products for which revenue has been deferred. Deferred revenue and deferred cost of revenue that are expected to be realized within one year are classified as current liabilities and current assets, respectively.

Restricted long-term investments

The Company purchases U.S. Treasury Strip Securities for the benefit of jackpot winners who elect to receive annual or weekly installment payments. These securities are held to maturity and recorded at cost plus interest accretion to date. Such securities are included in restricted long-term investments in the consolidated balance sheets, and totaled $13.1 million and $12.1 million as of June 30, 2010 and 2009, respectively.

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Property, plant and equipment and leased gaming equipment

Property, plant and equipment is stated at cost and depreciated over the estimated useful lives or lease term, if less, using the straight line method as follows: buildings and improvements, ten to forty years; furniture, fixtures and equipment, three to seven years; and leasehold improvements, the shorter of lease term or ten years. Leased gaming equipment is stated at cost and depreciated over the estimated useful lives ranging from two to three and one-half years. Depreciation and asset charges related to leased gaming equipment are recorded to cost of gaming operations in the consolidated statements of operations. Equipment under capital leases is recorded at the lower of the present value of the minimum lease payments or the fair value of the assets.

Significant replacements and improvements are capitalized while other maintenance and repairs are expensed. The cost and accumulated depreciation of assets retired or otherwise disposed of are eliminated from the accounts and any resulting gain or loss is credited or charged to income.

Depreciation and amortization expense

For the years ended June 30, 2010, 2009 and 2008, depreciation and amortization expense from continuing operations totaled $73.9 million, $68.8 million and $59.0 million, respectively. Of these amounts, $54.5 million, $49.8 million and $42.8 million of depreciation and amortization expense were included in cost of gaming operations in the consolidated statements of operations. Depreciation expense from leased gaming equipment under capital leases totaled $-0- million, $2.1 million and $2.8 million for the years ended June 30, 2010, 2009 and 2008, respectively.

For the years ended June 30, 2010, 2009 and 2008, depreciation and amortization expense from discontinued operations totaled $2.9 million, $3.3 million and $2.8 million, respectively.

Impairment of long-lived assets and goodwill

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of long-lived assets are measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset, undiscounted and without interest. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets.

The Company reviews goodwill for impairment annually at the beginning of its fourth fiscal quarter, or whenever events or circumstances indicate the carrying value may not be recoverable or warrant a revision to the estimated remaining useful life. The Company performs the impairment analysis of goodwill at a reporting unit level by comparing the fair value of a reporting unit with its carrying value, including goodwill. If the fair value is less than the carrying value, the impairment to be recognized is measured by the amount by which the carrying amount of the goodwill exceeds the fair value of the reporting unit goodwill.

During the year ended June 30, 2010, impairment charges of $5.9 million related to long-lived assets were recorded (see Note 4 to the consolidated financial statements, *Impairment Charges)*. During the years ended June 30, 2009 and 2008, no impairment charges related to long-lived assets were recorded.

During the years ended June 30, 2010, 2009 and 2008, no impairment charges related to goodwill were recorded.

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Jackpot liabilities

The Company recognizes jackpot expense, included in cost of gaming operations in the consolidated statements of operations, and a liability for jackpots incurred but not yet won in each jurisdiction based on the discounted net present value of the progressive meter liability. Jackpots are payable either in weekly or annual installments, or immediately in the case of instant win progressive jackpots. Winners may elect to receive a single payment for the present value of a jackpot discounted at applicable interest rates in lieu of annual installments. Interest rates used in the single payment calculation vary by jurisdiction and are impacted by market forces and other economic conditions.

Revenue recognition

The Company derives its revenues from the following:

Gaming Equipment	Sale of gaming devices and related equipment, parts and conversion kits;
Gaming Operations	Operation of linked progressive systems, video lottery and centrally determined systems and the rental of gaming devices and content; and
Systems	Sale and support of specialized systems-based software and hardware products and related recurring hardware and software maintenance revenue.

Revenue is recognized when all of the following have been satisfied:

- Persuasive evidence of an arrangement exists;
- Delivery has occurred;
- The price or fee is fixed or determinable;
- Collectability is probable; and
- No significant contractual obligations remain.

Games placed with customers on a trial basis are not recognized as revenue until the trial period ends, or the customer accepts the games and collectability is probable. Amounts billed prior to completing the earnings process are deferred until revenue recognition criteria are met. Revenues are reported net of incentive rebates, discounts, sales taxes, and other taxes of a similar nature.

Gaming revenues from our discontinued casino operations were recognized as the net win from gaming machine and table game operations, which is the difference between currency deposited into the devices or placed at the table games and the payouts made to the players, less any coupons or other promotional allowances, if applicable.

Gaming operations revenue consists of the operation of linked progressive systems and from gaming devices, software content and the related systems placed in casinos on a daily fee or rental basis. Revenue from these sources is recognized based on the contractual terms of the arrangement and is generally based on a share of money wagered, a share of the net winnings, or on a fixed daily rental rate basis. The daily fee entitles the customer to full use of the gaming device and includes rental and maintenance of the gaming device, licensing of the game content and connection to our linked progressive system, where applicable. In certain markets, the Company also charges a daily system connection fee for the customer to connect to our central determination systems and/or back-office system. The Company does not consider these arrangements to have multiple revenue-generating

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

activities as the services offered are a comprehensive solution in exchange for a daily fee and all of the products and services are delivered contemporaneously.

Gaming equipment and systems revenue is generated from the sale of gaming devices and licenses of software, conversion kits, systems-based hardware, services, and the licensing of computerized monitoring systems and related software maintenance fees. The Company licenses its software on a perpetual basis or under time-based licenses. The Company's time-based licenses are generally for twelve month periods, and are bundled with software maintenance and product support fees. Software maintenance provides customers with rights to unspecified software product upgrades, maintenance and patches released during the term of the support period. The majority of the Company's customers purchase both software and hardware maintenance and product support when they license software. In addition, substantially all customers renew these maintenance agreements annually.

The Company sells or licenses its products and services individually or under arrangements in which there are multiple elements, such as a combination of gaming devices, system-based hardware, software license fees, maintenance and product support fees and professional services.

Effective July 1, 2009, the Company adopted new accounting guidance related to revenue recognition for multiple deliverable arrangements and certain revenue arrangements that include software elements. The Company elected to adopt this guidance prior to the required effective date using the prospective method. Accordingly, this guidance was applied to all new or materially modified revenue arrangements entered into since the start of the Company's fiscal year of adoption, which was July 1, 2009.

The guidance replaces and significantly changes the existing separation criteria for multiple-deliverable revenue arrangements by eliminating the criterion for objective and reliable evidence of fair value for the undelivered products or services to determine a unit of accounting. Instead, revenue arrangements with multiple deliverables should be allocated and recognized based on separate units of accounting if the deliverables meet both of the following criteria:

- The delivered items have value to the customer on a standalone basis. The item or items have value on a standalone basis if they are sold separately by any vendor or the customer could resell the delivered item(s) on a standalone basis; and

- If the arrangement includes a general right of return relative to the delivered items, delivery or performance of the undelivered items is considered probable and substantially in the control of the vendor.

The guidance also eliminates the use of the residual method of allocation and requires, instead, that arrangement consideration be allocated, at the inception of the arrangement, to all deliverables based on their relative selling price (i.e., the relative selling price method). When applying the relative selling price method, a hierarchy is used for estimating the selling price based first on vendor-specific objective evidence ("VSOE"), then third-party evidence ("TPE") and finally management's estimate of the selling price ("ESP").

In addition, the guidance amends the scope of software revenue recognition to exclude all tangible products containing both software and nonsoftware components that function together to deliver the product's essential functionality. As a result, certain products that were previously accounted for under the scope of software revenue recognition guidance are no longer accounted for as software. Prior to July 1, 2009, the Company determined its gaming devices included software that was "more than incidental" to the product as a whole; accordingly, the sales of gaming devices was accounted for under the scope of software revenue recognition guidance. Application of the new guidance resulted in the Company determining that gaming devices no longer fall under the scope of software revenue recognition guidance. Under the new guidance, which applies to new or modified arrangements since July 1, 2009, revenue related to systems arrangements that contain software and nonsoftware deliverables require an allocation of the arrangement fee to the separate deliverables using the relative selling price method. Revenue for the software deliverables continue to be recognized under the software revenue recognition guidance, while revenue for the nonsoftware deliverables, such as gaming devices and other hardware, are no longer accounted for under the software revenue recognition guidance.

In allocating the arrangement fees to separate deliverables, the Company used a combination of VSOE of selling price and ESP for gaming devices, maintenance and product support fees for perpetual licenses and professional services; a combination of VSOE and ESP for system-based hardware products; and ESP for software products and maintenance and product support fees on time-based licenses. ESP is determined based upon the Company's normal pricing and discounting practices. VSOE of selling price is measured based on the price for each deliverable when it is sold separately. VSOE of selling price for software maintenance and product support fees sold with perpetual licenses are measured by the contractual renewal rate offered to the customer.

Advertising costs

The Company expenses advertising costs as incurred, which totaled $9.1 million, $6.8 million and $5.0 million from continuing operations for the years ended June 30, 2010, 2009 and 2008, respectively.

Warranty expense

Gaming devices are typically sold with a 90-day parts and labor warranty. Warranty expense is calculated using historical experience, and totaled $2.3 million, $3.3 million and $3.1 million for the years ended June 30, 2010, 2009 and 2008, respectively.

Research and development

Research and development expenses related to product development are expensed until technological feasibility has been established. The Company has determined that technological feasibility is not established for its products until completion of the regulatory approval process. As this process is completed shortly before the products are made available to customers, any development costs incurred after the establishment of technological feasibility are typically not significant and expensed as incurred.

Income taxes

The Company accounts for income taxes under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the period that includes the enactment date. Taxes on income of the Company's foreign subsidiaries are provided at the tax rates applicable to the tax jurisdictions in which they are located.

On July 1, 2007, the Company adopted accounting guidance related to accounting for uncertainty in income taxes, which creates a single model to address uncertainty in income tax positions and prescribes the minimum recognition threshold a tax position is required to meet before being

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

recognized in the financial statements. It also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition.

The Company recognizes tax benefits from an uncertain position only if it is more likely than not that the position will be sustained upon examination by taxing authorities based on the technical merits of the issue. The amount recognized is the largest benefit that the Company believes has greater than a 50% likelihood of being realized upon settlement.

Share-based compensation

The Company accounts for share-based compensation based on the calculated fair value of the award measured on the grant date, which is recognized, net of estimated forfeitures, as an expense over the employee's requisite service period. The Company classifies share-based compensation expense in the same financial statement line as cash compensation, including cost of gaming equipment and systems and casino operations, research and development costs, and selling, general and administrative expenses.

The excess tax benefit from stock option exercises and tax deductions in excess of compensation cost recognized are classified as a financing activity in the statement of cash flows.

Foreign currency translation

The functional currency of the Company's foreign subsidiaries is their local currency. Assets and liabilities of foreign operations are translated into U.S. dollars at the rate of exchange at the end of the period, and the income and expense accounts are translated at the average rate of exchange for the period. Translation adjustments are reflected as accumulated other comprehensive income within stockholders' equity. Gains and losses on foreign currency transactions are included in the consolidated statements of operations.

Recently adopted accounting pronouncements

On July 1, 2009, the Company adopted the new Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") which establishes two levels of U.S. GAAP: authoritative and nonauthoritative. The ASC is now the single source of authoritative nongovernmental U.S. GAAP. All other literature is considered non-authoritative. The Company's adoption of this statement had no impact on the consolidated results of operations, financial position and cash flows, but rather changes the reference used to cite specific FASB accounting literature.

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The impact of applying the new revenue recognition accounting guidance (See Revenue recognition above) to new or materially modified arrangements entered into since July 1, 2009, is as follows:

	For the Year Ended June 30, 2010	
	As Reported	Pro Forma Basis as if the Previous Accounting Guidance Were in Effect
	(in 000s)	
Revenues:		
Gaming Equipment	$ 273,718	$ 261,047
Systems	217,523	216,962
Gaming equipment and systems	$ 491,241	$ 478,009

The impact on future periods is dependent upon the prevalence of multiple deliverable arrangements whereby a combination of gaming devices, hardware, software, maintenance and product support fees and consulting services are sold under one arrangement and the software license is time-based. Under such arrangements, all revenue was previously recognized ratably over the term of the time-based license as the Company was unable to establish VSOE of fair value for the software maintenance and product support, which runs contemporaneously with the license period. Under the new guidance, revenue from non-software elements delivered under such multiple deliverable arrangements will no longer be deferred if VSOE of fair value does not exist for an undelivered element. Rather, the revenue allocated to the non-software elements using the relative selling price method would be recognized upon delivery and customer acceptance, and only the revenue allocated to the software elements will be deferred and recognized over the term of the time-based license.

On July 1, 2009, the Company adopted new accounting guidance related to business combinations which clarifies the accounting for certain separately identifiable intangible assets which an acquirer does not intend to actively use. This guidance requires an acquirer in a business combination to account for a defensive intangible asset as a separate unit of accounting which should be amortized to expense over the period the asset diminishes in value. Future effects will be dependent upon acquisitions of defensive intangible assets, if any, at that time. In addition, there is new guidance for determining the useful life of a recognized intangible asset. This guidance is applied prospectively to intangible assets acquired after the effective date. However, the disclosure requirements are applied prospectively to all intangible assets recognized in financial statements. In addition, the new guidance requires that an acquiring entity recognize all of the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions, requires the expense of acquisition costs, and also includes a substantial number of new disclosure requirements. The Company's adoption of this guidance did not have a significant impact on the disclosures or the consolidated results of operations, financial position and cash flows for the year ended June 30, 2010.

On July 1, 2009, the Company adopted new accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. Specifically, this guidance requires the recognition of a noncontrolling interest (minority interest) as equity in the consolidated financial statements and separate from the parent's equity. The amount of net income attributable to the noncontrolling interest will be included in consolidated net income on the face of the income statement. This guidance also clarifies that changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation are equity transactions if the parent retains its controlling financial interest and requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated. Such gain or loss will be measured using the fair value of the noncontrolling equity investment on the deconsolidation date. The guidance also includes expanded disclosure requirements regarding the interests of the parent and its noncontrolling interest. The adoption of this statement did not have a material impact on the consolidated results of operations, financial position and cash flows, but did affect presentation and disclosure. As a result of the adoption, the Company reclassified noncontrolling interests in the amount of $2.4 million from minority interest to equity in the June 30, 2009 Consolidated Balance Sheets and Statements of Stockholders' Equity. Certain reclassifications to the Consolidated Statements of Operations and Consolidated Statements of Cash Flows have been made to prior period amounts to conform to the presentation of the current period. Recorded amounts for prior periods previously presented as Net income which are now presented as Net income attributable to Bally Technologies, Inc., have not changed as a result of the adoption of this guidance.

On July 1, 2009, the Company adopted new accounting guidance requiring additional disclosures about fair value of financial instruments in interim and annual financial statements. The Company's adoption of this guidance resulted in the disclosure of information about the fair value of financial instruments consistent with the disclosures in the Company's most recent annual financial statements.

Recently issued accounting pronouncements not yet adopted

In April 2010, the FASB issued new accounting guidance related to accruals for casino jackpot liabilities. Specifically, the guidance clarifies that an entity should not accrue jackpot liabilities, or portions thereof, before a jackpot is won if the entity can avoid paying the jackpot. Jackpots should be accrued and charged to revenue when an entity has the obligation to pay the jackpot. The guidance applies to both base and progressive jackpots. The new guidance is effective for fiscal years beginning on or after December 15, 2010. The new guidance will be applied by recording a cumulative-effect adjustment to opening retained earnings in the period of adoption. The Company expects to adopt the guidance in fiscal year 2012 and is currently in the process of evaluating the impact the guidance will have on its consolidated results of operations, financial position and cash flows.

In July 2010, the FASB issued new accounting guidance to address concerns about the credit quality of financing receivables and the related allowance for credit losses. The guidance is intended to provide additional information to assist financial statement users in assessing an entity's credit risk exposures and evaluating the adequacy of its allowance for credit losses. Disclosures will require information at disaggregated levels, including the nature of the credit risk and how it is analyzed in arriving at the allowance for credit losses, a roll-forward schedule of and reasons for changes in the allowance, credit quality indicators, and aging of past due accounts, the nature and extent of modifications, and significant purchase or sales. The guidance is effective for disclosures for interim and annual reporting periods ending on or after December 15, 2010. The Company expects to adopt the guidance in the second quarter of fiscal year 2011, and is currently evaluating the impact the guidance will have on its future disclosures. Other than enhanced disclosures, the guidance will have no impact on its results of operations, financial position and cash flows.

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. EARNINGS PER SHARE

Basic earnings per share are computed by dividing earnings by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share reflect the additional dilution from all potentially dilutive securities.

The following computation of basic and diluted earnings per share applicable to the Company's common stock is as follows:

	Year Ended June 30,		
	2010	2009	2008
	(in 000s, except share amounts)		
Amounts attributable to Bally Technologies, Inc.:			
Income from continuing operations, net of tax	$ 109,223	$ 119,439	$ 96,972
Income from discontinued operations, net of tax	6,175	6,870	10,235
Gain on sale of discontinued operations, net of tax	22,079		
Net income attributable to Bally Technologies, Inc.	$ 137,477	$ 126,309	$ 107,207
After tax interest expense on convertible debt	14	160	301
Diluted earnings attributable to Bally Technologies, Inc.	$ 137,491	$ 126,469	$ 107,508
Weighted average common shares outstanding	54,576	54,449	54,428
Dilutive effect of:			
Stock options, Restricted Stock Units ("RSU") and restricted stock	3,063	2,423	3,478
Warrants	14	7	33
Convertible debt(1)	22	179	218
Weighted average diluted shares outstanding	57,675	57,058	58,157
Basic earnings per share attributable to Bally Technologies, Inc.:			
Income from continuing operations	$ 2.00	$ 2.19	$ 1.78
Income from discontinued operations	0.11	0.13	0.19
Gain on sale of discontinued operations	0.41		
Basic earnings per share	$ 2.52	$ 2.32	$ 1.97
Diluted earnings per share attributable to Bally Technologies, Inc.:			
Income from continuing operations	$ 1.89	$ 2.10	$ 1.67
Income from discontinued operations	0.11	0.12	0.18
Gain on sale of discontinued operations	0.38		
Diluted earnings per share	$ 2.38	$ 2.22	$ 1.85

(1) The Company had certain related party debt outstanding which was convertible into common stock at the Company's discretion. The related party debt was paid in full in December 2009. See Note 11 to the consolidated financial statements, *Related Party Transactions*.

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Certain securities were excluded from the diluted per share calculation because their inclusion would be anti-dilutive. Such securities consist of the following:

	Year Ended June 30,		
	2010	2009	2008
		(in 000s)	
Stock options, RSU and restricted stock	308	1,975	235
Warrants			100
	308	1,975	335

3. ASSETS HELD FOR SALE AND DISCONTINUED OPERATIONS

The Company owned and operated the Rainbow Casino, a dockside riverboat casino in Vicksburg, Mississippi, which was sold on June 8, 2010. Under the terms of the agreement, the Company was paid approximately $80.0 million in an all-cash transaction.

The assets and liabilities of the Rainbow Casino were classified as held for sale as of June 30, 2009 and the results of its operations for the years ended June 30, 2010, 2009 and 2008 were classified as discontinued operations because the Company does not expect to continue to receive significant cash flows from the Rainbow Casino. Inter-segment revenues, eliminated in consolidation, were $0.5 million, $1.2 million and $1.1 million for the years ended June, 2010, 2009 and 2008, respectively. The following table summarizes the assets held for sale and liabilities related to assets held for sale in the accompanying consolidated balance sheet:

	June 30, 2009
	(in 000s)
Cash and cash equivalents	$ 8,712
Accounts and notes receivable, net of allowances for doubtful accounts of $42	45
Inventories	55
Prepaid assets	184
Deferred income tax assets	312
Other current assets	8
Total current assets	9,316
Property, plant and equipment, net of accumulated depreciation of $20,336	43,479
Deferred income tax assets	(1,903)
Other assets, net	392
Total assets	$ 51,284
Accounts payable	$ 710
Accrued liabilities	1,890
Jackpot liabilities	95
Total current liabilities	2,695
Total liabilities	$ 2,695

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table summarizes income from discontinued operations:

	Year Ended June 30, 2010	2009	2008
	(in 000s)		
Revenues:			
Casino operations	$ 34,336	$ 39,669	$ 47,299
Costs and expenses:			
Direct cost of casino operations	14,081	16,750	18,847
Selling, general and administrative	6,821	7,864	8,223
Depreciation and amortization	2,873	3,337	2,755
	23,775	27,951	29,825
Operating income	10,561	11,718	17,474
Other income (expense):			
Interest income	7	26	134
Other, net	(25)	13	23
Income from discontinued operations before income taxes	10,543	11,757	17,631
Income tax expense	(3,362)	(3,700)	(5,511)
Income from discontinued operations	7,181	8,057	12,120
Less income attributable to noncontrolling interests	1,006	1,187	1,885
Income from discontinued operations attributable to Bally Technologies, Inc.	$ 6,175	$ 6,870	$ 10,235

The following table summarizes the gain on disposal of discontinued operations:

	Year Ended June 30, 2010
	(in 000s)
Sale proceeds	$ 80,000
Distributions to noncontrolling interest	(688)
Assets held for sale	(45,733)
Liabilities related to assets held for sale	1,161
Adjustments to proceeds for fees and expenses	(471)
Gain on disposal of discontinued operations before income taxes	34,269
Income tax expense	(12,190)
Gain on disposal of discontinued operations	$ 22,079

4. IMPAIRMENT CHARGES

As a result of recent actions concerning the legality of the charitable bingo market in Alabama, the Company recorded a charge of $11.4 million during the third quarter of fiscal 2010, which included full allowances for notes and accounts receivable of $5.5 million and an impairment of $5.9 million in long-lived assets.

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Recoverability of the long-lived assets and notes and accounts receivable were measured by a comparison of the carrying amount of the related asset to future net cash flows expected to be generated by the related asset. The impairment charges were measured by the amount by which the carrying amount of the assets exceeded the estimated fair value of the assets.

5. PROPERTY, PLANT AND EQUIPMENT AND LEASED GAMING EQUIPMENT

Property, plant and equipment and leased gaming equipment consist of the following:

	June 30, 2010	June 30, 2009
	(in 000s)	
Land and land improvements	$ 1,975	$ 1,975
Buildings and leasehold improvements	23,483	21,610
Gaming equipment	26,508	24,832
Furniture, fixtures and equipment	27,842	28,770
Less accumulated depreciation	(47,714)	(43,777)
Property, plant and equipment, net	$ 32,094	$ 33,410
Leased gaming equipment	$ 236,137	$ 212,650
Less accumulated depreciation	(153,780)	(117,638)
Leased gaming equipment, net	$ 82,357	$ 95,012

6. GOODWILL AND INTANGIBLE ASSETS

Intangible assets consist of the following:

		June 30, 2010			June 30, 2009		
	Useful Life (Years)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
				(dollars in 000s)			
Computer software	3 - 9	$ 35,652	$ (28,395)	$ 7,257	$ 27,488	$ (19,083)	$ 8,405
License rights	3 - 5	3,624	(2,048)	1,576	2,117	(1,814)	303
Trademarks	5	2,203	(2,023)	180	2,203	(1,693)	510
Core technology	5 - 8	22,763	(10,346)	12,417	22,763	(6,585)	16,178
Contracts	10	10,836	(6,421)	4,415	10,043	(5,364)	4,679
Other intangibles	3 - 7	1,702	(999)	703	7,627	(5,504)	2,123
Total finite lived intangible assets		$ 76,780	$ (50,232)	$ 26,548	$ 72,241	$ (40,043)	$ 32,198
Trademark	indefinite	7,500		7,500			
Total		$ 84,280	$ (50,232)	$ 34,048	$ 72,241	$ (40,043)	$ 32,198

In September 2009, the Company recorded an intangible asset of approximately $7.5 million related to one-time consideration given for a perpetual, world-wide license for the use of the Bally trademark in connection with the Company's business. Consideration for this intangible asset included approximately $5.0 million related to the delivery of gaming devices and $2.5 million in forgiveness of certain customer receivable balances. Previously, a royalty fee was paid and expensed based upon the number of units produced and sold using the trademark.

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Total amortization expense related to finite lived intangible assets totaled $10.3 million, $9.8 million and $7.4 million for the years ended June 30, 2010, 2009 and 2008, respectively, which included computer software amortization expense of $4.4 million, $4.1 million and $3.3 million, respectively. Future amortization of finite lived intangible assets is scheduled as follows:

Year Ended June 30,	(in 000s)
2011	$ 8,991
2012	6,771
2013	5,634
2014	1,950
2015	647
Thereafter	2,555
Total	$ 26,548

All goodwill is associated with continuing operations. The changes in the carrying amount of goodwill for the years ended June 30, 2010 and 2009 are as follows:

	(in 000s)
Balance as of June 30, 2008	$ 162,727
Foreign currency translation adjustment	(767)
Balance as of June 30, 2009	161,960
Foreign currency translation adjustment	(807)
Balance as of June 30, 2010	$ 161,153

No impairment charges for goodwill and intangible assets were necessary for the years ended June 30, 2010, 2009 and 2008.

7. OTHER CURRENT ASSETS

Other current assets consist of the following:

	June 30,	
	2010	2009
	(in 000s)	
Refundable deposits	$ 413	$ 2,476
Games on trial	2,744	2,448
Derivative financial instrument asset		255
Other	193	7,831
Total other current assets	$ 3,350	$ 13,010

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

8. ACCRUED AND OTHER LIABILITIES

Accrued liabilities consist of the following:

	June 30, 2010	June 30, 2009
	(in 000s)	
Payroll and related costs	$ 24,148	$ 23,240
Royalties	3,045	3,737
Professional and consulting fees	2,857	2,672
Regulatory approval costs	1,604	1,629
Derivative financial instrument liability	2,698	
Other	11,310	14,237
Total accrued and other liabilities	$ 45,662	$ 45,515

9. LONG-TERM DEBT

Long-term debt consists of the following:

	June 30, 2010	June 30, 2009
	(in 000s)	
Term loan facility	$ 173,750	$ 206,250
Related party debt (see Note 11)		2,800
Other	43	37
Long-term debt	173,793	209,087
Less current maturities	(42,543)	(35,337)
Long-term debt, net of current maturities	$ 131,250	$ 173,750

On September 29, 2008, the Company entered into a new $225.0 million term loan and a new $75.0 million revolving credit facility (collectively, the "Credit Facility"). The Credit Facility matures in September 2012. The proceeds from the Credit Facility and cash-on-hand of $14.6 million were used to repay the then existing bank term loans totaling $289.6 million. The Company also used cash-on-hand to pay for transaction fees and expenses totaling $10.7 million, which are being amortized to interest expense over the term of the Credit Facility.

On April 9, 2010, the Company entered into a new $75.0 million revolving credit facility, which matures in March 2014, and increases the Company's total undrawn revolver capacity to $150.0 million. The new revolver has the same terms, security, pricing and conditions as the existing Credit Facility. The Company paid approximately $1.0 million in fees and expenses related to the new revolving credit facility.

As of June 30, 2010, there was approximately $150.0 million of undrawn availability under the revolving credit facilities. Availability under the revolving credit facility is reduced to the extent of outstanding letters of credit.

The interest rate on the Credit Facility is subject to a leverage-based pricing grid. On April 9, 2010, the Company amended the Credit Facility to, among other items, change the leverage-based pricing grid. If the leverage ratio, as defined under the term loan, is greater than 2.5, the interest rate will be LIBOR plus a margin of 3.25%; if the leverage ratio is between 2.0 and 2.5, the interest rate will be LIBOR

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

plus a margin of 3.00%; if the leverage ratio is between 1.5 and 2.0, the interest rate will be LIBOR plus a margin of 2.75%; if the leverage ratio is between 1.0 and 1.5, the interest rate will be LIBOR plus a margin of 2.50%; and if the leverage ratio is below 1.0, the interest rate will be LIBOR plus a margin of 2.25%. The Company paid approximately $1.90 million in fees and expenses for the amendment. The amendment did not affect the floating-to-fixed interest rate swap.

Prior to the amendment, if the Company's leverage ratio, as defined under the Credit Facility, was greater than 1.5, the interest rate would have been LIBOR plus a margin of 3.25%; if the leverage ratio was between 1.0 and 1.5, the interest rate would have been LIBOR plus a margin of 3.00%; and if the leverage ratio was below 1.0, the interest rate would have been LIBOR plus a margin of 2.75%.

In December 2008, the Company entered into a floating-to-fixed interest rate swap, as discussed below, fixing the interest rate of the term loan at 1.89% plus the applicable margin (2.25% at June 30, 2010) for the remaining term. The interest rate on the revolving credit facility was 4.14% and 3.07% at June 30, 2010 and 2009, respectively.

The term loan is in its second year and requires quarterly principal reductions of $8.75 million through September 30, 2010 and $11.25 million quarterly during each of the third and fourth years of the agreement, with a balloon payment due at maturity in September 2012. The Credit Facility is collateralized by substantially all of the Company's domestic property and is guaranteed by each of the Company's domestic subsidiaries, excluding any noncontrolling interests, and is secured by a pledge agreement.

The fair value of long-term debt is estimated by discounting expected cash flows using current interest rates at which similar loans would be made to borrowers with similar credit ratings and remaining maturities. As of June 30, 2010 and 2009, respectively, the fair value of long-term debt approximated the carrying value.

The Credit Facility contains a number of covenants that, among other things, restrict the ability of the Company and certain of its subsidiaries to dispose of assets, incur additional indebtedness or issue preferred stock, pay dividends or make other distributions, enter into certain acquisitions, repurchase equity interests or subordinated indebtedness, issue or sell equity interests of the Company's subsidiaries, engage in mergers or acquisitions or certain transactions with subsidiaries and affiliates, and that otherwise restrict corporate activities.

The financial covenants under the Credit Facility consist of a leverage ratio and a fixed charges coverage ratio. The leverage ratio is computed as total debt outstanding at the end of the quarter divided by the trailing twelve months Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA"), excluding certain cash and non-cash charges. The fixed charges coverage ratio is computed as EBITDA, adjusted for the trailing twelve months capital expenditures, share repurchases and cash taxes paid, divided by the trailing twelve months interest charges plus all payments of principal made during the previous twelve months.

A breach of any of the covenants or the inability to comply with the required financial ratios could result in a default under the Credit Facility. In the event of any such default, the lenders could elect to declare all borrowings outstanding under the Credit Facility, together with any accrued interest and other fees, to be due and payable. If the Company were unable to repay the indebtedness upon its acceleration, the lenders could proceed against the underlying collateral. The Company was in compliance with all of the Credit Facility covenants as of June 30, 2010.

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Interest Rate Swap Agreement

In December 2008, the Company entered into a floating-to-fixed interest rate swap agreement with an original notional value of $218.8 million and a maturity date of September 26, 2012. This interest rate swap serves to fix the floating LIBOR based debt under the term loan to fixed rate debt at an interest rate of 1.89% plus the applicable margin to manage the risk exposure to interest rate fluctuations.

The Company has documented and designated this interest rate swap as a cash flow hedge. Based on the assessment of effectiveness using statistical regression, the Company determined that the interest rate swap is effective. Effectiveness testing of the hedge relationship and measurement to quantify ineffectiveness is performed each fiscal quarter using the hypothetical derivative method. As the interest rate swap qualifies as a cash flow hedge, the Company adjusts the cash flow hedge on a quarterly basis to its fair value with a corresponding offset to accumulated Other Comprehensive Income ("OCI"). The interest rate swap has been and is expected to remain highly effective for the life of the hedge. Effective amounts are reclassified to interest expense as the related hedged expense is incurred. Any ineffectiveness is reclassified from accumulated other comprehensive income to other income (expense). As of June 30, 2010, the Company had no ineffectiveness on its cash flow hedge. Amounts related to the swap expected to be reclassified from other comprehensive income to interest expense in the next twelve months total $1.9 million.

Additional information on the Company's interest rate swap is as follows:

Interest Rate Swaps		**Balance Sheet Location**	**Fair Value (in 000s)**	**Location of Offsetting Balance**
Cash flow hedge	$173.8 million LIBOR based debt	Accrued Liabilities	$ 2,698	Accumulated other comprehensive loss

Principal Repayments

The following annual principal maturities of long-term debt for each of the fiscal years ending subsequent to June 30, 2010, are as follows:

Year Ended June 30,	**(in 000s)**
2011	$ 42,543
2012	45,000
2013	86,250
Total	$ 173,793

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BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. LEASES

The Company leases certain office space, equipment, autos, warehouse and repair facilities and other property locations under non-cancelable operating leases which are generally included in selling, general and administrative expenses. Operating rental expense is as follows:

	Year Ended June 30,		
	2010	2009	2008
	(in 000s)		
Equipment and office space leases	$ 8,325	$ 6,969	$ 6,319
Sublease rental income	(251)	(201)	(64)
	$ 8,074	$ 6,768	$ 6,255

A schedule of future minimum rental payments required under noncancelable operating leases for each of the five fiscal years ending after June 30, 2010, is as follows:

Year Ended June 30,	Operating
2011	$ 7,279
2012	5,342
2013	3,485
2014	2,732
2015	1,703
Thereafter	1,968
Total minimum payments	$ 22,509

11. RELATED PARTY TRANSACTIONS

In connection with the acquisition of SDG, the consideration paid included subordinated debt issued to the former principals of SDG. Certain of the former principals are now employees of the Company. At the Company's discretion, the principal and accrued interest thereon could have been paid in cash, or converted into shares of the Company's common stock using the average stock price for the 20 business days prior to the delivery of such shares. As of June 30, 2009, the subordinated debt totaled $2.8 million, all of which was included in current maturities. The subordinated debt was paid in full in December 2009.

During fiscal 2008, the Company entered into an agreement with the former principals of MindPlay to settle a $3.0 million note payable, $0.5 million of accrued interest and $1.0 million in certain other related liabilities related to the previous acquisition of MindPlay for $1.8 million. The settlement resulted in a gain of approximately $2.7 million that is included in selling, general and administrative expense in fiscal 2008.

12. SHARE-BASED COMPENSATION

Employee Stock Purchase Plan

The 2008 ESPP provides that eligible employees are able to contribute up to 10% of their eligible earnings towards the quarterly purchase of the Company's common stock. The employee's purchase price is equal to 85% of the fair market value. During the years ended June 30, 2010 and 2009,

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

employees purchased 53,716 and 88,774 shares of common stock for approximately $1.9 million and $1.7 million, respectively. No purchases were made during the year ended June 30, 2008.

Share-Based Award Plans

The Company's 2001 Long-Term Incentive Plan, as amended, (the "2001 Plan") provides for the issuance of up to 12,050,000 shares of common stock to Company employees, directors and designated paid consultants of which up to 1,400,000 shares may be granted in the form of restricted stock or restricted stock units ("RSUs"). Generally, options are granted at the fair value of the Company's common stock at the date of grant and are exercisable over five to ten years.

The Company's 1996 Long-Term Incentive Plan (the "1996 Plan") provided for the issuance of up to 3,428,000 shares of common stock to Company employees, directors and designated paid consultants. Generally, options were granted at the fair value of the Company's common stock at the date of grant and are exercisable over five to ten years. No shares of common stock remain available under the 1996 Plan for the grant of new awards.

The Company's 1991 Long Term Incentive Plan, as amended, (the "1991 Plan") provided for the issuance of up to 3,428,000 shares of common stock to Company employees and directors. Generally, options were granted at the fair market value of the Company's common stock at the date of the grant and are exercisable over five to ten years. No shares of common stock remain available under the 1991 Plan for the grant of new awards.

The Company issues new shares for shares delivered under the 1991 Plan, the 1996 Plan and the 2001 Plan (collectively, the "Plans").

Stock option activity as of and for the year ended June 30, 2010 is summarized below:

		Weighted Average		
	Shares	**Exercise Price**	**Remaining Contractual Term**	**Aggregate Intrinsic Value**
	(in 000s)	**(per share)**	**(years)**	**(in 000s)**
Balance outstanding as of June 30, 2009	6,903	$ 17.96		$ 85,222
Granted	368	40.55		
Exercised	(2,144)	14.03		
Forfeited or expired	(66)	27.60		
Balance outstanding as of June 30, 2010	5,061	$ 21.14	4.60	$ 61,186
Exercisable as of June 30, 2010	3,897	$ 18.77	4.24	$ 54,149

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Restricted stock and RSU activity as of and for the year ended June 30, 2010 is summarized below:

	Restricted Stock	Weighted Average Grant Date Fair Value	RSUs	Weighted Average Grant Date Fair Value
	(in 000s)	(per share)	(in 000s)	(in 000s)
Balance outstanding as of June 30, 2009	310	$ 30.42	623	$ 17.71
Granted	145	40.18	42	38.98
Released	(124)	27.89	(23)	36.70
Forfeited or expired	(2)	32.62		
Balance outstanding as of June 30, 2010	329	$ 35.66	642	$ 18.27
Vested as of June 30, 2010			534	$ 16.04

The following is additional information about stock options, restricted stock and RSUs exercised, granted and vested during the periods:

	Year Ended June 30,		
	2010	2009	2008
	(in 000s, except per share amounts)		
Weighted average grant-date fair value per share:			
Stock options granted	$ 19.56	$ 10.62	$ 14.58
Stock options vested	$ 10.71	$ 9.23	$ 8.93
Restricted stock and RSUs vested	$ 29.99	$ 20.16	$ 18.04
Total grant-date fair value of stock options vested	$ 7,123	$ 13,186	$ 10,954
Total grant-date fair value of restricted stock and RSUs vested	$ 4,384	$ 3,758	$ 3,106
Exercises under all share-based payment arrangements:			
Total intrinsic value	$ 59,583	$ 7,297	$ 38,887
Cash received	$ 30,074	$ 9,628	$ 21,798
Tax benefit realized	$ 16,730	$ 688	$ 13,693

Shares Reserved

The following shares are reserved for stock options issued and available for issue under the Plans and the 2008 ESPP:

	(in 000s)
Stock options, restricted stock and RSUs issued and currently outstanding	5,703
Shares available for future issuance	611
Warrants	5
Total	6,319

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Share-Based Compensation

The following table presents share-based compensation expense and related effect of the income tax benefit included in the Company's consolidated statements of operations:

	Year Ended June 30,		
	2010	2009	2008
		(in 000s)	
Selling, general and administrative	$ 10,382	$ 13,377	$ 10,762
Research and development	3,231	2,736	2,032
Cost of gaming equipment and systems and operations	180	146	82
Share-based compensation expense before tax	$ 13,793	$ 16,259	$ 12,876
Income tax benefit	(4,828)	(5,691)	(4,507)
Net share-based compensation expense	$ 8,965	$ 10,568	$ 8,369

Share-based compensation expense from discontinued operations before income tax was $137,000, $146,000 and $141,000 for the years ended June 30, 2010, 2009 and 2008, respectively.

Included in share-based compensation expense in the consolidated statements of operations for the years ended June 30, 2010, 2009 and 2008 is restricted stock amortization of $6.4 million, $4.6 million and $2.8 million, respectively.

During the year ended June 30, 2009, the Company modified certain fully vested stock options, previously issued to certain members of the Company's Board of Directors, extending the contractual term for 2.15 years. The modification resulted in the recognition of additional share-based compensation expense of approximately $400,000, which was equal to the net increase in the fair value of the modified stock option.

Additionally, during the year ended June 30, 2009, the Company's Board of Directors approved the accelerated vesting of all unvested stock options previously issued to the Company's former Chief Technology Officer. This accelerated vesting affected options for approximately 360,000 shares of the Company's common stock and resulted in the acceleration of $1.4 million in share-based compensation.

As of June 30, 2010, there was $11.6 million of total unrecognized compensation expense related to the unvested portion of stock options which will be recognized over the subsequent 1.90 years. In addition, as of June 30, 2010, there was $8.5 million of total unrecognized compensation expense related to the unvested portion of restricted stock and RSUs which will be recognized over the subsequent 1.63 years.

The Company estimates the fair value of stock options using the Black-Scholes valuation model. Key input assumptions used to estimate the fair value of stock options include the exercise price of the option, the expected option term, the expected volatility of the Company's common stock over the option's expected term, the risk-free interest rate over the option's expected term and the Company's expected annual dividend yield. The Company believes that the valuation technique and the approach utilized to develop the underlying assumptions are appropriate in calculating the fair values of the Company's stock options granted. Estimates of fair value are not intended to predict actual future events, or the value ultimately realized by the recipients of equity awards.

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The fair value of each option granted during the periods referenced below was estimated on the grant date using the Black-Scholes valuation model with the following assumptions:

	Year Ended June 30,		
	2010	**2009**	**2008**
Weighted Average:			
Expected option term (in years)	4.66	4.53	4.94
Expected volatility	56.04%	51.07%	45.42%
Risk-free interest rate	2.23%	2.63%	3.03%
Expected annual dividend yield	0%	0%	0%

For the years ended June 30, 2010, 2009 and 2008, the expected option term was determined using the simplified method for share based payments as the Company does not have sufficient historical exercise data to provide a reasonable basis upon which to estimate expected term. Certain employees could not exercise options until November 2007 during the time the Company was delinquent in its SEC filings. In addition, there was a significant change in the contractual term of its stock options grants from ten years to seven years, a change in the vesting schedule of stock options from three year to four year periods and changes in the percentage vesting within each year. Expected volatility is based on historical market factors related to the Company's common stock. Risk-free interest rate is based on U.S. Treasury rates appropriate for the expected term.

13. STOCKHOLDERS' EQUITY, OPTIONS, WARRANTS AND RIGHTS

Warrants

The Company previously issued 100,000 stock purchase warrants in connection with a prior acquisition. The strike price of the warrant is $24.69 with a term of seven years. During the year ended June 30, 2010, 95,375 stock purchase warrants were exercised and converted into 40,080 shares of the Company's common stock. The exercises were cashless and net shares were issued for the difference between the strike price of the warrant and the market value of the Company's common stock upon exercise.

Share Repurchase Plan

The Company's Board of Directors have approved a variety of share repurchase plans under which, subject to price and market conditions, purchases of shares can be made from time to time in the open market or in privately negotiated transactions using available cash.

On April 4, 2010, the Company's Board of Directors approved a new share repurchase plan to purchase up to $150 million of common stock which replaced the previous plan. As of June 30, 2010, $103.0 million remained available under the plan for repurchase in future periods.

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the years ended June 30, 2010, 2009 and 2008, the Company made the following purchases under its share repurchase plans:

	Year Ended June 30,		
	Shares	Average Price per share	Amount (in 000s)
For the year ended June 30, 2008(1)	436,200	$ 39.23	$ 17,111
For the year ended June 30, 2009	1,557,216	$ 24.58	$ 38,275
For the year ended June 30, 2010	2,297,278	$ 39.71	$ 91,221
Total	4,290,694	$ 34.17	$ 146,607

(1) Excludes 149,523 shares of our common stock repurchased at $40.20 per share for approximately $6.0 million from a prior officer of the Company.

Special Stock

The Company's Articles of Incorporation authorize the issuance of up to 10,000,000 shares of special stock ("Special Stock"). The Special Stock may be issued from time to time in one or more series, each having such designations, preferences and relative, participating, optional or other special rights, qualifications, limitations or restrictions as shall be stated and expressed in the resolution providing for the issuance of Special Stock or any series thereof adopted by the Board of Directors. Special Stock consists of non-voting stock where no holder of the Special Stock shall be entitled to vote at any meeting of stockholders or otherwise, except as may be specifically provided by law or as approved by the Board of Directors in certain limited circumstances at the time of the stock issuance.

To date, there have been four series of Special Stock authorized for issuance: the Initial Series, the Series B, the Series E and the Series F. In June 1996, the Company issued shares of Series E Special Stock to certain holders of the Company's $7^1/_2$% Convertible Subordinated Debentures (which were retired in 1996) who elected to receive such stock in lieu of receiving common stock. The holders of shares of Series E Special Stock have no voting rights except as required by law. A total of 115 shares of Series E Special Stock remain outstanding. No other shares of Special Stock remain outstanding.

14. INCOME TAXES

Consolidated income from continuing operations before taxes and noncontrolling interest for domestic and foreign operations is as follows:

	Year Ended June 30,		
	2010	2009	2008
		(in 000s)	
United States	$ 160,265	$ 169,756	$ 169,028
Foreign	10,553	15,204	(8,043)
Total	$ 170,818	$ 184,960	$ 160,985

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The components of the Company's income tax expense from continuing operations are as follows:

	Year Ended June 30,		
	2010	2009	2008
		(in 000s)	
Current:			
Federal	$ 59,626	$ 26,956	$ 55,826
State	5,928	4,820	9,184
Foreign	5,057	3,711	(4,678)
	70,611	35,487	60,332
Deferred:			
Federal	(9,261)	26,458	2,438
State	(796)	2,770	(2,028)
Foreign	167	66	540
	(9,890)	29,294	950
Income tax expense	$ 60,721	$ 64,781	$ 61,282

A reconciliation of the Company's income tax provision as computed by applying the U.S. federal statutory tax rate compared to the income tax provision for continuing operations is as follows:

	Year Ended June 30,		
	2010	2009	2008
U.S. federal statutory income tax rate	35.0%	35.0%	35.0%
Income attributable to noncontrolling interest	(0.2)	(0.1)	(0.6)
State income taxes, net of federal benefit	2.0	3.5	2.3
Foreign earnings subject to U.S. tax	1.2	2.2	2.0
Change in valuation allowance	(0.3)	(0.2)	(4.9)
Tax credits	(2.3)	(5.8)	(2.1)
Domestic production activities deduction	(0.5)	(1.5)	(0.8)
Capital loss carryforward			5.5
Other, net	0.6	1.9	1.7
	35.5%	35.0%	38.1%

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The major components of the deferred tax assets and liabilities from continuing operations are as follows:

	June 30, 2010	June 30, 2009
	(in 000s)	
Deferred tax assets:		
Share-based compensation	$ 13,621	$ 14,718
Deferred revenue, net of deferred costs	10,124	14,398
Accruals not currently deductible for tax purposes	13,516	10,908
Property and equipment	7,663	807
Inventory	3,985	4,036
Net operating loss carryforwards	3,800	4,564
Intangible assets	1,563	
Allowance for doubtful accounts	4,428	1,752
Foreign tax credit carryforwards	1,902	
Other tax credits	1,448	
Deferred compensation for tax purposes		1,207
Other	4,625	3,154
Total gross deferred tax assets	66,675	55,544
Less: Valuation allowance	(1,526)	(2,089)
Deferred tax assets	$ 65,149	$ 53,455
Deferred tax liabilities:		
Intangible assets	$	$ 377
Other	100	
Total gross deferred tax liabilities	$ 100	$ 377
Net deferred tax assets	$ 65,049	$ 53,078

Current deferred income tax liabilities of $362,000 and $-0- of as of June 30, 2010 and 2009, respectively, are included in accrued and other liabilities and noncurrent deferred income tax liabilities of $542,000 and $-0- as of June 30, 2010 and 2009, respectively, are included in other liabilities in the accompanying Consolidated Balance Sheets. In addition, $1.6 million of net deferred tax liabilities of discontinued operations are included in assets held for sale in the accompanying Consolidated Balance Sheets as of June 30, 2009.

The Company has not provided income taxes on approximately $15.4 million and $12.0 million of undistributed earnings as of June 30, 2010 and 2009, respectively, from certain foreign subsidiaries. The Company plans to permanently invest the earnings in the foreign subsidiaries and therefore has not recorded a deferred tax liability associated with the undistributed earnings.

At June 30, 2010, the Company had net operating loss carryforwards for U.S. federal income tax purposes of approximately $6.2 million. The entire amount of the net operating loss carryforwards are subject to limitations under Section 382 of the Internal Revenue Code. Section 382 limits the amount of carryforwards available per year for use against future taxable income. Based on the Company's recent history of taxable income and projections of taxable income in the future, the Company expects to utilize all of its federal net operating loss carryforwards. The Company also has net operating losses in several foreign jurisdictions, mainly the United Kingdom. Due to a history of net operating losses in

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

these jurisdictions, management has determined that it is more likely than not that these losses will not be realized and therefore has established a full valuation allowance.

The Company's subsidiary in India operates under a tax holiday currently set to expire March 2011.

The Company recorded $16.7 million and $0.7 million as an increase to stockholder's equity for certain tax benefits from employee share-based compensation for the years ended June 30, 2010 and 2009, respectively.

The Company had $11.6 million and $19.0 million of liabilities for unrecognized tax benefits as of June 30, 2010 and 2009, respectively. Of these amounts, $10.2 million and $15.9 million, respectively, if recognized, would impact our effective tax rate. The Company recognizes interest and penalties related to unrecognized tax benefits as tax expense. As of June 30, 2010 and 2009, the Company had accrued interest and penalties of $3.7 million and $5.6 million, respectively. Interest and penalties of ($1.9) million and $3.4 million were accrued during the years ended June 30, 2010 and 2009, respectively.

Changes to the balance of unrecognized tax benefits are as follows:

	June 30,	
	2010	2009
	(in 000s)	
Balance, beginning of year	$ 19,049	$ 22,380
Additions based on tax provisions related to current year	463	1,183
Additions for tax positions of prior years	330	2,275
Reductions for tax positions of prior years	(2,485)	(3,517)
Settlements	(5,395)	(3,424)
Lapse of statute of limitations	(213)	
Foreign currency translation adjustment	(112)	152
Balance, end of year	$ 11,637	$ 19,049

The Internal Revenue Service ("IRS") commenced examination of the Company's United States federal income tax returns for 2003 through 2005 in the fourth quarter of 2006. Throughout the examination, the IRS has proposed, and management has agreed to, certain adjustments related to the open tax years that have been recorded in the income tax provision. In January 2009, the IRS completed its field examination of the open tax years and issued a Revenue Agent's Report. Also in January 2009, the Company paid $3.4 million in tax and $1.2 million in interest to the IRS to settle certain agreed adjustments. The Company filed a formal protest regarding certain unagreed adjustments and the case was assigned to the IRS Las Vegas Appeals Office in July 2009. In June 2010, the Company agreed to settle all remaining issues with the IRS.

The Company files numerous consolidated and separate income tax returns in the United States and various state and foreign jurisdictions. With few exceptions, the Company is no longer subject to United States federal income tax examinations for years before 1995 and is no longer subject to state and local, or foreign income tax examinations for years before 2003.

It is reasonably possible that the Company's amount of unrecognized tax benefits may decrease within the next twelve months by a range up to $8.0 million.

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

15. COMMITMENTS AND CONTINGENCIES

Commitments

The Company is obligated under several agreements to pay certain royalties on the sale or rental of gaming devices. Total royalty expense for the Company for the years ended June 30, 2010, 2009 and 2008 was $8.3 million, $15.6 million and $15.6 million, respectively, and is included in the cost of gaming equipment and systems in the accompanying consolidated statements of operations. In addition, the Company has obtained the rights to certain game themes and intellectual property that call for payment of royalties based on either fixed amounts or variable amounts based on game performance.

Litigation

Liabilities for loss contingencies arising from claims, assessments, litigation, fines and penalties, or other sources are recorded when it is probable that a liability has been incurred and the amount of the liability can be reasonably estimated. The Company has not recorded any loss accruals for these contingencies unless otherwise noted below.

On December 7, 2004, IGT filed a patent infringement lawsuit against the Company in the United States District Court for the District of Nevada. The complaint asserted that the Company's wheel-based games, such as Monte, Carlo Lucky Wheel and Cash For Life , its games with a reel in the top box, such as Bonus Frenzy , and its iVIEW products infringed on patents held by IGT, and sought injunctive relief and damages in unspecified amounts. As part of the defense, the Company asserted counterclaims seeking damages and other relief against IGT, including claims that IGT's patents were invalid, unenforceable and not infringed, as well as several claims that IGT engaged in anti-competitive conduct in violation of state and federal antitrust laws. In October 2008, the court granted the Company's motions for summary judgment, ruling that IGT's two "wheel" patents and a touch-screen player-tracking patent were invalid; that even if the patents were valid, the Company's wheel-based games at issue would not infringe; and that certain of its iVIEW products do not infringe the two asserted player-tracking patents. The summary judgment determinations were upheld by the Federal Circuit Court of Appeals. The parties are now moving towards trial on the remaining portion of the case regarding IGT's alleged inequitable conduct before the U.S. Patent and Trademark and Bally's infringement of a player tracking patent. Summary judgment motions have now been submitted on these issues as well.

In April 2006, IGT filed a patent infringement lawsuit against the Company in the United States District Court for the District of Delaware. The complaint asserted that the Company's Bally Power Bonusing products infringe patents held by IGT, and sought injunctive relief and damages in unspecified amounts. Of the nine patents and 200 claims originally filed in the case by IGT, all but three patents and eight claims have been dismissed. On April 28, 2009, the District Court issued an order finding that the Company's Power Promotions, Power Bank, and SDS/CMP Power Winners products do not infringe IGT's patents. The court also found that the Company's ACSC Power Winners and ACSC Power Reward products infringe some patent claims asserted by IGT, but not others. Appeals by both parties have been filed. In the meantime, the Company has undertaken technical changes to ensure non-infringement for the two products partially in question. The Company does not believe that potential infringement damages, if any, would be material to its financial position as the revenues from these two products to date have not been material.

In September 2006, the Company filed a patent infringement lawsuit against IGT in the United States District Court for the District of Nevada. The complaint asserted that certain of IGT's bonus wheel games infringe a patent held by the Company, and sought injunctive relief and damages. IGT filed an

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

answer generally denying the claims and filed a motion for summary judgment which was granted in September 2008 declaring the wheel patent "obvious" and therefore invalid. The summary judgment ruling has been upheld by the Federal Circuit Court of Appeals.

The Company is also a party to various lawsuits relating to routine matters incidental to its business. Management does not believe that the outcome of such litigation, including the matters discussed above, in the aggregate, will have a material adverse effect on its consolidated financial position, results of operations or cash flows.

16. SEGMENT AND GEOGRAPHICAL INFORMATION

The Company's consists of three sources: Gaming Equipment, which includes the sale of gaming devices and related equipment, parts and conversion kits; Gaming Operations, which includes the operation of wide-area progressive, video lottery and centrally determined systems and the rental of gaming devices and content; and Systems, which includes the sale and support of computerized monitoring systems and related recurring hardware and software maintenance revenue.

The following is a summary of revenues and gross margin:

	Year Ended June 30,		
	2010	2009	2008
		(in 000s)	
Revenues:			
Gaming Equipment and Systems			
Gaming Equipment	$ 273,718	$ 357,037	$ 410,147
Gaming Operations	286,950	274,965	235,983
Systems	217,523	211,758	206,262
Total revenues	$ 778,191	$ 843,760	$ 852,392
Gross Margin(1):			
Gaming Equipment and Systems			
Gaming Equipment	$ 138,000	$ 166,826	$ 182,843
Gaming Operations	203,844	194,882	155,589
Systems	156,542	150,259	145,793
Total gross margin	$ 498,386	$ 511,967	$ 484,225

(1) Gross Margin from Gaming Equipment and Systems excludes amortization related to certain intangibles including core technology and license rights, which are included in depreciation and amortization.

Revenues from discontinued operations related to the Rainbow Casino were $34.3 million, $39.7 million and $47.3 million for the years ended June 30, 2010, 2009 and 2008, respectively. Gross margin from discontinued operations was $20.3 million, $22.9 million and $28.5 million for the years ended June 30, 2010, 2009 and 2008, respectively.

The Company has operations based primarily in the United States as well as significant sales and distribution offices based in Europe, and other foreign locations, including South America. The table

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

below presents information as to the Company's revenues, operating income and identifiable assets by geographic region which is determined by country of destination:

	Year Ended June 30,		
	2010	2009	2008
		(in 000s)	
Revenues:			
United States and Canada	$ 621,205	$ 701,817	$ 717,927
International	156,986	141,943	134,465
Total revenues	$ 778,191	$ 843,760	$ 852,392
Operating income:			
United States and Canada	$ 144,060	$ 170,727	$ 153,902
International	40,050	32,291	27,817
Total operating income	$ 184,110	$ 203,018	$ 181,719
Identifiable assets:			
United States and Canada	$ 743,426	$ 736,634	$ 851,019
International	169,750	144,248	144,105
Total identifiable assets	$ 913,176	$ 880,882	$ 995,124

Operating income from discontinued operations was $10.6 million, $11.7 million and $17.5 million for the years ended June 30, 2010, 2009 and 2008, respectively.

17. 401(k) PLAN

The Company is the sponsor of the Bally Technologies, Inc. 401(k) Savings Plan (the "401(k) Plan"). The 401(k) Plan was adopted for domestic employees of Bally Technologies, Inc. and all its domestic subsidiaries. Employees may enroll in the plan after meeting certain age and length of employment criteria, and plan participants may defer up to 25% of their compensation, up to certain IRS imposed limitations.

The Company matches 50% of any participant's contributions, up to the first 6% of their compensation (as defined in the plan document). Company matching contributions totaled approximately $1.9 million, $1.9 million and $2.3 million for the years ended June 30, 2010, 2009 and 2008, respectively.

For participants hired through December 31, 2000, employee and employer matching contributions are 100% vested immediately. For employees hired on or after January 1, 2001, vesting of the employer match is on a 20%, 5-year vesting schedule. Effective October 1, 2005, vesting of employer match is on a 25% 4-year vesting schedule.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

18. SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

The following tables set forth unaudited quarterly financial information for the years ended June 30, 2010 and 2009.

	Fiscal Year 2010 Quarterly Results			
	September 30,	December 31,	March 31,	June 30,
	(in 000s, except per share data)			
Statement of Operations Data:				
Revenues	$ 187,330	$ 204,973	$ 190,640	$ 195,248
Cost of revenues	69,463	74,701	66,455	69,186
Selling, general and administrative	45,196	53,721	52,545	51,733
Research and development costs	19,471	19,571	20,279	20,980
Impairment charges(1)			11,379	
Income from continuing operations before income taxes	45,863	48,629	31,992	44,334
Income tax expense	(16,255)	(16,456)	(11,262)	(16,748)
Income from continuing operations	29,608	32,173	20,730	27,586
Income from discontinued operations, net taxes	1,749	1,430	2,363	1,639
Gain on disposal of discontinued operations, net taxes				22,079
Net income	31,357	33,603	23,093	51,304
Less net income attributable to noncontrolling interests	733	350	534	263
Net income attributable to Bally Technologies, Inc.	$ 30,624	$ 33,253	$ 22,559	$ 51,041
Basic earnings per share attributable to Bally Technologies, Inc.:				
Income from continuing operations	$ 0.53	$ 0.59	$ 0.37	$ 0.50
Income from discontinued operations	0.03	0.02	0.04	0.03
Gain on sale of discontinued operations				0.40
Basic earnings per share	$ 0.56	$ 0.61	$ 0.41	$ 0.93
Diluted earnings per share attributable to Bally Technologies, Inc.:				
Income from continuing operations	$ 0.50	$ 0.56	$ 0.36	$ 0.48
Income from discontinued operations	0.03	0.02	0.03	0.03
Gain on sale of discontinued operations				0.38
Diluted earnings per share	$ 0.53	$ 0.58	$ 0.39	$ 0.89

(1) Impairment charges of $11.4 million were recognized in the third quarter related to the Alabama charitable bingo market (see Note 4, *Impairment Charges).*

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Fiscal Year 2009 Quarterly Results			
	September 30,	December 31,	March 31,	June 30,
	(in 000s, except per share data)			
Statement of Operations Data:				
Revenues	$ 227,350	$ 223,648	$ 196,814	$ 195,948
Cost of revenues	97,382	86,709	74,969	72,733
Selling, general and administrative	55,129	55,934	50,168	51,504
Research and development costs	19,871	19,331	19,291	18,784
Income from continuing operations before income taxes	44,059	50,046	43,160	47,695
Income tax expense	(16,224)	(17,881)	(15,073)	(15,603)
Income from continuing operations	27,835	32,165	28,087	32,092
Income from discontinued operations, net of taxes	2,002	1,709	2,529	1,817
Net income	29,837	33,874	30,616	33,909
Less net income attributable to noncontrolling interests	(467)	310	1,365	719
Net income attributable to Bally Technologies, Inc.	$ 30,304	$ 33,564	$ 29,251	$ 33,190
Basic earnings per share attributable to Bally Technologies, Inc.:				
Income from continuing operations	$ 0.52	$ 0.59	$ 0.50	$ 0.58
Income from discontinued operations	0.03	0.03	0.04	0.03
Basic earnings per share	$ 0.55	$ 0.62	$ 0.54	$ 0.61
Diluted earnings per share attributable to Bally Technologies, Inc.:				
Income from continuing operations	$ 0.49	$ 0.57	$ 0.48	$ 0.55
Income from discontinued operations	0.03	0.02	0.04	0.03
Diluted earnings per share	$ 0.52	$ 0.59	$ 0.52	$ 0.58

BALLY TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS

Years ended June 30, 2010, 2009 and 2008

	Balance at Beginning of Year	Additions	Net Write-offs/ (Recoveries)	Balance at End of Year
		(in 000s)		
Allowance for doubtful accounts (current and long-term):				
Year Ended June 30, 2010(1)	$ 8,897	$ 8,382	$ 2,136	$ 15,143
Year Ended June 30, 2009	$ 12,027	$ (57)	$ 3,073	$ 8,897
Year Ended June 30, 2008	$ 8,457	$ 5,213	$ 1,643	$ 12,027

(1)

Additions includes $5.5 million in impairment charges related to the Alabama charitable bingo market (see Note 4, *Impairment Charges*).

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