HENNESSY ADVISORS INC
Form 10-Q
January 18, 2011
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended December 31, 2010

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

For the Transition Period From ______ to ______

Commission File Number 000-49872

HENNESSY ADVISORS, INC.

(Exact name of registrant as specified in its charter)

California	**68-0176227**
(State or other jurisdiction of incorporation or organization)	**(IRS Employer Identification No.)**

7250 Redwood Blvd., Suite 200 Novato, California	**94945**
(Address of principal executive office)	**(Zip Code)**

(415) 899-1555

(Issuer s telephone number)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer	¨	Accelerated Filer	¨
Non-accelerated Filer	¨	Smaller Reporting Company	x

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

As of January 5, 2011 there were 5,734,919 shares of common stock issued and outstanding.

Table of Contents

HENNESSY ADVISORS, INC.

INDEX

		Page Number
PART I.	Financial Information	
Item 1.	Unaudited Condensed Financial Statements	
	Balance Sheets as of December 31, 2010 (unaudited) and September 30, 2010	3
	Statements of Operations for the three months ended December 31, 2010 and 2009 (unaudited)	4
	Statement of Changes in Stockholders Equity for the three months ended December 31, 2010 (unaudited)	5
	Statements of Cash Flows for the three months ended December 31, 2010 and 2009 (unaudited)	6
	Notes to Unaudited Condensed Financial Statements	7
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	17
Item 4.	Controls and Procedures	25
PART II.	Other Information	26
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	26
Item 6.	Exhibits	27
Signatures		27

Table of Contents

Hennessy Advisors, Inc.

Balance Sheets

(In thousands, except share and per share amounts)

	December 31, 2010 (Unaudited)	September 30, 2010
Assets		
Current assets:		
Cash and cash equivalents	$ 7,312	$ 8,054
Investments in marketable securities, at fair value	5	5
Investment fee income receivable	654	619
Prepaid expenses	129	186
Deferred income tax asset	77	118
Other current assets	25	22
Total current assets	8,202	9,004
Property and equipment, net of accumulated depreciation of $409 and $383, respectively	164	180
Management contracts	22,284	22,284
Investment in the Hennessy Micro Cap Growth Fund, LLC, at fair value	422	364
Other assets, net of accumulated amortization of $103 and $101, respectively	65	67
Total assets	$ 31,137	$ 31,899
Liabilities and Stockholders Equity		
Current liabilities:		
Accrued liabilities and accounts payable	$ 353	$ 1,005
Income taxes payable	35	18
Current portion of deferred rent	49	50
Current portion of long-term debt	625	573
Total current liabilities	1,062	1,646
Long-term debt	2,396	2,552
Long-term portion of deferred rent	12	24
Deferred income tax liability	3,353	3,177
Total liabilities	6,823	7,399
Commitments and Contingencies (Note 9)		
Stockholders equity:		
Adjustable rate preferred stock, $25 stated value, 5,000,000 shares authorized: zero shares issued and outstanding		
Common stock, no par value, 15,000,000 shares authorized: 5,734,919 shares issued and outstanding at December 31, 2010 and 5,709,839 at September 30, 2010	9,460	9,456
Accumulated other comprehensive loss	(90)	(148)
Retained earnings	14,944	15,192

Total stockholders equity	24,314	24,500
Total liabilities and stockholders equity	$ 31,137	$ 31,899

See accompanying notes to unaudited condensed financial statements

Table of Contents

Hennessy Advisors, Inc.

Statements of Operations

(In thousands, except share and per share amounts)

(Unaudited)

	Three Months ended December 31, 2010	2009
Revenue		
Investment advisory fees	$ 1,730	$ 1,782
Shareholder service fees	214	209
Other	5	7
Total revenue	1,949	1,998
Operating expenses		
Compensation and benefits	555	723
General and administrative	567	524
Mutual fund distribution	166	179
Sub-advisor fees	158	176
Amortization and depreciation	28	28
Total operating expenses	1,474	1,630
Operating income	475	368
Interest expense	17	10
Other expense, net		6
Income before income tax expense	458	352
Income tax expense	192	149
Net income	$ 266	$ 203
Earnings per share:		
Basic	$ 0.05	$ 0.04
Diluted	$ 0.05	$ 0.04
Weighted average shares outstanding:		
Basic	5,714,841	5,692,790
Diluted	5,719,554	5,697,476

See accompanying notes to unaudited condensed financial statements

Table of Contents

Hennessy Advisors, Inc.

Statement of Changes in Stockholders Equity

Three Months Ended December 31, 2010

(In thousands, except share data)

(Unaudited)

	Common Shares	Common Stock	Retained Earnings	Other Comprehensive Loss	Total Stockholders Equity
Balance at September 30, 2010	5,709,839	$ 9,456	$ 15,192	$ (148)	$ 24,500
Net Income			266		266
Dividends paid			(514)		(514)
Unrealized gain on investment in Hennessy Micro Cap Growth Fund, LLC				58	58
Employee and director restricted stock vested	26,835				
Repurchase of vested employee restricted stock for tax withholding	(1,755)	(4)			(4)
Deferred restricted stock unit compensation		70			70
Tax effect of RSU vesting		(62)			(62)
Balance at December 31, 2010	5,734,919	$ 9,460	$ 14,944	$ (90)	$ 24,314

See accompanying notes to unaudited condensed financial statements

- 5 -

Table of Contents

Hennessy Advisors, Inc.

Statements of Cash Flows

(Unaudited)

	Three Months Ended December 31, 2010	2009
	(In thousands)	
Cash flows from operating activities:		
Net income	$ 266	$ 203
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	28	28
Deferred income taxes	217	228
Tax effect from restricted stock unit vesting	(62)	(79)
Restricted stock units vested	(4)	(12)
Deferred restricted stock unit compensation	70	129
(Increase) decrease in operating assets:		
Investment fee income receivable	(35)	(107)
Prepaid expenses	57	33
Other current assets	(3)	(63)
Other assets		(1)
Increase (decrease) in operating liabilities:		
Accrued liabilities and accounts payable	(652)	(1,036)
Income taxes	17	1
Current portion of deferred rent	(1)	(4)
Long-term portion of deferred rent	(12)	(1)
Net cash used in operating activities	(114)	(681)
Cash flows used in investing activities:		
Purchases of property and equipment	(10)	(28)
Payments related to acquisition of management contracts		(42)
Net cash used in investing activities	(10)	(70)
Cash flows used in financing activities:		
Principal payments on bank loan	(104)	(206)
Dividend payment	(514)	
Net cash used in financing activities	(618)	(206)
Net decrease in cash and cash equivalents	(742)	(957)
Cash and cash equivalents at the beginning of the period	8,054	5,747
Cash and cash equivalents at the end of the period	$ 7,312	$ 4,790
Supplemental disclosures of cash flow information:		
Unrealized gain on investment	$ 58	$ 34

Cash paid for:				
Income taxes	$		$	
Interest	$	15	$	11

See accompanying notes to unaudited condensed financial statements

Table of Contents

Hennessy Advisors, Inc.

Notes to Unaudited Condensed Financial Statements

(1) Basis of Financial Statement Presentation

The accompanying condensed balance sheet as of September 30, 2010, which has been derived from audited financial statements, and the unaudited interim condensed financial statements as of December 31, 2010 have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission and include the accounts of Hennessy Advisors, Inc. (the Company). Certain information and footnote disclosures, normally included in financial statements prepared in accordance with generally accepted accounting principles, have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the financial statements reflect all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the financial position at December 31, 2010, the operating results for the three months ended December 31, 2010 and December 31, 2009, and the cash flows for the three months ended December 31, 2010 and December 31, 2009. These financial statements and notes should be read in conjunction with the Company s audited financial statements and notes thereto for the year ended September 30, 2010, included in the Company s Form 10-K filed with the Securities and Exchange Commission.

The operating activities of the Company consist of providing investment management and shareholder services to ten open-end mutual funds (collectively the Hennessy Funds), seven of which also have institutional share classes; and investment management services to one non-registered private pooled investment fund, the Hennessy Micro Cap Growth Fund, LLC. The Company serves as investment advisor for all classes of the Hennessy Cornerstone Growth Fund, the Hennessy Cornerstone Growth Fund, Series II, the Hennessy Focus 30 Fund, the Hennessy Cornerstone Large Growth Fund, the Hennessy Cornerstone Value Fund, the Hennessy Select Large Value Fund, the Hennessy Select SPARX Japan Fund, the Hennessy Select SPARX Japan Smaller Companies Fund, the Hennessy Total Return Fund, the Hennessy Balanced Fund, and the Hennessy Micro Cap Growth Fund, LLC.

(2) Management Contracts

As of December 31, 2010, Hennessy Advisors had contractual management agreements with Hennessy Funds, Inc. for the Hennessy Balanced Fund and the Hennessy Total Return Fund; with Hennessy Mutual Funds, Inc. for all classes of the Hennessy Cornerstone Growth Fund, the Hennessy Cornerstone Value Fund, and the Hennessy Focus 30 Fund; with Hennessy Funds Trust for all classes of the Hennessy Cornerstone Growth Fund, Series II, the Hennessy Cornerstone Large Growth Fund, and the Hennessy Select Large Value Fund; and with Hennessy SPARX Funds Trust for all classes of the Hennessy Select SPARX Japan Fund and the Hennessy Select SPARX Japan Smaller Companies Fund.

The management agreements for the Hennessy Cornerstone Large Growth Fund and the Hennessy Select Large Value Fund were approved by the Board of Trustees of Hennessy Funds Trust on March 3, 2009 (and subsequently approved by shareholders) for an intial period of two years, to be renewed annually thereafter; and the management agreements for the Hennessy Select SPARX Japan Fund and the Hennessy Select SPARX Japan Smaller Companies Fund were approved by the Board of Trustees of Hennessy SPARX Funds Trust on July 13, 2009 (and subsequently approved by shareholders) for an intial period of two years, to be renewed annually thereafter.

Table of Contents

The management agreements for the other Hennessy Funds are renewed annually by (1) the board of directors or trustees of the applicable investment company or by a majority vote of the outstanding shares of the applicable fund and (2) by the vote of a majority of the directors or trustees of the applicable investment company who are not parties to the management agreement and are disinterested directors or trustees. These management agreements were renewed by the Board of Directors of the Hennessy Funds, Inc. and Hennessy Mutual Funds, Inc. and by the Board of Trustees of the Hennessy Funds Trust on March 3, 2010 for a period of one year.

Other than non-renewal, two other circumstances might lead to termination of the management agreements: (1) the assignment of a management agreement to another advisor automatically terminates the agreement (assignment includes an indirect assignment by transferring a controlling block of our common stock); and (2) the termination of the agreement by the Company or by one of the Hennessy Funds investment companies upon 60 days prior written notice.

Under the terms of the management agreements, each fund bears all expenses incurred in its operation that are not specifically assumed by Hennessy Advisors, the administrator or the distributor. Hennessy Advisors bears the expense of providing office space, shareholder servicing, fulfillment, clerical and bookkeeping services and maintaining books and records of the Hennessy Funds.

The Company waives its investment management fees to comply with contractual expense ratio limitations for certain of the Hennessy Funds. The fee waivers are calculated daily by our fund accountants and are expensed monthly by the Company as an offset to revenue. The fees are deducted from the management fee income, and are deducted from the funds received from our fund accountants in the subsequent month.

In the past, fees have only been waived based on contractual obligations. However, the Company regularly analyzes the fees and has the right to waive fees at its discretion to compete with other mutual funds with lower expense ratios. Any decision to waive fees would not apply to previous periods, but would apply on a going forward basis.

Hennessy Advisors is also the Managing Member of the Hennessy Micro Cap Growth Fund, LLC (the Micro Cap Fund). Hennessy Advisors will serve as the Managing Member until its resignation or removal. The Managing Member may voluntarily resign with 30 days prior written notice to the other members or 60 days prior written notice if there is not then a remaining Managing Member. At any time, the Managing Member may designate an additional Managing Member or designate a successor Managing Member with no further consent or approval required from the other members. The Managing Member may be removed at any time, with or without cause, by the vote of the other members owning a majority-in-interest of the capital accounts of the Disinterested Members, defined as members other than members who are the Managing Member or affiliates of the Managing Member.

Table of Contents

Under the terms of the management agreement for the Micro Cap Fund, the Managing Member bears all organizational expenses (defined as expenses incurred in connection with and directly related to the formation, qualification and funding of the Micro Cap Fund), but the Micro Cap Fund bears all of its operating, investment and other expenses. However, the Managing Member is responsible for the ordinary and extraordinary costs of administering the Micro Cap Fund, including any placement fees incurred in connection with the offering of interests in the Micro Cap Fund.

Hennessy Advisors, as the Managing Member of the Micro Cap Fund, has the right to reduce or waive the management fee or incentive allocation (as defined in Note 5) chargeable to any member s account without the consent of or notice to any other member.

As of December 31, 2010, no events or changes in circumstances occurred that indicated potenial impairment of the management contracts.

(3) Investment in the Hennessy Micro Cap Growth Fund, LLC

On October 30, 2007, Hennessy Advisors invested $0.5 million in the Micro Cap Fund. The investment currently represents approximately 23.5% of the total subscriptions in the Micro Cap Fund. The Micro Cap Fund is a limited liability company for which Hennessy Advisors is the Managing Member.

The investment is classified as an available-for-sale security, and is included on the balance sheet at market value. The fair market value of the investment at December 31, 2010 was $0.4 million.

The accounting method the Company uses for its equity investments is generally dependent upon the influence the Company has over the investee. If there are investments where the Company can exert control over the financial and operating policies of the investee, which generally exists if there is a 50% or greater voting interest (the Company s ownership in the Micro Cap Fund is approximately 23.5%), the investee will be consolidated into the Company s financial statements. Further, as managing member of an investee, the Company is generally presumed to control the investee (and should consolidate the investee into the Company s financial statements) unless this presumption is overcome because members of the investee other than the Company and its affiliates have the substantive ability to dissolve the investee or otherwise remove the Company as the managing member without cause. After considering the above with respect to the investment in the Micro Cap Fund and the Financial Accounting Standards Board s (FASB) guidance on investment in equity and variable interest entities with respect to the investment in the Micro Cap Fund, the Company determined that the Micro Cap Fund should not be consolidated because the investment is less than 25% of the total investment, and the Company can be removed from the position of managing member at any time, with or without cause, by the vote of the other members owning a majority-in-interest of the capital accounts of the Disinterested Members (defined as members other than members who are the Managing Member or affiliates of the Managing Member).

Table of Contents

(4) Bank Loan

On March 11, 2004, Hennessy Advisors secured financing from US Bank National Association to acquire the management contracts for certain Lindner Funds. The loan agreement required fifty-nine (59) monthly payments in the amount of $94,060 plus interest at the bank s prime rate less one percent. On July 1, 2005, the loan was amended to provide an additional $6.7 million to fund acquisition of the management contract for the Henlopen Fund. An additional $2.0 million was loaned to the Company on September 27, 2010, and the loan was amended to require 60 monthly payments in the amount of $52,083 plus interest at the bank s prime rate (currently 3.25%, in effect since December 17, 2008) less one percent (effective interest rate of 2.25%) and is secured by the Company s assets. The final installment of the then outstanding principal and its interest are due September 30, 2015. The loan agreement includes certain reporting requirements and loan covenants requiring the maintenance of certain financial ratios. The Company is in compliance for the three month period ended December 31, 2010.

In connection with securing the financing discussed above, Hennessy Advisors incurred loan costs in the amount of $31,250. These costs are included in other assets and the unamortized balance of $31,250 (as of the loan amendment date of September 27, 2010) is being amortized on a straight-line basis over 60 months.

(5) Investment Advisor and Shareholder Service Fee Revenue

Investment advisory and shareholder services, which are the primary sources of revenue, are recorded when earned. The Company receives investment advisory fees monthly at an annual rate of 0.74% of the average daily net assets of the Hennessy Cornerstone Growth Fund, the Hennessy Cornerstone Growth Fund, Series II, the Hennessy Focus 30 Fund, the Hennessy Cornerstone Large Growth Fund, and the Hennessy Cornerstone Value Fund; at an annual rate of 0.85% of the average daily net assets of the Hennessy Select Large Value Fund; at an annual rate of 1.00% of the Hennessy Select SPARX Japan Fund; and at an annual rate of 1.20% of the Hennessy Select SPARX Japan Smaller Companies Fund. The annual advisory fee for the Hennessy Balanced Fund and the Hennessy Total Return Fund is 0.60%, and the annual advisory fee for the Micro Cap Fund is 2.0% of the aggregate capital accounts of the members, but no management fee is charged to the capital account of the Company.

The Company has delegated the day-to-day portfolio management of the Hennessy Select Large Value Fund, the Hennessy Select SPARX Japan Fund and the Hennessy Select SPARX Japan Smaller Companies Fund (the Select Funds) to sub-advisors. Hennessy Advisors pays RBC Global Asset Management (U.S.) Inc. at an annual rate of 0.35% of the average daily net assets of the Hennessy Select Large Value Fund; and Hennessy Advisors pays SPARX Asset Management Co., Ltd. at an annual rate of 0.35% of the average daily net assets of the Hennessy Select SPARX Japan Fund and of 0.20% of the average daily net assets of the Hennessy Select SPARX Japan Smaller Companies Fund.

Fees are earned for shareholder support services provided for each of the original class shares of the ten Hennessy Funds. The shareholder servicing fees are charged at an annual rate of 0.1% of average daily net assets.

Table of Contents

In the Micro Cap Fund, an additional incentive allocation can potentially be earned on any member s balance, other than the Company s balance. The allocation is determined at the end of each calendar quarter as 20% of the amount by which net profits (defined as the amount by which the net asset value on the last day of a period exceeds the net asset value on the commencement of the same period), if any, exceed the positive balance, if any, of a member s loss carryforward (defined as a memorandum account kept for each member having an intial balance of zero that is increased by the net loss, if any, allocated to each member for each calendar period). The incentive fee is calculated and earned on the last day of the quarter, at which point it would be recognized in accordance with FASB guidance on revenue recognition, which specifies that the following criteria must be met for revenue recognition: persuasive evidence of an arrangement exists, delivery has occurred or the service has been rendered, the fee is fixed and determinable, and collectability is probable. The incentive income is not subject to any clawback provisions that would require us to return fees to investors. There was no incentive fee earned in the three months ended December 31, 2010 and 2009.

(6) Income Taxes

The following is our tax position at December 31, 2010 and 2009:

The provision for income taxes comprised of the following for the three months ended December 31, 2010 and 2009:

	12/31/2010	12/31/2009
Current		
Federal	$ 30,000	$ 800
State	7,200	
	37,200	800
Deferred		
Federal	132,300	126,300
State	22,100	21,800
	154,400	148,100
Total	**$ 191,600**	**$ 148,900**

The principal reasons for the differences from the federal statutory rate of 34% are as follows:

	12/31/2010	12/31/2009
Federal tax at statutory rate	34.00%	34.00%
State tax at statutory rate	5.54%	5.83%
Permanent differences	2.30%	2.42%
Effective Tax Rate	**41.84%**	**42.25%**

Table of Contents

The tax effects of temporary differences that give rise to significant portions of deferred tax assets and liabilities as of December 31, 2010 and 2009 are presented below:

	12/31/2010	12/31/2009
Current deferred tax assets:		
Accrued compensation	$ 20,800	$ 90,600
Accrued rent	24,300	1,300
State taxes	2,500	
Net operating loss		72,100
Other	29,200	9,200
Total deferred tax assets	76,800	173,200
Noncurrent deferred tax liabilities:		
Net operating loss	40,700	
Property and equipment	(1,800)	(18,700)
Management contracts	(3,392,100)	(2,747,900)
Total deferred tax liabilities	(3,353,200)	(2,766,600)
Net deferred tax liabilities	**$ (3,276,400)**	**$ (2,593,400)**

The Company files U.S. federal and state tax returns and has determined that its major tax jurisdictions are the United States and California. The tax years ended in 2006 through 2009 remain open and subject to examination by the appropriate governmental agencies in the U.S., and the 2003 through 2009 tax years remain open in California.

The Company s effective tax rate for the three months ended December 31, 2010 and 2009, were 41.8% and 42.3%, respectively, and differ from the federal statutory rate of 34% primarily due to the effects of state income taxes.

(7) Earnings or Loss per Share

Basic earnings or loss per share are determined by dividing net earnings or loss by the weighted average number of shares of common stock outstanding, while diluted earnings or loss per share are determined by dividing net earnings or loss by the weighted average number of shares of common stock outstanding adjusted for the dilutive effect of common stock equivalents.

There were 678,025 common stock equivalents, consisting of unexercised options and unvested RSUs, excluded from the per share calculations for the three months ended December 31, 2010 because they were anti-dilutive. There were 774,344 common stock equivalents, consisting of unexercised options and unvested RSUs, excluded from the per share calculations for the three months ended December 31, 2009 because they were anti-dilutive.

Table of Contents

(8) Stock-Based Compensation

On May 2, 2001, the Company established an omnibus incentive plan (the Plan) providing for the issuance of options, stock appreciation rights, restricted stock, performance awards, and stock loans for the purpose of attracting and retaining executive officers and key employees. The maximum number of shares which may be issued under the Plan is 25% of the outstanding common stock of the Company, subject to adjustment by the compensation committee of the Board of Directors. The 25% limitation does not invalidate any awards made prior to a decrease in the number of outstanding shares, even though such awards have resulted or may result in shares constituting more than 25% of the outstanding shares being available for issuance under the Plan. Shares available under the Plan which are not awarded in one particular year may be awarded in subsequent years. The compensation committee of the Board of Directors has the authority to determine the awards granted under the Plan, including among other things, the individuals who receive the awards, the times when they receive them, vesting schedules, performance goals, whether an option is an incentive or nonqualified option and the number of shares to be subject to each award. However, no participant may receive options or stock appreciation rights under the Plan for an aggregate of more than 75,000 shares in any calendar year. The exercise price and term of each option or stock appreciation right is fixed by the compensation committee except that the exercise price for each stock option which is intended to qualify as an incentive stock option must be at least equal to the fair market value of the stock on the date of grant and the term of the option cannot exceed 10 years. In the case of an incentive stock option granted to a 10% shareholder, the exercise price must be at least 110% of the fair market value on the date of grant and cannot exceed five years. Incentive stock options may be granted only within ten years from the date of adoption of the Plan. The aggregate fair market value (determined at the time the option is granted) of shares with respect to which incentive stock options may be granted to any one individual, which stock options are exercisable for the first time during any calendar year, may not exceed $100,000. An optionee may, with the consent of the compensation committee, elect to pay for the shares to be received upon exercise of their options in cash or shares of common stock or any combination thereof.

As the exercise price of all options granted under the Plan was equal to the market price of the underlying common stock on the grant date and all options were granted and fully vested prior to the adoption of the revised FASB guidance on Stock Compensation, no stock-based employee compensation cost related to options granted was recognized in net income. There were no options granted during the three months ended December 31, 2010 and 2009.

Table of Contents

Under the Plan, participants may be granted restricted stock units (RSUs), representing an unfunded, unsecured right to receive a Company common share on the date specified in the recipient s award. The Company issues new shares for shares delivered for RSU recipients. The RSUs granted under the Plan vest over four years, at a rate of 25 percent per year. The Company recognizes compensation expense on a straight-line basis over the four-year vesting term of each award. There were no RSUs granted during the three months ended December 31, 2010 and 2009. RSU activity for the three months ended December 31, 2010 was as follows:

	Restricted Stock Unit Activity Three Months Ended December 31, 2010	
	Number of Restricted Share Units	Weighted Fair Value Per Share at Each Date
Non-vested Balance at September 30, 2010	43,527	$ 5.84
Granted		
Vested (1)	(7,989)	$ 8.80
Forfeited		
Non-vested Balance at December 31, 2010	35,538	$ 5.18

(1) The restricted stock units vested includes partially vested shares. Shares of common stock have not been issued for the partially vested shares, but the related compensation costs have been expensed. Additionally, some of the shares issued in the current year were partially vested (and expensed) in the prior fiscal year. There were 25,080 shares of common stock issued for restricted stock units vested (net of shares repurchased for tax withholding) in the three months ended December 31, 2010.

Restricted Stock Unit Compensation

Three Months Ended December 31, 2010

	(In Thousands)
Total expected compensation expense related to Restricted Stock Units	$ 2,181
Compensation Expense recognized as of December 31, 2010	(1,997)
Unrecognized compensation expense related to RSU s at December 31, 2010	$ 184

As of December 31, 2010, there was $0.2 million of total RSU compensation expense related to non-vested awards not yet recognized, which is expected to be recognized over a weighted-average vesting period of 1.6 years.

(9) Commitments and Contingencies

The Company s headquarters is located in leased office space under a single non-cancelable operating lease at 7250 Redwood Blvd., Suite 200, in Novato, California. On April 1, 2010, the Company signed an amended lease agreement for the Novato office space extending the term through March 31, 2012 with an option for an additional three years thereafter.

Table of Contents

The Company s portfolio trading operation is located in leased office space under a non-cancelable lease at One Landmark Square, Suite 424, in Stamford, Connecticut. The lease was amended on April 1, 2008 and expires September 30, 2011.

As of December 31, 2010, there were no material changes in the leasing arrangements that would have a significant effect on future minimum lease payments reported in our Annual Report on Form 10-K for the fiscal year ended September 30, 2010.

(10) Fair Value Measurements
In September, 2006, the FASB issued new standard Fair Value Measurements, which was effective for our fiscal year 2009. In February, 2008, the FASB issued a new standard which delayed the effective date for all non-financial assets and liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis, to the fiscal year beginning after November 15, 2008 (our fiscal year 2010). The Company adopted the fair value measurement for all financial and non-financial assets and liabilities as of October 1, 2009. Based on the scope of the new accounting guidance, all of the non-financial assets and non-financial liabilities on the Company s balance sheet are excluded from the new accounting guidance. The standard defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. It also establishes a fair value hierarchy consisting of the following three levels that prioritize the inputs to the valuation techniques used to measure fair value:

Level 1 quoted market prices in active markets for identical assets or liabilities that are accessible at the measurement date.

Level 2 from other than quoted market prices that are observable for the asset or liability, either directly or indirectly (namely, similar assets or from markets that are not active).

Level 3 unobservable and shall be used to measure fair value to the extent that observable inputs are not available (namely, reflecting an entity s own assumptions).

Table of Contents

Based on the definitions, the following table represents the Company s assets categorized in the level 1 to 3 hierarchy as of December 31, 2010:

	Fair Value Measurements at Reporting Date (amounts in thousands)			
	Level 1	Level 2	Level 3	Total
Money market fund deposits	$ 7,312	$	$	$ 7,312
Mutual fund investments	5			5
Investment in domestic equities		422		422
Total	$ 7,317	$ 422	$	$ 7,739
Amounts included in:				
Cash and cash equivalents	$ 7,312	$	$	$ 7,312
Investments in marketable securities	5			5
Investment in the Hennessy Micro Cap Fund		422		422
Total	$ 7,317	$ 422	$	$ 7,739

(11) New Accounting Pronouncements

In June, 2009, the FASB issued amendments to accounting for Consolidation of Variable Interest Entities. The amendment requires ongoing reassessments of whether an enterprise is the primary beneficiary of a variable interest entity. It also eliminates the quantitative approach previously required for determining the primary beneficiary of a variable interest entity. The amendment is effective for annual and interim reporting periods in fiscal years beginning after December 15, 2009 (the Company s fiscal year 2011). We have evaluated the amendment and determined that the effect on our financial statements or results of operations financial statements is immaterial.

In January, 2010, the FASB issued Accounting Standards Update (ASU) No. 2010-06, Improving Disclosure about Fair Value Measurements. This ASU will add new requirements for disclosures into and out of Levels 1 and 2 fair value measurements and information on purchases, sales, issuances and settlements on a gross basis in the reconciliation of Level 3 fair value measurements. It also clarifies existing fair value disclosures about the level of disaggregation, inputs and valuation techniques. The guidance in the ASU is effective for annual and interim reporting periods in fiscal years beginning after November 15, 2010 (the Company s fiscal year 2012). We do not anticipate the adoption of the new guidance to have any effect on our financial statements or results of operations.

There have been no other significant changes in the Company s critical accounting policies and estimates during the three months ended December 31, 2010 as compared to what was previously disclosed in the Company s Form 10-K for the year ended September 30, 2010 as filed with the SEC on December 3, 2010.

Table of Contents

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

Forward Looking Statements

Certain statements in this report are forward-looking within the meaning of the federal securities laws. Although management believes that the expectations reflected in the forward-looking statements are reasonable, future levels of activity, performance or achievements cannot be guaranteed. Additionally, management does not assume responsibility for the accuracy or completeness of these statements. There is no regulation requiring an update of any of the forward-looking statements after the date of this report to conform these statements to actual results or to changes in our expectations.

Our business activities are affected by many factors, including, without limitation, redemptions by mutual fund shareholders, general economic and financial conditions, movement of interest rates, competitive conditions, industry regulation, fluctuation in the stock market, and others, many of which are beyond the control of our management.

Statements regarding the following subjects are forward-looking by their nature:

- our business strategy, including our ability to identify and complete future acquisitions;
- market trends and risks;
- our assumptions about changes in the market place, especially with the extreme volatility in the global and US financial markets;
- our estimates for future performance;
- our estimates regarding anticipated revenues and operating expenses; and
- our ability to retain the mutual fund assets we currently manage.

Although we seek to maintain cost controls, a significant portion of our expenses are fixed and do not vary greatly. As a result, substantial fluctuations in our revenue can directly impact our net income from period to period.

Overview

We derive our operating revenue from management fees and shareholder servicing fees paid to us by the Hennessy Funds. These fees are calculated as a percentage of the average daily net assets in our mutual funds and vary from fund to fund. The fees we receive fluctuate with changes in the total net asset value of the assets in our mutual funds, which are affected by our investment performance, redemptions, completed acquisitions of management agreements, market conditions and the success of our marketing efforts. Average assets under management were $896.4 million and $933.0 million for the three months ended December 31, 2010 and 2009, respectively.

Table of Contents

Total assets under management were $885.4 million as of December 31, 2010. Our total assets under management have decreased since December 31, 2009, due to redemptions, partly offset by market appreciation and inflows. The following table illustrates the changes in assets under management from December 31, 2009 through December 31, 2010:

	Assets Under Management At Each Quarter End, December 31, 2009 through December 31, 2010				
	12/31/2009	3/31/2010	6/30/2010 (In Thousands)	9/30/2010	12/31/2010
Beginning assets under management	$ 923,404	$ 944,915	$ 960,816	$ 812,595	$ 892,465
Acquisition inflows					
Organic inflows	39,117	36,134	16,185	41,125	23,894
Redemptions	(70,015)	(71,086)	(74,029)	(47,706)	(100,443)
Market appreciation (depreciation)	52,409	50,853	(90,377)	86,451	69,438
Ending assets under management	$ 944,915	$ 960,816	$ 812,595	$ 892,465	$ 885,354

The principal asset on our balance sheet, management contracts net of accumulated amortization, represents the capitalized costs incurred in connection with the acquisition of management agreements. As of December 31, 2010, this asset had a net balance of $22.3 million.

The principal liability on our balance sheet is the bank debt incurred in connection with the acquisition of the management agreements for the Lindner Funds and the Henlopen Fund. As of December 31, 2010, this liability had a balance of $3.0 million.

Table of Contents

Results of Operations

The following table displays items in the statements of operations as dollar amounts and as percentages of total revenue for the three months ended December 31, 2010 and 2009:

	Three Months Ended December 31, 2010		2009	
	(In thousands, except percentages)			
	Amounts	Percent of Total Revenue	Amounts	Percent of Total Revenue
Revenue:				
Investment advisory fees	$ 1,730	88.8%	$ 1,782	89.2%
Shareholder service fees	214	11.0	209	10.5
Other	5	0.2	7	0.3
Total revenue	1,949	100.0	1,998	100.0
Operating expenses:				
Compensation and benefits	555	28.5	723	36.2
General and administrative	567	29.1	524	26.2
Mutual fund distribution	166	8.5	179	9.0
Sub-advisor fees	158	8.1	176	8.8
Amortization and depreciation	28	1.4	28	1.4
Total operating expenses	1,474	75.6	1,630	81.6
Operating income	475	24.4	368	18.4
Interest expense	17	0.9	10	0.5
Other income			6	0.3
Income before income tax expense	458	23.5	352	17.6
Income tax expense	192	9.9	149	7.4
Net income	$ 266	13.6%	$ 203	10.2%

Revenues: Total revenue decreased 2.5% to $1.9 million in the three months ended December 31, 2010, due to decreased average assets under management. Investment advisory fees decreased 2.9% to $1.7 million in the three months ended December 31, 2010, but shareholder service fees increased 2.4% to $0.2 million in the three months ended December 31, 2010. The decrease in investment advisory fees is due to decreases in the average daily net assets of our mutual funds, which can differ considerably from total net assets of our mutual funds at the end of an accounting period.

The increase in shareholder servicing fees is due to the implementation of a shareholder servicing fee on the original class shares of the Hennessy SPARX Japan Fund and the Hennessy SPARX Japan Smaller Companies Fund June 1, 2010.

Average daily net assets in our mutual funds for the three months ended December 31, 2010 decreased by $36.6 million, or 3.9%, to $896.4 million from $933.0 million in the prior comparable period. The decrease in average daily net assets is attributable to net outflows. The largest net outflows were from the Hennessy Cornerstone Growth Fund ($55.3 million) and the Hennessy Focus 30 Fund ($39.4 million). The net outflows are partly offset by market appreciation in the Hennessy Focus 30 Fund ($34.4 million) and the Hennessy Cornerstone Growth Fund ($21.7 million).

Table of Contents

Almost a quarter of the total average daily net assets ($210.1 million) for the period are concentrated in the Hennessy Cornerstone Growth Fund. All of the largest funds generate revenue at a rate of 0.84% of daily average assets, except for the Hennessy Select Large Value Fund, which generates revenue at a rate of 0.95% of daily average assets. However, the Company pays a sub-advisor fee of 0.35% of daily average assets of the Hennessy Select Large Value Fund, which reduces the net income generated by the fund for the Company.

Total net assets in our mutual funds decreased by $59.6 million, or 6.3%, as of December 31, 2010, from $944.9 million as of the end of the prior comparable period. The $59.6 million decrease in net mutual funds assets is attributable to net outflows of $175.9 million, offset by market appreciation of $116.4 million. Redemptions as a percentage of assets under management increased from an average of 2.6% per month to 3.8% per month during the same period due to increased net outflows, as discussed below.

The decrease in assets under management is due to net outflows from the funds as investors remain apprehensive of the equity market. Despite investor fear, there has been market appreciation since the prior period, which has partially offset the net outflows.

The market appreciation was due, among other factors, to the following:

- During the most recent economic downturn, many public companies reduced their expenses, such as their number of employees, creating leaner, more profitable companies. The increased corporate profits have created an upturn in the stock market.
- Even though the markets remain volatile, some investors are gradually returning to the equity market.
- The economy has shown signs of strengthening, which has encouraged appreciation in the stock market.

Redemptions from the funds were due, among other factors, to the following:

- The economic environment remains a difficult one, which is still requiring some investors to draw-down liquid investments, such as investments in mutual funds, to pay for daily living expenses.
- The equity market is still quite volatile, and the fear created by that volatility continues to send many mutual fund investors from equity mutual funds to fixed income investment products.
- While each of the ten funds had positive performance for the calendar year ended December 31, 2010, and over half of the funds outperformed their relative benchmarks, current shareholders are uneasy and are liquidating their equity investments. Prospective investors are either investing their money in fixed income vehicles or remaining on the sidelines.

Table of Contents

In the past, the Company has been obligated to waive fees to comply with contractual expense ratio limitations. The Company does not normally waive fees, nor does it anticipate waiving fees, on a voluntary basis. The Company waived fees of $159 for the three months ended December 31, 2010, a decrease of $34,000, or 99.5%, from the prior comparable period. The decrease is mainly due to the expiration of contractual waivers for the Hennessy Select Large Value Fund and the Hennessy Cornerstone Large Growth Fund (on March 31, 2010) and for the Hennessy Select SPARX Japan Fund and the Hennessy Select SPARX Japan Smaller Companies Fund (on February 28, 2010).

Although the Company may earn incentive income on the Micro Cap Fund, the Company did not earn incentive income for the three months ended December 31, 2010.

Operating Expenses: Total operating expenses decreased 9.6% to $1.48 million in the three months ended December 31, 2010, from $1.63 million in the prior comparable period. The decrease is mainly due to decreased compensation and benefits expense. As a percentage of total revenue, total operating expenses decreased by 6.0% to 75.6% in the three months ended December 31, 2010, as compared to 81.6% in the prior comparable period.

Compensation and Benefits: Compensation and benefits decreased 23.2% to $0.56 million in the three months ended December 31, 2010, from $0.72 million in the prior comparable period. The decrease resulted primarily from the elimination of a position in January, 2010, as well as a retirement in June, 2010. As a percentage of total revenue, compensation and benefits decreased by 7.7% to 28.5% for the three months ended December 31, 2010, compared to 36.2% in the prior comparable period.

General and Administrative Expenses: General and administrative expense increased 8.2% to $0.57 million in the three months ended December 31, 2010, from $0.52 million in the prior comparable period, primarily due to increased public relations expense (mainly for media tours promoting our mutual funds to the investing public). As a percentage of total revenue, general and administrative expense increased by 2.9% to 29.1% in the three months ended December 31, 2010, from 26.2% in the prior comparable period.

Mutual Fund Distribution Expenses: Distribution expense decreased 7.3% to $0.17 million in the three months ended December 31, 2010, from $0.18 million in the prior comparable period. As a percentage of total revenue, distribution expense decreased by 0.5% to 8.5% for the three months ended December 31, 2010, compared to 9.0% in the prior comparable period.

The mutual fund distribution expense consists of fees paid for our mutual funds to be offered on various financial platforms. The platforms allow consumers to purchase shares from numerous mutual fund companies through a single location, which provides those customers with a single statement of investments and a single source for mutual fund information and customer service. When our funds are purchased through one of these platforms, such as Charles Schwab, Fidelity, TD Ameritrade or Morgan Stanley Smith Barney, the platform typically charges us an asset based fee which is recorded in mutual fund distribution expense in our statement of operations. The fees increase or decrease in line with the value of the funds held on the platforms, which can be affected by inflows, outflows and market impact.

The decreased costs in the current period are due to a decrease in the value of average assets held through mutual fund platforms such as Charles Schwab, Fidelity and TD Ameritrade due to net outflows. For the three months ended December 31, 2010, the value of the mutual funds held on Charles Schwab (the platform that makes up over half of our mutual fund fees) decreased by more than 13% from the prior comparable period, mainly due to net outflows.

Table of Contents

The incremental assets purchased through the mutual fund platforms are not as profitable as those purchased in direct shareholder accounts due to the participation fees paid on assets held in the various mutual fund platforms. All of our funds are impacted by activity on the financial platforms as they are all available on several platforms.

Sub-advisor Fee Expense: Sub-advisor fee expense decreased 10.2% to $0.16 million in the three months ended December 31, 2010, from $0.18 million in the prior comparable period. The decrease is a result of a decrease in sub-advised assets in the current period, mainly due to net outflows. As a percentage of total revenue, sub-advisor fee expense decreased by 0.7% to 8.1% for the three months ended December 31, 2010, compared to 8.8% in the prior comparable period.

Amortization and Depreciation Expense: Amortization and depreciation expense remained the same at $0.03 million in the three months ended December 31, 2010 as compared to the prior comparable period. As a percentage of total revenue, amortization and depreciation expense remained the same at 1.4% for the three months ended December 31, 2010 as compared to the prior comparable period.

Interest Expense: Interest expense increased by 70% from the prior comparable period due to an amendment to the loan providing an additional $2.0 million on September 27, 2010. Monthly principal payments of $0.05 million began in November, 2010. As a percentage of total revenue, interest expense increased by 0.4% to 0.9% for the three months ended December 31, 2010, compared to 0.5% in the prior comparable period.

Other Income: Other income decreased by 100% from the prior comparable period due to lower interest rates earned on our cash. As a percentage of total revenue, other income decreased by 0.3% to 0% for the three months ended December 31, 2010, compared to 0.3% in the prior comparable period.

Income Taxes: The provision for income taxes increased 28.9% to $0.2 million in the three months ended December 31, 2010, from $0.1 million in the prior comparable period. The change is due to increased income before tax in the current period.

Net Income: Net income increased by 31.0% to a net income of $0.3 million in the three months ended December 31, 2010, from $0.2 million in the prior comparable period, as a result of the factors discussed above.

Recent Accounting Pronouncements

In June, 2009, the FASB issued amendments to accounting for Consolidation of Variable Interest Entities. The amendment requires ongoing reassessments of whether an enterprise is the primary beneficiary of a variable interest entity. It also eliminates the quantitative approach previously required for determining the primary beneficiary of a variable interest entity. The amendment is effective for annual and interim reporting periods in fiscal years beginning after November 15, 2009 (the Company s fiscal year 2011). We have evaluated the amendment and determined that the effect on our financial statements or results of operations financial statements is immaterial.

In January, 2010, the FASB issued Accounting Standards Update (ASU) No. 2010-06, Improving Disclosure about Fair Value Measurements. This ASU will add new requirements for disclosures into and out of Levels 1 and 2 fair value measurements and information on purchases, sales, issuances and settlements on a gross basis in the reconciliation of Level 3 fair value measurements. It also clarifies existing fair value disclosures about the level of disaggregation, inputs and valuation techniques. The guidance in the ASU is effective for annual and interim reporting periods in fiscal years beginning after December 15, 2010 (the Company s fiscal year 2012). We do not anticipate the adoption of the new guidance to have any effect on our financial statements or results of operations.

Table of Contents

Critical Accounting Policies

Accounting policies, methods, and estimates are an integral part of the financial statements prepared by management and are based upon management s current judgments. Those judgments are normally based on knowledge and experience with regard to past and current events and assumptions about future events. Certain accounting policies, methods, and estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management s current judgment.

Our operating revenues consist of contractual management and shareholder servicing fees. We earn our management fees through portfolio management of our mutual funds and private pooled equity fund, and we earn our shareholder servicing fees by assisting customers in purchases, sales, distribution and customer service. The revenues are earned and calculated daily by our fund accountant. In accordance with the FASB guidance on revenue recognition, the fees are recognized monthly by the Company. Our contractual agreements provide persuasive evidence that an arrangement exists with fixed and determinable fees, and the services are rendered daily. The collectability is probable as the fees are received from our fund accountant in the month subsequent to the month in which the services are provided.

The management agreements acquired by the Company are considered intangible assets with an indefinite life. In June 2001, the Financial Accounting Standards Board issued the FASB guidance Intangibles Goodwill and Other. It states that goodwill and intangible assets with indefinite useful lives are not amortized, but are tested at least annually for impairment. We fully implemented the provisions of the FASB guidance on October 1, 2002, at which time we ceased amortization of these intangible assets. Impairment analysis is conducted quarterly and coincides with our quarterly and annual financial reporting.

In conducting the impairment analysis, the future revenues are calculated as a percent of assets under management based on our existing management agreements with the Hennessy Funds. The future expenses are based on projections of our current expenses, adjusted for changes in the assets under management. For example, variable expenses such as platform fees and sub-advisor fees grow in direct proportion with our assets under management. Other semi-variable expenses, such as office rent and professional services, grow at a rate slower than the growth in assets under management. Specifically, the projected revenues and expenses are based on assumptions about the growth of our assets under management. Since our management contracts have an indefinite life, the projections of revenues and expenses in theory are calculated into perpetuity. The actual values, however, were calculated over the future 15 years, and the value developed for the periods beyond the 15 year forecast is reflected in the terminal value calculation. Ultimately, growth rates of equities over the long-term were used in estimating future rates, primarily based on the consistent tendency of returns to center about the 11% range, as evidenced by S&P 500 returns since inception. In addition, studies have concluded that in general, flows into various mutual fund groups are highly correlated with market performance, which suggests the Hennessy Funds will average reasonable inflows over the future 15 years in response to market appreciation.

Table of Contents

We engaged an independent valuation firm and measured the fair value of the management contracts by incorporating our estimates and assumptions into a projection of future revenues, based in part upon estimates of assets under management growth and client attrition, and expenses. Based on the analysis, we concluded that projected revenues exceed projected expenses by an amount that is greater than the current carrying value of the management contracts. We therefore concluded that the management contract assets are not impaired as of September 30, 2010. We continually evaluate whether events or circumstances have occurred that indicate the management contracts may be impaired. If future valuations in the marketplace decline, the valuation of management agreements acquired may become impaired and net earnings would be negatively impacted by the resulting impairment adjustment. As of December 31, 2010, no events or circumstances occurred that indicated potential impairment of the management contracts.

The costs related to the Company s acquisition of management contracts are capitalized as incurred. The costs are defined as an intangible asset per FASB standard Intangibles Goodwill and Other. The acquisition costs include legal fees, fees for soliciting shareholder approval and a percent of asset costs to acquire the management contracts. The amounts are included in the management contract asset totaling $22.3 million as of December 31, 2010.

Liquidity and Capital Resources

We continually review our capital requirements to ensure that we have sufficient funding available to support our growth strategies. Management anticipates that cash and other liquid assets on hand as of December 31, 2010 will be sufficient to meet our short-term capital requirements. To the extent that liquid resources and cash provided by operations are not adequate to meet long-term capital requirements, management plans to raise additional capital through debt or equity markets. There can be no assurance that we will be able to borrow funds or raise additional equity.

Total assets under management as of December 31, 2010 were $885.4 million, which was a decrease of $7.1 million, or 0.7%, from September 30, 2010. The primary source of our revenue, liquidity and cash flow are our fees, which are based on and generated by our average assets under management. Property and equipment and management agreements acquired totaled $22.4 million as of December 31, 2010. We also invested $0.5 million in the Micro Cap Fund on October 30, 2007. We intend to keep this investment, decreasing our short-term liquidity. Our remaining assets are very liquid, consisting primarily of cash and receivables derived from mutual fund asset management activities. As of December 31, 2010, we had cash and cash equivalents of $7.3 million.

Table of Contents

The following table summarizes key financial data relating to our liquidity and use of cash for the three months ended December 31, 2010 and 2009:

	For the Three Months Ended December 31, (unaudited, in thousands)	
	2010	2009
Cash flow data:		
Operating cash flows	$ (114)	$ (681)
Investing cash flows	(10)	(70)
Financing cash flows	(618)	(206)
Net increase (decrease) in cash and cash equivalents	$ (742)	$ (957)

The decrease in cash used in operating activities is due to the second payment on the acquisition of the Tamarack funds of $0.7 million which was paid in October, 2009.

The decrease in cash used for investing activities is due to $0.04 million paid to acquire the SPARX funds in the prior period.

The increase in cash used for financing activities is due to a $0.5 million annual dividend payment made in November, 2010.

Our Bank Loan: We have an outstanding bank loan with U.S. Bank National Association. We incurred $7.9 million of indebtedness in connection with acquiring the management agreements for the Lindner Funds and an additional $6.7 million of indebtedness in connection with acquiring the management agreement for The Henlopen Fund. The indebtedness we incurred to acquire the management agreement of The Henlopen Fund was rolled into a single loan with the indebtedness we incurred to acquire the management agreements of the Lindner Funds. On September 27, 2010, we amended the loan to borrow an additional $2.0 million, which bears interest at U.S. Bank National Association s prime rate, as set by U.S. Bank National Association from time to time, less one percent (2.25% as of December 17, 2008) and is secured by the Company s assets. The loan was amended to require 60 monthly payments in the amount of $52,083 plus interest, with the final installment of the then outstanding principal and interest due on September 30, 2015. The loan agreement includes certain reporting requirements and loan covenants requiring the maintenance of certain financial ratios. We are in compliance with our loan covenants as of December 31, 2010. As of December 31, 2010, we have $3.0 million currently outstanding under our bank loan.

Item 4. Controls and Procedures

An evaluation was performed by management of the effectiveness of the design and operation of the Company's disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended, as of December 31, 2010. Based on that evaluation, management, including the Company s principal executive and principal financial officers, concluded that the Company's disclosure controls and procedures are effective.

Table of Contents

There has been no change in the internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Rules 13a-15 and 15d-15 of the Securities Exchange Act of 1934 that occurred during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

Part II. OTHER INFORMATION

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

We purchased shares underlying vested RSU s from employees to provide withholding and tax payments on behalf of our employees. The stock repurchases are presented in the following table for the three months ended December 31, 2010:

Period	Total number of shares purchased (a)	Average price paid per share (b)	Total number of shares purchased as part of publicly announced plans or programs (4) (c)	Maximum number of shares that may yet be purchased under the plans or programs (4) (d)
October 2010	0	$ 0.00	0	908,807
November 2010 (1)	1,316	$ 2.46	0	908,807
December 2010 (2)	439	$ 2.70	0	908,807
Total (3)	1,755	$ 2.52	0	908,807

(1) The shares repurchased on November 1, 2010 and November 15, 2010 were repurchased, according to the employee s instructions, to pay for tax expense and withholding on the compensation recognized for vested RSU s, granted on November 15, 2006 and November 1, 2008, and were not purchased pursuant to the stock buyback program described below. Withholding requirements are at statutory rates.

(2) The shares repurchased on December 6, 2010 were repurchased, according to the employee s instructions, to pay for tax expense and withholding on the compensation recognized for vested RSU s, granted on December 6, 2007, and were not purchased pursuant to the stock buyback program described below.

(3) The total shares repurchased were purchased at a weighted average price of $2.52 share.

(4) The share repurchases related to the RSUs were not completed pursuant to a plan or program, and are therefore not subject to a maximum per a plan or program. The Company has adopted a stock buyback program which it announced August 5, 2010. Pursuant to the program, the Company is authorized to purchase a maximum on 1,000,000 shares. The program has no expiration date.

Table of Contents

Item 6. Exhibits

- 31.1 Rule 13a-14a Certification of the Chief Executive Officer
- 31.2 Rule 13a-14a Certification of the Chief Financial Officer
- 32.1 Written Statement of the Chief Executive Officer, Pursuant to 18 U.S.C. § 1350
- 32.2 Written Statement of the Chief Financial Officer, Pursuant to 18 U.S.C. § 1350

Signatures

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

HENNESSY ADVISORS, INC.

Date: January 18, 2011

By: /s/ Teresa M. Nilsen
Teresa M. Nilsen, Executive Vice President, Chief Financial Officer and Secretary

EXHIBIT INDEX

- 31.1 Rule 13a 14a Certification of the Chief Executive Officer
- 31.2 Rule 13a 14a Certification of the Chief Financial Officer
- 32.1 Written Statement of the Chief Executive Officer, Pursuant to 18 U.S.C. § 1350
- 32.2 Written Statement of the Chief Financial Officer, Pursuant to 18 U.S.C. § 1350

P ALIGN="right">-1,858,362

Shareholders equity in accordance with U.S. GAAP

5,516,033 4,582,945 3,439,645

F-59

EDP - Energias de Portugal, S.A. and Subsidiaries

Notes to the Financial Statements

December 31, 2004, 2003 and 2002

Changes in consolidated statements of Shareholders Equity in accordance with U.S. GAAP are as follows:

	Total Shareholders Equity	Share capital	Share premium	Reserves and retained earnings	Accumulated other comprehensive income	Treasury stock
	Euro 000	Euro 000	Euro 000	Euro 000	Euro 000	Euro 000
Balances as at December 31, 2001 (restated)	**4,456,015**	**3,000,000**		**1,589,575**	**-100,465**	**-33,095**
Dividends paid	-337,675			-337,675		
Purchase and sale of treasury stock	-10,399					-10,399
Net profit for the year restated	264,459			264,459		
Exchange differences arising on consolidation	-300,028				-300,028	
Other reserves arising on consolidation	1,358			1,358		
Additional minimum pension liability (net of tax)	-145,000				-145,000	
Fair Value of investments available for sale (net of tax)	7,076				7,076	
Deferred Income Taxes	-70,503			-70,503		
Balances as at December 31, 2002 (restated)	**3,865,303**	**3,000,000**		**1,447,214**	**-538,417**	**-43,494**
Dividends paid	-268,275			-268,275		
Purchase and sale of treasury stock	-5,526					-5,526
Net profit for the year restated	451,162			451,162		
Fair Value of investments available for sale (net of tax)	23,225				23,225	
Exchange differences arising on consolidation	-193,032				-193,032	
Other reserves arising on consolidation	3,717			3,717		
Additional minimum pension liability (net of tax)	-56,112				-56,112	
Deferred Income Taxes	-380,817			-380,817		
Balances as at December 31, 2003 (restated)	**3,439,645**	**3,000,000**		**1,253,001**	**-764,336**	**-49,020**
Dividends paid	-268,008			-268,008		
Treasury stock	15,034					15,034
Net profit for the year	238,599			238,599		
Increase in capital with the issue of 656,537,715 new shares in Dec 2004	1,208,029	656,538	551,491			
Expenses with share capital increase (net of tax)	-64,937		-64,937			
Fair Value of investments available for sale (net of tax)	-5,999				-5,999	
Exchange differences arising on consolidation	936				936	
Cash flow hedge - Fair value reserve (net of tax)	466				466	
Additional minimum pension liability (net of tax)	16,171				16,171	
Other reserves	3,009			3,009		
Balances as at December 31, 2004	**4,582,945**	**3,656,538**	**486,554**	**1,226,601**	**-752,762**	**-33,986**

F-59

Table of Contents

EDP - Energias de Portugal, S.A. and Subsidiaries

Notes to the Financial Statements

December 31, 2004, 2003 and 2002

Certain significant line items of the balance sheets as presented on a Portuguese GAAP basis would be as follows after application of U.S. GAAP differences:

	Group	
	2004	Restated 2003
	Euro 000	Euro 000
Fixed assets	9,721,775	7,172,209
Total Assets	23,525,081	17,730,012
Total current liabilities	6,919,644	3,269,671
Total long-term liabilities	11,230,463	10,873,342
Total Liabilities	18,150,108	14,143,013
Shareholders Equity	4,582,945	3,439,645
Total Liabilities and Shareholders Equity	23,525,081	17,730,012

Accounts receivable

The amount of accounts receivable, trade and long-term receivables in accordance with U.S. GAAP are as follows:

	Group	
	2004	2003
	Euro 000	Euro 000
Accounts receivable, trade		
Accounts receivables	1,200,561	765,936
PPA receivables, short-term (less than 1 year)	133,680	121,527
	1,334,241	887,463
Long-term receivables		
Long-term receivables	945,423	435,842
PPA receivables, long-term (over 1 year)	3,056,474	3,190,154
	4,001,897	3,625,996

The amounts received from the PPA agreements are analyzed as follows:

	2004 Euro 000	2003 Euro 000	2002 Euro 000
Rents received	452,695	453,347	457,570
Interest received	331,168	342,275	352,756
Capital reimbursement	121,527	111,072	104,814

Income taxes

The components of the income tax provision and deferred income tax assets and liabilities in accordance with U.S. GAAP, before minority interest, are as follows:

	Group		
	2004 Euro 000	Restated 2003 Euro 000	Restated 2002 Euro 000
Current			
- Portugal	-216,919	-178,821	-172,407
- Other	-39,890	-60,434	1,239
	-256,809	-239,255	-171,168
Deferred	191,104	-11,570	62,825
Income tax as reported	-65,705	-250,825	-108,343
Effect of restatement		-1,700	-1,700
Income tax as restated		-252,525	-110,043

Of the Eur 191.1 million of deferred tax expense for 2004, Eur 149.2 million relates to activities in Portugal and the balance of Eur 41.9 million relates to activities abroad.

Table of Contents

EDP - Energias de Portugal, S.A. and Subsidiaries

Notes to the Financial Statements

December 31, 2004, 2003 and 2002

Components of deferred income tax assets and liabilities are analyzed as follows:

	Group	
	2004	Restated 2003
	Euro 000	Euro 000
Deferred tax assets:		
Tangible fixed assets	259,663	267,938
Intangible fixed assets and deferred costs	29,517	14,948
Accrued pension and post retirement liabilities	207,197	201,853
Power purchase agreements	64,485	61,234
Investments	57,106	11,811
Other provisions	84,626	95,438
Provision for doubtful accounts	22,544	42,278
Regulatory assets	102,052	12,765
Tax losses carried forward and tax credits	388,134	335,185
Investments in associates	38,563	41,053
Others		23,976
Total deferred tax assets	1,253,887	1,108,479
Deferred tax liabilities:		
Tangible fixed assets	106,998	77,952
Hydrological correction account		86,787
Tariff deviations	7,669	20,771
Concession subsidies	17,009	
Derivative instruments	19,134	31,624
Goodwill	138,045	40,874
Investments	11,211	1,712
Others	24,899	
Total deferred tax liabilities	324,965	259,720
Total net deferred tax assets	928,922	848,759
Valuation allowance	-131,851	-157,133
Total net deferred tax assets as reported	797,071	691,626
Effect of restatement		
Concession subsidies		-15,616

Total net deferred tax assets as restated	676,010

The change in deferred tax assets, for the year, was recognized as follows:

	Group
	2004 Euro 000
Changes in equity	11,608
Other comprehensive income	-12,785
Business combination	-63,218
Other charges	-5,648
Net income	191,104
	121,061

Table of Contents

EDP - Energias de Portugal, S.A. and Subsidiaries

Notes to the Financial Statements

December 31, 2004, 2003 and 2002

The reconciliation of the expected income tax provision computed using the company s portuguese statutory income tax rate to the actual income tax provision for the years 2004, 2003 and 2002, is as follows:

	Group		
		Restated	Restated
	2004	2003	2002
	Euro 000	Euro 000	Euro 000
Net income before minority interest and taxes under U.S. GAAP as reported	314,836	696,356	190,460
Effect of restatement		5,001	5,001
Net income before minority interest and taxes under U.S. GAAP as restated	314,836	701,357	195,461
Expected income tax expense at the statutory rate	78,709	210,407	58,638
Municipal income taxes	7,871	21,041	5,864
Change in tax rate and in estimates	7,534	-13,069	-22,863
Investments in associates, taxed at lower rates	-16,134	-10,419	-25,985
Goodwill amortization		115,113	71,945
Other	-12,275	-70,548	22,444
	65,705	252,525	110,043

An additional reconciliation of the expected income tax provision computed using the Company s Portuguese statutory income tax rate of 27.5% in 2004 to the actual income tax provision, is as follows:

	Group
	2004
	Euro 000
Net income in accordance with U.S. GAAP	238,599
Minority interest	10,532
Income tax for the year	
Current	256,809
Deferred	-191,104

	65,705
Income before minority interest and tax in accordance with U.S. GAAP	
Portugal	201,073
Other	113,763
	314,836
Income tax rate for the year	27.5%
Income tax using the domestic corporate tax rate	86,580
Tax exempt revenues	-9,083
Tax credits in the year	-11,471
Tax incentives	-209
Change in previous years estimates	7,534
Change in valuation allowance	-25,282
Foreign tax rate difference	-1,552
Non-deductible depreciation on fixed assets	1,111
Non-deductible pension costs	4,164
Other non-deductible costs	30,047
Investments in associates taxed at lower rates	-16,134
	65,705

The total tax losses carried forward can be analized as follows:

	Group
	2004
	Euro 000
Expiration date:	
2005	60,418
2006	153,443
2007	248,236
2008	413,149
2009	323,805
2010	169,428
2011	230,075
	1,598,554

Additionally, the Group has tax credits in the amount of Eur 80.7 million, generated by its Spanish subsidiary, Hidrocantábrico. These tax credits can be used until 2025.

Table of Contents

EDP - Energias de Portugal, S.A. and Subsidiaries

Notes to the Financial Statements

December 31, 2004, 2003 and 2002

Pensions

EDP uses a December 31, 2004 measurement date for all of its plans. The components of the net periodic pension cost under U.S. GAAP include the following:

	Group		
	2004	**2003**	**2002**
	Euro 000	**Euro 000**	**Euro 000**
Service cost	9,768	12,240	13,222
Interest cost	79,342	84,849	88,824
Expected return on plan assets	-51,048	-50,086	-56,031
Worker s contributions	-473	-552	
Amortization of net actuarial losses	33,563	19,892	72,431
Amortization of transition obligation	5,826	5,826	6,130
Net periodic pension cost	76,978	72,169	124,576

The following table sets forth the changes and the funded status of the pension plan under U.S. GAAP:

	Group	
	2004	**2003**
	Euro 000	**Euro 000**
Change in benefit obligation		
Benefit obligation at the beginning of the year	1,477,290	1,448,733
Service cost	9,768	12,240
Interest cost	79,342	84,849
Estimated benefits paid	-147,121	-140,975
Curtailments/Settlements	271,908	847
Actuarial losses/(gains)	401,039	71,189
Exchange losses/(gains)	906	407
Benefit obligation of Brazilian subsidiaries	30,200	
Other fluctuations	-1,654	

Benefit obligation at the end of the year	2,121,678	1,477,290

The benefit obligation of Brazilian subsidiaries are covered with plan assets.

F-63

Table of Contents

EDP - Energias de Portugal, S.A. and Subsidiaries

Notes to the Financial Statements

December 31, 2004, 2003 and 2002

	Group	
	2004	2003
	Euro 000	Euro 000
Change in plan assets		
Fair value of plan assets at the beginning of the year	816,502	749,945
Actual company contributions	62,012	58,287
Worker s contributions	462	552
Benefits paid	-56,144	-51,856
Actual return on plan assets	75,481	59,277
Exchange losses/(gains)	495	297
Plan assets of Brazilian subsidiaries	30,200	
Fair value of plan assets at the end of the year	929,008	816,502
Funded status of plan (underfunded)	-1,192,670	-660,788
Unrecognized net actuarial losses/(gains)	878,749	532,458
Unrecognized transition obligation	38,883	50,678
Prepaid/(accrued) benefit cost	-275,038	-77,652
Additional minimum pension liability recognized in OCI	-271,509	-293,814
Additional minimum pension liability recognized as intangible asset	-38,883	-50,678
Prepaid/(accrued) benefit cost / pension liability	-585,430	-422,144

The accumulated benefit obligation in excess of plan assets, is as follows:

	Group	
	2004	2003
	Euro 000	Euro 000
Projected benefit obligation	2,121,678	1,477,290
Accumulated benefit obligation	1,479,114	1,207,234
Fair value of plan assets	929,008	816,502

As of December 31, 2003 and 2004 plan assets consisted of:

	Group	
	2004 Euro 000	2003 Euro 000
Portuguese State bonds	75,701	51,248
Foreign public bonds	224,700	133,380
Bonds	168,115	201,452
Investment fund units	158,463	138,139
Shares	105,986	90,522
Own Shares	1,059	627
Buildings	185,757	185,894
Cash and equivalents	42,032	41,921
Commercial paper		3,994
	961,813	847,177
Plan assets relating to others (REN)	-32,805	-30,675
	929,008	816,502

EDP Group considered the target asset allocation mentioned below to be the appropriate for the stability and security of Pension Fund assets, level of periodic contributions and of the financing of the projected liabilities, taking into account investments restrictions, a risk profile and a level of returns:

a) Investment strategy for three years, except actual property in the amount of 186 million Euros, currently rented to the Associates that should be reduced:

Bonds : 70% (min. 50%, max. 85%)

Equities: 30% (min. 15%, max. 40%)

Property: max. 5%.

b) Asset returns measures against strategic benchmark.

c) Risk diversification policies.

A summary of the assets of the plan, classified into its major assets classes, is shown below as at December 31, 2003 and 2004:

Group	
2004	2003

Total Bonds	49.70%	45.60%
Total Cash	4.40%	5.60%
Total Equities	24.60%	23.70%
Property	21.30%	25.10%
	100.00%	100.00%

F-64

EDP - Energias de Portugal, S.A. and Subsidiaries

Notes to the Financial Statements

December 31, 2004, 2003 and 2002

In calculating the liabilities inherent in pension and other benefits within the EDP Group the following financial and actuarial assumptions were used:

	2004					
	Pension Benefits				Other benefits	
		Brazil				
	Portugal	Bandeirante	Escelsa	Enersul	Portugal	Brazil
Assumptions						
Discount rate	5.00%	10.76% aa	10.76% aa	10.76% aa	5.00%	10.76%
Long term rate of return on assets	6.40%	10.76% aa	12.98% aa	12.81% aa	n.a.	n.a.
Wage growth rate	3.50%	7.12% aa	6.08% aa	6.08% aa	n.a.	n.a.
Pension growth rate	3.00%	4% aa	4% aa	4% aa	n.a.	n.a.
Inflation rate	2.40%	4% aa	4% aa	4% aa	n.a.	n.a.
Medical trend rate	n.a.	n.a.	n.a.	n.a.	4.50%	8.16%

	2003		
	Pension Benefits		Other benefits
	Portugal	Brazil	Portugal
Assumptions			
Discount rate	5.20%	10.24%	5.20%
Long term rate of return on assets	5.70%	10.24%	n.a.
Wage growth rate	3.30%	7.12%	n.a.
Pension growth rate	2.25%	7.12%	n.a.
Inflation rate	2.00%	4.00%	n.a.
Medical trend rate	n.a.	n.a.	4.50%

The assumptions to determine the overall expected, Rate of return on assets , was determined with reference to EDP s target allocation and the best expectations for the long term returns on each of the following assets classes:

2004			Expected rate of return on assets
Weight	Real return	Weight return	Weight

					Expected return on year	Long term expected return [4]
Bonds [1]						
Government bonds	31.00%	2.30%	0.70%	18.00%	3.80%	5.00%
Corporate bonds [2]	21.00%	3.40%	0.30%	32.00%	4.80%	5.50%
Equities						
Global equities [3]	22.00%	7.60%	1.70%	30.00%	6.00%	7.00%
Alternatives						
Property	26.00%	5.00%	1.20%	5.00%	5.50%	5.00%
Private equity	n.a.	n.a.	n.a.	5.00%	15.00%	20.00%
Hedge funds	n.a.	n.a.	n.a.	10.00%	7.00%	10.00%
Cash						
Money market & short term funds	n.a.	n.a.	n.a.	0.00%	2.50%	4.00%
Euro inflation	n.a.	1.80%	1.80%	n.a.	n.a.	n.a.
Total	100.00%		5.70%	100.00%	5.70%	7.00%

(1) Includes euro and international bonds hedged into Eur.

(2) Includes fixed and floating rate bonds.

(3) Includes international equities hedged into Eur.

(4) Time horizon is 5 years.

The following is a summary of the significant assumptions used in the determination of the pension obligation:

	2004 Rates	2003 Rates	2002 Rates
Weighted average discount rate	5.0%	5.2%	6.0%
Rate of increase in compensation	3.5%	3.3%	3.3%
Expected rate of return on plan assets	6.4%	5.7%	6.5%
Expected percentage of eligible staff electing early retirement	*	*	*

* During 2002 it was estimated that employees applying for early retirement would be 70% of the eligible employees. From 2003 and on, it was estimated that only 40% of eligible employees will apply for early retirement.

Other post-retirement benefits

EDP provides comprehensive medical coverage, in addition to that provided by the Portuguese national health system, for retired employees (including those who have taken early retirement) and their dependents. Additionally, the Company provides a death benefit to its retirees survivors. The Company manages the program internally and assumes the full cost of funding the program net of employee contributions

amounting to approximately 10% of the total medical expenses covered.

Table of Contents

EDP - Energias de Portugal, S.A. and Subsidiaries

Notes to the Financial Statements

December 31, 2004, 2003 and 2002

A summary, of the components of the net periodic post-retirement benefit cost under U.S. GAAP, is presented in the following table:

	Group		
	2004 **Euro 000**	**2003** **Euro 000**	**2002** **Euro 000**
Service cost	8,044	5,942	6,540
Interest cost	34,946	29,049	30,095
Amortization of transition obligation	12,759	5,022	4,873
Net periodic post-retirement benefit cost	55,749	40,013	41,508

The following table sets forth the changes and the funded status of the plan under U.S. GAAP as of December 31, 2003 and 2004:

	Group	
	2004 **Euro 000**	**2003** **Euro 000**
Change in benefit obligation		
Benefit obligation at the beginning of the year	660,255	496,201
Service cost	8,044	5,942
Interest cost	34,946	29,049
Actuarial losses	29,837	153,162
Curtailments / Settlements	15,793	
Currency fluctuation	3	
Other	12,500	
Benefit paid	-24,121	-24,099
Benefit obligation at the end of the year	737,257	660,255
Unfunded status of plan	-737,257	-660,255
Unrecognized (gains)/losses	224,625	205,251
Unrecognized transition obligation	37,892	42,377
Accrued benefit cost	-474,740	-412,627

In accordance with FAS 87, EDP has performed a sensitivity analysis regarding Other post-retirement benefits, in accordance with the growth assumptions used as at December 31, 2004 for the projected increased in percentage terms of medical expenses:

	%		
	2005 to 2012	**after 2012**	**Obligations projected Euro 000**
Assumptions at December 31, 2004	4.5%	4%	737,257
Increase of 1%	5.5%	5%	837,985
Decrease of 1%	3.5%	3%	627,468

The assumed discount rate and salary growth rate used in determining the accumulated post-retirement benefit obligation was 5% and 3.5%, respectively, as of December 31, 2004 and 5.2% and 3.3%, respectively as of December 31, 2003.

FAS 106 allows recognition of the cumulative effect of the liability in the year of adoption or the amortization of the obligation over a period of up to 20 years. The Company has elected to recognize the initial post-retirement benefit obligation of Eur 101,455 thousand as of January 1, 1995, over a period of 17.7 years, the average remaining service period of the employee group.

The table below shows the expected benefit payments projections for the next ten years, based on the same assumptions used in the current year in accordance with FAS 132:

	Expected benefit payments	
	Pension	**Other**
2005	173,658	28,529
2006	170,699	29,544
2007	166,472	30,589
2008	161,390	31,669
2009	156,603	32,723
2010	152,022	33,798
2011	146,688	34,913
2012	141,377	36,039
2013	136,111	37,390
2014	132,152	38,711
2015	127,767	40,223

The estimated contributions for 2005 amount to Eur 57,636 thousand.

Table of Contents

EDP - Energias de Portugal, S.A. and Subsidiaries

Notes to the Financial Statements

December 31, 2004, 2003 and 2002

Defined Contribution Plans

Hidrocantábrico in Spain, Bandeirante, Escelsa and Enersul in Brazil have social benefits defined contribution plans that complement those benefits granted by the Social Welfare Systems to the companies employees, under which they pay a contribution to these plans each year, calculated in accordance with the rules established in each case. The payments in 2004 and 2003 were as follows:

	Social Welfare System		Defined Contribution plan		Total payments	
	2004	2003	2004	2003	2004	2003
Hidrocantábrico Group	18,452	16,941	2,885	3,628	21,337	20,569
Bandeirante	3,629	4,177	146	142	3,775	4,319
Escelsa	6,081	6,089	100	107	6,181	6,196
Enersul	4,145	3,982			4,145	3,982

Research and development expenses

Under U.S. GAAP the Research and development expenses were totaly adjusted during 2004. In 2003 and 2002, the amount of Research and development expenses under U.S. GAAP was Eur 15,523 thousand and Eur 44,180 thousand, respectively.

Comprehensive income

For purposes of presenting its reconciliation of shareholders net equity and net income from Portuguese GAAP to U.S. GAAP, in 1998 the Company adopted FAS 130, Reporting Comprehensive Income . This standard requires reporting the components of comprehensive income, the change in equity (net assets) of a business enterprise during a period from transactions and other events and circumstances from non-owner sources, and the components thereof in an entity s financial statements. The non-owner changes in equity that have not been included in income include accounts such as foreign currency translation adjustments and unrealized gains and losses on available-for-sale securities and additional minimum pension liabilities. The adoption of FAS 130 resulted in revised and additional disclosures for U.S. GAAP reporting purposes, but had no effect on the financial position, results of operations, or liquidity of the Company.

The comprehensive income for each of the three years in the period ended December 31, 2004, 2003 and 2002 is as follows:

	Group		
	2004	Restated 2003	Restated 2002
	Euro 000	Euro 000	Euro 000
Net income in accordance with U.S. GAAP (restated)	238,599	451,162	264,459
Change in currency translation adjustment	936	-193,032	-300,028
Unrealized gains (losses) on investments	475	31,980	10,560
Tax effect of unrealized gains (losses) on investments	-6,474	-8,755	-3,484
Cash-flow hedge	643		
Tax effect on cash-flow hedge	-177		
Additional minimum pension liability	22,305	-77,396	-216,418
Tax effect on additional minimum liability	-6,134	21,284	71,418
Comprehensive income	250,173	225,243	-173,493

Accumulated Comprehensive Income as at December 31, 2004, 2003 and 2002 is analized as follows:

	Group		
	2004	Restated 2003	Restated 2002
	Euro 000	Euro 000	Euro 000
Change in currency translation adjustment	-571,565	-572,501	-379,469
Unrealized gains (losses) on investments	11,231	10,756	-21,224
Tax effect of unrealized gains (losses) on investments	-7,953	-1,479	7,276
Cash-flow hedge	643		
Tax effect on cash-flow hedge	-177		
Additional minimum pension liability	-271,509	-293,814	-216,418
Tax effect on additional minimum liability	86,568	92,702	71,418
	-752,762	-764,336	-538,417

In relation to other comprehensive income, in prior years, a reconciliation between the opening and closing balance of accumulated other comprehensive income was not presented in the notes to the financial statements in accordance with SFAS No. 130. SFAS No. 130 requires that the total of accumulated other comprehensive income should be disclosed separately from retained earnings. The Group has included the information required for the total of accumulated other comprehensive income for each of the reported periods and has restated the balances to comply with the requirements of SFAS No. 130. While this restatement had an impact on the total value of accumulated other comprehensive income, it had no impact on the total value of shareholders equity as at December 31, 2003 and 2002.

EDP - Energias de Portugal, S.A. and Subsidiaries

Notes to the Financial Statements

December 31, 2004, 2003 and 2002

Earnings per ordinary share

Basic earnings per share is based upon the weighted average number of Ordinary Shares outstanding during the year. Diluted earnings per share is computed on the basis of the weighted average number of Ordinary Shares outstanding during the year plus the effect of Ordinary Shares issuable upon the exercise of employee stock options using the treasury stock method. During 1999, the Company established two employee stock option plans. The shares issued under these plans had no effect on the weighted average Ordinary Shares outstanding, for the periods presented because the effect of such options was anti-dilutive. Ten Ordinary Shares equal one American Depository Share (ADS).

	Group		
	2004	**2003**	**2002**
	Euro 000	**Euro 000**	**Euro 000**
Net income Portuguese GAAP	440,152	381,109	335,216
Net income U.S. GAAP	238,599	451,162	264,459
Net income from continuing operations:			
Net income Portuguese GAAP	440,152	381,109	779,216
Net income U.S. GAAP	238,599	451,162	708,459
Weighted average Ordinary Shares outstanding	3,039,526,910	2,978,569,036	2,982,571,074
Weighted average ADS outstanding	303,952,691	297,856,904	298,257,107

	Group		
	2004	**2003**	**2002**
	Euro	**Euro**	**Euro**
Net income per Ordinary Share:			
Basic and diluted Portuguese GAAP	0.14	0.13	0.11
Basic and diluted U.S. GAAP	0.08	0.15	0.09
Net income from continuing operations:			
Basic and diluted Portuguese GAAP	0.14	0.13	0.26
Basic and diluted U.S. GAAP	0.08	0.15	0.24
Net income per ADS:			
Basic and diluted Portuguese GAAP	1.45	1.28	1.12
Basic and diluted U.S. GAAP	0.78	1.51	0.89
Net income from continuing operations:			
Basic and diluted Portuguese GAAP	1.45	1.28	2.61
Basic and diluted U.S. GAAP	0.78	1.51	2.38

The consolidated net income for the years ended December 31, 2003 and 2002 and

the corresponding net income per ordinary share have been restated.

Table of Contents

EDP - Energias de Portugal, S.A. and Subsidiaries

Notes to the Financial Statements

December 31, 2004, 2003 and 2002

Goodwill

For U.S. GAAP purposes, the goodwill for each reportable segment is as such:

	Group					
	Electricity Spain	**Electricity Brazil**	**Telecom**	**IT**	**Other business**	**TOTAL**
December 31, 2002 (Net)	582	1,948	113,177	63,803	19,002	198,511
Acquisitions/Disposals	184,245	1,933	1,064	241	29,648	217,131
Transfers	552,339					552,339
December 31, 2003 (Net)	737,166	3,881	114,241	64,044	48,650	967,981
Acquisitions/Disposals	1,329,877	58,251	-17,593	-9,903	-4,795	1,355,837
Transfers	-136,028		9,124	4,058	637	-122,209
Impairment		-253	-9,475	-34,749		-44,476
December 31, 2004 (Net)	1,931,015	61,880	96,297	23,450	44,492	2,157,133

From January 1, 2002, goodwill is no longer amortized under U.S. GAAP but reviewed annually for impairment under FAS 142 Goodwill and Other Intangible Assets . Goodwill amortization of Eur 54,439 thousand in 2003 and Eur 56,219 thousand in 2004 are charged against Portuguese GAAP earnings and reversed in the U.S. GAAP reconciliation.

Group EDP s primary strategic focus is on consolidating and expanding its position in energy activities in the Iberian Peninsula. Accordingly, it is positioning itself for the Iberian electricity market that will develop in the future, particularly following the implementation of MIBEL. In this context, Group EDP acquired operating control of Hidroelectrica del Cantábrico in 2001, the fourth largest electricity operator in Spain, which, in turn, acquired Naturcorp, the second largest gas operator in Spain, in 2003.

In December, 2004 EDP increased its financial position in Hidroelectrica del Cantábrico from 39.5% to 95.7% of total shares gaining control of the company. The additional investment of 56.2% through the acquisition of additional 23,915,657 shares amounts to Eur 1,200.8 million.

EDP Group entered into a shareholders agreement with CajAstur and Caser, which retained an aggregate stake in Hidrocantábrico of 3.1%. The shareholders agreement gives CajAstur and Caser certain veto rights, which will preserve Hidrocantábrico s links with the region of Asturias. In addition, CajAstur has a long-term put option entitling it to sell its interest in Hidrocantábrico to EDP at a price indexed to the value of EDP s ordinary shares. As at December 31, 2004, the referred put option has a residual fair value as the strike price approximates the market price of the underlying entity.

For Portuguese GAAP the resulting goodwill from this transaction was in the amount of Eur 242.1 million based on the shareholders equity of Hidrocantábrico as at December 31, 2004.

For U.S. GAAP purposes, this goodwill was adjusted considering the U.S. GAAP adjustments related to Hidrocantábrico Group, resulting in a reduction in goodwill of Eur 6.2 million, net of deferred taxes. The goodwill for U.S. GAAP purposes amounts to Eur 235.9 million.

Proportional consolidation

Until June 30, 2004, the Company consolidates interests in jointly controlled entities, using the proportional method, namely Hidrocantábrico (HC). For U.S. GAAP purposes, investments in jointly controlled entities must be accounted for using the equity method. The differences in accounting treatment between proportional consolidation and the equity method of accounting have no impact on reported stockholders equity or net income. Rather, they relate solely to matters of classification and disclosure. Following the acquisition of 56.2% of Hidrocantábrico Group in December 31, 2004, Hidrocantábrico group was consolidated under the full consolidation method.

Condensed financial information relating to the Company s pro rata interest in Hidrocantábrico is as follows:

	HC 2003 Euro 000	HC 2002 (*) Euro 000
Balance sheet information		
Tangible and intangible fixed assets	1,870,271	1,657,112
Current assets	150,572	168,582
Non current assets	21,500	248
Total assets	2,042,343	1,825,942
Loans	787,675	816,634
Current Liabilities	188,895	128,679
Non-current liabilities	99,191	95,442
Total liabilities	1,075,761	1,040,755
Minority interests	175,127	4,916
EDP s investment	791,455	780,271
Statement of income information		
Net revenue	664,022	321,351
Operating costs, net	-601,142	-295,194
Other operating income (costs)	-41,539	-29,257

Minority interests	-5,215	391
Net income	16,126	-2,709

(*) For 2002, HC was proportionally consolidated since June 1, 2002.

Table of Contents

EDP - Energias de Portugal, S.A. and Subsidiaries

Notes to the Financial Statements

December 31, 2004, 2003 and 2002

Intangible assets

For concession rights and other intangible assets, subject to amortization under U.S. GAAP, the agregate amortization expense for the current year and estimated agregate amortization expense for each of the five succeeding fiscal years are:

Agregate amortization expense	
2004	55,658
Estimated amortization expense	
2005	67,416
2006	67,416
2007	67,416
2008	64,757
2009	61,888

Unrealized losses in investments available for sale, defined as temporary losses

The temporary unrealized losses in investments available for sale are analyzed as follows:

	Book Value	Market Value	Temporary losses
	Euro 000	Euro 000	Euro 000
CERJ - Companhia Eléctrica do Rio de Janeiro	95,049	85,905	-9,144
BCP - Banco Comercial Português, S.A.	305,039	295,939	-9,100
	400,088	381,844	-18,244

The book value of BCP is net of impairment losses in the amount of Eur 247,751 thousand. Both of the above investments have been in an unrealized loss position for more than 12 months. At June 30, 2005 the market value of BCP shares increased to Eur 2.12 per share compared with December 31, 2004 (Eur 1.89 per share).

Fair value of financial assets and liabilities

The carrying amount of the financial assets and liabilities and the respective fair value is analyzed as follows:

	2004		2003	
	Carrying Value	Market Value	Carrying Value	Market Value
	Euro 000	Euro 000	Euro 000	Euro 000
Accounts receivable				
Accounts receivable - Trade, net (see Note 5)	1,243,067	1,243,067	1,108,064	1,108,064
Accounts receivable - Other, net (see Note 6)	846,395	846,395	509,202	509,202
Long term receivables, net (see Note 8)	945,423	945,423	435,842	435,842
	3,034,885	3,034,885	2,053,108	2,053,108
Investments				
Equity holdings (see Note 9)	1,560,802	1,560,802	1,508,922	1,508,922
Investments in properties (see Note 9)	2,185	2,185	1,062	1,062
Other financial investments (see Note 9)	52,306	52,306	72,800	72,800
	1,615,293	1,615,293	1,582,784	1,582,784
Debt - Short and Medium/long term				
Short term loans - Current (see Note 15)	-1,857,830	-1,857,830	-1,579,130	-1,579,130
Medium/long-term loans (see Note 15)	-6,741,014	-7,160,036	-5,913,579	-6,251,355
	-8,598,844	-9,017,866	-7,492,709	-7,830,485
Accounts payable				
Accounts payable - Trade (see Note 16)	-1,073,465	-1,073,465	-782,626	-782,626
Accounts payable - Other (see Note 17)	-305,583	-305,583	-187,262	-187,262
	-1,379,048	-1,379,048	-969,888	-969,888
Financial instruments - Derivatives (*)				
Trading (see Note 6 and 18)	-25,296	-25,296	127,865	127,865
Hedging (see Note 6 and 18)	180,555	180,555		
	155,259	155,259	127,865	127,865

(*) The fair value presented corresponds to the clean price of the derivatives portfolio.

The market value of accounts receivable and short term loans is equal to carrying amount considering that they are short term in nature. The market value of long terms receivables is equivalent to the carrying amount, because carrying amount is presented at the net present value of future estimated discounted cash flows. Investments are accounted at the market value (carrying amount is equal to market).

F-70

EDP - Energias de Portugal, S.A. and Subsidiaries

Notes to the Financial Statements

December 31, 2004, 2003 and 2002

Equity investments

EDP s investments in associates accounted for under the equity method are presented in note 9 of these consolidated financial statements. The summarized financial information of the most relevant are presented below:

	2004			2003		
	REN	**HC (*)**	**Other**	**REN**	**HC**	**Other**
	Euro 000	**Euro 000**	**Euro 000**	**Euro 000**	**Euro 000**	**Euro 000**
Fixed assets	1,480,618		995,923	1,422,362	4,385,891	1,290,596
Current assets	721,668		414,317	221,993	376,429	161,511
Non current assets	422,427		572,890	696,422	53,749	10,465
Total Assets	2,624,713		1,983,130	2,340,777	4,816,069	1,462,572
Loans	747,373		883,270	280,000	1,969,187	722,184
Current liabilities	1,014,023		388,850	1,193,071	472,238	161,788
Non current liabilities	990		135,414	20,297	247,977	123,808
Total Liabilities	1,762,386		1,407,534	1,493,368	2,689,402	1,007,780
Minority interest					437,817	
Equity	862,328		575,597	847,409	1,688,850	454,792
Total Equity	862,328		575,597	847,409	2,126,667	454,792
Net revenue	2,462,582		1,041,223	2,359,587	1,660,055	559,545
Operating costs	-2,183,507		-674,881	-2,004,361	-1,528,064	-299,052
Other operating income	-160,321		-194,765	-227,287	25,210	-90,441
Non operating costs, net	-49,455		-74,280	-34,451	-103,847	-127,789
Minority interest					-13,038	
Net income	69,299		97,297	93,488	40,316	42,263
Percentage owned by EDP:	30%			30%	40%	

(*) After the aditional acquisition of 56.2% of Hidrocantábrico Group in December 31, 2004 the consolidation method applied was the full consolidated method on the balance sheet.

	2002		
	REN	HC	Other
	Euro 000	Euro 000	Euro 000
Fixed assets	1,380,797	3,852,993	1,281,738
Current assets	222,323	421,456	81,375
Non current assets	342,901	619	61,661
Total Assets	1,946,021	4,275,068	1,424,774
Loans	326,667	2,041,585	642,535
Current liabilities	523,443	321,698	165,540
Non current liabilities	308,024	238,606	115,588
Total Liabilities	1,158,134	2,601,889	923,663
Minority interest		12,290	
Equity	787,887	1,660,889	501,111
Total Equity	787,887	1,673,179	501,111
Net revenue	2,302,868	1,462,082	579,489
Operating costs	-2,278,753	-1,316,361	-311,652
Other operating income	92,423		-133,543
Non operating costs, net	-51,113	-133,291	-92,740
Minority interest		2,135	
Net income	65,425	14,565	41,554
Percentage owned by EDP:	30%	40%	

EDP - Energias de Portugal, S.A. and Subsidiaries

Notes to the Financial Statements

December 31, 2004, 2003 and 2002

Employee stock option plans

The Company has two fixed option plans. Under the 1999 option plan for members of the Board of Directors of EDP, the Company may grant options for up to 2,450,000 shares of common stock. Under the 1999 option plan for members of the boards of directors of the EDP s operating companies and senior officers of EDP and its subsidiaries, the Company may grant options for up 16,250,000 shares of common stock. Under both plans, the exercise price of each option equals the market price of the Company s stock on the date of grant and an option s maximum term is 5 years. Options are granted at the discretion of the board of directors of EDP and vest over a two year service period.

A summary of the status of the Company s two fixed stock option plans as of December 31, 2003 and 2004, and changes during the years then ended on those dates is presented below:

	Shares available for grant under 1999 option plans	Option activity	Weighted average exercise price
Balance December 31, 2002	16,413,750	2,286,250	3.43
Options forfeited[1]		-353,992	
Options granted	-980,000	490,000	
Balance December 31, 2003	15,433,750	2,422,258	3.36
Options forfeited[1]		-2,299,533	
Options granted[2]		490,000	
Balance December 31, 2004	15,433,750	612,725	2.44

(1) *Option forfeited includes options not exercised within the required period and option forfeited by departing plan participants.*

(2) *The number of options to be granted for 2005 has not yet been determined.*

There was no compensation expenses regarding the options forfeited.

The following table summarizes information about stock options outstanding and exercisable as of December 31, 2004.

Options outstanding	Weighted average exercise price	Weighted average remaining contractual life	Options exercisable	Options fair value Eur 000

612,725	2.44	2.62 Years	283,111	71.3

Table of Contents

EDP - Energias de Portugal, S.A. and Subsidiaries

Notes to the Financial Statements

December 31, 2004, 2003 and 2002

EDP Group pro-forma profit and loss account considering the acquisition of Hidrocantábrico Group as at January 1, 2004

As at December 31, 2004 and resulting from an additional investment of 56.2%, the Hidrocantábrico Group is consolidated under the full consolidation method in the balance sheet.

EDP Group pro-forma profit and loss account for the year ended December 31, 2004, considering the impact of the acquisition of the referred 56.2% in Hidrocantábrico Group as if it had occured on January 1, 2004, is analyzed as follows:

	Consolidated income statement as reported	Adjustments	Consolidated pro-forma income statement
	Euro 000	Euro 000	Euro 000
Sales	6,699,294	1,035,752	7,735,046
Cost of sales	-4,017,270	-731,150	-4,748,420
Gross margin	2,682,024	304,602	2,986,626
Other operating income			
Services rendered	522,396	34,401	556,797
Own work capitalized	258,774	9,204	267,978
Other operating income	97,353	6,264	103,617
	878,523	49,869	928,392
	3,560,547	354,471	3,915,018
Other operating expenses			
Supplies and services	-649,504	-55,086	-704,590
Personnel costs	-642,619	-58,627	-701,246
Other operating expenses	-220,762	-13,092	-233,854
	-1,512,885	-126,805	-1,639,690
Gross operating margin	2,047,662	227,666	2,275,328
Provisions	-114,078	-422	-114,500
Depreciation and amortization	-875,138	-104,158	-979,296
Operating margin	1,058,446	123,086	1,181,532
Financial income/(expenses)	-239,728	-45,497	-285,225
(Financial investments amortization)	-95,524	-48,687	-144,211

Current income	723,194	28,902	752,096
Non-operating gains/(losses)	-164,732	16,869	-147,863
Profit before taxes	558,462	45,771	604,233
Provision for income taxes	-256,809	-13,832	-270,641
Provision for deferred taxes	97,192		97,192
Profit after taxes	398,845	31,939	430,784
Minority interests	41,307	-11,915	29,392
Attributable net income	440,152	20,024	460,176

Table of Contents

EDP - Energias de Portugal, S.A. and Subsidiaries

Notes to the Financial Statements

December 31, 2004, 2003 and 2002

42.ii Restatement of prior years

The Company has restated its 2003 and 2002 previously reported U.S. GAAP amounts to correct the following errors:

During 2003, the Company had established a liability related to certain guarantee arrangements through a direct charge to shareholders equity. After further reconsideration, the Company realized the liability had been established in error.

The Company determined that accrued income related to certain concession arrangements was not being amortized as it should have been for U.S. GAAP purposes.

Under both Portuguese GAAP and U.S. GAAP, in prior years, the losses attributable to minority interests that exceeded the equity capital attributable to minority interests in subsidiaries had been recorded as negative minority interests in the balance sheet. In the income statement, the referred losses attributable to minority interest were charged to the minority interest in the proportion of their shareholding. Under Portuguese GAAP, and beginning January 1, 2004, the EDP Group adopted a new accounting policy, by which the negative minority interest in the balance sheet resulting from the accumulated losses attributable to minority interests which exceed the equity capital attributable to minority interests in subsidiaries are debited against equity when there is no binding obligation of the minority interests to cover such losses. In the income statement, under Portuguese GAAP, losses continue to be attributed to minority interest in the proportion of their shareholding. Under U.S. GAAP, as there is no binding obligation of the minority interest to cover such losses, such losses which exceed the equity attributable to the minority interest are charged to the majority interest, therefore the net income of the prior years has been restated to allocate the losses attributable to minority interests in 2002 and 2003 to the majority interest (EDP). If future earnings do materialize, the majority interest will be credited to the extent of such losses previously absorbed.

The reconciliation between the previously reported and restated net income and shareholders equity in accordance with U.S. GAAP for the years December 31, 2003 and 2002, is as follows:

Net income

	Group	
	2003	**2002**
	Euro 000	**Euro 000**
Net income in accordance with U.S. GAAP, as previously reported	498,007	299,988
Losses attributable to minority interest charged against majority interest	-48,759	-37,443
Accrued subsidies income	2,900	2,900
Deferred tax related	-986	-986

Net income in accordance with U.S. GAAP, restated	451,162	264,459

Shareholders equity

	Group
	2003
	Euro 000
Shareholders equity in accordance with U.S. GAAP, as at December 31, 2002 as previously reported	3,886,264
Losses attributable to minority interest charged against majority interest	-37,443
Accrued subsidies income	24,973
Deferred tax related	-8,491
Shareholders equity in accordance with U.S. GAAP, as at December 31, 2002 as restated	3,865,303
Shareholders equity in accordance with U.S. GAAP, as at December 31, 2003 as previously reported	3,497,337
Impact of restatement on shareholders equity as at December 31, 2002	-20,961
Guarantees	10,114
Losses attributable to minority interest charged against majority interest	-48,759
Accrued subsidies income	2,900
Deferred tax related	-986
Shareholders equity in accordance with U.S. GAAP, as at December 31, 2003 as restated	3,439,645

EDP - Energias de Portugal, S.A. and Subsidiaries

Notes to the Financial Statements

December 31, 2004, 2003 and 2002

43. Relevant and subsequent events

EDP signs an agreement for the sale of a 60% stake in Edinfor share capital

In January 2005, EDP signed a Sale and Purchase Agreement for the sale of a 60% stake of the share capital of Edinfor Sistemas Informáticos, S.A. (Edinfor) with LogicaCMG Corporate Holdings Limited (LogicaCMG). Simultaneously, Edinfor has acquired 40% of the share capital of Ace Holding, SGPS, S.A. (Ace), resulting in the full control of the share capital by Edinfor. The transaction value of the above mentioned 60% stake in Edinfor (including the shares and the respective shareholders loans) is Eur 81 million, based on a total enterprise value of Eur 135 million. The value assumes that the consolidated financial accounts of Edinfor will be debt free, by the completion date, and therefore the final transaction value may be adjusted as a result of the final debt position of the company. The agreement provides EDP with an option, for a period of two years, to buyback the shares and shareholders loans that are being sold. This option can be exercised if certain exceptional conditions are met, notably in the case of a breach by Edinfor of the Outsourcing Contracts, and with an exercise price based on the current transaction value. The agreement also provides EDP with an option to sell the remaining 40% of the share capital of Edinfor (including the remaining shareholders loans) to LogicaCMG, starting from the end of the second year of partnership.

With the completion of this transaction, EDP now holds 40% of Edinfor s share capital and LogicaCMG 60%. As of December 31, 2004, the book value of EDP s 60% stake in Edinfor amounted to Eur 82.6 million. From the date of the signature of the share purchase agreement, EDP started accounting for its investment in Edinfor through the equity method.

EDP signs PPAs early termination agreements with concessionary of the Portuguese transmission grid

Following the information conveyed to the financial markets related with the process of early termination of the electricity Power Purchase Agreements (PPAs), EDP s fully owned subsidiary CPPE Companhia Portuguesa de Produção de Electricidade, S.A. (CPPE) and REN Rede Eléctrica Nacional, S.A. (REN), acting as the concessionary of the Portuguese electricity transmission grid, has signed the PPA s termination agreements for all CPPE s power plants operating in the Public Electricity System as foreseen in the Decree-Law 240/2004 of December 27, 2004. The agreements set the global amount of the compensation to be granted to EDP as a result of the early termination of all of its PPAs, at present value, in Eur 3.36 billion. This compensation, aimed at ensuring economic benefits equivalent to those delivered by the PPAs to all parties involved in these contracts, was calculated based on a number of economic assumptions and parameters comprised in the above mentioned diploma namely the present value of the existing PPAs, the forecasted revenues of these power plants operating under market conditions and a discount rate that, at present, is of 3.78%. Completion of the early termination agreements signed between CPPE and REN is subject to the start of an integrated Iberian electricity spot market and the grant of non-binding generation licenses. As such, the value of the compensation to be received by EDP will still be subject to a revision to adjust for the effective termination date of the PPAs as well as to the prevailing sovereign debt interest rate (to determine discount rate) at the time of such termination. The compensation value for the early termination of the PPAs was deemed by two independent entities Rothschield and Deloitte based upon the applicable legal framework, market valuation and a set of data and assumptions provided by, among others, EDP.

Early reimbursement of EDP s 22nd Issue

In accordance with the EDP 22nd issue initial terms, as of August 9, 2005, 35,547,848 bonds had been redeemed.

Portugal s Economy Ministry grants licenses for new combined cycle gas turbine plants

The Portuguese Economy Ministry, through the Direcção Geral de Geologia e Energia (DGGE), informed EDP about the new licenses granted for the connection to the public electricity network of new CCGT plants to be built in Portugal totaling approximately 2,870 MW. The EDP Group was granted one license of approximately 395 MW in the region of Figueira da Foz and, together with Endesa, a license of approximately 790 MW in the region of Sines, consisting of two 395 MW Groups. The start of operations of the second of these Groups is subject to some technical restrictions in the connection to the grid which are expected to be sorted out by 2010. The other licenses were attributed to GalpPower in Sines (app. 395 MW), to Iberdrola in Figueira da Foz (app. 420 MW) and to Tejo Energia in Pego (app. 865 MW). These licenses will be provisional until all the mandatory Environmental Impact Studies are conducted and delivered for appreciation by the relevant authorities, a process that must be completed within one year from the moment the licenses are granted.

EDP appeals the decision by the European Commission to block the acquisition of joint control of GDP

EDP received notice of the European Commission s decision on the concentration by which EDP and ENI S.p.A. would acquire joint control over GDP Gás de Portugal, SGPS, S.A. (the Decision). In this Decision the Commission considered that such acquisition is incompatible with the common market, in accordance with Article 8(3) of Council Regulation no. 4064/89, of December 21, on the control of concentrations between undertakings (Merger Regulation) and, as a consequence, not permitted. Given its opposition to the Decision, and following a detailed analysis made by entities not involved in the initial notification, EDP, within the legally defined period, filed a judicial appeal with the Court of First Instance of the European Communities (CFI), pursuant to Art. 230 (4) of the EC Treaty, requesting the annulment of such Decision.

On September 21, 2005, the CFI rendered a judgement that rejected the appeal brought by EDP. Consequently, the European Commission s decision continues to be applicable. EDP has decided not to present an appeal with the Court of Justice of the European Communities in relation to this judgement.

EDP will continue to implement the necessary measures, at an Iberian level, aimed at strengthening its electricity and gas business portfolio.

EDP purchases shareholdings in Turbogás and Portugen

EDP announced that, through the exercise of a call option, EDP Participações S.G.P.S., S.A. (EDPP) a fully owned subsidiary of EDP has acquired on March 2005 from National Power International Holdings BV (IPBV), for a total consideration of Eur 51,985 thousand, a shareholding of 20% in Turbogás Produtora Energética, S.A. (Turbogás) and of 26.667% in Portugen Energia, S.A. (Portugen). Upon completion of this transaction, EDPP now holds a shareholding of 40% in Turbogás, which other shareholder is IPBV with a shareholding of 60%. In addition, EDPP has become a shareholder of Portugen with a 26.667% shareholding, while the other shareholder is International Power Portugal Holdings S.G.P.S., S.A. with a 73.333% shareholding. Turbogás was incorporated in 1994 with the sole purpose of carrying out the development, construction and operation of a combined-cycle gas fired power station at Tapada do Outeiro, in Portugal, with a total installed capacity of 990 MW. Turbogás currently sells the whole of its production to REN Rede Eléctrica Nacional S.A., within the Portuguese public supply system, under a long term power purchase agreement. Portugen is the entity in charge of the operation and maintenance of this power station.

Hidrocantábrico sells 3% on REE

Under the terms of Article 248 of CMVM, EDP announced that, in accordance with the Spanish legislation, namely the Regulation 5/2005, from March 11 regarding the investments in Red Eléctrica de España, S.A. (REE), Hidroeléctrica del Cantábrico, S.A. (Hidrocantábrico), a subsidiary of EDP Group, sold for the amount of Eur 76 million the investment of 3% held at REE. This transaction has originated a gain for Hidrocantábrico in the amount of Eur 33 million.

Table of Contents

EDP - Energias de Portugal, S.A. and Subsidiaries

Notes to the Financial Statements

December 31, 2004, 2003 and 2002

EDP completes debt exchange offer on the Eurobonds 2008 and 2011 and issues 500,000,000 Eurobond 3.750% maturing in 2015

EDP has completed the Exchange Offer on its Eur 500,000,000 5.000% Eurobond due 2008 issued by EDP Finance B.V. and the Eur 1,000,000,000 5.875% Eurobond issued by EDP due 2011 for a new Euro denominated 3.750% fixed rate Notes due 2015 issued by EDP Finance B.V. The New Eurobond will be issued under EDP s and EDP Finance B.V. s Eur 5,000,000,000 Programme for the Issuance of Debt Instruments and application will be made for the New Eurobond to be admitted to official listing on the London Stock Exchange. Through this transaction, EDP has achieved its principal objectives in respect of its debt portfolio management, namely extending the average life of the debt portfolio and managing efficiently the refinancing risk of the Group.

Execution of the reorganization process of EDP - Energias do Brasil s corporate structure

EDP Energias do Brasil, S.A. (Energias do Brasil) a fully owned subsidiary of EDP signed on April 7, 2005 an agreement concerning the reorganization of its subsidiaries Bandeirante Energia S.A. (Bandeirante), Iven S.A. (Iven), Espírito Santo Centrais Elétricas S.A. Escelsa (Escelsa), Magistra Participações S.A. (Magistra) e Empresa Energética de Mato Grosso do Sul S.A. (Enersul). The current reorganization consists, fundamentally, in the roll-up of the above mentioned companies minority shareholders into Energias do Brasil share capital. Following the completion of the process, EDP Brasil now has full ownership of these companies and their minority shareholders hold approximately 30.7% in Energias do Brasil.

This reorganization process - which results in a more transparent and straightforward shareholding structure for the Energias do Brasil Group pursues four main objectives: (i) to allow the concentration of the share capital of Energias do Brasil s subsidiaries into one single entity thus providing increased liquidity to those company s shareholders; (ii) to facilitate the implementation of management decisions directed at improving efficiency at the operating companies and reducing operational costs; (iii) to optimize tax efficiency throughout the Energias do Brasil Group; and (iv) to create the conditions for the fulfilment of ANEEL s regulatory requirements regarding the unbundling of the generation, transmission and distribution activities of vertically integrated electricity companies in Brazil.

The exchange ratios associated to this reorganization were, under the legally applicable terms, subject to independent valuations undertaken by specialized companies of national and international recognition.

The reorganization process was submitted for approval at the Extraordinary Shareholders Meetings of the respective companies, which was held on April 29, and was approved by the regulatory entity of the Brazilian electricity sector (ANEEL). This reorganization process was completed prior to the listing of Energias do Brasil shares in Bovespa (São Paulo stock exchange market).

Energias do Brasil starts trading in the Novo Mercado of the Bovespa following initial public offering

On July 13, 2005, shares of Energias do Brasil were admitted for the first time to the Novo Mercado of the Bovespa (São Paulo, Brasil) following an initial public offering (the IPO) of 24,161,000 ordinary shares at a price of R$18 per share, corresponding to a total amount of R$434.9 million (excluding the exercise of the Greenshoe).

The IPO had an effective demand corresponding to 2.5 times the total number of shares on offer, with approximately 50% of the subscription orders coming from the USA and approximately 40% from Brazil.

Simultaneously with this transaction, EDP converted into Energias do Brasil ordinary shares the equivalent of R$670 million in respect of the Senior Notes of Escelsa owned by EDP, through the issuance of 37,222,222 ordinary shares at the same price as those of the IPO (the Capitalization).

Prior to the IPO, to the Capitalization and to the roll-up of the minority shareholders of our subsidiaries Escelsa, Enersul and Bandeirante into Energias do Brasil share capital in April 2005, EDP owned 100% of Energias do Brasil. Following the roll-up , accepted by nearly 100% of the minority shareholders, EDP s stake in the company was of 69%. As a result of the IPO and the Capitalization, EDP will now own 66% of the share capital of Energias do Brasil.

The main objective of this operation, from the point of view of Energias do Brasil, was to (i) establish the beginning of a long term partnership with the Brazilian capital market, giving greater visibility to the assets held by the company; (ii) supply the resources to finance expansion projects, particularly investments in the generation of electricity; and (iii) confer greater financial autonomy to Energias do Brasil.

The conclusion of the IPO allows the EDP Group to achieve the following main objectives:

- position Energias do Brasil as one of the leaders of the Brazilian energy market by developing a long term growth strategy on a self-sustainable basis - it is not anticipated that there will be any need for new investments by EDP into Energias do Brasil in the foreseeable future;

- control a vehicle that will be able to take advantage of new opportunities in the Brazilian electricity sector - namely the need to expand the country s installed generation capacity;

- substantially strengthen the capital structure of Energias do Brasil and reduce the potential volatility associated with the foreign currency denominated debt it owned namely that related with the Escelsa bonds.

Finally, EDP demonstrates its commitment to the highest standards of corporate governance, though the fair and transparent manner in which it has conducted the process, including the listing of Energias do Brasil in the Novo Mercado of the Bovespa.

ANEEL revises Enersul s 2003 tariff increase from 43.59% to 50.81%

The Brazilian Electricity Regulator, defined the final average tariff increase granted to Enersul in the revision of April 2003, amending the previous increase from 43.59% to 50.81%.

This review impacts the tariff base defined in April 2003, which is the starting date of the regulatory period ending in April 2008. The retroactive impact of this review on Enersul s operating results, between April 2003 and April 2005, amounts to R$75 million (Eur 22 million), which will be recovered through the tariffs until April 2008.

In addition, on April 8, 2005, ANEEL granted to Enersul a 20.69% average tariff increase, within the scope of the annual tariff adjustment that reflects the change in non-controllable costs and the adjustment of controllable costs to inflation. This increase already reflects the amendment to the 2003 tariff revision.

ANEEL revises Escelsa s 2004 tariff increase and approves 2005 tariff adjustment

ANEEL has approved Escelsa s final average 2004 tariff increase - previously defined, on a provisional basis, within the scope of the triennial tariff revision for that company on August 7, 2004 - amending the previous increase from 6.33% to 8.58%.

This final review results from the amendment of Escelsa s regulated asset base, depreciation rate and operating costs of the reference company and impacts the tariff base defined in August 2004, which is the starting date of the regulatory period ending August 2007. The retroactive impact of this review on Escelsa s operating results, between August 2004 and August 2005, amounts to R$17.2 million (Eur. 6 million), and will be recovered through the tariffs until August 7, 2006.

In addition, within the scope of the annual tariff adjustment, that reflects the pass-through of some costs components incurred by the company for the twelve months ended August 7, 2005, namely in non-controllable costs and the adjustment of controllable costs to inflation (IGPM adjusted by an X factor), ANEEL granted Escelsa a 6.93% average tariff increase, starting August 7, 2005. This increase already reflects the amendment to the 2004 tariff revision.

EDP transfers to its pension fund 65,473,757 shares representative of 2.01% of BCP share capital

EDP announced on June 30, 2005 the transfer, to its Pension Fund, as a contribution in kind, of part of the 142,096,224 shares representative of 4.36% of Banco Comercial Português, S.A. (BCP) share capital, owned by its fully-owned subsidiary EDP Participações SGPS, S.A.. Through this operation, 65,473,757 shares, representative of 2.01% of BCP share capital, were transferred to EDP s Pension Fund at Eur. 2.12 per share, the closing price of BCP stock on June 30th, 2005.

Following this transaction EDP holds, through its subsidiary EDP Participações S.G.P.S., S.A., a 2.35% stake in BCP share capital and an equal percentage of the total voting rights. EDP s Pension Fund also holds a qualified shareholding in this company s share capital.

EDP was also informed by BCP that it has transferred to the BCP Pension Fund , as a contribution in kind, 78,956,008 EDP shares corresponding to 2.16% of the company s share capital and 2.17% of the total voting rights. With this operation, BCP now holds a direct stake of 2.90% of EDP share capital and 2.92% of the total voting rights (106,039,594 shares of EDP).

These cross-shareholdings result from a strategic alliance established in March 2000, aimed at exploring business opportunities by taking advantage of the leading position of both companies in their respective sectors. The above-mentioned transactions are part of the financial management and capital allocation initiatives undertaken by EDP and BCP. EDP reiterates its intention to pursue the analysis and development of joint opportunities and business initiatives, which could enable both institutions to extract value from the existing partnership. No changes to the current shareholdings currently held by both institutions are foreseen.

ONI S.G.P.S. sells its Spanish telecomminications operations to TELE2 Telecommunication Services, S.L.

On July 14, 2005, Oni SGPS (Oni), a wireline telecommunications service provider 56.61% owned by the EDP Group, signed a Sale and Purchase Agreement for the sale of its 99.93% stake in the share capital of Comunitel Global S.A. (Comunitel), along with all its subsidiaries and affiliated companies, to Tele2 Telecommunication Services, S.L. (Tele2).

Comunitel, the Spanish arm of ONI s fixed line business, is a telecommunications operator specialized in providing voice and data communication services to small and medium size corporate clients, large enterprises, single owner - home office customers (SoHos) and more recently the top end of the residential market.

The transaction value of the above-mentioned 99.93% stake in Comunitel is based on a total enterprise value of Eur. 257 million and net financial debt of Eur. 42 million. The consideration to be received in cash on completion is Eur. 215 million (including shareholders loans in the amount of Eur. 100 million). The book value of the Comunitel stake object of the Sale and Purchase Agreement now entered into by Oni and Tele2 is of Eur. 164 million and the company is expected to register a Eur. 51 million accounting gain resulting from this transaction. The successful completion of this transaction is conditional on a non-opposition decision by the Spanish competition authority.

This transaction is in line with the decision taken by Oni and its shareholders to completely focus the company s activities on the Portuguese broadband fixed line telecommunications business where it has a relative competitive advantage by virtue of the strong backing of its shareholders, national leaders in their respective economic sectors. In addition, the proceeds from the transaction will enable Oni to significantly reduce its financial debt.

Caixa Geral de Depósitos reduces holding in EDP s share capital from 9.796 to 4.890%

Caixa Geral de Depósitos, S.A. (CGD) notified EDP that, on September 23, 2005, it sold to Parpública - Participações Públicas, S.G.P.S., S.A. 179,372,198 of unprivatised shares which represents 4.906% of EDP share capital.

CGD also informed EDP of the following:

1. Following this transaction, CGD reduced its direct and indirect shareholding in EDP from 358,176,841 shares, representing 9.796% of EDP share capital, to 178,804,643 shares, representing 4.890% of EDP share capital. Considering that EDP holds 19,857,109 own shares, CGD s holding represents 4.917% of the total voting rights;

2. The current direct shareholding of CGD in EDP amounts to 175,495,171 of privatized shares which represent 4.799% of EDP share capital and 4.826% of the total voting rights;

3. The indirect shareholding of CGD s in EDP amounts to 3,309,472 shares corresponding to 0.091% of EDP share capital. The companies to which these holdings respect, in accordance with no. 1 of article 20 of the Portuguese Securities Market Code, are as follows:

CGD holds 100% of the share capital and corresponding voting rights of Caixa Seguros, SGPS, S.A., which in turn holds 100% of the share capital and corresponding voting rights of Companhia de Seguros Fidelidade-Mundial, S.A. and also 70% of the share capital and corresponding voting rights of Império Bonança, S.G.P.S., S.A., which in turn holds 100% of the share capital and corresponding voting rights of Império Bonança - Companhia de Seguros, S.A.

Fidelidade-Mundial owns 317,289 of EDP common stock, representing 0.009% of EDP share capital and 0.009% of the total voting rights of EDP. Império Bonança - Companhia de Seguros, S.A. owns 2,992,183 of EDP common stock, representing 0.082% of EDP share capital and 0.082% of the total voting rights of EDP.

EDP enters into an agreement for the increase of its indirect shareholding in Portgás and Setgás

In the context of the implementation of EDP s strategy for the Iberian gas market, the company concluded on September 5, 2005 negotiations with Endesa Gas, S.A. (Endesa) for the acquisition of a 49% shareholding in NQF Gás, S.A. (NQF Gás) and the respective shareholders loans, for a reference global consideration of Eur. 56.5 million (accrued of the corresponding financial costs). NQF Gás directly holds a 25.348% shareholding in Portgás - Sociedade de Produção e Distribuição de Gás, S.A. (Portgás) and, indirectly, a 19.8% shareholding in Setgás - Sociedade de Produção e Distribuição de Gás, S.A. (Setgás).

Upon completion of this transaction (which is subject to the required authorizations, in particular the decision of non-opposition by the Competition Authority), EDP will be the sole shareholder of NQF Gás, thus increasing its direct and indirect shareholdings in Portgás and Setgás to 72.0% and of 19.8%, respectively.

Portgás is the second largest distributor of natural gas in Portugal, operating in a concession area which includes 29 municipalities within the Oporto, Braga and Viana do Castelo districts.

Gaz de France and Elyo remain shareholders of Portgás, with a joint shareholding position of 25.34%.

Setgás operates on the Setúbal peninsula districts. The company s major shareholders are Galp (45%), Eni (21.9%) and Koch (13.2%).

EDP s statement on sector consolidation movements in the Iberian Market

EDP has been strongly committed to contribute to, and prepare itself for, the construction and operation of the Iberian Energy Market, which precedes the Internal Market in Electricity created by the Directive 2003/54/CE from the European Parliament and the Council, dated June 26, 2003.

The market, as well as the Portuguese and Spanish authorities, have witnessed the effort undertaken by EDP in the prosecution of the above-mentioned objective through several initiatives developed - some successfully, other unsuccessfully due to administrative hurdles - to improve efficiency. EDP considers that market integration in Europe demands the existence of large and efficient operators and that competition is increasingly less limited to local and national markets. In this regard, EDP believes that operators should have the freedom, in a competitive market environment and in compliance with the prevailing regulatory framework, to prepare and strengthen themselves for this competition, to the benefit of consumers, shareholders and the sector as a whole.

In light of these principles, EDP is closely monitoring the ongoing concentration movement in the Iberian Market, following the Gas Natural bid over ENDESA.

Within the legal framework available to it at the national level (in Portugal and Spain) and at the EU level, EDP will resort to every means at its reach to block discriminatory treatments (taking into consideration its own recent experience) and behaviours or agreements that distort the market by unduly benefiting any party, protecting or strengthening them through less transparent methods that are eventually non-compatible with market rules.

EDP is available to discuss and cooperate with other operators, in Portugal, Spain - including the target and the bidder companies involved in the aforementioned tender offer - or even outside the Iberian Market, in order to ensure the fulfilment of legal and regulatory market rules and to cooperate in the balanced rationalization of the sector, assuring effective competition in the context of the Iberian Market.