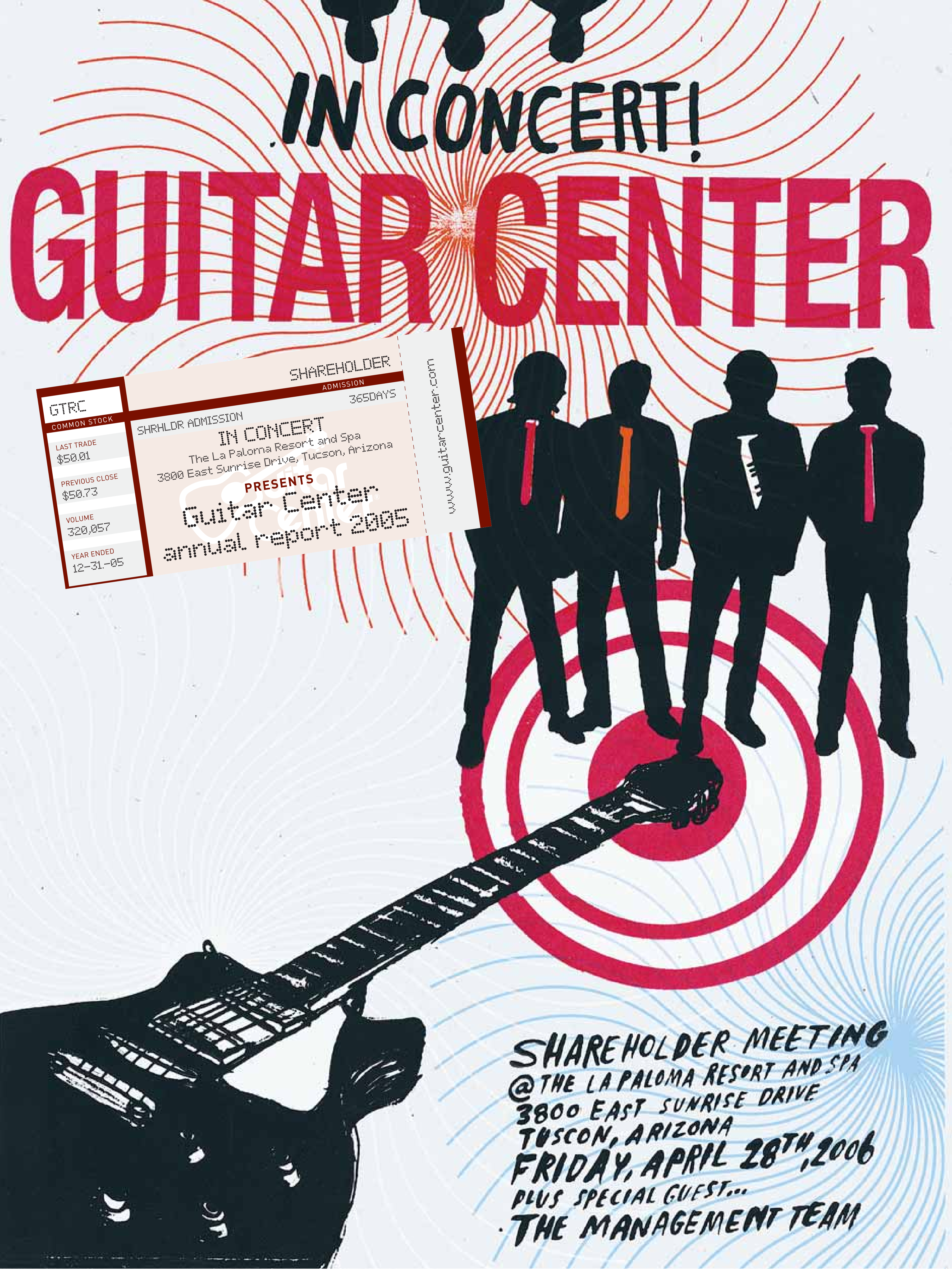


IN CONCERT!
GUITAR CENTER
GTRC
COMMON STOCK
LAST TRADE
$50.01
PREVIOUS CLOSE
$50.73
VOLUME
320,057
YEAR ENDED
12-31-05
SHAREHOLDER
ADMISSION
365DAYS
SHRHLDR ADMISSION
IN CONCERT
The La Paloma Resort and Spa
3800 East Sunrise Drive, Tucson, Arizona
PRESENTS
Guitar Center
annual report 2005
www.guitarcenter.com
SHAREHOLDER MEETING
@ THE LA PALOMA RESORT AND SPA
3800 EAST SUNRISE DRIVE
TUSCON, ARIZONA
FRIDAY, APRIL 28TH, 2006
PLUS SPECIAL GUEST...
THE MANAGEMENT TEAM

NOW ON STAGE

THE INVESTOR RELATIONS TOUR

The Band

Seems like yesterday that these legends of music retailing were just getting started, jamming in the garage for local buyers until their hook laden blend of merchandising and distribution had them exploding onto the Southern California soundscape. Now, some four decades later, Guitar Center's playing smarter than ever, out with a new book, crammed full of great new numbers.
It's The Investor Relations Tour and GC's...
IN CONCERT!


MUSICIAN'S CHOICE ATTRACTIONS PRESENTS...
GUITAR CENTER
IN CONCERT
PLACE: THE ALL NEW GUITAR CENTER
WHERE: GREENVILLE, SOUTH CAROLINA
WHEN: JULY 19, 2005
GUITAR CENTER
CELEBRATING THEIR 150TH LIVE APPEARANCE!
JOIN GC AND A HOST OF SPECIAL GUESTS AS THEY CELEBRATE THEIR 150TH LIVE APPEARANCE!
"A LANDMARK ACHIEVEMENT IN MUSICAL INSTRUMENT & TECHNOLOGY RETAILING!"

Guitar Center

With Investor Relations, their ninth AR recorded since taking their show public, Guitar Center delivers yet another winning set as the nation's #1 retailer of guitars, amplifiers, percussion instruments, keyboards and pro-audio and recording equipment. In a business of manufactured stars and cheap imitators, this outfit's the real deal—true musicians every one of them—pros selling to pros. Theirs is a trademark sound, a distinctive style and a meticulous attention to craft that has their devoted following coming out in force for their Guitar Center stores—a 161 city tour that now includes 126 venues in 50 primary markets, 34 in secondary markets and 1 tertiary market. It's Guitar Center... <u>in concert</u> with their customers, <u>in concert</u> with their investors, in concert this year to the tune of $1.31 billion in net sales!

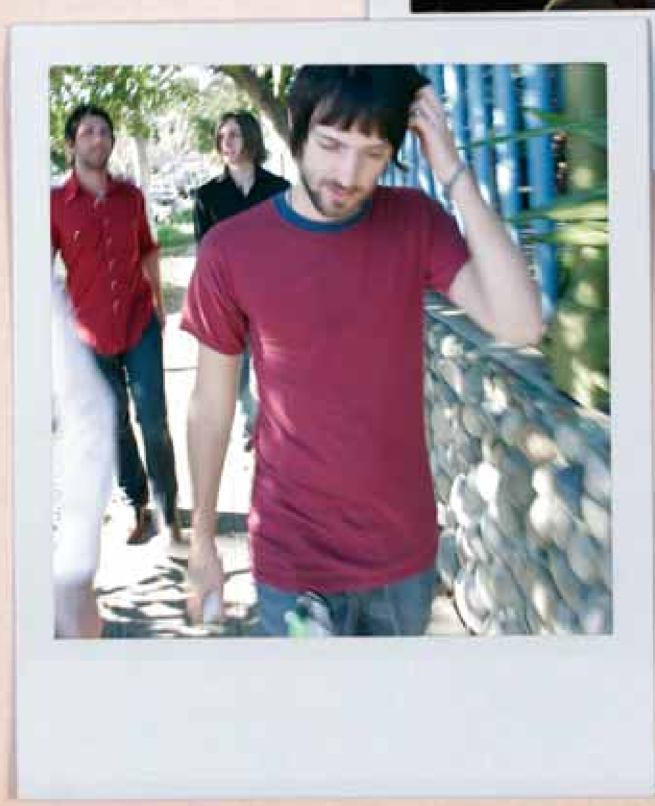
journal entry

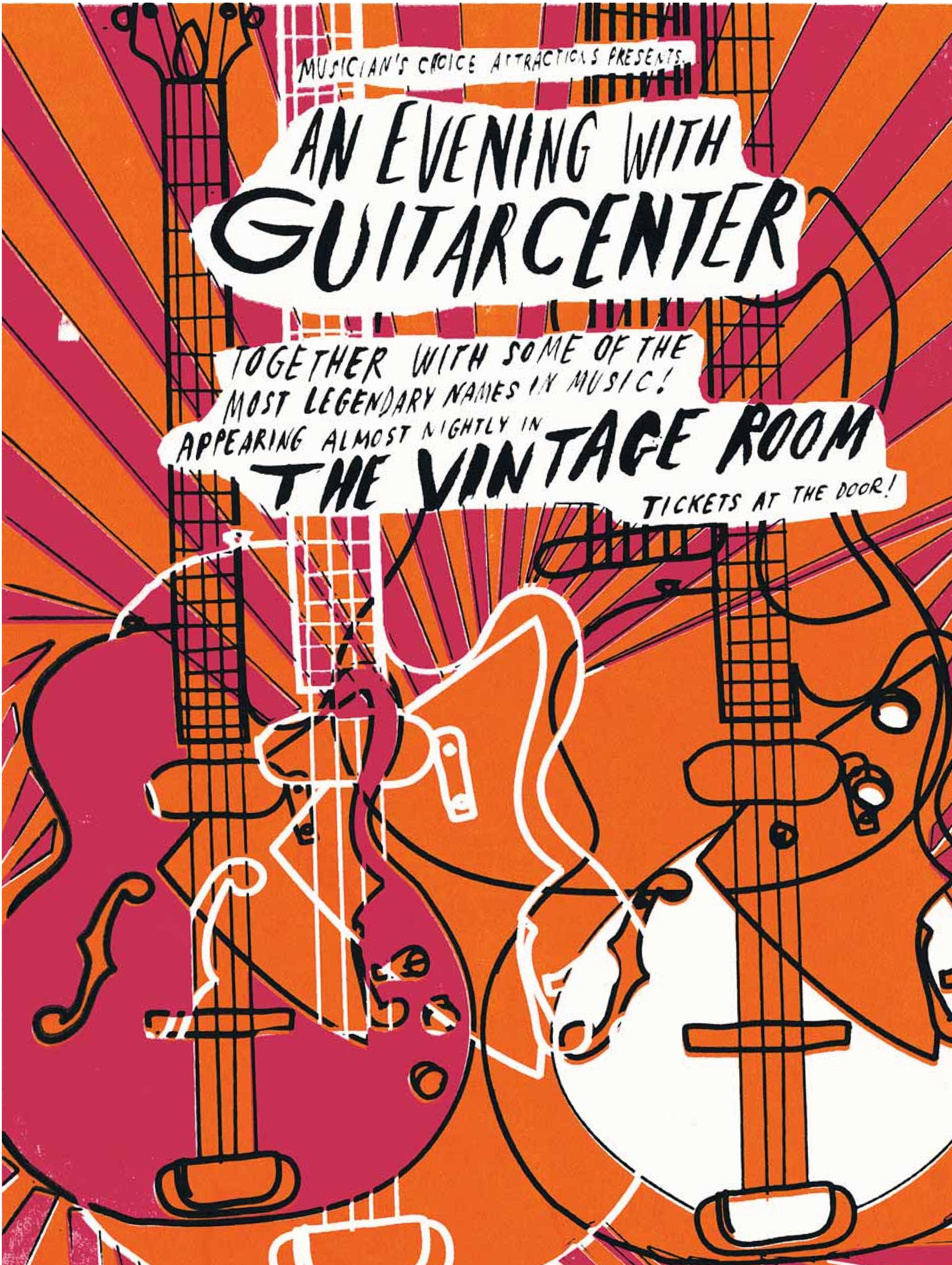
7.14.05

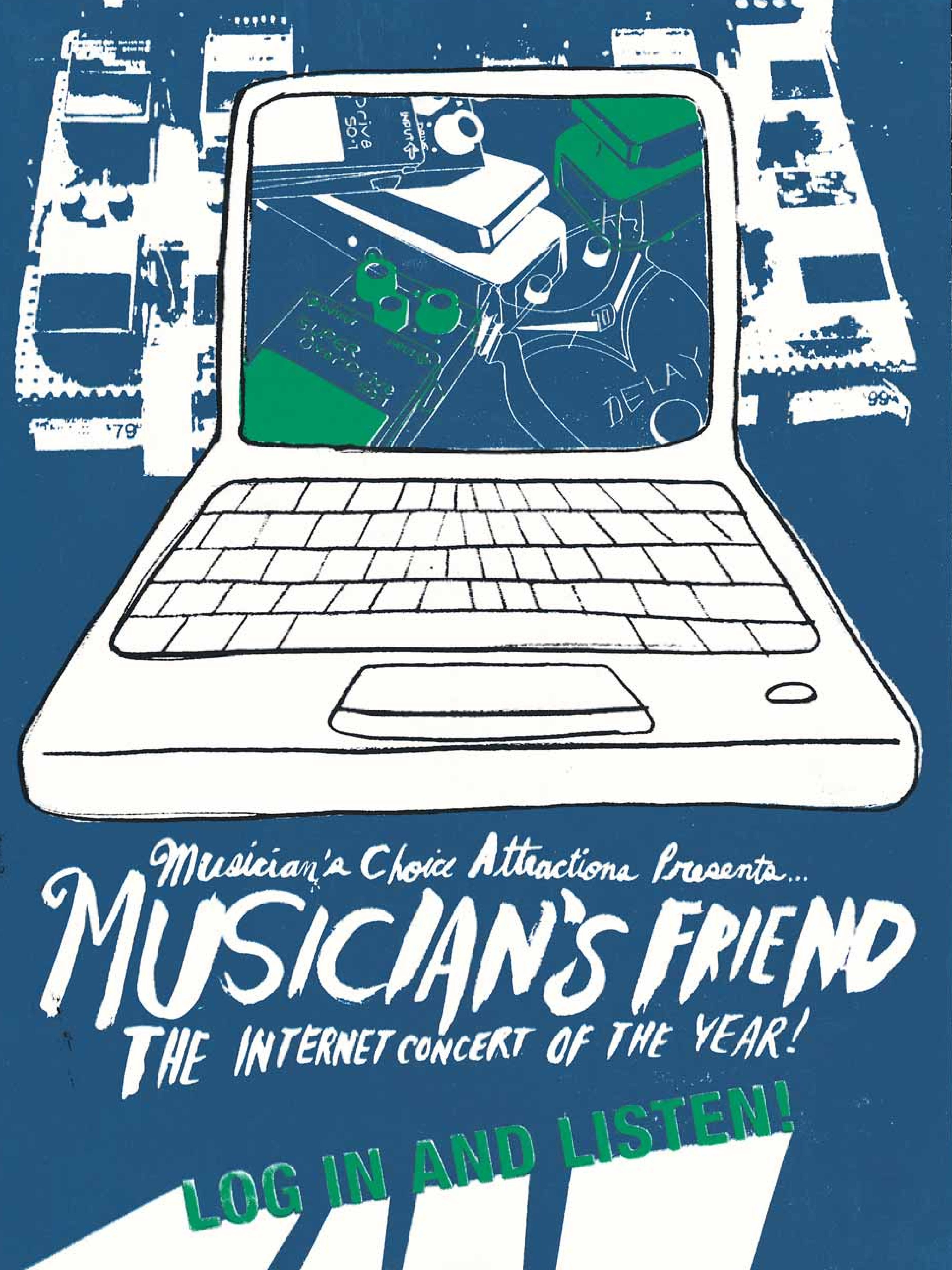
"Another major milestone! Opened our 150th store in Greenville, South Carolina tonight and man was it fantastic! Kicked off the show just after dark with a gala pyrotechnics (that's roadie-talk for fireworks) display! Joined onstage by some great bands and gave away a ton of cool stuff—including guitars, amps and more! Who would have thought we'd make it this far? But our strategy of bringing the best technology to the most people continues to pay off and pay well!"

.... recording
some b-sides -
everyone agreeing
to disagree
- as long as we
did it
Nick's way.

Roadtrip!



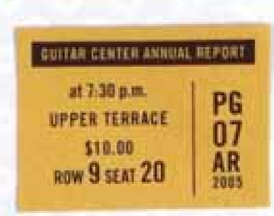

MUSICIAN'S CHOICE ATTRACTIONS PRESENTS.
AN EVENING WITH
GUITARCENTER
TOGETHER WITH SOME OF THE
MOST LEGENDARY NAMES IN MUSIC!
APPEARING ALMOST NIGHTLY IN
THE VINTAGE ROOM
TICKETS AT THE DOOR!


Drive
SO-1
INPUT
SUPER
OverDrive
DELAY
79
99
Musician's Choice Attractions Presents...
MUSICIAN'S FRIEND
THE INTERNET CONCERT OF THE YEAR!
LOG IN AND LISTEN!

Musician's Friend

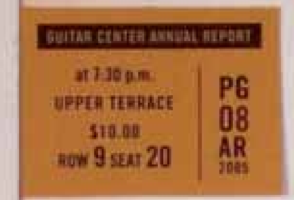
Consummate performers they may be, it's as much their talent as composers—GC's ability to really connect with their audience—that's elevated this unit to the status of "super-group"! Having penned some of the most memorable strategies in music retail history, their impressive Musician's Friend catalog and accompanying website www.musiciansfriend.com—has in fact made these guys the largest direct response retailer of musical instruments and pro audio gear in the U.S. Every title a chart topper—it's a catalog of instantly recognizable name brands and hit proprietary products that has gone on to make Musician's Friend... <u>in concert</u> with pros, <u>in concert</u> with enthusiasts, in concert this year to the tune of $365.1 million in net sales!

Contemplating our next move - after we had to sign a contract not to throw a party in one hotel room!



journal entry

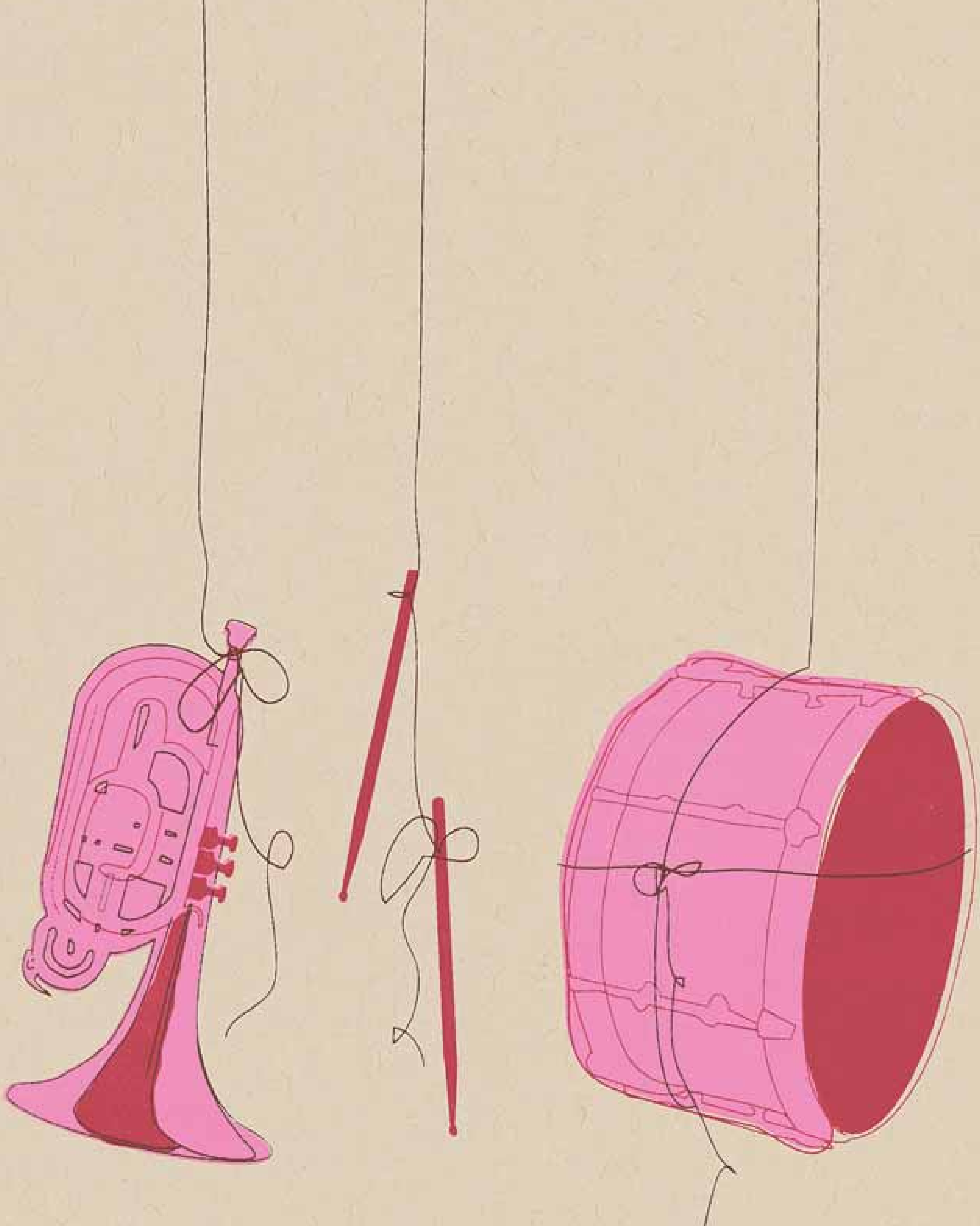
4.15.05



...more "band in the park" shots courtesy of our devoted manager...

"Added another 61 retail locations to the tour today with the company's acquisition of privately held, Maryland-based Music & Arts Center, one of the nation's largest band instrument retailers with an emphasis on the beginner musician and music education. How cool is that? Now, we'll be able to reach our audience throughout every stage of their involvement in the music industry—starting with our Music & Arts Center, "Cool for Kids/Safe for Parents"!

...got back into studio, recording the vocals for the new arrangement of 'Investor Relations' which we are really, really stoked on since we all thought the mix that made it onto the album still needed a little work...



Musician's Choice Attractions Presents...

The First Annual

MUSIC & ARTS CENTER FESTIVAL

with special guests

GUITAR CENTER

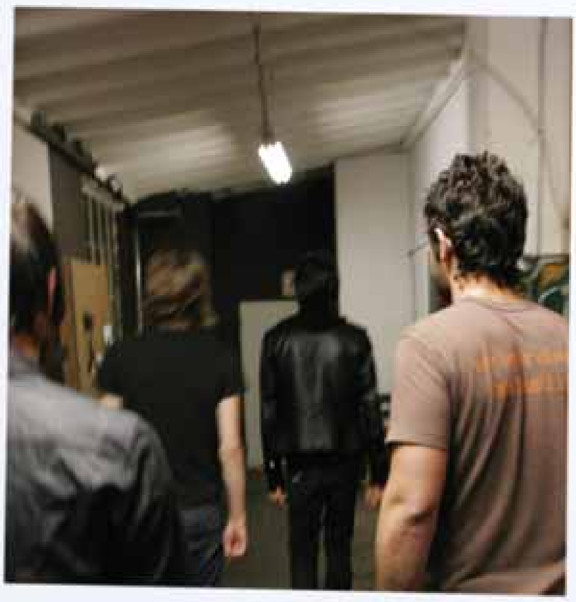
plus- joining GC on stage

"THE NEIGHBORHOOD KIDS"

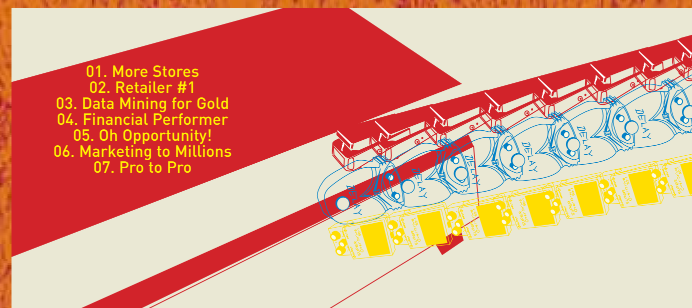
see them now before they become stars!

Music & Arts Center

There was nothing remarkable about them when they first got together, nothing that alluded to their future greatness—just another band of kids—rock-'n roll-dreamers—who got their start in the neighborhood music store. And so it's there that Guitar Center returned with the acquisition of Music & Arts Center, Inc. Here kids can rent their first instrument and take their first lessons—building skills and brand awareness at the same time. Combined with the company's former American Music Stores, the new Music & Arts Center adds 81 stores to this leg of the tour serving thousands of educators and students. It's Music & Arts Center... in concert with kids, in concert with families, in concert this year to the tune of $103.1 million in net sales!

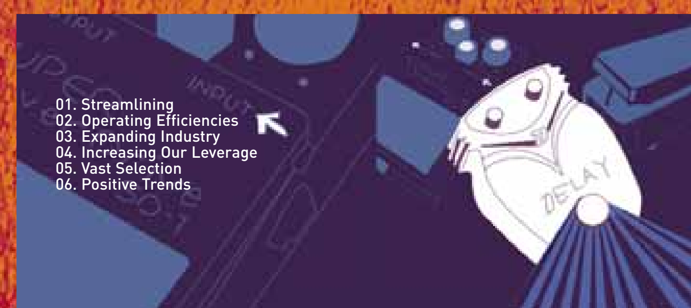


Discography

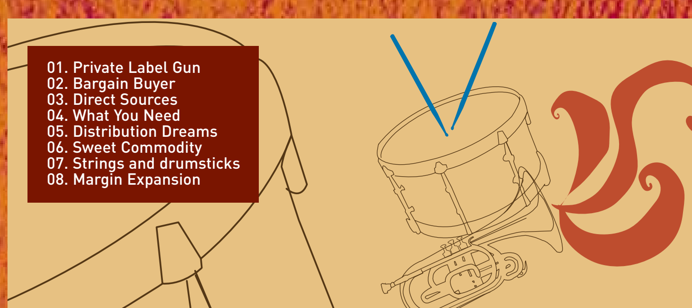


Still Growing Strong

Increasing Our Share



Advantages & Momentum



Proprietary Products

Direct Response Masters

Cool For Kids/Safe For Parents

journal entry

12.31.05

Special thanks to the gang at GC Pro for dialing us in with the best gear out there and making it happen when it absolutely had to! Sounds so good, we're bound to make it onto the Rockwalk of fame now!

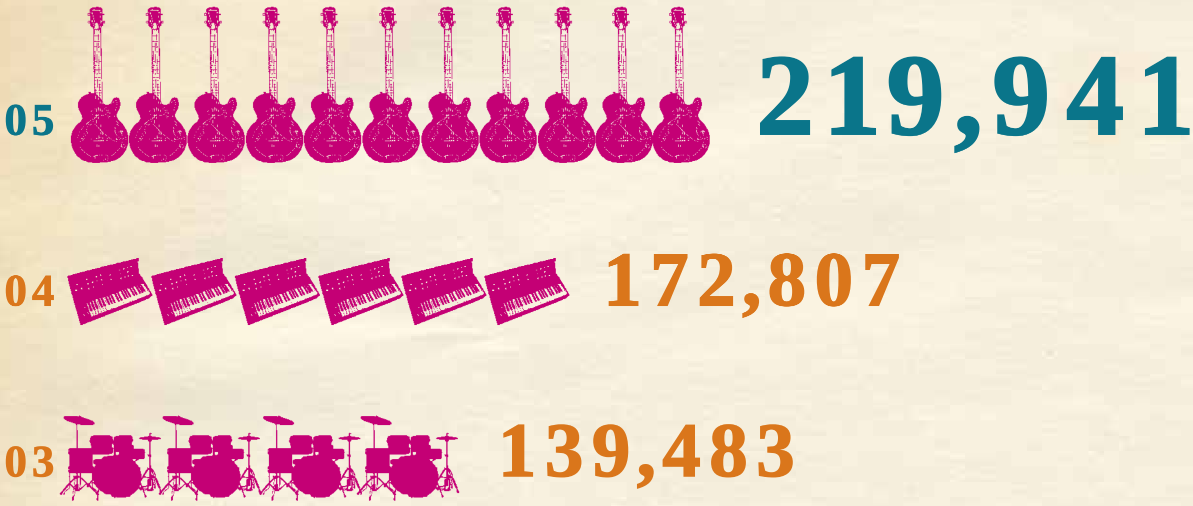
Finale

Investor Relations… the words, the music, the tour. To understand what inspired us in the beginning, you'll need to look to the end… or to that hour in the night when we're hot and tired and our throats are raw. By now, we've long ago left the safety and confines of any set list. But still, we continue to jam—increasing our mature store base, improving our operating efficiencies and leveraging our infrastructure investments! It's how we continue to grow. And we do it all for you—our loyal fans and steadfast investors—who are on your feet and cheering us on wherever Guitar Center appears… in concert!

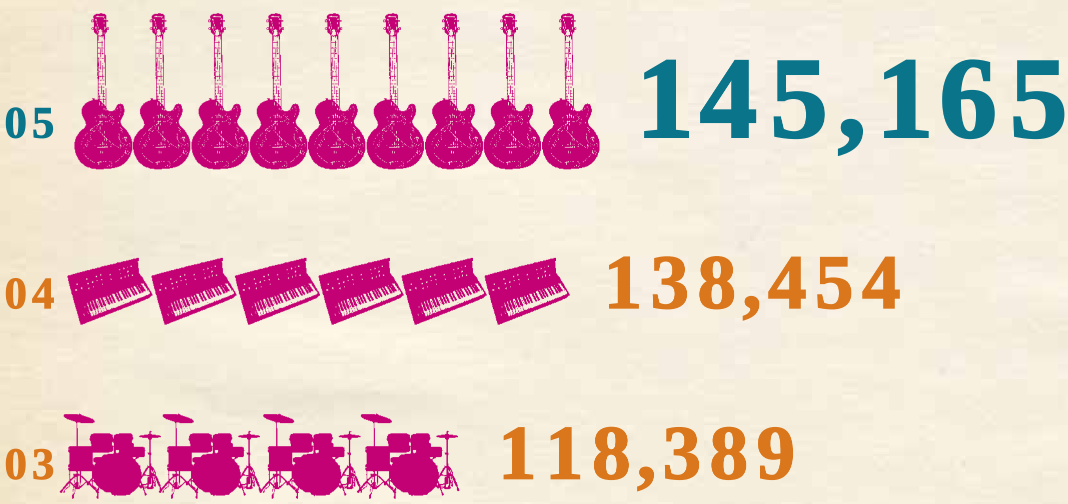
To you, this tour is dedicated… ROCK ON!

GC

Internet Net Sales
in thousands



Catalog/Contact Center Net Sales
in thousands




$1.78
Billion
Guitar Center, Inc.
Consolidated Net Sales

THE INVESTOR RELATIONS TOUR

In Concert Guitar Center annual report 2005

GUITAR CENTER

ALABAMA
- Mobile 2004
- Birmingham 2005
- Montgomery (1) 2006

ARIZONA
- Phoenix 1997
- Tempe 1997
- Tucson 2001
- Scottsdale 2003

ARKANSAS
- Little Rock 2002

CALIFORNIA (SOUTHERN)
- Hollywood 1964
- San Diego 1973
- Fountain Valley 1980
- Sherman Oaks 1982
- Covina 1985
- Southbay 1985
- San Bernardino 1993
- Brea 1995
- San Marcos 1996
- Rancho Cucamonga 1999
- El Toro 1999
- Oxnard 2000
- Bakersfield 2000
- Palmdale 2001
- Pasadena 2002
- Cerritos 2003
- Northridge 2005
- Murrieta (1) 2006

(NORTHERN)
- San Francisco 1972
- San Jose (2) 1978
- El Cerrito 1983
- Concord 1996
- Fresno 2000
- Sacramento 2000
- Modesto 2001
- Gilroy (1) 2006

COLORADO
- Denver 1998
- Englewood 1998
- Arvada 1999
- Colorado Springs 2002
- Pueblo 2005

CONNECTICUT
- Manchester 1999
- Orange 2002

FLORIDA
- North Miami area 1996
- South Miami area 1996
- West Palm Beach 2001
- Orlando 2002
- Lakeland 2003
- Tampa 2003
- Ft. Myers 2004
- Orlando 2005
- Jacksonville 2005
- Tallahassee 2005
- Pensacola 2005
- Clearwater (1) 2006

GEORGIA
- Atlanta 1997
- Marietta 1997
- Lawrenceville 2004

IDAHO
- Boise 2001

ILLINOIS
- South Chicago 1979
- North Chicago 1981
- Central Chicago 1988
- Villa Park 1996
- Highland Park 2001
- Peoria 2004
- Naperville 2004
- Rockford (1) 2006
- Country Club Hills (1) 2006
- Algonquin (1) 2006
- Joliet (1) 2006

INDIANA
- Indianapolis 2001
- Hobart 2003
- South Bend 2004
- Ft. Wayne 2005
- Terre Haute (1) 2006
- Evansville (1) 2006
- Greenwood (1) 2006

IOWA
- Des Moines 2005

KANSAS
- Wichita 2005
- Overland Park 2005

LOUISIANA
- New Orleans 1999
- Baton Rouge 2004

MAINE
- Portland (1) 2006

MARYLAND
- Towson 1998
- Rockville 2000
- Glen Burnie 2004

MASSACHUSETTS
- Boston 1994
- Danvers 1996
- Natick 1997
- N. Attleboro 1998
- Millbury (1) 2006

MICHIGAN
- Detroit 1994
- Southfield 1996
- Canton 1998
- Grand Rapids 2002
- Saginaw 2003
- Kalamazoo 2004
- Flint 2005
- Allen Park (1) 2006

MINNESOTA
- Twin Cities 1988
- Edina 1997

MISSISSIPPI
- Jackson 2005

MISSOURI
- N. St. Louis 1999
- Bridgeton 1999
- Independence 2005

NEBRASKA
- Lincoln (1) 2006

NEVADA
- Las Vegas 1998
- Summerlin 2005

NEW HAMPSHIRE
- Nashua 2004

NEW JERSEY
- Springfield 1998
- E. Brunswick 1998
- Totowa 1999
- Paramus 1999
- Cherry Hill 2001
- Atlantic City 2002

NEW MEXICO
- Albuquerque 2004

NEW YORK
- Carle Place 1998
- Queens 1999
- Larchmont 1999
- Commack 2000
- Buffalo 2000
- Rochester 2001
- Albany 2003
- Manhattan 2003
- Syracuse 2005
- Brooklyn 2005

NORTH CAROLINA
- Charlotte 2002
- Raleigh 2002
- Durham (1) 2006

OHIO
- Cleveland 1997
- Mayfield Heights 1998
- Cincinnati 1998
- Columbus 2002
- Toledo 2004
- Akron 2005
- Youngstown 2005

OKLAHOMA
- Oklahoma City 2000
- Tulsa 2005

OREGON
- Medford 1987
- Eugene 1996
- Clackamas 2000
- Beaverton 2000

PENNSYLVANIA
- Philadelphia 2000
- Plymouth Meeting 2001
- Monroeville 2001
- Harrisburg 2003
- Pittsburgh 2005

RHODE ISLAND
- Warwick 2003

SOUTH CAROLINA
- Greenville 2005
- Charleston 2005

TENNESSEE
- Knoxville 1998
- Memphis 2003
- Nashville 2003
- Chattanooga 2005

TEXAS
- Dallas 1989
- Arlington 1991
- South Houston 1993
- North Houston 1994
- Central Dallas 1998
- Clearlake 1998
- Austin 2000
- Plano 2000
- Corpus Christi 2002
- Ft. Worth 2004
- South Austin 2005
- El Paso (1) 2006
- Lubbock (1) 2006

UTAH
- Salt Lake City 1998
- Ogden 2002

VIRGINIA
- Fairfax 1999
- Seven Corners 1999
- Virginia Beach 2000
- Fredericksburg 2003
- Richmond 2003

WASHINGTON
- Tukwila 1997
- Kirkland 1997
- Seattle 1997
- Lynnwood 1998
- Tacoma 2001
- Spokane 2001

WISCONSIN
- Brookfield 2004
- Madison (1) 2006
- Appleton (1) 2006

MUSIC & ARTS CENTER

ARIZONA
- Phoenix 1987
- Mesa 1995
- Tucson 2004
- North Tucson 2005

COLORADO
- Englewood 2000
- Loveland 2001
- Littleton 2002
- Westminster 2002

CONNECTICUT
- East Hartford 1993
- Avon 2002
- Vernon 2003
- West Hartford 2003
- Waterford 2005

DELAWARE
- Wilmington 2000

FLORIDA
- Longwood 1986
- Jupiter 1995
- Jacksonville 2002

GEORGIA
- North Fulton 1996
- Lawrenceville 1997
- Snellville 1997
- Peachtree 2001
- Valdosta 2002
- Albany 2002
- East Cobb 2004

ILLINOIS
- Naperville 2003
- Itasca 2004

MASSACHUSETTS
- Norwood 1980
- Greenfield 1982

MARYLAND
- Bel Air 1993
- Ellicott City 1994
- Rockville 1994
- Frederick 1996
- Germantown 1997
- Timonium 1997
- Severna Park 1998
- South Howard 1999
- Hagerstown 2001
- Bowie 2004

MAINE
- West Falmouth 1973

NORTH CAROLINA
- Burlington 2001
- Cary 2003
- Huntersville 2003
- North Charlotte 2003
- Charlotte 2005

NEW HAMPSHIRE
- Manchester 2004

NEW JERSEY
- Pennsauken 2000
- Marlton 2003
- Princeton 2003

NEVADA
- Henderson 2002
- Summerlin 2005

NEW YORK
- Syracuse 1970
- Pittsford 1975
- New York Mills 1999

PENNSYLVANIA
- Lancaster 1993
- Plymouth Meeting 1994
- Horsham 1998
- Exton 2000
- Doylestown 2004
- Newton Square 2004

SOUTH CAROLINA
- Columbia 1999
- Spartanburg 2002
- Charleston 2004

TENNESSEE
- Murfreesbro 1993
- Cool Springs 2001
- Hendersonville 2002

TEXAS
- Houston 2003

VIRGINIA
- Springfield 1989
- Richmond 1990
- Oakton 1991
- Midlothian 1994
- Virginia Beach 1995
- Manassas 1997
- McLean 1997
- Kempsville 1998
- Sterling 1998
- Yorktown 1998
- Woodbridge 1999
- Chesapeake 2000
- Baileys 2001
- Burke 2002
- Charlottesville 2002

(1) We have signed leases for these locations and presently expect each to open in 2006.
(2) Represents stores relocated in 2005.

design: McNulty & Company mcnultyco.com editorial: Richard Huvard photography: Aaron Farley

GC Retail Net Sales
in thousands

05 1,314,277

04 1,161,511

03 978,962

GC Stores Open

05 161

04 136

03 122

To Our Shareholders:

2005 was another outstanding year for Guitar Center, marking our ninth consecutive year of revenue growth since completing our initial public offering in 1997. From 2001 to 2005, our net sales grew at an annual compound growth rate of 17%, principally due to comparable store sales growth of 7% per year, our successful new store openings, and a 21% per year increase in our direct response division. We believe such volume increases are the result of continued success in the implementation of our business strategy, ongoing growth in the music products industry and increasing consumer awareness of the Guitar Center, Musician's Friend and Music & Arts Center brand names.

Our net revenues for the year totaled $1.78 billion, an increase of 17.8% over 2004. We grew our operating margin by 29 basis points, marking our third consecutive year of operating margin expansion. We delivered 21% growth in net income year over year, generating a record $76.7 million, or $2.67 per diluted share.

Our financial position remains strong. We closed out the year with $404.8 million in stockholders equity, an increase of $98.1 million over the previous year. In addition, our return on invested capital was 23% and our return on average equity was 22%.*

POISED FOR THE FUTURE:

Perhaps our most important accomplishments of 2005 were decisions we made and planning we completed to prepare Guitar Center for the future. While we have always had 12- to 18-month plans, we have now completed a detailed five year strategic plan to properly plan our infrastructure enhancements and support our expected growth.

As we evaluate the Company's potential for growth over the next three to five years, we continue to see opportunity to increase our revenue and earnings through our three existing divisions as well as through international expansion. The investments we are making in 2006, and the key initiatives we are undertaking, are intended to position the Company for its next stage of expansion. Our long-term growth objectives continue to be achieving 13% to 15% top line growth and 18% to 20% net income growth over time.

As of December 31, 2005 we operated 161 Guitar Center stores. We plan to open approximately 35 to 40 additional Guitar Center stores in 2006, including eight to 10 major market stores, 25 to 28 secondary market stores and two tertiary market stores. Generally, in the coming year, we expect to see positive trends in our Guitar Center division similar to those we experienced in 2005.

In 2005, we successfully acquired Music & Arts Center, Inc. and integrated it with our American Music business, resulting in 81 stores targeted toward students and the beginning musician. Our retail growth strategy involves increasing the number of Music & Arts Center stores through acquisitions and opening approximately three to five new stores in 2006.

Our direct response division has been on a strong growth track for a number of years. While we are seeing a natural maturing of this business over time, we continue to anticipate direct response revenue growth in the range of 15% to 20% in 2006. We expect to generate a solid operating margin in this division, but anticipate the margin will be below what we have recently generated due to the important investments in technology, people and our fulfillment operations that we are making in this business in 2006.

VALUES AND VALUE CREATION:

Whether it is our ability to successfully open multiple stores or to make significant acquisitions and integrate them quickly and efficiently, Guitar Center continues to

* Return on invested capital and return on equity figures are non-GAAP data. A reconciliation of these figures to GAAP can be found under the Supplemental Data in the Investor Relations section of the Company's website.

excel. Although several factors contributed to our success in 2005, none is more important or appreciated than the hard work, dedication and tireless efforts of the incredibly talented people in our Company. Our employees continue to be the strength of our organization and the driving force behind our achievements. We thank each of them for their passionate commitment that allows us to enjoy a reputation as a truly great multi-channel retailer of musical instruments and a great place to work.

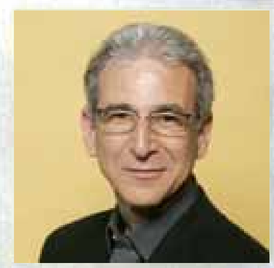
At Guitar Center, there is an inseparable link between our values and the value creation we offer our shareholders. We have made substantial progress over the past several years in strengthening our business. We are committed to continuing this progress. We appreciate the support of our customers, partners, associates and shareholders and look forward to the future, which we believe will offer even greater opportunities for continued financial success.


Marty Albertson
Chairman &
Chief Executive Officer,
Guitar Center, Inc.


Robert Eastman
Chief Executive Officer,
Musician's Friend, Inc.


Kenny O' Brien
Chief Executive Officer,
Music & Arts Center


Bruce Ross
Executive Vice President
& Chief Financial Officer,
Guitar Center, Inc.


David Angress
Executive Vice President
International Development
and Proprietary Brands,
Guitar Center, Inc.


William Deeney
Executive Vice President
& Chief Logistics Officer,
Guitar Center, Inc.


Mark Galster
Executive Vice President
of Stores,
Guitar Center, Inc.


Craig Johnson
Executive Vice President
of Merchandising and
Marketing,
Musician's Friend, Inc.


Erick Mason
Executive Vice President
& Chief Administrative
Officer,
Guitar Center, Inc.


Leland Smith
Executive Vice President
of Corporate Development,
General Counsel & Secretary,
Guitar Center, Inc.


Jay Wanamaker
Executive Vice President
& General Merchandise
Manager,
Guitar Center, Inc.


Jon White
Executive Vice President
of Operations,
Musician's Friend, Inc.


John Zavada
Executive Vice President
& Chief Information Officer,
Guitar Center, Inc.

Financial Table of Contents

Selected Financial Data

The selected data presented below under the captions "Income Statement Data" and "Balance Sheet and Other Data" for, and as of the end of, each of the years in the five-year periods ended December 31, 2005, are derived from the consolidated financial statements of Guitar Center, Inc. and subsidiaries, which financial statements have been audited by KPMG LLP, independent registered public accounting firm. The consolidated financial statements as of December 31, 2005 and 2004, and for each of the years in the three-year period ended December 31, 2005, and the report thereon, are included elsewhere in this annual report. The selected historical financial data should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations, our consolidated financial statements and the notes thereto included elsewhere in this annual report.

Year Ended December 31, (in thousands, except per share and operating data)	2005	2004	2003	2002	2001
INCOME STATEMENT DATA:					
Net sales	$ 1,782,499	$ 1,513,172	$ 1,275,059	$ 1,100,889	$ 949,284
Cost of goods sold	1,262,097	1,087,899	931,014	810,474	702,310
Gross profit	520,402	425,273	344,045	290,415	246,974
Selling, general and administrative expenses	388,380	317,585	271,996	236,537	200,748
Operating income	132,022	107,688	72,049	53,878	46,226
Other expense:					
Other expense	—	—	—	—	3,539
Interest expense, net	7,339	5,390	12,540	13,077	13,411
Total other expense	7,339	5,390	12,540	13,077	16,950
Income before income taxes	124,683	102,298	59,509	40,801	29,276
Income taxes	48,005	38,873	22,649	15,545	12,243
Net income	$ 76,678	$ 63,425	$ 36,860	$ 25,256	$ 17,033
Net income per share (diluted)	$ 2.67	$ 2.29	$ 1.47	$ 1.09	$ 0.75
Diluted weighted average shares outstanding(1)	29,846	28,976	26,119	23,130	22,700
OPERATING DATA:					
Guitar Center net sales per gross square foot(2)	$ 599	$ 585	$ 560	$ 546	$ 537
Net sales growth	17.8%	18.7%	15.8%	16.0%	19.4%
Increase in Guitar Center comparable store sales(3)	5.8%	9.7%	6.9%	6.5%	5.5%
Guitar Center stores open at end of period	161	136	122	108	96
Ratio of earnings to fixed charges(4)	6.5X	6.6X	3.5X	2.8X	2.4X
Net cash provided by operating activities (thousands)	$ 65,710	$ 85,506	$ 58,005	$ 12,248	$ 16,511
EBITDA (thousands)(5)	$ 161,022	$ 129,992	$ 92,669	$ 70,738	$ 57,693
BALANCE SHEET AND OTHER DATA:					
Net working capital	$ 287,098	$ 269,859	$ 198,713	$ 110,825	$ 90,113
Property and equipment, net	149,209	97,349	93,347	89,702	81,056
Total assets	780,190	574,593	460,871	452,399	404,684
Total long-term and revolving debt (including current portion)	132,266	100,000	100,000	149,590	144,466
Stockholders' equity	404,817	306,682	214,171	154,928	123,868
Capital expenditures	75,493	26,151	24,245	26,309	24,697

Footnotes appear on following page.

Footnotes to table on previous page

[(1)]Weighted average shares represents shares calculated on a diluted basis. For the years ended December 31, 2005 and 2004, the 2.9 million shares of common stock issuable upon conversion of the 4% Senior Convertible Notes issued in June 2003 (reflecting an effective conversion price of $34.58) are deemed to be potential common stock and are deemed to be outstanding for the purposes of calculating diluted earnings per share under the "if-converted" method of accounting under which the after-tax interest expense, including amortization of deferred financing costs, for the year is added back to net income. For the year ended December 31, 2003, 1.6 million shares of common stock were deemed to be potential common stock and are included in the calculation of earnings per share representing the weighted average shares issuable upon the conversion of the 4% Senior Convertible Notes for the period of June 16, 2003, the issuance date of the Notes, to December 31, 2003, under the "if-converted" method. The diluted earnings per share for 2003 has been restated to conform to EITF 04-08, ***Accounting Issues Related to Certain Features of Contingently Convertible Debt and the Effect on Diluted Earnings per Share.***

[(2)]Net sales per gross square foot is a measure of sales efficiency based on square footage. This calculation is presented for Guitar Center retail stores only, excluding Music & Arts Center retail stores, and does not include new stores opened during the reporting period.

[(3)]Compares net sales for the comparable periods, excluding net sales attributable to stores not open for 14 months as of the end of the latter reporting period. All references in this annual report to comparable store sales results are based on this calculation methodology. This calculation is presented for Guitar Center retail stores only, excluding Music & Arts Center retail stores.

[(4)]For the purpose of calculating the ratio of earnings to fixed charges, "earnings" represents income before provision for income taxes and fixed charges. "Fixed charges" consist of interest expense, amortization of debt financing costs, and one third of lease expense, which management believes is representative of the interest component of lease expense.

[(5)]Represents net income before interest expense, income taxes, and depreciation and amortization expense. The reconciliation from reported net income to EBITDA is as follows:

EBITDA	2005	2004	2003	2002	2001
Net income as reported	$ 76,678	$ 63,425	$ 36,860	$ 25,256	$ 17,033
Income taxes	48,005	38,873	22,649	15,545	12,243
Interest expense	7,339	5,390	12,540	13,077	13,411
Depreciation and amortization	29,000	22,304	20,620	16,860	15,006
EBITDA	$ 161,022	$ 129,992	$ 92,669	$ 70,738	$ 57,693

EBITDA is not a measure of financial performance under generally accepted accounting principles. We present EBITDA because many investors view this information as a useful measure of a company's ability to generate cash flow and service debt or capital obligations, and some of our debt instruments have in the past and may in the future include covenants that use similar concepts. EBITDA should not, however, be considered as a substitute for measures determined under generally accepted accounting principles, such as net income and cash flow from operations. Further, the calculation of EBITDA varies from company to company and thus the amount that we calculated using the methodology described above may not be comparable to the amount of EBITDA reported by other companies.

Management's Discussion and Analysis

GENERAL

Guitar Center, Inc. is the leading United States retailer of guitars, amplifiers, percussion instruments, keyboards and pro-audio and recording equipment. As of December 31, 2005, our retail store subsidiary operated 161 Guitar Center stores across the United States, with 126 stores in 50 primary markets, 34 stores in secondary markets and one tertiary market store. In addition, as of December 31, 2005, our Music & Arts Center division operated 81 stores specializing in band instruments for sale and rental, serving thousands of teachers, band directors, college professors and students. We are also the largest direct response retailer of musical instruments in the United States through our wholly owned subsidiary, Musician's Friend, Inc., and its catalog and website, www.musiciansfriend.com.

In 2005, we opened a total of 25 Guitar Center stores, including 12 primary market stores, 12 secondary market stores and one tertiary market store. We presently expect to open approximately 35 to 40 additional Guitar Center stores in 2006, including eight to 10 primary market stores, 25 to 28 secondary market stores and two tertiary market stores.

As we enter new markets, we expect that we will initially incur higher administrative and promotional costs per store than is currently experienced in established markets. We expect competition to continue to increase as other music product retailers attempt to execute national growth strategies. Our business strategy will also emphasize opportunities to continue to grow each of our brands, including further acquisitions if attractive candidates can be located for reasonable prices.

From 2001 to 2005, our net sales grew at an annual compound growth rate of 17%, principally due to the comparable store sales growth of our retail stores averaging 7% per year, the opening of new stores, and a 21% per year increase in the direct response channel. We believe such volume increases are the result of the continued success of the implementation of our business strategy, continued growth in the music products industry and increasing consumer awareness of the Guitar Center, Musician's Friend and Music & Arts Center brand names. Our retail stores achieved comparable store sales growth of 5.4%, 9.4%, and 7.0% for the fiscal years ended December 31, 2005, 2004 and 2003, respectively. We believe this growth reflects the strength of our merchandise selection, effective advertising and promotion, and well-trained and committed personnel.

EXECUTIVE SUMMARY

Consolidated net sales in 2005 increased 17.8% to $1.8 billion from $1.5 billion in 2004. Consolidated net income in 2005 increased 20.9% to $76.7 million, or $2.67 per diluted share, from $63.4 million, or $2.29 per diluted share, in 2004.

During 2005, our Guitar Center stores generated 5.8% comparable store sales growth and an increase of 13.2% in total net sales compared to 2004. Sales from new stores totaled $85.3 million and represented 55.9% of the overall increase in sales. We opened 25 new Guitar Center stores in 2005.

Musician's Friend, our direct response unit, generated an increase in net sales of 17.3% in 2005 compared to 2004. Within the overall sales increase for direct response, our web-based sales grew at a rate of 27.3% in 2005, reflecting an increased consumer preference in using the web to place orders. Our initial order fill rate improved to 93.3% in 2005 from 92.3% in 2004. Initial order fill rate reflects the percentage of items ordered by our customers that we are able to supply in the initial shipment to that customer. Gross profit margins decreased by 2.5% of net sales due primarily to increased online competition leading, in particular, to expanded free freight offers in 2005. We are also spending more on internet search engine advertising in order to drive more traffic to our site.

We completed our acquisition on April 15, 2005 of Music & Arts Center, Inc., a Maryland-based musical instrument retailer with an emphasis on the beginning musician. At the time of acquisition, Music & Arts Center, Inc. operated 61 retail locations primarily located in the Northeast, Mid-Atlantic and Southern regions of the United States. The acquired business was combined with our former American Music business into a new division of our retail store subsidiary that operates under the Music & Arts Center name.

Financial results prior to April 15, 2005 for our Music & Arts Center business reflect only our former American Music stores and do not include results from the acquired business. However, comparable sales for the year are computed using the combined comparable sales of Music & Arts Center, Inc., and American Music stores. Primarily as a result of this acquisition, the net sales for the Music & Arts Center business increased from $40.4 million in 2004 to $103.1 million in 2005. Comparable sales for the year decreased 0.3% which is inclusive of a decrease of 16.1% at the American Music locations, offset by a 9.6% increase in comparable sales at the Music & Arts Center locations. Comparable sales decreased at American Music principally due to the reduction in low margin institutional sales which is not part of our ongoing Music & Arts Center strategy. We saw gross margin expand to 41.8% for the year ended December 31, 2005 compared to 34.8% for the same period in 2004. This margin expansion is principally due to improved product mix and better pricing under the Music & Arts Center business and elimination of the institutional sales.

DISCUSSION OF CRITICAL ACCOUNTING POLICIES

In the ordinary course of business, we have made a number of estimates and assumptions relating to the reporting of results of operations and financial condition in the preparation of our financial statements in conformity with accounting principles generally accepted in the United States. Actual results could differ significantly from those estimates under different assumptions and conditions. We believe that the following discussion addresses our most critical accounting policies, which are those that are most important to the portrayal of our financial condition and results and require management's most difficult, subjective and complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. Additionally, the policy described below regarding credits and other vendor allowances is unique to our industry and deserves the attention of a reader of our financial statements.

Valuation of Inventory

We value our merchandise inventory at the lower of cost using the weighted average method or market. Rental inventories are valued at the lower of cost or market using the specific identification method and are depreciated on a straight-line basis while out under a rental agreement for rent-to-own sales. We record adjustments to the value of inventory based upon obsolescence and changes in market value. Applicable costs associated with bringing inventory through our Guitar Center retail distribution center are capitalized to inventory. The amounts are expensed to cost of goods sold as the associated inventory is sold. Management has evaluated the current level of inventories considering future customer demand for our products, taking into account general economic conditions, growth prospects within the marketplace, competition, market acceptance of current and upcoming products, and management initiatives. Based on this evaluation, we have recorded impairment adjustments to inventory and to cost of goods sold for estimated decreases in net realizable value. These judgments are made in the context of our customers' shifting needs, product and technological trends, and changes in the demographic mix of our customers. A misinterpretation or misunderstanding of these conditions and uncertainties in the future outlook of our industry or the economy, or other failure to estimate correctly, could result in inventory valuation changes as of any given balance sheet date.

Valuation of Long-Lived Assets

Long-lived assets such as property and equipment and identifiable intangibles with finite lives are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Goodwill and other intangibles with indefinite lives that are not amortized are required to be reviewed for impairment on an annual basis, or more frequently when triggering events occur. Factors we consider important, which could trigger impairment, include, among other things:

- Significant underperformance relative to historical or projected operating results;
- Significant changes in the manner of our use of the acquired assets or the strategy of our overall business;
- Significant negative industry or economic trends; and
- Significant decline in stock value for a sustained period.

For long-lived assets other than goodwill and intangibles that are not amortized, the determination of whether impairment has occurred is based on an estimate of undiscounted future cash flows attributable to the assets, as compared to the carrying value of the assets. Assumptions used in these cash flows are consistent with internal forecasts and consider current and future expected sales volumes and related operating costs and any anticipated increases or declines based on expected market conditions and local business environment factors. If a potential impairment is identified, the amount of the impairment loss recognized would be determined by estimating the fair value of the assets and recording a loss if the fair value was less than the book value. Fair value will be determined based on appraisal values assessed by third parties, if deemed necessary, or a discounted future cash flows analysis. For goodwill and other intangibles that are not amortized, impairment to be recognized is measured as the amount by which the carrying amount of the assets exceeds the fair value of the related assets of the underlying reporting unit to which the goodwill relates.

Our assessment regarding the existence of impairment factors is based on market conditions and the operational performance of our business. Our review of factors present and the resulting appropriate carrying value of our goodwill, intangibles and other long-lived assets are subject to judgments and estimates that management is required to make.

Sales Returns

As part of our "satisfaction guaranteed" policy, we allow Guitar Center customers to return product generally within 30 days after the date of purchase, and we allow Musician's Friend customers to return product within 45 days. Music & Arts Center customers have 14 business days from the date of purchase to return product. We regularly review and revise, when deemed necessary, our estimates of sales returns based upon historical trends. While our estimates during the past few years have approximated actual results, actual returns may differ significantly from estimate, either favorably or unfavorably, if factors such as economic conditions or the competitive environment differ from our expectations.

Credits and Other Vendor Allowances

We receive cooperative advertising allowances (i.e., an allowance from the manufacturer to subsidize qualifying advertising and similar promotional expenditures we make relating to the vendor's products), price protection credits (i.e., credits from vendors with respect to in-stock inventory if the vendor subsequently lowers their wholesale price for such products) and vendor rebates (i.e., credits or rebates provided by vendors based on the purchase of specified products and paid at a later date). Cooperative advertising allowances are recognized as a reduction to selling, general, and administrative expense when we incur the advertising expense eligible for the credit. We recognized cooperative advertising allowances of $10.1 million, $6.4 million and $5.1 million for the years ended December 31, 2005, 2004 and 2003, respectively, recorded as an offset to selling, general and administrative expense. Price protection credits and vendor rebates are accounted for as a reduction of the cost of merchandise inventory and are recorded at the time the credit or rebate is earned. The effect of price protection credits and vendor rebates is recognized in the income statement at the time the related inventory is sold as a reduction in cost of goods sold. The reserve against rebates receivable is determined by specifically identifying uncollectible accounts through an aging review and an analysis of vendor relationships. We received payments for vendor rebates of $30.6 million, $20.9 million and $11.0 million for the years ended December 31, 2005, 2004 and 2003, respectively. We earned and recognized vendor rebates of $28.3 million, $23.2 million and $17.6 million for the years ended December 31, 2005, 2004 and 2003, respectively. None of these credits are recorded as revenue.

RESULTS OF OPERATIONS

The following table presents our consolidated statements of income, as a percentage of sales, for the periods indicated:

Fiscal Year Ended December 31,	2005	2004	2003
Net sales	100.0%	100.0%	100.0%
Gross profit	29.2	28.1	27.0
Selling, general and administrative expenses	21.8	21.0	21.3
Operating income	7.4	7.1	5.7
Interest expense, net	0.4	0.3	1.0
Income before income taxes	7.0	6.8	4.7
Income taxes	2.7	2.6	1.8
Net income	4.3%	4.2%	2.9%

FISCAL 2005 COMPARED TO FISCAL 2004

Net sales for the year ended December 31, 2005 increased 17.8% to $1.8 billion, compared with $1.5 billion in 2004.

Net sales from Guitar Center stores for fiscal 2005 totaled $1.3 billion, a 13.2% increase from $1.2 billion in fiscal 2004. Net sales from new stores contributed $85.3 million and represented 55.9% of the total increase in retail store sales. Comparable Guitar Center store sales for the full year increased 5.8%. Comparable store sales are defined as sales for the comparable periods, excluding net sales attributable to stores not open for 14 months as of the end of the reporting period. We believe that comparable store sales are a more useful indicator of store performance than the change in total net sales, since comparable store sales exclude the effects of changes in the number of stores open.

The financial information of the Music & Arts Center division for the year ended December 31, 2005 includes the results of American Music for the entire year and Music & Arts Center from the time of its acquisition on April 15, 2005 through December 31, 2005, while the 2004 results include only American Music. However, comparable store sales for the year ended December 31, 2005 is computed using the comparable store sales of American Music stores for the year ended December 31, 2005 combined with comparable store sales for the Music & Arts Center, Inc. stores for the period from April 15, 2005 through December 31, 2005. Net sales from Music & Arts Center for 2005 totaled $103.1 million compared to $40.4 million in 2004. The increase in net sales is primarily due to the acquisition of Music & Arts Center, Inc. Comparable sales for only American Music locations decreased 16.1%, while comparable sales for only Music & Arts Center locations, increased 9.6%, resulting in the combined comparable sales decrease of 0.3%. Comparable sales decreased at American Music principally due to the reduction in low margin institutional sales which is not part of our ongoing Music & Arts Center strategy.

Net sales from the direct response channel totaled $365.1 million in 2005, a $53.8 million, or 17.3%, increase from 2004. The increase primarily reflects the benefits from increased advertising, free freight incentives and improved leveraging of an expanding buyer file offset somewhat by competitors' expanded free shipping programs and increased competition. We continued to face increased competition. We expect this trend of increased competition in the direct response channel and its negative impact on that segment's net sales and gross margin to continue for the foreseeable future. Sales from the contact center, which represents sales placed via phone, live chat, mail and e-mail, increased 4.8% to $145.2 million in 2005 from $138.5 million in 2004. Internet sales from orders placed via the Musician's Friend, Giardinelli and affiliate web sites increased 27.3% to $219.9 million in 2005 from $172.8 million in 2004. The growth of web-based sales reflects the continued trend of our catalog customers' preference in using the web to place their orders, the success of web-based promotions and that the web site includes a more complete inventory presentation than our catalogs.

Gross profit for the year ended December 31, 2005 compared to 2004 increased 22.4% to $520.4 million from $425.3 million. Gross profit as a percentage of net sales for the year ended December 31, 2005 compared to 2004 increased to 29.2% from 28.1%.

Gross profit as a percentage of net sales for the Guitar Center stores was 28.0% compared with 26.7% for each of the years ended December 31, 2005 and 2004. The increase is due to higher selling margin of 1.2% and reduced freight of 0.1%. We define selling margin as net sales less the cost of the associated merchandise charged by the vendor plus the associated inventory costs from fulfilling inventory through our distribution center. The cost of merchandise inventory is net of all associated vendor discounts and rebates. Freight is not included in selling margin.

The gross profit margin for the Music & Arts Center division was 41.8% for the year ended December 31, 2005 compared to 34.8% for the same period in 2004. The increase in gross profit margin is due to higher selling margin 9.6% and reduced freight 0.4%, offset by increased shrink 1.4% and higher occupancy costs 1.0%. During the second quarter of 2005, we recorded a charge of $588,000 to cost of sales, or 0.6% of sales, for the Music & Arts Center division, reflecting a reduction of the value of certain inventories previously in our American Music assortment that we discontinued upon the acquisition of Music & Arts Center, Inc. Otherwise the improved selling margin was driven by a change in product mix and better pricing under the Music & Arts Center business as compared to the American Music business in 2004. We discontinued our low margin institutional sales which are not part of our ongoing Music & Arts Center strategy.

Gross profit margin for the direct response division was 29.8% for the year ended December 31, 2005 compared to 32.3% for the same period in 2004. The 2005 selling margin was significantly impacted by expanded free freight offers made during the year in response to the increased competition and due to lower selling margin driven by increased online competition.

Selling, general and administrative expenses for 2005 increased 22.3% to $388.4 million from $317.6 million in fiscal 2004. As a percentage of net sales, selling, general and administrative expenses for 2005 increased to 21.8% from 21.0% in 2004.

Selling, general and administrative expenses as a percentage of sales for the Guitar Center stores for 2005 decreased to 19.9% from 20.2% in fiscal 2004. The decrease is primarily due to leveraging of our advertising spend 0.3% and payroll costs 0.2%, reduced bad debt 0.1%, offset by higher legal and settlement costs associated with the settlement of a California wage and hour class action lawsuit 0.2% and higher rent costs associated with the termination of two equipment leases 0.1%.

Selling, general and administrative expenses for Music & Arts Center were 47.9% of sales for 2005 compared to 46.2% for the same period in 2004. Excluding acquisition related charges of $2.9 million, selling, general and administrative expenses were 45.1% of sales for 2005 compared to 46.2% for the same period in 2004. The charge of $2.9 million represents the elimination of a redundant point of sales system, severance costs and moving costs to relocate certain American Music employees to the Music & Arts Center corporate office in Maryland. The decrease is due to improved leveraging on the higher revenue base of the combined businesses of Music & Arts Center and American Music. The reductions as a percentage of sales were in payroll 2.2%, travel costs 1.2%, supplies 0.4%, computer maintenance 0.3% and insurance 0.4%, offset by higher advertising 1.8%, amortization of intangibles 0.7%, depreciation 0.4%, credit card expense 0.3%, and consulting fees 0.2% .

Selling, general and administrative expenses for the direct response division were 21.2% of sales for 2005 compared to 20.7% for the same period in 2004. The increase was driven by advertising expense related to programs to increase web traffic 1.2%, offset by reduced credit card expense 0.1%, reduced bad debt expense 0.1%, leveraging of payroll 0.3% and insurance costs 0.1%, and lower consulting fees 0.1%.

Operating income increased 22.6% to $132.0 million in 2005 from $107.7 million in 2004. This increase reflects the strong performance of the Guitar Center stores in 2005, with increased sales of 13.2%, increased gross profit as a percentage of sales of 1.3%, and leveraging of selling, general and administrative expenses as a percentage of sales by 0.3%, when compared to 2004. This was offset by a decline in the direct response operating income of $4.7 million, or down 13.0%, from 2005 compared to 2004. We experienced increased competition in our direct response unit, resulting in lower selling margins and higher marketing and advertising costs. The direct response unit gross profit as a percentage of sales decreased 2.5% while selling general and administrative expenses as a percentage of sales increased 0.5% for 2005 compared to 2004. Music & Arts Center operating loss as a percentage of sales improved from negative 11.4% of sales in 2004 to negative 6.1% of sales in 2005. Excluding acquisition related charges, Music & Arts Center operating loss as a percentage of sales was negative 2.7% of sales in 2005.

Interest expense, net for 2005 increased to $7.3 million from $5.4 million in 2004. The increase is primarily due to interest on borrowings related to the acquisition of Music & Arts Center, Inc., increased inventory levels at our Guitar Center retail stores and purchases of a corporate office building and other property and equipment.

For the year ended December 31, 2005, a $48.0 million provision for income taxes was recorded compared to $38.9 million for the same period in 2004, based on effective tax rates of approximately 38.5% and 38.0%, respectively. There was a change in the effective tax rate as a result of higher blended state income tax rates as well as $0.5 million in non-deductible costs associated with our California wage and hour class action settlement.

Net income for 2005 increased to $76.7 million from $63.4 million in 2004 as a result of the combinations of factors described above.

FISCAL 2004 COMPARED TO FISCAL 2003

Net sales for the year ended December 31, 2004 increased 18.7% to $1.5 billion, compared with $1.3 billion last year.

Net sales from Guitar Center stores for fiscal 2004 totaled $1.162 billion, an 18.6% increase from $979.0 million in fiscal 2003. Sales from new stores contributed $87.8 million and represented 48.1% of the total increase in retail store sales. Comparable Guitar Center store sales for the full year increased 9.8%. Comparable store sales are defined as sales for the comparable periods, excluding net sales attributable to stores not open for 14 months as of the end of the reporting period. We believe that comparable store sales are a more useful indicator of store performance than the change in total net sales, since comparable store sales exclude the effects of changes in the number of stores open. The increase in comparable store sales was due to positive response to our advertising and marketing strategy for our Guitar Center stores. Total advertising and marketing expense increased from $28.5 million to $33.5 million in 2004. Net sales from American Music for 2004 totaled $40.4 million, a 5.7% increase from $38.2 million in 2003. Comparable American Music sales for 2005 increased 1.0%.

Net sales from the direct response channel totaled $311.3 million in 2004, a $53.4 million, or 20.7%, increase from 2003. This increase primarily reflects the improved performance of catalog circulation strategies. Sales from the contact center, which represents sales placed via phone, live chat, mail and e-mail, increased 17.0% to $138.5 million from $118.4 million in 2003. Internet sales from orders placed via the Musician's Friend and Giardinelli web sites increased 23.9% to $172.8 million from $139.5 million for the same period last year. The growth of web-based sales reflects the continued trend of our catalog customers' preference in using the web to place their orders, the success of web-based promotions, and that the web site includes a more complete inventory presentation than our catalogs.

Gross profit for the year ended December 31, 2004 compared to 2003 increased 23.6% to $425.3 million from

$344.0 million. Gross profit as a percentage of net sales for the year ended December 31, 2004 compared to 2003 increased to 28.1% from 27.0%. Gross profit as a percentage of net sales for the Guitar Center stores was 26.7% compared with 25.3% for the year ended December 31, 2004 and 2003. The increase is due to higher selling margin 1.2%, leveraged occupancy costs 0.2% due to the strong comparable store sales increase, and lower inventory shrink 0.1%. We define selling margin as net sales less the cost of the associated merchandise charged by the vendor plus the associated inventory costs from fulfilling inventory through our distribution center. The cost of merchandise inventory is net of all associated vendor discounts and rebates. Freight is not included in selling margin. The gross profit margin for American Music was 34.8% compared to 35.7% for the same period last year. The decrease is due to lower selling margin 0.9% and an increase in occupancy costs 0.4%, partially offset by a decrease in inventory shrink 0.2% and freight costs 0.2%. The gross profit margin for the direct response division was 32.3% for 2004 compared to 32.1% in 2003. The increase is due to higher selling margin 0.1% and reduction in inventory shrink 0.1%.

Selling, general and administrative expenses for 2004 increased 16.8% to $317.6 million from $272.0 million in fiscal 2003. As a percentage of net sales, selling, general and administrative expenses for 2004 decreased to 21.0% from 21.3% in 2003. The overall increase is due to the operation of 136 Guitar Center stores in 2004 compared to 122 Guitar Center stores in 2003. Selling, general and administrative expenses as a percentage of sales for the Guitar Center stores were 20.2% for both December 31, 2004 and 2003. The unchanged percentage reflects reduced general insurance 0.1% and lower computer repairs and maintenance 0.1%, offset by an increase in bonus costs 0.2%. Selling, general and administrative expenses for American Music were 46.2% of sales compared to 48.0% last year. The decrease is primarily due to decreased advertising expense 1.8%, bad debt expense 0.7%, and medical insurance 0.6%, partially offset by increases in depreciation and amortization 0.5% and salary costs 0.6%.

Selling, general and administrative expenses for the direct response division were 20.7% of sales in 2004 compared to 21.6% last year. The improvement is primarily due to leveraging on better than expected sales and increased operational efficiencies as indicated by a reduction in payroll costs 0.8% and a decrease in depreciation and amortization 0.3%, partially offset by an increase in advertising expense primarily related to programs to increase web traffic 0.2%.

Operating income increased 49.5% to $107.7 million from $72.0 million in 2004. This increase reflects the performance of the Guitar Center and Musician's Friend businesses at or above expected levels, offset somewhat by continued spending on systems and infrastructure build out and merchandising and operational challenges at American Music resulting in an operating loss of approximately $4.6 million for this segment for the year ended December 31, 2004.

Interest expense, net for 2004 decreased to $5.4 million from $12.5 million in 2003. The reduction in interest expense is due primarily to the retirement of $67 million in 11% senior notes through a $100 million 4% convertible bond offering completed in June 2003 and the use of cash flow from operations to pay off our line of credit borrowings. Accordingly, included in interest expense for 2003 are the redemption premium of $1.2 million and the write-off of deferred financing costs of $0.7 million associated with the Senior Notes redeemed in July 2003 for a total of $1.9 million.

Income tax expense for 2004 was $38.9 million compared to $22.6 million for the same period last year, both based on an effective tax rate of approximately 38%.

Net income for 2004 increased to $63.4 million from $36.9 million in 2003 as a result of the combinations of factors described above.

LIQUIDITY AND CAPITAL RESOURCES

Disclosures about Contractual Obligations and Commercial Commitments

The following table aggregates the material contractual obligations and commercial commitments that affect our financial condition and liquidity as of December 31, 2005:

	Payments Due by Period				
Contractual Cash Obligations (In thousands)	Total	Less than 1 Year	1-3 Years	3-5 Years	After 5 Years
Long-term obligations[1]	$ 132,266	$ 32,266	$ 100,000	$ —	$ —
Operating lease obligations[2]	252,878	44,457	79,654	55,858	72,909
Total	$ 385,144	$ 76,723	$ 179,654	$ 55,858	$ 72,909

[1] Long-term debt consists of the $100 million principal amount of 4% Senior Convertible Notes due in 2013 and $32.3 million of revolving line of credit. In July 2008 and July 2010, holders may at their election require us to purchase all of the notes at 100% of the principal amount, plus any accrued interest, including contingent interest.

[2] Operating lease commitments consist principally of real property leases for our corporate offices, retail store facilities and distribution centers. These leases frequently include options which permit us to extend the terms beyond the initial fixed lease term. We also have rented personal property through operating leases. Payments for these lease commitments are provided for by cash flows generated from operations. Please see Note 8 to the consolidated financial statements.

Our need for liquidity will arise primarily from the funding of capital expenditures, working capital requirements and payments on our indebtedness, as well as possible acquisitions. We have historically financed our operations primarily through internally generated funds and borrowings under our credit facilities. Please see “Risk Factors” provided in our Form 10-k filed with Securities and Exchange Commission for a discussion of factors which could reasonably likely result in a decrease in the amount of internally generated funds available to finance capital expenditures and working capital requirements. As of December 31, 2005, we had $32.3 million in borrowings under our credit facility and had available borrowings of $75.6 million (net of $7.1 million of outstanding letters of credit).

In February of 2005, we amended our credit facility with a syndicate of banks led by Wells Fargo Retail Finance. The credit facility permits borrowings up to $125 million (which may be increased to $150 million at our option), subject to borrowing base limitations. The actual amount available is tied to our inventory and receivable base, and our obligations under the credit facility are secured by liens on our principal assets. Borrowing options are prime rate (7.25% at December 31, 2005) plus applicable prime margin, or London Interbank Offered Rate or LIBOR (twelve month rate at December 31, 2005 was 4.8%), plus applicable LIBOR margin. The applicable prime and LIBOR margins are based upon levels of excess availability and adjusted quarterly. If excess availability is greater than $20 million, the applicable prime margin is 0.00% and applicable LIBOR margin is 1.0%. If excess availability is less than or equal to $20 million and greater than $10 million, the applicable prime margin is 0.00% and the applicable LIBOR margin is 1.25%. If excess availability is less than or equal to $10 million, the applicable prime margin is 0.00% and the applicable LIBOR margin is 1.5%. An unused fee of 0.25% is assessed on the unused portion of the credit facility. The agreement underlying the credit facility includes significant restrictive negative covenants. Among other things, these covenants restrict or prohibit our ability to incur debt and issue specified equity instruments, incur liens on our assets, make any significant changes in our corporate structure or the nature of our business, dispose of assets, make guaranties, prepay debt, engage in a change in control transaction, pay dividends, make investments or acquisitions, engage in transactions with affiliates and incur capital expenditures, and also require that we satisfy a minimum availability test. The minimum availability test requires that we maintain $10 million of reserved availability under the agreement based on its borrowing base limitations. The amount we disclose in our public reports from time to time as available to borrow under the agreement is already reduced by this required reserve and outstanding letters of credit, and thus represents a net amount available under the agreement. The agreement also includes representations and warranties which must be true each time we borrow funds under the credit facility and affirmative covenants. The full text of the contractual requirements imposed by this financing is set forth in the Amended and Restated Loan and Security Agreement and related amendments which have been filed with the Securities and Exchange Commission. Subject to limited cure periods, the lenders under our credit facility may demand repayment of these borrowings prior to stated maturity upon the occurrence of specified events, including if we breach the terms of the agreement, suffer a material adverse change, engage in a change in control transaction, suffer a significant adverse legal judgment, default on other significant obligations, or in the event of specified events of insolvency. The credit agreement matures in December 2010.

On June 16, 2003, we completed the issuance of $100 million principal amount of 4.00% Senior Convertible Notes due 2013. The convertible notes bear interest at the rate of 4.00% per annum, subject to the payment of contingent interest under certain circumstances commencing January 15, 2006, and are convertible into shares of common stock at a conversion price of $34.58 per share, subject to adjustment under specified circumstances. Under the contingent conversion feature of the convertible notes, subject to certain exceptions, they are not convertible into common stock unless and until the trading price of the common stock reaches at least $41.50 for a specified period in advance of each quarterly conversion period or designated corporate events occur. As of December 31, 2005, the convertible notes were convertible for the current quarterly conversion period. The convertible notes will also become convertible upon the occurrence of specified corporate transactions and other events described in the indenture. The final maturity of the convertible notes is July 2013, although holders may require us to repurchase the Notes at their election in July 2008, July 2010 or upon the occurrence of a change in control, in each case for a purchase price equal to the original principal amount plus accrued interest. The indenture governing the convertible notes does not limit our ability to incur indebtedness or otherwise substantively restrict the operation of our business to any significant degree. Subject to limited cure periods, the holders of the convertible notes may demand repayment of these borrowings prior to the stated maturity upon the occurrence of specified events, including if we fail to pay interest or principal when due, if we fail to satisfy our conversion obligation, if another obligation of ours having an outstanding principal amount in excess of $15 million is accelerated prior to stated maturity and upon the occurrence of specified events of insolvency.

For the years ended December 31, 2005, 2004 and 2003, $1.0 million, $1.0 million and $0.9 million of amortization of deferred financing fees was included in interest expense. Capitalized deferred financing fees at December 31, 2005 and 2004 were $2.5 million and $3.6 million and related accumulated amortization was $2.1 million and $1.0 million, respectively.

During 2002 we entered into master operating lease agreements with General Electric Capital Corporation and US Bank to lease equipment and other property primarily to support the operations of the distribution center for our Guitar Center retail stores. Under these agreements, we leased a total of $10.5 million in equipment and other property. The agreements call for monthly payments of $138,000 for a term of 36 months through September 30, 2009.

The terms of our significant financing agreements, including those related to our credit facility, the convertible notes and the equipment lease facilities described above, are not dependent on any change in our credit rating. We believe that the key company-specific factors affecting our ability to maintain our existing debt and lease financing relationships and to access such capital in the future are our present and expected levels of profitability and cash flow from operations, our working capital and fixed asset collateral bases, our expected level of capital expenditures, and the level of our equity capital relative to the level of debt obligations. In addition, as noted above, our existing agreements include significant restrictions on future financings, including among others, limits on the amount of indebtedness that we may incur and whether or not such indebtedness may be secured by any of our assets.

As is the case with most multi-unit retailers, substantially all of the real property used in our business is leased under operating lease agreements. Please see Item 2. Properties, "—Disclosures About Contractual Obligations and Commercial Commitments" provided in our Form 10-k filed with Securities and Exchange Commission and Note 8 to the Consolidated Financial Statements. We anticipate making additional capital investments of $8.0 million to $10.0 million in connection with the expansion of our Guitar Center stores distribution center and we expect to incur increased rent expense for that facility starting during the third quarter of 2006.

Net cash provided by operating activities was $65.7 million for the year ended December 31, 2005 compared to $85.5 million for the same period last year. The largest use of cash was an increase in inventories of $74.2 million. The increase in inventories was primarily due to the opening of 25 new Guitar Center retail stores and carrying somewhat higher inventory levels at our existing stores.

Cash used in investing activities increased to $157.8 million for the year ended December 31, 2005 compared to $49.7 million for the same period last year. The investing activities for the year ended December 31, 2005 consisted primarily of the purchase of Music & Arts Center, Inc. for approximately $93.0 million, a new corporate office building for $12.2 million, a corporate airplane for $10.6 million, capital expenditures for store expansions and remodels of $36.8 million compared to $16.8 million in the prior period, and computer equipment purchases of $12.2 million in the current period compared to $7.4 million in the same period last year. Additionally, we received net proceeds from the sale of available-for-sale securities of $20.2 million.

Cash provided by financing activities totaled $46.1 million for the year ended December 31, 2005 compared to $19.3 million used in the same period last year. The cash provided by financing activities consists primarily of the borrowings under our credit facility of $32.3 million and remaining from the net proceeds received from the exercise of stock options and other employee purchases of our common stock. The increase in borrowings was required to support the Music & Arts Center, Inc. acquisition and the capital spending described above.

We believe that our current operating cash flow, working capital, cash on hand, borrowings available under our credit facility and other sources of liquidity we believe are available to us will be sufficient to meet our obligations in the ordinary course of business over the next 12 months, including capital expenditures and new store openings.

Our known capital resource and liquidity requirements for 2006 are expected to be primarily provided by net cash flow from operations and borrowings available under our credit facility. Traditionally, we have experienced the largest use of cash from operating activities in the latter part of the third quarter and in the fourth quarter due to the build up of inventory to support the holiday season, resulting in additional borrowings under our line of credit. We believe that our peak seasonal liquidity needs during 2006 during this period will exceed our projected net cash flow from operations and borrowings currently available under our existing credit facility. We are in discussions with our lending syndicate regarding an increase in the amount of maximum borrowings permitted under our credit facility. However, these discussions are preliminary in nature and there is no assurance that an increase in the borrowings under credit facility will be available to us.

Depending upon market conditions, we may also elect or be required to raise additional capital in the form of common or preferred equity, debt or convertible securities for the purpose of providing additional capital to fund working capital needs or continued growth of our existing business, or to refinance existing obligations including the senior convertible debentures which may be called for redemption at our election commencing in July 2006. Any such financing activity will be dependent upon many factors, including our liquidity needs, market conditions and prevailing market terms, and we cannot assure you that future external financing for us will be available on attractive terms or at all. If we require but are unable to obtain additional liquidity on favorable terms, we may be required to curtail our 2006 growth plans and our financial condition and results of operations would likely be materially adversely impacted.

We intend to pursue an aggressive growth strategy by opening additional stores in new and existing markets. Each new primary market format Guitar Center store typically has required approximately $2.0 to $2.5 million for gross inventory. Historically, our cost of capital improvements for a primary market format Guitar Center store has been approximately $1.1 million consisting of leasehold improvements, fixtures and equipment. We incur higher costs in some geographic areas, particularly the Northeast, and when we build a larger flagship store. We have developed secondary market Guitar Center stores to build in sites that we do not believe will support our primary market format units. We have opened 36 secondary market stores between late 2000 and December 31, 2005. Our secondary market stores have typically required approximately $1.7 million to $2.0 million for gross inventory and approximately $850,000 in capital expenditures. In late 2005, we opened our first tertiary market format store to serve smaller population centers. Our tertiary market format stores have required approximately $1.0 million for gross inventory and approximately $500,000 in capital expenditures. We expect the future costs to build new Guitar Center stores to rise from these historical amounts as we have experienced significant increases in the cost of construction.

We are also anticipating additional capital and strategic requirements related to improving our fulfillment facilities, upgrading our technology and systems, including a data warehouse and new point-of-sale system and pursuing new opportunities in the e-commerce activities of our retail and direct response divisions as well as related businesses. We also continue to make significant investments in information technology across our businesses and to incur costs and make investments designed to expand the reach of our businesses on the Internet. The costs of these initiatives and other investments related to our businesses will continue to be significant.

Throughout our history, we have primarily grown organically. However, we also believe there may be attractive opportunities to expand by selectively acquiring existing music products retailers or other complimentary businesses, if attractive opportunities can be identified. We believe that our growth at Music & Arts Center will in large part be driven through many small acquisitions. While we cannot provide assurance that we will complete any further acquisition transactions, in the ordinary course of our business we investigate and engage in negotiations regarding such opportunities. Acquisitions will be financed with cash on hand, drawings under our existing credit facilities, expansion of our credit facilities, issuance of debt or equity securities, or a combination, depending upon transaction size and market conditions, among other things.

NEW ACCOUNTING PRONOUNCEMENTS

In May 2005, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Accounting Standards ("SFAS") No. 154, ***Accounting Changes and Error Corrections***, which replaces ***Accounting Principles Board ("APB") Opinion No. 20***, ***Accounting Changes***, and supersedes FASB Statement No. 3, ***Reporting Accounting Changes in Interim Financial Statements—an amendment of APB Opinion No. 28***. SFAS 154 requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. When it is impracticable to determine the period-specific effects of an accounting change on one or more individual prior periods presented, SFAS 154 requires that the new accounting principle be applied to the balances of assets and liabilities as of the beginning of the earliest period for which retrospective application is practicable and that a corresponding adjustment be made to the opening balance of retained earnings for that period rather than being reported in an income statement. When it is impracticable to determine the cumulative effect of applying a change in accounting principle to all prior periods, SFAS 154 requires that the new accounting principle be applied as if it were adopted prospectively from the earliest date practicable. SFAS 154 will be effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. This statement does not change the transition provisions of any existing accounting pronouncements, including those that are in a transition phase as of the effective date of this statement. We do not expect the provisions of the SFAS 154 to have a significant impact on our consolidated financial statements.

In November 2004, the FASB issued SFAS No. 151, ***Inventory Costs—An Amendment of ARB No. 43, Chapter 4***. SFAS No. 151 amends the guidance in Accounting Research Bulletin ("ARB") No. 43, Chapter 4, ***Inventory Pricing***, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). Among other provisions, the new rule requires that items such as idle facility expense, excessive spoilage, double freight, and rehandling costs be recognized as current-period charges regardless of whether they meet the criterion of "so abnormal" as stated in ARB No. 43. Additionally, SFAS 151 requires that the allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS No. 151 is effective for fiscal years beginning after June 15, 2005 and is required to be adopted in the first quarter of fiscal 2006. We do not expect the adoption of SFAS No. 151 to have a material impact on our consolidated financial statements.

In December 2004, the FASB issued FASB Statement No. 123 (revised 2004) ***Share-Based Payment***, or SFAS 123R, which is a revision of FASB Statement No. 123, ***Accounting for Stock-Based Compensation***. SFAS 123R supersedes APB opinion No. 25, ***Accounting for Stock Issued to employees***, and amends FASB Statement No. 95, ***Statement of Cash Flows***. Generally, the approach in SFAS 123R is similar to the approach described in Statement 123. However, SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values rather than pro forma footnote disclosure. SFAS No. 123R is effective for public companies in the first fiscal year beginning on or after January 1, 2006.

SFAS 123R requires measurement of the cost of share-based payment transactions to employees at the fair value of the award on the grant date and recognition of expense over the requisite service or vesting period. SFAS 123R allows implementation using a modified version of prospective application, under which compensation expense for the unvested portion of previously granted awards and all new awards will be recognized on or after the date of adoption. FAS 123R also allows companies to implement by restating previously issued financial statements, basing the amounts on the expense previously calculated and reported in their pro forma footnote disclosures required under FAS 123. We will adopt FAS 123R using the modified prospective method beginning January 1, 2006. The impact of adopting FAS 123R on our consolidated results of operations is not expected to differ materially from the pro forma disclosures currently required by FAS 123 (see "Employee stock-based compensation"). In addition, FAS 123R requires classification of the tax benefit from the exercise of stock options in cash flows from financing activities, rather than cash flows from operating activities. In 2005, cash flows from operating activities included a cash inflow of $7.6 million related to tax benefits from the exercise of stock options.

In July 2005, the FASB issued an exposure draft of a proposed interpretation, ***Accounting for Uncertain Tax Positions—an Interpretation of FASB Statement No. 109***. The proposed interpretation would apply to all open tax positions accounted for in accordance with SFAS No. 109, including those acquired in business combinations. In October 2005, the FASB decided to postpone issuance of the final interpretation until fiscal year 2006. The Company will evaluate the impact of any change in accounting standard on the Company's financial position and results of operations when the final interpretation is issued.

In June 2005, the Emerging Issues Task Force ("EITF") issued EITF Issue 05-6, ***Determining the Amortization Period for Leasehold Improvements Purchased after Lease Inception or Acquired in a Business Combination***. The EITF reached a consensus that the amortization period for leasehold improvements acquired in a business combination or acquired subsequent to lease inception should be based on the lesser of the useful life of the leasehold improvements or the period of the lease including all renewal periods that are reasonably assured of exercise at the time of the acquisition. This consensus is consistent with the Company's policy regarding leasehold improvements. The adoption of EITF Issue 05-6 did not have a material impact on our consolidated financial statements.

In October 2005, the FASB issued FASB Staff Position ("FSP") No. FAS 13-1 ("FSP13-1"), ***Accounting for Rental Costs Incurred during the Construction Period***, which requires that rental costs associated with ground or building operating leases that are incurred during a construction period be recognized as rental expense. These rental costs shall be included in income from continuing operations. The effective date of this FSP guidance is the first reporting period beginning after December 15, 2005. Early adoption is permitted for financial statements or interim financial statements that have not yet been issued. The adoption of FSP 13-1 will not have a material impact on our consolidated financial statements.

In March 2005, the FASB issued FASB Interpretation No. 47 ("FIN 47"), ***Accounting for Conditional Asset Retirement Obligations***, which is an interpretation of SFAS No. 143 ("SFAS 143"), ***Accounting for Asset Retirement Obligations***. FIN 47 clarifies terminology within SFAS 143 and requires an entity to recognize a liability for the fair value of a conditional asset retirement obligation when incurred if the liability's fair value can be reasonably estimated. FIN 47 is effective for fiscal years ending after December 15, 2005. The adoption of FIN 47 did not have a material impact on our consolidated financial statements.

SEASONALITY

Our business follows a seasonal pattern, peaking during the holiday selling season in November and December. Sales in the fourth quarter are typically significantly higher on a per store basis and through the direct response unit than in any other quarter. In addition, band rental season for our Music & Arts Center business starts in August and carries through mid-October, but that seasonality does not have a significant impact on our consolidated results.

INFLATION

We believe that the relatively moderate rates of inflation experienced in recent years have not had a significant impact on our net sales or profitability. However, in 2006 we anticipate that rising steel, lumber, concrete, labor, fuel and freight costs may increase expenses related to opening, remodeling, operating and relocating our stores, expanding our distribution center and operating our business.

FORWARD-LOOKING STATEMENTS; BUSINESS RISKS

This annual report contains forward-looking statements relating to, among other things, future results of operations, growth and investment plans, sales, trends in gross margin, growth in the Internet portion of our direct response business and other factors affecting growth in sales and earnings. Specific forward-looking statements are provided regarding our management's current views regarding comparable store sales, new store openings, capital expenditure levels and the dates new facilities and systems will become operational. Statements regarding new store openings are based largely on our current expectations and are necessarily subject to associated business risks related to, among other things, the identification of suitable sites or acquisition opportunities, the timely construction, staffing and merchandising of those stores and other matters, some of which are outside of our control. Comparable store sales growth is highly dependent upon the state of the economy, the effectiveness of our sales and promotion strategies, and the effect of competition, including other national operators of music products stores attempting to implement national growth strategies. Statements regarding the dates new facilities and systems will become operational are dependent upon third parties and events beyond our control, such as the availability of third party consulting resources, construction delays, technology development delays and other events. Sales and earnings trends are also affected by many other factors including, among others, world and national political events, general economic conditions, the effectiveness of our promotion and merchandising strategies, changes in the music products industry, retail sales trends and the emergence of new or growing specialty retailers of music products.

In light of these risks, there can be no assurance that the forward-looking statements contained in this report will in fact be realized. The statements made by us in this report represent our views as of the date of this report, and it should not be assumed that the statements made herein remain accurate as of any future date. We do not presently intend to update these statements and undertake no duty to any person to affect any such update under any circumstances.

For further discussion of risks associated with our business, please see the discussion under the caption "Risks Factors" provided in our Form 10-K filed with the Securities and Exchange Commission.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We do not have any assets or liabilities which, in our view, impose upon us significant market risk except for our outstanding indebtedness represented by $100 million principal amount of our convertible notes with a fixed interest rate of 4% (subject to contingent interest commencing January 15, 2006) and our credit facility which has a variable rate of interest generally consisting of stated premiums above LIBOR. As of December 31, 2005, the fair value of our 4% Senior Convertible Notes was $148 million, based on quoted market prices. At

December 31, 2005, we had $32.3 million in outstanding borrowings under our credit facility. To the extent prevailing short-term interest rates fluctuate, the interest expense we incur on our credit facility will change with a resulting effect (positive or negative) on our financial position, results of operations and cash flows. We do not use derivative financial instruments in our investment portfolio. Historically, we have not carried significant cash balances and any cash in excess of our daily operating needs has been used to reduce our borrowings. Excess cash is generally invested in short-term, high quality interest bearing investments.

CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed pursuant to the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required by Securities and Exchange Commission Rule 13a-15(b), we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective.

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(e) and 15d-15(e). Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an assessment of the effectiveness of our internal control over financial reporting based on the framework in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under the framework in Internal Control—Integrated Framework, our management concluded that our internal control over financial reporting was effective as of December 31, 2005.

Guitar Center, Inc. acquired Music & Arts Center, Inc., on April 15, 2005, and management excluded from its assessment of the effectiveness of Guitar Center, Inc.'s internal control over financial reporting as of December 31, 2005, Music & Arts Center internal control over financial reporting associated with total assets of $197.0 million and total revenues of $103.1 million included in the consolidated financial statements of Guitar Center, Inc. and subsidiaries as of and for the year ended December 31, 2005.

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

There has been no change in our internal control over financial reporting during our most recent fiscal quarter end that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING

Our management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2005 has been audited by KPMG LLP, an independent registered public accounting firm, as stated in their report which is included herein.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders
Guitar Center, Inc.:

We have audited management's assessment, included in the accompanying Management's Report on Internal Controls, that Guitar Center, Inc. maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Guitar Center, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

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

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

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

In our opinion, management's assessment that Guitar Center, Inc. maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also, in our opinion, Guitar Center, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Guitar Center, Inc. acquired Music & Arts Center, Inc., on April 15, 2005, and management excluded from its assessment of the effectiveness of Guitar Center, Inc's internal control over financial reporting as of December 31, 2005, Music & Arts Center's internal control over financial reporting associated with total assets of $197,045,000 and total revenues of $103,116,000 included in the consolidated financial statements of Guitar Center, Inc. and subsidiaries as of and for the year ended December 31, 2005. Our audit of internal control over financial reporting of Guitar Center, Inc. also excluded an evaluation of the internal control over financial reporting of Music & Arts Center.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Guitar Center, Inc. and subsidiaries as of December 31, 2005 and 2004, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2005, and our report dated March 9, 2006 expressed an unqualified opinion on those consolidated financial statements.

KPMG LLP

Los Angeles, California
March 9, 2006

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
Guitar Center, Inc.:

We have audited the accompanying consolidated balance sheets of Guitar Center, Inc. and subsidiaries as of December 31, 2005 and 2004, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2005. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Guitar Center, Inc. and subsidiaries as of December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Guitar Center, Inc.'s internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 9, 2006 expressed an unqualified opinion on management's assessment of, and the effective operation of, internal control over financial reporting.

KPMG LLP

Los Angeles, CA
March 9, 2006

Consolidated Balance Sheets

Guitar Center, Inc. and subsidiaries

December 31 (In thousands, except per share data)	2005	2004
ASSETS		
Current assets:		
Cash and cash equivalents	$ 14,529	$ 60,453
Investments in marketable securities	—	3,810
Accounts receivable, less allowance for doubtful accounts $4,931 and $3,489, respectively	40,844	27,627
Merchandise inventories	445,771	314,961
Prepaid expenses and deposits	15,533	13,367
Deferred income taxes	13,492	5,552
Total current assets	530,169	425,770
Property and equipment, net	149,209	97,349
Investments in marketable securities	—	16,997
Goodwill	85,929	26,474
Deposits and other assets, net	14,883	8,003
	$ 780,190	$ 574,593
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 79,497	$ 49,771
Accrued expenses and other current liabilities	106,181	83,606
Merchandise advances	25,127	22,534
Borrowing under revolving line of credit	32,266	—
Total current liabilities	243,071	155,911
Other long-term liabilities	11,995	6,943
Deferred income taxes	20,307	5,057
Long-term debt	100,000	100,000
Total liabilities	375,373	267,911
Stockholders' equity:		
Preferred stock; 5,000 authorized, none issued and outstanding	—	—
Common stock, $0.01 par value, authorized 55,000 shares, issued and outstanding 26,092 at December 31, 2005 and 25,359 at December 31, 2004	261	254
Additional paid-in capital	326,755	305,305
Retained earnings	77,801	1,123
Stockholders' equity	404,817	306,682
	$ 780,190	$ 574,593

See accompanying notes to consolidated financial statements.

Consolidated Statements of Income

Guitar Center, Inc. and subsidiaries

Year ended December 31, (In thousands, except per share data)	2005	2004	2003
Net sales	$ 1,782,499	$ 1,513,172	$ 1,275,059
Cost of goods sold, buying and occupancy	1,262,097	1,087,899	931,014
Gross profit	520,402	425,273	344,045
Selling, general and administrative expenses	388,380	317,585	271,996
Operating income	132,022	107,688	72,049
Interest expense, net of interest income of $1,108, $189 and $122, respectively	7,339	5,390	12,540
Income before income taxes	124,683	102,298	59,509
Income taxes	48,005	38,873	22,649
Net income	$ 76,678	$ 63,425	$ 36,860
Net income per share:			
Basic	$ 2.96	$ 2.55	$ 1.59
Diluted	$ 2.67	$ 2.29	$ 1.47
Weighted average shares outstanding:			
Basic	25,873	24,856	23,255
Diluted	29,846	28,976	26,119

See accompanying notes to consolidated financial statements.

Consolidated Statements of Stockholders' Equity

Guitar Center, Inc. and subsidiaries

(In Thousands)	Number of Shares	Common Stock	Additional Paid-in Capital	Retained Earnings (Accumulated Deficit)	Total
Balance at December 31, 2002	22,746	$ 227	$ 253,863	$ (99,162)	$ 154,928
Exercise of employee stock options, including tax benefit of $4,091	1,203	12	21,462	—	21,474
Stock issued under employee stock purchase plan	49	1	908	—	909
Net income	—	—	—	36,860	36,860
Balance at December 31, 2003	23,998	240	276,233	(62,302)	214,171
Exercise of employee stock options, including tax benefit of $9,756	1,313	14	27,537	—	27,551
Stock issued under employee stock purchase plan	48	—	1,535	—	1,535
Net income	—	—	—	63,425	63,425
Balance at December 31, 2004	25,359	254	305,305	1,123	306,682
Exercise of employee stock options, including tax benefit of $7,591	687	7	19,418	—	19,425
Stock issued under employee stock purchase plan	46	—	2,032	—	2,032
Net income	—	—	—	76,678	76,678
BALANCE AT DECEMBER 31, 2005	26,092	$ 261	$ 326,755	$ 77,801	$ 404,817

See accompanying notes to consolidated financial statements.

Consolidated Statements of Cash Flows

Guitar Center, Inc. and subsidiaries

Year ended December 31, (In thousands)	2005	2004	2003
OPERATING ACTIVITIES:			
Net income	$ 76,678	$ 63,425	$ 36,860
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	29,000	22,304	20,620
Loss on sale and disposal of property and equipment	1,849	—	—
Amortization of deferred financing fees	1,045	1,045	938
Write-off of deferred financing fees	—	—	722
Deferred income taxes	(5,476)	916	1,314
Tax benefit from exercise of stock options	7,591	9,756	4,091
Changes in operating assets and liabilities, net of acquisitions:			
Accounts receivable	(7,415)	(3,341)	(4,052)
Merchandise inventories	(74,188)	(24,281)	3,220
Prepaid expenses and deposits	(862)	(1,824)	(2,917)
Deposits and other assets	(733)	(2,869)	(657)
Accounts payable	16,215	1,994	(22,967)
Accrued expenses and other current liabilities	19,397	11,990	17,320
Other long-term liabilities	4,314	961	291
Merchandise advances	(1,705)	5,430	3,222
Net cash provided by operating activities	65,710	85,506	58,005
INVESTING ACTIVITIES:			
Purchase of property and equipment	(75,493)	(26,151)	(24,245)
Purchase of available-for-sale securities	(27,305)	(20,807)	—
Proceeds from the sale of available-for-sale securities	47,460	—	—
Acquisition of businesses, net of cash acquired	(102,428)	(2,775)	—
Net cash used in investing activities	(157,766)	(49,733)	(24,245)
FINANCING ACTIVITIES:			
Net change in revolving line of credit	32,266	—	(82,690)
Proceeds from exercise of stock options	11,834	17,795	17,383
Proceeds from stock issued under employee purchase plan	2,032	1,535	909
Net proceeds from Senior Convertible Note	—	—	96,875
Payments on Senior Note	—	—	(66,667)
Payments under capital lease	—	—	(151)
Net cash provided by (used in) financing activities	46,132	19,330	(34,341)
Net (decrease) increase in cash and cash equivalents	(45,924)	55,103	(581)
Cash and cash equivalents at beginning of year	60,453	5,350	5,931
Cash and cash equivalents at end of year	$ 14,529	$ 60,453	$ 5,350
NON-CASH INVESTING ACTIVITIES:			
Acquisition of businesses, in which the fair value of assets and liabilities were as follows:			
Current assets	$ 5,587	$ 2,528	$ —
Inventory	57,655	—	—
Property and equipment	3,692	—	—
Intangible assets	10,549	—	—
Goodwill	59,455	404	—
Total assets acquired	136,938	2,932	—
Current liabilities	(21,724)	(157)	—
Deferred tax liability	(12,048)	—	—
Other long-term liabilities	(738)	—	—
Total liabilities assumed	(34,510)	(157)	—
Net assets acquired	$ 102,428	$ 2,775	$ —
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:			
Cash paid during the year for:			
Interest	$ 6,005	$ 4,665	$ 12,808
Income taxes	$ 34,747	$ 27,611	$ 15,931

See accompanying notes to consolidated financial statements.

Notes To Consolidated Financial Statements

DECEMBER 31, 2005

1 NATURE OF BUSINESS AND SIGNIFICANT ACCOUNTING POLICIES

Nature of Business

Guitar Center, Inc. is the leading United States retailer of guitars, amplifiers, percussion instruments, keyboards and pro-audio and recording equipment. As of December 31, 2005, our retail subsidiary operated 161 Guitar Center stores across the United States, with 126 stores in 50 primary markets, 34 stores in secondary markets and one tertiary market store. In addition, as of December 31, 2005, our Music & Arts Center division operated 81 stores specializing in band instruments for sale and rental, serving thousands of teachers, band directors, college professors and students. We are also the largest direct response retailer of musical instruments in the United States through our wholly owned subsidiary, Musician's Friend, Inc., and its catalog and website, www.musiciansfriend.com.

Principles of Consolidation

The consolidated financial statements include the financial statements of Guitar Center, Inc. and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with generally accepted accounting principles requires the Company to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from our estimates.

Cash and Cash Equivalents

Cash and cash equivalents consist of cash on hand and marketable debt securities with original maturities of three months or less.

Investments

Marketable securities are classified as "available-for-sale" and recorded at fair value. Unrealized gains and losses, net of related tax effect, are excluded from earnings and are reported as a separate component of other comprehensive income until realized. Realized gains and losses from the sale of available-for-sale securities are determined on a specific-identification basis.

Accounts Receivable

In the normal course of business, the Company grants credit directly to certain customers, after a credit analysis based on financial and other criteria and generally requires no collateral. Accounts receivable are recorded net of an allowance for doubtful accounts. The Company maintains allowances for doubtful accounts for estimated losses that result from the inability of its customers to make their required payments. The Company bases its allowances on analysis of the aging of accounts receivable at the date of the financial statements, assessments of historical collections trends and an evaluation of the impact of current economic conditions.

Merchandise Inventories

Inventories, including used merchandise and vintage guitars, are valued at the lower of cost using the weighted average method or market. Applicable costs associated with bringing inventory through the Guitar Center retail distribution center are capitalized to inventory. The amounts are expensed to cost of goods sold as the associated inventory is sold. Rental inventories are valued at the lower of cost or market using the specific identification method and are depreciated on a straight-line basis while out under the rental agreement for rent-to-own sales. We receive price protection credits and vendor rebates from vendors, which are accounted for as a component of merchandise inventory and are recorded at the time the credit or rebate is earned. The effect of price protection credits and vendor rebates is recognized in the income statement as an effective reduction in cost of goods sold at the time the related item of inventory is sold. None of these credits are recorded as revenue.

Property and Equipment

Property and equipment are recorded at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets; generally five years for furniture and fixtures, computer equipment and vehicles, and 15 years for buildings. Leasehold improvements are amortized over the shorter of their estimated useful lives or the terms of the related leases. Corporate aircraft is depreciated over 10 years with a 50% salvage value. Maintenance and repair costs are expensed as they are incurred, while renewals and betterments are capitalized.

Goodwill and Other Intangibles

Goodwill represents the excess of the purchase price over the fair value of the net assets acquired resulting from business acquisitions. In 2002, we adopted SFAS No. 142, ***Goodwill and Other Intangible Assets***, which eliminated the systematic amortization of goodwill. As of December 31, 2005 and 2004 we had unamortized goodwill in the amount of $85.9 million and $26.5 million, respectively. We also had unamortized identifiable intangible assets with indefinite lives in the amount of $5.3 million and $325,000, as of December 31, 2005 and 2004, respectively. Our policy is to test for impairment on an annual basis, or more frequently when triggering events occur. We have tested goodwill and intangible assets for impairment under the provisions of SFAS No. 142 and these tests indicated that there was no impairment as of December 31, 2005.

Impairment and Disposal of Long-Lived Assets

We account for the impairment or disposal of long-lived assets in accordance with SFAS No. 144, ***Accounting for the Impairment or Disposal of Long-Lived Assets***, which requires long-lived assets, such as property and equipment, to be evaluated for impairment whenever events or changes in circumstances indicate the carrying value of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of the assets to future undiscounted net cash flows expected to be generated by said assets. If such assets are considered to be impaired, the impairment to be recognized is the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less selling costs. No impairment was identified for the years ended December 31, 2005, 2004 and 2003.

Merchandise Advances

Merchandise advances represent layaway deposits which are recorded as a liability pending consummation of the sale when the full purchase price is received from the customer, outstanding gift certificates or gift cards which are recorded as a liability until redemption by the customer, credit on account for customer returns and special orders.

Self-Insurance Reserves

We maintain a self-insurance program for workers' compensation of up to $250,000 per claim and medical insurance of up to $150,000 per claim, with any amounts in excess of these covered by stop-loss insurance coverage. Estimated costs under these programs, including incurred but not reported claims, are recorded as expenses based upon actuarially determined historical experience and trends of paid and incurred claims. Self-insurance reserves for workers' compensation and medical insurance amounted to $3.3 million and $1.0 million at December 31, 2005 and $2.8 million and $0.7 million at December 31, 2004, respectively. The balances are included in accrued expenses and other current liabilities in the accompanying consolidated balance sheets.

Revenue Recognition

Retail sales are recognized at the time of sale, net of a provision for estimated returns. Band instrument rentals are recognized on a straight-line basis over the term of the rental agreement, unless a trial period is offered, in which circumstances the rental income for the trial period is amortized over the trial period. The terms of the majority of our rental agreements do not exceed 36 months. Trial periods are usually from one to four months. Direct response sales are recognized when the products are estimated to be received by the customers, net of a provision for estimated returns. Direct response items sold to customers are estimated to be received, on average, three days after shipment. Return allowances are estimated using historical experience.

Advertising Costs

We expense Guitar Center's and Music & Arts Center's advertising costs as incurred. Advertising costs included in the consolidated statements of income for the years ended December 31, 2005, 2004 and 2003 is $36.6 million, $34.0 million, and $29.6 million, respectively. Musician's Friend's non-catalog advertising costs for the years ended December 31, 2005, 2004 and 2003 were $12.6 million, $5.5 million and $3.7 million, respectively. Mail order catalog costs are capitalized on a catalog by catalog basis and are amortized over the expected period of future benefits, not to exceed five months, under the provisions of AICPA Statement of Position 93-7, ***Reporting of Advertising Costs***. Capitalized mail order catalog costs included in prepaid expenses and deposits at December 31, 2005, 2004 and 2003 were $1.8 million, $4.5 million and $3.1 million, respectively. The realizability of the capitalized mail order catalog costs, are evaluated at each balance sheet date by comparing the carrying amount of such assets on a cost-pool-by-cost-pool basis to the probable remaining future net revenues expected to result directly from such advertising. If the carrying amounts of such deferred mail order catalog costs exceed the remaining future net revenues that probably will be realized from such catalog, the excess capitalized amount is written down and expensed in the current period. There was no write-down of capitalized mail order catalog costs for the years ended December 31, 2005, 2004 and 2003.

We receive cooperative advertising allowances from manufacturers in order to subsidize qualifying advertising and similar promotional expenditures we make relating to the vendor's products. These advertising allowances are recognized as a reduction to selling, general and administrative expense when we incur the advertising costs eligible for the credit. Guitar Center, Musician's Friend and Music & Arts Center recognized cooperative advertising allowances of $10.1 million, $6.4 million and $5.1 million for the years ended December 31, 2005, 2004 and 2003, respectively.

Rent Expense

We lease the majority of our store locations under operating leases that provide for monthly payments that increase over the life of the leases. The aggregate of the minimum annual payments are expensed on a straight-line basis over the term of the related lease. The amount by which straight-line rent expense exceeds actual lease payment requirements in the early years of the leases is accrued as deferred minimum rent and reduced in later years when the actual cash payment requirements exceed the straight-line expense. When a lease includes lease incentives (such as a rent holiday or reimbursement of certain lessee construction costs) or requires fixed escalations of the minimum lease payments, rental expense is recognized on a straight-line basis over the initial term of the lease and the difference between the average rental amount charged to expense and amounts payable under the lease is included in deferred rent and lease incentives in the accompanying consolidated balance sheets.

Income Taxes

We account for income taxes under SFAS No. 109, ***Accounting for Income Taxes***. Under the asset and liability method of SFAS No. 109, deferred income tax assets and liabilities are recognized for the future tax consequences attributable to differences between financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. Under SFAS No. 109, the effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

In assessing the realizability of deferred tax assets, we consider whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. We consider the scheduled reversals of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment.

Stock-Based Compensation

In July 2005, our Board of Directors approved the Guitar Center, Inc. 2005 Long-Term Incentive Plan. Historically, we have provided equity-based incentives to our senior management solely in the form of stock options issued under stockholder-approved plans. The purpose of the long-term incentive plan is to provide equity incentives to senior management that include not only stock options or similar grants, but also a performance share program that measures performance on a multi-year basis. The performance period under the long- term incentive plan began on July 1, 2005 and ends on December 31, 2007. The target number of performance shares potentially issuable under the plan is expected to be approximately 260,000 with the actual number of shares being between zero and 520,000 depending on the Company's actual performance. Under the terms of the plan, there may be stock option grants to the participants of the plan that will be for a term of ten years and will vest over three to four years in equal annual installments. Through December 31, 2005, the Company has accounted for the long- term incentive plan using the variable plan accounting method established by Accounting Principles Board Opinion ("APB") No. 25, ***Accounting for Stock Issued to Employees*** and related interpretations. Commencing January 2006, all our stock-based compensation plans will be accounted for under SFAS 123R. Details of the plan were included in the 8-K we filed on July 28, 2005.

We have adopted SFAS No. 123, ***Accounting for Stock-Based Compensation***, which permits entities to recognize as expense over the vesting period the fair value of all stock-based awards on the date of grant. Alternatively, SFAS No. 123 allows entities to continue to apply the provisions of APB 25, ***Accounting for Stock Issued to Employees***, and related interpretations and provide pro forma net income and pro forma income per share disclosures for employee stock options as if the fair-value-based method defined in SFAS No. 123 had been applied. We have elected to continue to apply the provisions of APB 25 and provide the pro forma disclosure provisions of SFAS No. 123.

In December 2004, the Financial Accounting Standards Board issued SFAS No. 123 (revised 2004) ***Share-Based Payment*** ("SFAS No. 123R"). SFAS No. 123R requires that the cost from all share-based payment transactions, including stock options, be recognized in the financial statements at fair value. SFAS No. 123R is effective for public companies in the first fiscal year beginning after June 15, 2005. We will adopt the provisions of this statement effective January 1, 2006. We will adopt SFAS 123R using the modified prospective method beginning January 1, 2006, pursuant to which we will not restate any prior periods.

In the second quarter of 2005, we converted to a lattice-based binomial model from a Black-Scholes model, which our management believes to be a superior method for valuing the impact of different employee option exercise patterns under various economic and market conditions. The conversion was implemented beginning with grants issued during the second quarter of 2005. The fair value of our grants issued prior to the second quarter of 2005 was determined using best-estimate assumptions effective as of the grant date using the Black-Scholes model.

We granted 109,000 options in the third quarter of 2005. Assumptions used to determine the fair value of options granted during the third quarter of 2005 using the lattice-based binomial model were developed in consultation with an outside valuation specialist. The lattice-based binomial model requires the input of several assumptions including expected volatility, dividend yield, and risk-free rate of return, as well as certain assumptions regarding exercise behavior. Unlike the Black-Scholes model where the expected term is an input assumption, the expected-term is an output variable of the lattice-based binomial model. For fiscal year 2004, the Company reflected a volatility assumption of 59.6% for stock options granted during the fiscal year. This was based on the historical price of our stock over the expected life of the option. Using the lattice model the expected volatility assumption was developed based on an analysis of historical prices of our stock and options traded in the open market. The volatility of historical prices for fiscal year 2005 was 52% while the volatility for open market exchanged options issued "near-the-money" was 32%. Therefore, a best-estimate range of 32% to 52% was developed. When no point in a range is more or less likely to be the best estimate, SFAS No. 123 directs the use of an average. This implies that 42% is the best estimate volatility assumption for the Company. The risk free interest rate varies by duration, from 3.5% to 4.0%.

Assumptions were developed separately for our senior management from the other participants of our stock plans, since senior management's exercise behavior is expected to differ materially from the other participants.

Under APB 25, compensation expense for stock options issued to employees is recorded on the date of grant only if the current market price of the underlying stock exceeds the exercise price. Had we determined compensation cost based upon the fair value at the grant date for our stock options using the methodologies described above, pro forma net income and pro forma net income per share, including the following weighted average assumptions used in these calculations, would have been as follows for the period ended December 31, 2005, 2004 and 2003:

December 31, ($ in thousands, except per share data-unaudited)	2005	2004	2003
Net income, as reported	$ 76,678	$ 63,425	$ 36,860
Deduct: Total stock-based employee compensation expense determined under fair value based methods for all awards, net of related tax effects	$ 6,608	$ 6,271	$ 4,821
Pro forma net income	$ 70,070	$ 57,154	$ 32,039
Earnings per share:			
Basic – as reported	$ 2.96	$ 2.55	$ 1.59
Basic – pro forma	$ 2.71	$ 2.30	$ 1.38
Diluted – as reported	$ 2.67	$ 2.29	$ 1.47
Diluted – pro forma	$ 2.44	$ 2.07	$ 1.29
Risk free interest rate	3.8%	3.9%	3.8%
Expected lives	5.82	6.70	6.92
Expected volatility	42.0%	59.6%	62.9%
Expected dividends	—	—	—

Earnings Per Share

The following table summarizes the reconciliation of basic to diluted weighted average shares for the years ended December 31, 2005, 2004, 2003:

(in thousands)	2005	2004	2003
Basic shares	25,873	24,856	23,255
Dilutive effect of options outstanding	1,081	1,228	1,306
Dilutive effect of conversion of Convertible Notes	2,892	2,892	1,558
Diluted shares	29,846	28,976	26,119

Calculation of diluted earnings per share:

(in thousands)	2005	2004	2003
Net income, as reported	$ 76,678	$ 63,425	$ 36,860
Add back interest, net of tax, on 4% Senior Convertible Notes[a]	2,907	2,931	1,540
Net income excluding interest expense on 4% Senior Convertible Notes	79,585	66,356	38,400
Basic weighted average shares outstanding	25,873	24,856	23,255
Dilutive effect of stock options outstanding	1,081	1,228	1,306
Incremental shares on assumed conversion of 4% Senior Convertible Notes[b]	2,892	2,892	1,558
Dilutive weighted average shares outstanding	29,846	28,976	26,119
Dilutive income per share	$ 2.67	$ 2.29	$ 1.47

[a] Represents the interest expense, including amortization of deferred financing costs, on the 4% Senior Convertible Notes, net of tax, using an effective tax rate for 2005 of 38.5% and for 2004 of 38.0%.

[b] Represents the number of incremental common shares resulting from the conversion of the 4% Senior Convertible Notes.

For the years ended December 31, 2005, 2004 and 2003, the only potential common stock outstanding with the Company are stock options and the Senior Convertible Notes. For the year ended December 31, 2005, options to acquire 261,479 shares at prices ranging from $58.83 to $64.66 were outstanding but were excluded from the computation of diluted earnings per share because the exercise price of these options was greater than the average market price of our Common Stock. For the year ended December 31, 2004, all options outstanding had a dilutive effect. For the year ended December 31, 2003, options to acquire 223,000 shares at prices ranging from $28.30 to $30.70 were outstanding but were excluded from the computation of diluted earnings per share because the exercise price of these options was greater than the average market price of our common stock.

For the years ended December 31, 2005 and 2004, the 2.9 million shares of common stock issuable upon conversion of the 4% Senior Convertible Notes issued in June 2003 (reflecting an effective conversion price of $34.58) are deemed to be potential common stock and are deemed to be outstanding for the purposes of calculating diluted earnings per share under the “if-converted” method of accounting under which the after-tax interest expense, including amortization of deferred financing costs, for the year is added back to net income. For the year ended December 31, 2003, 1.6 million shares of common stock were deemed to be potential common stock and are included in the calculation of earnings per share representing the weighted average shares for the period of June 16, 2003, the issuance date of the Notes, to December 31, 2003, under the “if-converted” method.

In July 2004, the Emerging Issues Task Force ("EITF") reached a consensus on Issue No. 04-8, ***Accounting Issues Related to Certain Features of Contingently Convertible Debt and the Effect on Diluted Earnings per Share*** (EITF No. 04-8) that contingently convertible debt instruments, such as our 4% Senior Convertible Notes, should be included in the computation of diluted earnings per share under the if-converted method regardless of whether the market price trigger (or other contingent feature) has been met. The consensus must be applied by retroactive restatement based on the term in effect on the last day of the fiscal period in which the consensus becomes effective. This consensus became effective for all financial statements issued after December 15, 2004. Accordingly, we retroactively restated all earnings per share measures for all periods to reflect the consensus.

Concentration of Credit Risk

Our cash deposits are with various high quality financial institutions. Customer purchases generally are transacted using cash or credit cards. In limited instances, we grant credit for larger purchases, generally to professional musicians, under normal trade terms. Trade accounts receivable were approximately $10.5 million and $7.7 million at December 31, 2005 and 2004, respectively. Credit losses have historically been within our expectations.

Fair Value of Financial Instruments

The principal amount of our revolving line of credit reflects the fair value based upon current rates available to us for similar debt. Based on quoted market prices, the fair value of our 4% Senior Convertible Notes was $148 million and $151 million as of December 31, 2005 and 2004, respectively. The book value of all other financial instruments is representative of their fair values.

New Accounting Pronouncements

In May 2005, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Accounting Standards ("SFAS") No. 154, ***Accounting Changes and Error Corrections***, which replaces ***Accounting Principles Board ("APB") Opinion No. 20, Accounting Changes***, and supersedes FASB Statement No. 3, ***Reporting Accounting Changes in Interim Financial Statements—an amendment of APB Opinion No. 28***. SFAS 154 requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. When it is impracticable to determine the period-specific effects of an accounting change on one or more individual prior periods presented, SFAS 154 requires that the new accounting principle be applied to the balances of assets and liabilities as of the beginning of the earliest period for which retrospective application is practicable and that a corresponding adjustment be made to the opening balance of retained earnings for that period rather than being reported in an income statement. When it is impracticable to determine the cumulative effect of applying a change in accounting principle to all prior periods, SFAS 154 requires that the new accounting principle be applied as if it were adopted prospectively from the earliest date practicable. SFAS 154 will be effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. This statement does not change the transition provisions of any existing accounting pronouncements, including those that are in a transition phase as of the effective date of this statement. We do not expect the provisions of the SFAS 154 to have a significant impact on our consolidated financial statements.

In November 2004, the FASB issued SFAS No. 151, ***Inventory Costs - An Amendment of ARB No. 43, Chapter 4. SFAS*** No. 151 amends the guidance in Accounting Research Bulletin ("ARB") No. 43, Chapter 4, ***Inventory Pricing***, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). Among other provisions, the new rule requires that items such as idle facility expense, excessive spoilage, double freight, and rehandling costs be recognized as current-period charges regardless of whether they meet the criterion of "so abnormal" as stated in ARB No. 43. Additionally, SFAS 151 requires that the allocation of fixed production overhead to the costs of conversion be based on the normal capacity of the production facilities. SFAS No. 151 is effective for fiscal years beginning after June 15, 2005 and is required to be adopted in the first quarter of fiscal 2006. We do not expect the adoption of SFAS No. 151 to have a material impact on our consolidated financial statements.

In December 2004, the FASB issued FASB Statement No. 123 (revised 2004) ***Share-Based Payment***, or SFAS 123R, which is a revision of FASB Statement No. 123, ***Accounting for Stock-Based Compensation***. SFAS 123R supersedes APB opinion No. 25, ***Accounting for Stock Issued to employees***, and amends FASB Statement No. 95, ***Statement of Cash Flows***. Generally, the approach in SFAS 123R is similar to the approach described in Statement 123. However, SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values rather than pro forma footnote disclosure. SFAS No. 123R is effective for public companies in the first fiscal year beginning on or after January 1, 2006.

SFAS 123R requires measurement of the cost of share-based payment transactions to employees at the fair value of the award on the grant date and recognition of expense over the requisite service or vesting period. SFAS 123R allows implementation using a modified version of prospective application, under which compensation expense for the unvested portion of previously granted awards and all new awards will be recognized on or after the date of adoption. FAS 123R also allows companies to implement by restating previously issued financial statements, basing the amounts on the expense previously calculated and reported in their pro forma footnote disclosures required under FAS 123. We will adopt FAS 123R using the modified prospective method beginning January 1, 2006. The impact of adopting FAS 123R on our consolidated results of operations is not expected to differ materially from the pro forma disclosures currently required by FAS 123 (see "Employee stock-based compensation"). In addition, FAS 123R requires classification of the tax benefit from the exercise of stock options in cash flows from financing activities, rather than cash flows from operating activities. In 2005, cash flows from operating activities included a cash inflow of $7.6 million related to tax benefits from the exercise of stock options.

In July 2005, the FASB issued an exposure draft of a proposed interpretation, ***Accounting for Uncertain Tax Positions—an Interpretation of FASB Statement No. 109***. The proposed interpretation would apply to all open tax positions accounted for in accordance with SFAS No. 109, including those acquired in business combinations. In October 2005, the FASB decided to postpone issuance of the final interpretation until fiscal year 2006. The Company will evaluate the impact of any change in accounting standard on the Company's financial position and results of operations when the final interpretation is issued.

In June 2005, the Emerging Issues Task Force ("EITF") issued EITF Issue 05-6, ***Determining the Amortization Period for Leasehold Improvements Purchased after Lease Inception or Acquired in a Business Combination***. The EITF reached a consensus that the amortization period for leasehold improvements acquired in a business combination or acquired subsequent to lease inception should be based on the lesser of the useful life of the leasehold improvements or the period of the lease including all renewal periods that are reasonably assured of exercise at the time of the acquisition. This consensus is consistent with the Company's policy regarding leasehold improvements. The adoption of EITF Issue 05-6 did not have a material impact on our consolidated financial statements.

In October 2005, the FASB issued FASB Staff Position ("FSP") No. FAS 13-1 ("FSP13-1"), ***Accounting for Rental Costs Incurred during the Construction Period***, which requires that rental costs associated with ground or building operating leases that are incurred during a construction period be recognized as rental expense. These rental costs shall be included in income from continuing operations. The effective date of this FSP guidance is the first reporting period beginning after December 15, 2005. Early adoption is permitted for financial statements or interim financial statements that have not yet been issued. The adoption of FSP 13-1 will not have a material impact on our consolidated financial statements.

In March 2005, the FASB issued FASB Interpretation No. 47 ("FIN 47"), ***Accounting for Conditional Asset Retirement Obligations***, which is an interpretation of SFAS No. 143 ("SFAS 143"), ***Accounting for Asset Retirement Obligations***. FIN 47 clarifies terminology within SFAS 143 and requires an entity to recognize a liability for the fair value of a conditional asset retirement obligation when incurred if the liability's fair value can be reasonably estimated. FIN 47 is effective for fiscal years ending after December 15, 2005. The adoption of FIN 47 did not have a material impact on our consolidated financial statements.

2 ACQUISITIONS

On April 15, 2005, we completed the acquisition of Music & Arts Center, Inc., a Maryland-based musical instruments retailer with an emphasis on the beginning musician. At the time of the acquisition, Music & Arts Center, Inc. operated 61 retail locations, primarily located in the Northeast, Mid-Atlantic and Southern regions of the U.S. The acquired business and our existing American Music Group business have been combined into a new division under the Music & Arts Center name.

On June 10, 2005, our Musician's Friend unit completed the asset acquisition of Harmony-Central.com, an Internet content and information site. The acquired company is separately maintained and operated by Musician's Friend as Harmony Central Group, LLC. The results of operations and the assets of Harmony-Central.com were not material to Guitar Center's historical consolidated financial statements and, as such, pro-forma financial information is not presented. The results of operations are included in Guitar Center's consolidated financial statements from the date of the acquisition.

On July 18, 2005, our Music & Arts Center division completed the asset acquisition of John W. Coffey Music Co., Inc., band instruments retailer in Norwood, Massachusetts. Coffey Music services the greater Boston, Massachusetts metropolitan area. The results of operations and the assets of Coffey Music were not material to Guitar Center's historical consolidated financial statements and, as such, pro-forma financial information is not presented. The results of operations are included in Guitar Center's consolidated financial statements from the date of the acquisition.

We acquired Music & Arts Center, Coffey and Band Instrument Exchange to expand our existing presence in the band and orchestra instrument business. Harmony Central was purchased to drive traffic to our direct response Internet website.

The aggregate purchase price of the acquisitions was approximately $102.4 million and was funded from cash on hand and drawings under our line of credit. The aggregate purchase price was allocated to the following assets acquired and liabilities assumed at their estimated fair value (in thousands):

Current assets	$ 5,587
Inventory	57,655
Property & equipment	3,692
Intangible assets	10,549
Goodwill	59,455
Total assets acquired	136,938
Current liabilities	(21,724)
Deferred tax liability	(12,048)
Other long-term liabilities	(738)
Total liabilities assumed	(34,510)
Total purchase price	$ 102,428

The purchase price allocation between goodwill and deferred tax liability may change pending the filing of the final pre-acquisition income tax returns for Music & Arts Center.

The purchase price allocation described above resulted in our recording approximately $59 million in goodwill, which is not being amortized, but will be evaluated for impairment annually or when a triggering event occurs which may require an impairment test. For California income tax, the entire amount of acquired $59 million in goodwill is deductible. For all other states and Federal, approximately $4 million in goodwill is deductible.

The acquired intangible assets are summarized as follows:

Year ending December 31, 2005: (in thousands)	Gross Carrying Amount
Intangible assets	
Amortized	
Trademark	$ 110
Customer contracts	3,740
Covenant not to compete	1,460
Other	239
Unamortized trademark	5,000
Total intangible assets	$ 10,549
Aggregate amortization expense	$ 2,248
Estimated amortization expense	
For the year ended 12/31/2006	$ 2,529
For the year ended 12/31/2007	$ 431
For the year ended 12/31/2008	$ 215
For the year ended 12/31/2009	$ 126

The changes in our goodwill balance are summarized as follows:

Year ending December 31,	Balance at beginning of year	Additions	Deductions	Balance at end of year
2005	$ 26,474	59,455	—	$ 85,929
2004	$ 25,995	479	—	$ 26,474

Results of operations for the Music & Arts Center are included in the consolidated financial statements since April 15, 2005, the date of acquisition. The following table summarizes pro forma financial information assuming the Music & Arts Center, Inc. acquisition had occurred as of the beginning of the periods presented below:

December 31, (in thousands, except per share data)	2005	2004
Net sales	$1,808,945	$1,597,489
Net income	73,707	64,154
Income per share:		
Basic	2.85	2.58
Diluted	2.57	2.32

Included in pro forma net income for the year ended December 31, 2005 are after-tax charges of $3.6 million ($0.12 per diluted share) for bonus payments and legal fees associated with the acquisition. These charges were incurred prior to the acquisition on April 15, 2005. In addition, in conjunction with the acquisition, after-tax charges of $2.1 million ($0.07 per diluted share) were incurred primarily from the elimination of a redundant point of sales system, severance costs, moving costs to relocate certain American Music employees to the Music & Arts Center corporate office in Maryland and the write down of inventory carried at American Music resulting from a change in inventory assortment. These charges were incurred during the period of April 15, 2005 through June 30, 2005.

The pro forma information is not necessarily indicative of the operating results that would have occurred had the acquisition been made at the beginning of the periods presented nor are they necessarily indicative of any future operating results.

3 MERCHANDISE INVENTORIES

The major classes of merchandise inventories are as follows:

December 31, (in thousands)	2005	2004
Major goods	$ 246,260	$ 187,902
Band instruments	79,378	25,125
Accessories	97,950	77,200
Vintage guitars	11,795	10,831
Used major goods	20,056	19,121
	455,439	320,179
Less inventory reserves for writedowns	9,668	5,218
	$ 445,771	$ 314,961

Major goods include stringed merchandise, percussion, keyboards, live-sound/DJ and recording equipment. Band instruments include horns, flutes, brass and woodwind instruments. Accessories are comprised of accessories to major goods, and band instruments, apparel, cables and books.

4 PROPERTY AND EQUIPMENT

Property and equipment consists of the following:

December 31, (in thousands)	2005	2004
Land	$ 7,666	$ 2,946
Buildings	20,091	9,766
Furniture and fixtures	30,656	23,896
Transportation equipment	12,402	630
Computer equipment	73,877	58,174
Leasehold improvements	123,992	97,776
Construction in progress	5,965	4,076
	274,649	197,264
Less accumulated depreciation and amortization	125,440	99,915
	$ 149,209	$ 97,349

5 REVOLVING LINE OF CREDIT AND DEBT

In February of 2005, we amended our credit facility with a syndicate of banks led by Wells Fargo Retail Finance. The credit facility permits borrowings up to $125 million (which may be increased to $150 million at our option), subject to borrowing base limitations. The actual amount available is tied to our inventory and receivable base, and our obligations under the credit facility are secured by liens on our principal assets. Borrowing options are prime rate (7.25% at December 31, 2005) plus applicable prime margin, or London Interbank Offered Rate or LIBOR (twelve month rate at December 31, 2005 was 4.8%), plus applicable LIBOR margin. The applicable prime and LIBOR margins are based upon levels of excess availability and adjusted quarterly. If excess availability is greater than $20 million, the applicable prime margin is 0.00% and applicable LIBOR margin is 1.0%. If excess availability is less than or equal to $20 million and greater than $10 million, the applicable prime margin is 0.00% and the applicable LIBOR margin is 1.25%. If excess availability is less than or equal to $10 million, the applicable prime margin is 0.00% and the applicable LIBOR margin is 1.5%. An unused fee of 0.25% is assessed on the unused portion of the credit facility. The agreement underlying the credit facility includes significant restrictive negative covenants. Among other things, these covenants restrict or prohibit our ability to incur debt and issue specified equity instruments, incur liens on our assets, make any significant changes in our corporate structure or the nature of our business, dispose of assets, make guaranties, prepay debt, engage in a change in control transaction, pay dividends, make investments or acquisitions, engage in transactions with affiliates and incur capital expenditures, and also require that we satisfy a minimum availability test. The minimum availability test requires that we maintain $10 million of reserved availability under the agreement based on its borrowing base limitations. The amount we disclose in our public reports from time to time as available to borrow under the agreement is already reduced by this required reserve and outstanding letters of credit, and thus represents a net amount available under the agreement. The agreement also includes representations and warranties which must be true each time we borrow funds under the credit facility and affirmative covenants. The full text of the contractual requirements imposed by this financing is set forth in the Amended and Restated Loan and Security Agreement and related amendments which have been filed with the Securities and Exchange Commission. Subject to limited cure periods, the lenders under our credit facility may demand repayment of these borrowings prior to stated maturity upon the occurrence of specified events, including if we breach the terms of the agreement, suffer a material adverse change, engage in a change in control transaction, suffer a significant adverse legal judgment, default on other significant obligations, or in the event of specified events of insolvency. The credit agreement matures in December 2010.

Traditionally, we have experienced the largest use of cash from operating activities in the latter part of third quarter and in the fourth quarter due to the build up of inventory to support the holiday season, resulting in additional borrowings under our line of credit. We believe that our peak liquidity needs during 2006 during these periods will exceed our net cash flow from operations and borrowings currently available under our credit facility. We are in discussions with our lending syndicate regarding increasing the amount of borrowings under our credit facility to cover this shortfall. However, these discussions are preliminary in nature and there is no assurance that an increase in the borrowings under credit facility will be available to us.

On June 16, 2003, we completed the issuance of $100 million principal amount of 4.00% Senior Convertible Notes due 2013. The convertible notes bear interest at the rate of 4.00% per annum, subject to the payment of contingent interest under certain circumstances commencing January 15, 2006, and are convertible into shares of common stock at a conversion price of $34.58 per share, subject to adjustment under specified circumstances. Under the contingent conversion feature of the convertible notes, subject to certain exceptions, they are not convertible into common stock unless and until the trading price of the common stock reaches at least $41.50 for a specified period in advance of each quarterly conversion period or designated corporate events occur. As of December 31, 2005, the convertible notes were convertible for the current quarterly conversion period. The convertible notes will also become convertible upon the occurrence of specified corporate transactions and other events described in the indenture. The final maturity of the convertible notes is July 2013, although holders may require us to repurchase the Notes at their election in July 2008, July 2010 or upon the occurrence of a change in control, in each case for a purchase price equal to the original principal amount plus accrued interest. The indenture governing the convertible notes does not limit our ability to incur indebtedness or otherwise substantively restrict the operation of our business to any significant degree. Subject to limited cure periods, the holders of the convertible notes may demand repayment of these borrowings prior to the stated maturity upon the occurrence of specified events, including if we fail to pay interest or principal when due, if we fail to satisfy our conversion obligation, if another obligation of ours having an outstanding principal amount in excess of $15 million is accelerated prior to stated maturity and upon the occurrence of specified events of insolvency.

For the years ended December 31, 2005, 2004 and 2003, $1.0 million, $1.0 million and $0.9 million of amortization of deferred financing fees was included in interest expense. Capitalized deferred financing fees at December 31, 2005 and 2004 were $2.5 million and $3.6 million and related accumulated amortization was $2.1 million and $1.0 million, respectively.

6 SEGMENT INFORMATION

Our reportable business segments are Guitar Center stores, Music & Arts Center stores and Musician's Friend direct response (contact center and Internet). Prior to the acquisition of Music & Arts Center, Inc., that segment was referred to as American Music stores. Both brands have similar operations and there has been no change to the internal structure of the overall organization. Therefore, there has been no change in the nature of the company segment reporting. Management evaluates segment performance based primarily on net sales and income (loss) before income taxes. Accounting policies of the segments are the same as the accounting policies for the consolidated company. There are no differences between the measurements of profits or losses or assets of the reportable segments and those of the company on a consolidated basis. Our business segments under SFAS No. 131, ***Disclosures about Segments of an Enterprise and Related Information***, are consistent with our reporting units under SFAS No. 142, ***Goodwill and Other Intangible Assets***. SFAS No. 131 establishes standards for the reporting of operating segment information in annual financial statements and in interim financial reports issued to shareholders. SFAS No. 142 requires that goodwill no longer be amortized, reclassifications between goodwill and other intangible assets be made based upon certain criteria, and, once allocated to reporting units (the business segment level, or one level below), that tests for impairment of goodwill be performed at least annually. We will continue to evaluate goodwill annually or whenever events and circumstances indicate that there may be an impairment of the asset value.

Net sales, depreciation and amortization, income (loss) before income tax (benefit), capital expenditures and total assets are summarized as follows for the years ended December 31, 2005, 2004 and 2003 (in thousands):

	Guitar Center 2005	Music & Arts[1] 2005	Direct Response 2005	Total
Net sales	$ 1,314,277	$ 103,116	$ 365,106	$ 1,782,499
Depreciation and amortization	22,157	4,312	2,531	29,000
Income (loss) before income tax (benefit)	105,809	(14,095)	32,969	124,683
Capital expenditures	67,964	1,130	6,399	75,493
Total assets	$ 512,802	$ 197,045	$ 70,343	$ 780,190

	Guitar Center 2004	Music & Arts[1] 2004	Direct Response 2004	Total
Net sales	$ 1,161,511	$ 40,400	$ 311,261	$ 1,513,172
Depreciation and amortization	18,671	1,469	2,164	22,304
Income (loss) before income tax (benefit)	72,789	(7,228)	36,737	102,298
Capital expenditures	21,240	1,272	3,639	26,151
Total assets	$ 451,677	$ 63,365	$ 59,551	$ 574,593

	Guitar Center 2003	Music & Arts[1] 2003	Direct Response 2003	Total
Net sales	$ 978,962	$ 38,225	$ 257,872	$ 1,275,059
Depreciation and amortization	16,721	1,233	2,666	20,620
Income (loss) before income tax (benefit)	40,736	(7,894)	26,667	59,509
Capital expenditures	20,710	1,954	1,581	24,245
Total assets	$ 355,668	$ 64,071	$ 41,132	$ 460,871

[1]The information included for the Music & Arts Center division included only the operation of American Music prior to April 15, 2005.

7 INVESTMENT SECURITIES

Investment securities available-for-sale classified as current and long-term as of December 31, 2004 are as follows:

December 31, 2004 (in thousands)	Amortized Cost	Interest Earned	Amort. of Disc/Premium	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
General Obligation Municipal	$ 1,724	$ -	$ -	$ -	$ -	$ 1,724
Municipal Revenue	2,086	-	-	-	-	2,086
Short-term investment securities	$ 3,810	$ -	$ -	$ -	$ -	$ 3,810
General Obligation Municipal	$ 1,386	$ 1	$ (1)	$ -	$ -	$ 1,386
Municipal Revenue	15,611	2	(2)	-	-	15,611
Long-term investment securities	$ 16,997	$ 3	$ (3)	$ -	$ -	$ 16,997

We had no investments at December 31, 2005. We had no sales of investments in 2004. Gross unrealized gains and losses were immaterial.

8 LEASE COMMITMENTS

We lease offices, most of our retail store facilities, our distribution centers and various personal property used in our business under operating leases which expire at varying dates through December 2018. Generally, the agreements contain provisions which require us to pay for normal repairs and maintenance, property taxes and insurance.

The total minimum lease commitment at December 31, 2005, under operating leases, is as follows:

Year ended December 31 (in thousands)	Amount
2006	$ 44,457
2007	41,346
2008	38,308
2009	31,228
2010	24,630
Thereafter	72,909
	$ 252,878

Total rent expense included in the consolidated statements of income for the years ended December 31, 2005, 2004 and 2003 is $45.4 million, $38.2 million and $33.8 million respectively.

9 EMPLOYEE BENEFIT PLAN

We have a defined contribution 401(k) plan with a 401(a) profit-sharing component (the "Plan") maintained for the exclusive benefit of eligible employees and their beneficiaries. Eligible employees can contribute from one to seventy-five percent of their compensation. At our discretion, we can make matching contributions to the Plan, which will be a uniform percentage of the eligible employees' contributions. We may also, at our discretion, make profit-sharing contributions to the Plan. The profit-sharing contributions are allocated based on the relative compensation of all eligible employees. Contribution expense was $3.6 million, $2.1 million, $2.1 million for the years ended December 31, 2005, 2004 and 2003, respectively.

10 STOCK OPTION AND PURCHASE PLANS

1996 Performance Stock Option Plan

In June 1996, we adopted the 1996 Performance Stock Option Plan (as amended, the "1996 Plan"), which provided for the granting of options to officers and key employees. Under the 1996 Plan, the number of options available for grant was 713,782, with a maximum term of ten years and an exercise price equal to the fair market value of the underlying stock at the date of grant. The options generally vested ratably over three years. As of December 31, 2005, options to purchase 16,528 shares of common stock were outstanding and exercisable. At December 31, 2005, no shares were available for grant under the 1996 Plan and the outstanding options expire in June 2006.

1997 Equity Participation Plan

In January 1997, the 1997 Equity Participation Plan (as amended, the "1997 Plan") was adopted. Under the 1997 Plan, we may grant options to purchase up to 4,000,000 shares of common stock. Options granted under the 1997 Plan vest ratably over various terms with a maximum life of ten years. As of December 31, 2005, options to purchase 1,794,501 shares of common stock were outstanding under the 1997 Plan, and 1,378,223 shares were exercisable with exercise prices ranging from $8.34 to $53.83 and a weighted average exercise price of $22.31. At December 31, 2005, 14,626 shares were available for grant.

Included in the options outstanding are outstanding options to purchase 88,489 shares of common stock that were assumed in 1999 in connection with the merger with Musician's Friend.

2004 Incentive Stock Award Plan

In February 2004, the 2004 Incentive Stock Award Plan was adopted (as amended, the 2004 Plan). The 2004 Plan is an omnibus plan which provides for issuance of stock options, stock appreciation rights, restricted stock, deferred stock, dividend equivalents, performance awards and stock payment, or any combination thereof. Under the 2004 Plan, we may grant options to purchase up to 2,100,000 shares of common stock. Options granted under the plan vest over various terms with a maximum life of ten years and an exercise price equal to the fair market value of the underlying stock at the date of grant. As of December 31, 2005, options to purchase 991,365 shares of common stock were outstanding under the 2004 Plan, and 107,816 were exercisable with exercise prices ranging from $39.98 to $64.66 and a weighted average exercise price of $49.72. At December 31, 2005, 1,055,695 shares were available for grant.

Long Term Incentive Plan

On July 28, 2005, the Long Term Incentive Plan, or LTIP, was approved effective July 1, 2005. The purpose of the LTIP is to provide equity incentives to senior management that include not only stock options or similar grants, but also a performance share program that measures performance on a multi-year basis.

The performance period under the LTIP began on July 1, 2005 and ends on December 31, 2007. Awards under the LTIP will be made under the 2004 Plan or any successor plan. It is expected that each participant will receive an annual grant of stock options under the 2004 Plan. All such options will be for a term of ten years and will generally vest over four years in equal annual installments, except for options granted to Mr. Albertson, our CEO, which will vest over three years consistent with his preexisting employment agreement. The exercise price will be the fair market value of the underlying common stock on the date of grant. At the time of the initial adoption of the LTIP, we granted options to acquire an aggregate of 109,000 shares of common stock to participants.

Under the LTIP, participants also may receive performance awards in the form of common stock. Whether or not performance shares are earned by the participants will be determined based upon whether or not we achieve specified objective performance goals during the ten quarter performance period of the LTIP. The target number of performance shares potentially issuable under the LTIP is expected to be 260,076, with the actual number of shares ultimately issuable to be between zero and twice such amount, depending on actual performance. The compensation committee also has the discretion to make cash payments in lieu of performance shares. Individuals who become LTIP participants after initial adoption may receive a prorated award.

Under the terms of the Company's long-term incentive plan, a stock-based compensation expense is only recorded if the Company expects to meet or exceed the relevant earnings targets. Since we had not achieved the target as of the end of 2005, no accrual is necessary. A catch-up accrual would be required if future results put us back on track to achieve the planned targets.

Employee Stock Purchase Plan

In April 2001, the Employee Stock Purchase Plan (the "ESPP Plan") was adopted. The ESPP Plan is a tax-qualified employee stock purchase plan which authorizes 500,000 shares of our common stock, $0.01 par value, for issuance under the plan. Under the ESPP Plan, participants are granted options to purchase our common stock at a price which is eighty-five percent of the stock's fair market value on either the first or last day of the offering period, whichever price is lower. The options are then automatically exercised on the last business day of the offering period. The participants purchase the shares through payroll deductions. As of December 31, 2005, 221,913 shares had been purchased under the ESPP Plan at a weighted-average price of $24.47 per share.

We apply APB 25 in accounting for our plans. No stock-based employee compensation cost is reflected in net income, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant.

Stock option activity for all plans during the periods presented is as follows:

	No. of Shares	Weighted Average Exercise Price
Balance at December 31, 2002	4,397,963	$ 14.75
Granted	510,927	27.34
Exercised	(1,203,087)	14.45
Forfeited	(92,871)	20.02
Balance at December 31, 2003	3,612,932	16.54
Granted	804,100	39.78
Exercised	(1,313,555)	13.55
Forfeited	(75,660)	29.83
Balance at December 31, 2004	3,027,817	23.68
Granted	551,500	59.52
Exercised	(687,089)	17.22
Forfeited	(89,834)	37.42
Balance at December 31, 2005	2,802,394	$ 31.94

The following is a summary of stock options outstanding and exercisable at December 31, 2005:

Range of Exercise Prices	Outstanding Number of Options	Outstanding Weighted Average Years Remaining	Outstanding Weighted Average Exercise Price	Exercisable Number of Options	Exercisable Weighted Average Exercise Price
$ 8.34 TO $ 10.89	167,123	3.88	$ 10.59	167,123	$ 10.59
$ 13.44 TO $ 17.73	752,485	5.90	$ 16.01	696,993	$ 15.93
$ 18.25 TO $ 20.75	255,632	2.77	$ 19.70	255,632	$ 19.70
$ 21.96 TO $ 39.98	1,095,904	8.04	$ 35.47	382,819	$ 33.13
$ 53.08 TO $ 64.66	531,250	9.49	$ 59.82	0	$ 0
$ 8.34 TO $ 64.66	2,802,394	7.01	$ 31.94	1,502,567	$ 20.36

11 INCOME TAXES

Total income taxes for the years ended December 31, 2005, 2004 and 2003 consist of:

2005 (in thousands)	Current	Deferred	Total
Federal	$ 48,391	$ (5,223)	$ 43,168
State	5,090	(253)	4,837
	$ 53,481	$ (5,476)	$ 48,005

2004 (in thousands)	Current	Deferred	Total
Federal	$ 34,332	$ 793	$ 35,125
State	3,625	123	3,748
	$ 37,957	$ 916	$ 38,873

2003 (in thousands)	Current	Deferred	Total
Federal	$ 19,231	$ 1,005	$ 20,236
State	2,104	309	2,413
	$ 21,335	$ 1,314	$ 22,649

Actual income taxes for 2005, 2004 and 2003 differ from the statutory tax rate of 35% as applied to income before income taxes as follows:

(in thousands)	2005	2004	2003
Expected income tax expense	$ 43,641	$ 35,804	$ 20,827
State income taxes, net of federal tax benefit	3,317	2,436	1,459
Non deductible items	1,508	402	273
Change in valuation allowance	(52)	—	—
Other	(409)	231	90
Actual income tax expense	$ 48,005	$ 38,873	$ 22,649

The tax effects of temporary differences that give rise to significant portions of deferred tax assets and liabilities are presented below:

(in thousands)	2005	2004
Deferred tax assets:		
State net operating loss carryforward	$ 41	$ 38
Accrued liabilities	7,893	3,174
Merchandise inventories	5,568	2,340
Capital loss carryover	1,181	1,138
Total gross deferred tax assets	14,683	6,690
Deferred tax liabilities:		
Depreciation	$ (13,551)	$ (2,940)
Intangibles	(4,820)	—
Other	(1,936)	(2,117)
Total gross deferred tax liabilities	(20,307)	(5,057)
Net deferred tax assets/(liabilities) and net operating losses	(5,624)	1,633
Less valuation allowance	(1,191)	(1,138)
Net deferred tax assets/(liabilities)	$ (6,815)	$ 495

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. We consider scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projections of future taxable income over the periods which the deferred tax assets are deductible, management believes it is more likely than not that we will realize the benefits of these deductible differences. The amount of the deferred tax assets considered realizable, however, could be reduced in the near term if estimates of future taxable income during the carryforward periods are reduced. The valuation allowance for 2005 and 2004 consists of capital loss carryforwards and state net operating losses.

The Company accounts for the tax benefit resulting from the employee exercises of non-qualifying stock options or the disqualified disposition of incentive stock options as a reduction in income tax payable and an increase to additional paid-in capital in the accompanying consolidated financial statements. The Company recorded $7.6 million, $9.8 million and $4.1 million of a benefit in 2005, 2004 and 2003, respectively.

12 ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

The components of accrued expenses and other current liabilities are as follows:

December 31, (in thousands)	2005	2004
Wages, salaries and benefits	$ 30,564	$ 29,320
Sales tax payable	12,813	11,894
Accrued income taxes	18,846	7,576
Accrued advertising	8,193	6,038
Provision for sales returns	5,007	5,335
Accrued insurance	4,310	3,520
Unearned revenue	5,802	3,358
Accrued real estate tax	1,847	2,165
Accrued professional fees	4,281	2,030
Accrued interest	2,169	1,880
Accrued freight	1,432	988
Accrued catalog costs	369	882
Accrued utilities	922	887
Other	9,626	7,733
	$ 106,181	$ 83,606

13 LEGAL

On November 29, 2005, a case was filed against us and other defendants, including our Chief Executive Officer, in the United States District Court for the Southern District of Florida. The complaint asserts, among other things, violations of the Federal Racketeering Influenced and Corrupt Organization Act (RICO) and a corresponding Florida statute, Sections 1 and 2 of the Sherman Antitrust Act, Section 2 of the Clayton Act (as amended by the Robinson-Patman Act), the Antidumping Act of 1916, the Florida Antitrust Act of 1980, and the Florida Deceptive and Unfair Trade Practices Act, as well as tortious interference with business relationship under Florida law and civil conspiracy under Florida law by some or all of the identified defendants in connection with the claimed inability of Ace Pro Sound and Recording, L.L.C. to obtain vendor lines for its store. The complaint purports to be made as a class action on behalf of all current and former retail sellers of musical instruments and/or sound equipment and/or recording equipment with stores located in geographical regions in the United States wherein some or all of the defendants have carried on business, and seeks compensatory damages, treble damages, punitive damages, injunctive relief and attorneys fees. Service relating to the complaint was made on us on January 12, 2006 and a responsive pleading is due in March 2006.

While we believe this lawsuit is without merit and intend to defend it vigorously, it may, regardless of the outcome, result in substantial expenses and damages to us and may significantly divert the attention of our management. There can be no assurance that we will be able to achieve a favorable settlement of this lawsuit or obtain a favorable resolution of this lawsuit if it is not settled. An unfavorable resolution of this lawsuit could have a material adverse effect on our business, financial condition and results of operations. Regardless of the outcome, the costs and expenses incurred by us to defend this lawsuit could adversely impact our financial condition.

On May 6, 2005, a lawsuit entitled Farnam Street Financial, Inc. v. Guitar Center, Inc., Case No. CT 05-6546, was filed in the Fourth Judicial District in the State of Minnesota for the County of Hennepin. The lawsuit, which was filed by a Minnesota corporation, alleged breach of contract in connection with the lease of certain equipment located in our corporate office and retail stores. Among other things, the lawsuit alleged that we breached the contract by our failure to comply with the terms and conditions in connection with the return of the equipment and sought approximately $4.5 million of damages and attorneys' fees. We reached a settlement in this matter during a mediation held on January 16, 2006. Pursuant to the terms of the settlement agreement, we paid the plaintiff approximately $1 million for a full release and settlement of all claims, which were accrued for as of December 31, 2005.

On October 13, 2004, a putative class action lawsuit entitled Carlos Rodriguez v. The Guitar Center, Inc. [sic], Case No. GC322958, was filed in the Superior Court of the State of California for the County of Los Angeles. The lawsuit was filed by an individual purporting to represent all hourly retail store employees employed by us within the State of California. On December 15, 2004, a putative class action lawsuit entitled James McClain et. al. v. Guitar Center Stores, Inc., Case No. BC326002, was filed in the Superior Court of the State of California for the County of Los Angeles. The lawsuit was filed by three individuals purporting to represent all hourly retail store employees employed by us within the State of California. Among other things, the lawsuits alleged that we improperly failed to document and enforce break-time and lunch-time periods for such employees and sought an unspecified amount of damages, penalties and attorneys' fees.

On December 15, 2005 we reached preliminary agreement to settle these two purported class action lawsuits. Under the terms of the proposed settlement, which is subject to final documentation and court approval, we will make cash payments of up to $3.5 million to fully resolve claims by eligible class members, including payments to class members and payments for plaintiff attorneys' fees and the costs of a third-party administrator, an estimate of which were accrued for as of December 31, 2005.

In addition to the lawsuits described above, we are involved in various claims and legal actions arising in the ordinary course of our business and, while the results of those proceedings cannot be predicted with certainty, we believe that the final outcome of those matters will not have a material adverse effect on our business, financial condition and results of operations.

14 QUARTERLY FINANCIAL DATA (UNAUDITED)

(in thousands, except per share data)	2005 First	Second	Third	Fourth	Total
Net sales	$ 396,386	$ 402,296	$ 421,061	$ 562,756	$ 1,782,499
Gross profit	$ 111,172	$ 115,340	$ 123,818	$ 170,072	$ 520,402
Net income	$ 15,884	$ 12,911	$ 14,409	$ 33,474	$ 76,678
Net income per share (diluted)	$ 0.56	$ 0.46	$ 0.51	$ 1.14	$ 2.67

(in thousands, except per share data)	2004 First	Second	Third	Fourth	Total
Net sales	$ 349,703	$ 339,622	$ 354,909	$ 468,938	$ 1,513,172
Gross profit	$ 94,683	$ 94,213	$ 97,941	$ 138,436	$ 425,273
Net income	$ 11,780	$ 12,144	$ 12,411	$ 27,090	$ 63,425
Net income per share (diluted)	$ 0.44	$ 0.45	$ 0.45	$ 0.95	$ 2.29

Corporate Information

BOARD OF DIRECTORS

Marty Albertson
Chairman and Chief Executive Officer
Guitar Center, Inc.

Larry Livingston
Professor of Conducting
Flora L. Thorton School of Music at the University of Southern California

Bob Martin
Former President and Chief Executive Officer
Wal-Mart International

Pat MacMillan
Chief Executive Officer
Triaxia Partners

George Mrkonic
Former President/Vice Chairman
Borders Group, Inc.

Kenneth Reiss
Retired Partner, Ernst & Young

Walter Rossi
Director, Dick's Sporting Goods, Inc.

Peter Starrett
President, Peter Starrett Associates

Paul Tarvin
President and Chief Executive Officer
Cinmar, Inc.

EXECUTIVE OFFICERS & KEY PERSONNEL

GUITAR CENTER, INC.

Marty Albertson
Chairman and Chief Executive Officer

Bruce Ross
Executive Vice President and Chief Financial Officer

David Angress
Executive Vice President of International Development and Proprietary Brands

William Deeney
Executive Vice President and Chief Logistics Officer

Mark Galster
Executive Vice President of Stores

Erick Mason
Executive Vice President and Chief Administrative Officer

Joel Miller
Executive Vice President of Human Resources

Leland Smith
Executive Vice President of Corporate Development, General Counsel and Secretary

Jay Wanamaker
Executive Vice President and General Merchandise Manager

John Zavada
Executive Vice President and Chief Information Officer

Edward Chan
Senior Vice President of Information Systems

Dennis Haffeman
Senior Vice President of Operations

Andrew Heyneman
Senior Vice President of Strategic Development

Irene Messier
Senior Vice President of Planning and Allocation

David Robson
Senior Vice President and Principal Accounting Officer

Peter Schuelzky
Senior Vice President of Regional Sales, East

MUSICIAN'S FRIEND, INC.

Robert Eastman
Chief Executive Officer

Craig Johnson
Executive Vice President of Merchandising and Marketing

Jon White
Executive Vice President of Operations

Steve Zapf
Executive Vice President of Marketing

Sue Etling
Senior Vice President of Finance

Gene Joly
Senior Vice President of Merchandising

MUSIC & ARTS CENTER

Kenny O'Brien
Chief Executive Officer

Ron Beaudoin
Senior Vice President of Sales

Michael Boshart
Senior Vice President of Merchandising

Allan Greenberg
Senior Vice President of Operations

COUNSEL

Latham & Watkins LLP
Los Angeles, California

TRANSFER AGENT AND REGISTRAR

Mellon Investor Services
400 South Hope Street
Los Angeles, CA 90071
www.melloninvestor.com

INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

KPMG LLP
Los Angeles, California

SHAREHOLDER SERVICES

Inquiries from our Stockholders and potential investors of Guitar Center, Inc. are always welcome.

General financial information and inquiries should be directed to:

Guitar Center, Inc.
P.O. Box 5111
Thousand Oaks, CA 91359

Phone (818) 735-8800

Karen Lenehan
Stock Plan Administrator

ANNUAL MEETING

The Annual Meeting of the Stockholders will be held at 4:00p.m. on April 28, 2006 at The La Paloma Resort and Spa, 3800 East Sunrise Drive, Tucson, Arizona 85718
Phone (520) 742-6000

PRICE RANGE OF COMMON STOCK

The Company's common stock is traded on the NASDAQ under the symbol GTRC. The following Table sets forth, for the quarterly periods indicated, the high and the low sales prices of the common stock on the NASDAQ Composite Tape.

	2005		2004	
	High	Low	High	Low
First Quarter	$ 60.58	$ 50.84	$ 37.14	$ 30.49
Second Quarter	62.06	47.17	46.46	36.04
Third Quarter	65.00	53.88	45.91	40.02
Fourth Quarter	62.20	48.20	53.37	43.04

As of December 31, 2005, there were 500 stockholders of record, excluding the number of beneficial owners whose shares were held in street name. No dividends have been paid on the common stock and dividend payments are currently restricted by a covenant of the Company's debt agreement.

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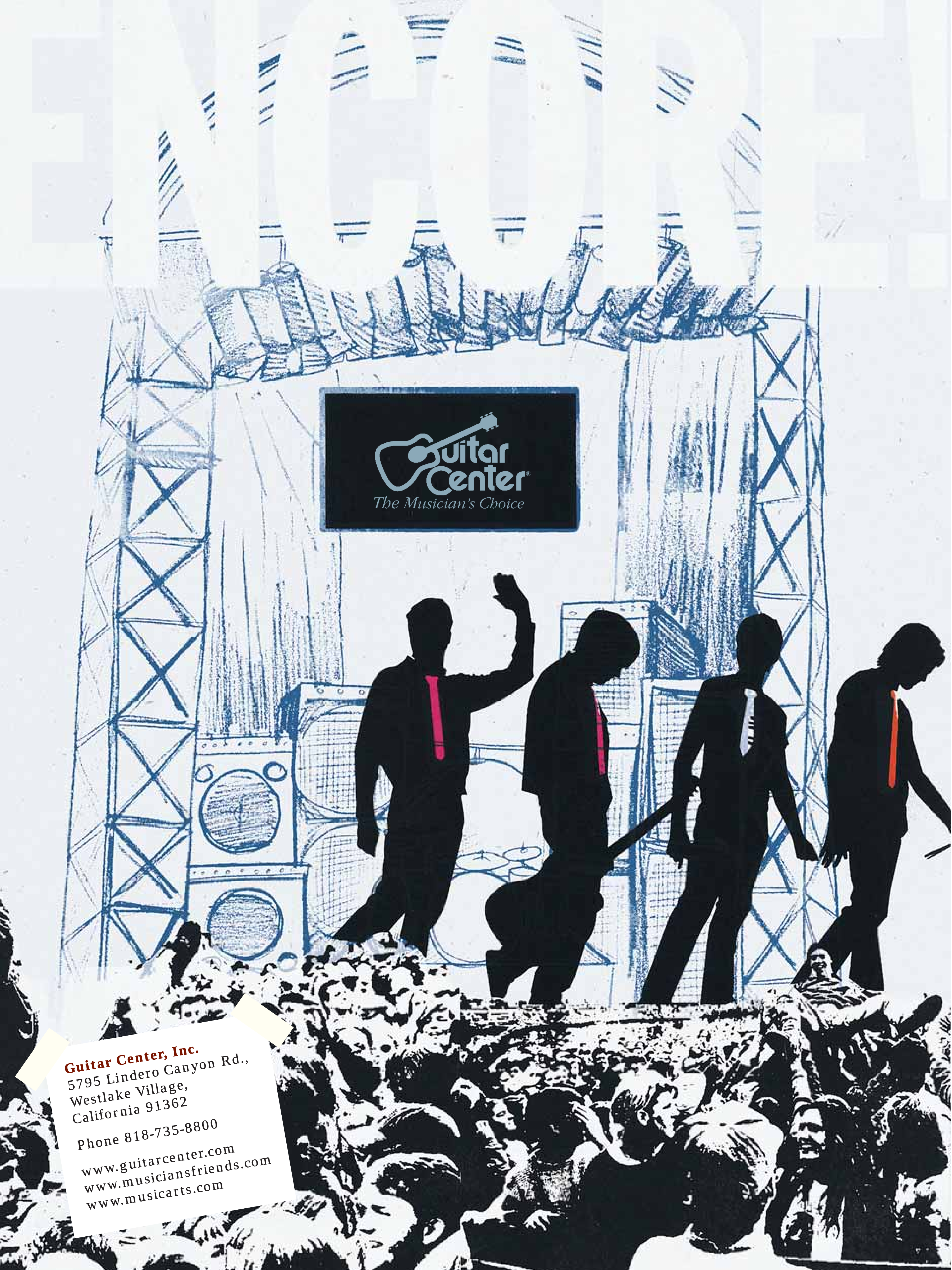
ENCORE!
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