UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

(Mark one)

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 1998.

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _________ to _________ .

Commission File Number 1-13796

Gray Communications Systems, Inc.
(Exact name of registrant as specified in its charter)

Georgia	58-0285030
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

126 N. Washington St., Albany, Georgia 31701
(Address of principal executive offices)
(Zip code)

(912) 888-9390
(Registrant's telephone number, including area code)

Not Applicable
(Former name, former address and former fiscal year, if changed since last report.)

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practical date.

Class A Common Stock, (No Par Value)	Class B Common Stock, (No Par Value)
6,847,042 shares as of November 13, 1998	5,131,778 shares as of November 13, 1998

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GRAY COMMUNICATIONS SYSTEMS, INC.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

GRAY COMMUNICATIONS SYSTEMS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)

	September 30, 1998	December 31, 1997
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 1,934,777	$ 2,367,300
Trade accounts receivable, less allowance for doubtful accounts of $1,802,000 and $1,253,000, respectively	20,026,127	19,527,316
Recoverable income taxes	2,914,128	2,132,284
Inventories	1,153,868	846,891
Current portion of program broadcast rights	4,304,231	2,850,023
Other current assets	1,139,467	968,180
Total current assets	31,472,598	28,691,994
PROPERTY AND EQUIPMENT:		
Land	2,196,021	889,696
Buildings and improvements	12,702,632	11,951,700
Equipment	63,376,848	52,899,547
	78,275,501	65,740,943
Allowance for depreciation	(25,676,551)	(23,635,256)
	52,598,950	42,105,687
OTHER ASSETS:		
Deferred loan costs	8,508,057	8,521,356
Goodwill and other intangibles	376,661,395	263,425,447
Other	1,955,762	2,306,143
	387,125,214	274,252,946
	$471,196,762	$345,050,627

GRAY COMMUNICATIONS SYSTEMS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited) (continued)

	September 30, 1998	December 31, 1997
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Trade accounts payable (includes $1,030,000 and $850,000 payable to Bull Run Corporation, respectively)	$ 2,876,617	$ 3,321,903
Employee compensation and benefits	5,391,076	3,239,694
Accrued expenses	3,094,259	2,265,725
Accrued interest	10,048,004	4,533,366
Current portion of program broadcast obligations	4,148,782	2,876,060
Deferred revenue	2,652,521	1,966,166
Current portion of long-term debt	581,530	400,000
Total current liabilities	28,792,789	18,602,914
LONG-TERM DEBT	262,555,097	226,676,377
OTHER LONG-TERM LIABILITIES:		
Program broadcast obligations, less current portion	886,150	617,107
Supplemental employee benefits	1,159,821	1,161,218
Deferred income taxes	41,276,522	1,203,847
Other acquisition related liabilities	4,955,254	4,494,016
	48,277,747	7,476,188
Commitments and contingencies		
STOCKHOLDERS' EQUITY:		
Serial Preferred Stock, no par value; authorized 20,000,000 shares respectively; issued and outstanding 1,850 and 2,060 shares ($18,500,000 and $20,600,000 aggregate liquidation value, respectively)	18,500,000	20,600,000
Class A Common Stock, no par value; authorized 15,000,000 shares; issued and outstanding 7,961,574 shares, respectively	10,568,660	10,358,031
Class B Common Stock, no par value; authorized 15,000,000 shares; issued and outstanding 5,273,046 shares, respectively	66,764,499	66,397,804
Retained earnings	45,957,669	6,603,191
	141,790,828	103,959,026
Treasury Stock at cost, Class A Common, 1,141,532 and 1,172,882 shares, respectively	(8,683,424)	(9,011,369)
Treasury Stock at cost, Class B Common, 144,902 and 250,185 shares, respectively	(1,536,275)	(2,652,509)
	131,571,129	92,295,148
	$471,196,762	$345,050,627

See notes to condensed consolidated financial statements.

GRAY COMMUNICATIONS SYSTEMS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	1998	1997	1998	1997
OPERATING REVENUES				
Broadcasting (net of agency commissions)	$ 22,346,463	$ 17,969,694	$ 64,547,517	$ 51,737,548
Publishing	7,378,818	6,278,540	21,295,267	17,585,142
Paging	2,119,635	1,736,158	6,044,508	4,921,143
	31,844,916	25,984,392	91,887,292	74,243,833
EXPENSES				
Broadcasting	13,447,709	10,869,586	38,227,117	30,168,978
Publishing	6,022,912	5,311,999	17,463,852	13,840,254
Paging	1,498,855	965,497	4,081,955	2,802,420
Corporate and administrative	810,902	716,736	2,127,831	2,091,055
Depreciation and amortization	5,044,603	3,849,777	12,887,910	10,610,021
	26,824,981	21,713,595	74,788,665	59,512,728
	5,019,935	4,270,797	17,098,627	14,731,105
Gain on exchange of television station	70,572,128	-0-	70,572,128	-0-
Miscellaneous income (expense), net	(35,300)	13,455	(349,576)	(26,378)
	75,556,763	4,284,252	87,321,179	14,704,727
Interest expense	6,624,799	5,728,331	18,591,538	15,785,529
INCOME (LOSS) BEFORE INCOME TAXES	68,931,964	(1,444,079)	68,729,641	(1,080,802)
Income tax expense (benefit)	27,102,280	(281,500)	27,545,657	(79,000)
NET INCOME (LOSS)	41,829,684	(1,162,579)	41,183,984	(1,001,802)
Preferred Dividends	345,682	350,690	1,063,678	1,050,690
NET INCOME (LOSS) AVAILABLE TO COMMON STOCKHOLDERS	$ 41,484,002	$ (1,513,269)	$ 40,120,306	$ (2,052,492)
AVERAGE OUTSTANDING COMMON SHARES:				
Basic	11,931,029	11,755,032	11,909,660	11,870,387
Stock compensation awards	595,362	-0-	521,346	-0-
Diluted	12,526,391	11,755,032	12,431,006	11,870,387
BASIC EARNINGS (LOSS) PER COMMON SHARE:				
Net income (loss) available to common stockholders	$ 3.48	$ (0.13)	$ 3.37	$ (0.17)
DILUTED EARNINGS (LOSS) PER COMMON SHARE:				
Net income (loss) available to common stockholders	$ 3.31	$ (0.13)	$ 3.23	$ (0.17)

See notes to condensed consolidated financial statements

GRAY COMMUNICATIONS SYSTEMS, INC.
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (unaudited)

	Preferred Stock		Class A Common Stock		Class B Common Stock	
	Shares	Amounts	Shares	Amounts	Shares	Amounts
Balance at December 31, 1997	2,060	$ 20,600,000	7,961,574	$ 10,358,031	5,273,046	$ 66,397,804
Net income for the nine months ended September 30, 1998						
Common stock dividends ($.06 per share)						
Preferred stock dividends						
Income tax expense relating to stock plans				210,629		173,482
Issuance of treasury stock:						
401 (k) plan						152,964
Non-qualified stock plan						40,249
Purchase of Class A Common Stock						
Issuance of Series B Preferred Stock	51	509,384				
Purchase of Series B Preferred Stock	(261)	(2,609,384)				
Balance at September 30, 1998	1,850	$ 18,500,000	7,961,574	$ 10,568,660	5,273,046	$ 66,764,499

	Retained Earnings	Class A Treasury Stock		Class B Treasury Stock		Total
		Shares	Amounts	Shares	Amounts	
Balance at December 31, 1997	$ 6,603,191	(1,172,882)	$ (9,011,369)	(250,185)	$ (2,652,509)	$ 92,295,148
Net income for the nine months ended September 30, 1998	41,183,984					41,183,984
Common stock dividends ($.06 per share)	(476,160)					(476,160)
Preferred stock dividends	(1,063,678)					(1,063,678)
Income tax expense relating to stock plans						384,111
Issuance of treasury stock:						
401 (k) plan				19,483	206,568	359,532
Non-qualified stock plan	(289,668)	47,100	639,008	85,800	909,666	1,299,255
Purchase of Class A Common Stock		(15,750)	(311,063)			(311,063)
Issuance of Series B Preferred Stock						509,384
Purchase of Series B Preferred Stock						(2,609,384)
Balance at September 30, 1998	$ 45,957,669	(1,141,532)	$ (8,683,424)	(144,902)	$ (1,536,275)	$131,571,129

See notes to condensed consolidated financial statements.

GRAY COMMUNICATIONS SYSTEMS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)

	Nine Months Ended September 30, 1998	Nine Months Ended September 30, 1997
OPERATING ACTIVITIES		
Net income (loss)	$ 41,183,984	$ (1,001,802)
Items which did not use (provide) cash:		
Depreciation	6,873,709	5,776,756
Amortization of intangible assets	6,014,201	4,833,265
Amortization of deferred loan costs	821,528	813,340
Amortization of program broadcast rights	3,011,826	2,510,305
Payments for program broadcast rights	(2,963,487)	(2,897,498)
Supplemental employee benefits	(220,994)	(146,910)
Common stock contributed to 401(k) Plan	359,532	316,145
Deferred income taxes	26,521,675	1,681,000
(Gain) on disposition of television station	(70,572,128)	-0-
Loss on disposal of assets	406,957	14,766
Changes in operating assets and liabilities:		
Receivables, inventories and other current assets	1,023,569	(1,728,005)
Accounts payable and other current liabilities	7,216,473	619,133
NET CASH PROVIDED BY OPERATING ACTIVITIES	19,676,845	10,790,495
INVESTING ACTIVITIES		
Acquisition of television businesses	(120,597,438)	(41,130,557)
Exchange of television station	76,508,009	-0-
Purchase of FCC License	(837,160)	-0-
Acquisition of satellite uplink business	-0-	(4,127,530)
Purchases of property and equipment	(7,316,945)	(7,600,897)
Deferred acquisition costs	-0-	(219,652)
Payments on purchase liabilities	(337,779)	(322,693)
Proceeds from asset sales	182,721	7,814
Other	(664,345)	(519,288)
NET CASH USED IN INVESTING ACTIVITIES	(53,062,937)	(53,912,803)
FINANCING ACTIVITIES		
Dividends paid	(1,076,164)	(1,070,608)
Common Stock transactions	384,111	1,101,798
Purchase of treasury stock-preferred	(2,609,384)	-0-
Purchase of treasury stock-common	(311,063)	(3,455,476)
Sale of treasury stock	1,299,255	523,917
Proceeds from borrowings of long-term debt	71,570,000	56,950,000
Payments on long-term debt	(35,502,750)	(9,706,204)
Loan acquisition costs	(800,436)	(510,008)
NET CASH PROVIDED BY FINANCING ACTIVITIES	32,953,569	43,833,419
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(432,523)	711,111
Cash and cash equivalents at beginning of period	2,367,300	1,051,044
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 1,934,777	$ 1,762,155

See notes to condensed consolidated financial statements.

NOTE A--BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements of Gray Communications Systems, Inc. (the "Company") have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the nine and three month periods ended September 30, 1998 are not necessarily indicative of the results that may be expected for the year ending December 31, 1998. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 1997.

Certain amounts in the accompanying unaudited condensed consolidated financial statements have been reclassified to conform to the 1998 format.

NOTE B--BUSINESS ACQUISITIONS AND DISPOSITION

Recent Transactions

On July 31, 1998, the Company completed the purchase of all of the outstanding capital stock of Busse Broadcasting Corporation ("Busse"). The net purchase price was $112 million plus associated transaction costs. The purchase price includes the assumption of Busse's indebtedness, including its 11 5/8% Senior Secured Notes due 2000. Immediately prior to the Company's acquisition of Busse, Cosmos Broadcasting Corporation acquired the assets of WEAU-TV ("WEAU") from Busse and exchanged them for the assets of WALB-TV, Inc. ("WALB"), the Company's NBC affiliate in Albany, Georgia. In exchange for the assets of WALB, the Company received the assets of WEAU, which were valued at $66 million, and approximately $12 million in cash for a total value of $78 million. The Company recognized a pre-tax gain of approximately $70.6 million and estimated deferred income taxes of approximately $27.5 million in connection with the exchange of WALB.

Immediately following the acquisition of Busse, the Company exercised its right to satisfy and discharge the Busse 11 5/8% Senior Secured Notes ("Busse Senior Notes"), effectively prefunding the Busse Senior Notes at the October 15, 1998 call price of 106 plus accrued interest. The amount necessary to satisfy and discharge the Busse Senior Notes was approximately $69.9 million. As a result of these transactions, the Company added the following television stations to its existing broadcast group: KOLN-TV("KOLN"), the CBS affiliate serving the Lincoln-Hastings-Kearney, Nebraska market; its satellite station KGIN-TV ("KGIN"), the CBS affiliate serving Grand Island, Nebraska; and WEAU, an NBC affiliate serving the Eau Claire-La Crosse, Wisconsin market. These transactions also satisfy the Federal Communication Commission's requirement for the Company to divest itself of WALB. The transactions described above are referred to herein as the "Busse-WALB Transactions."

The Company will pay Bull Run Corporation, a principal stockholder of the Company, a fee equal to 1% of the transaction values for services performed, of which $1,030,000 was included in accounts payable at September 30, 1998.

Pro forma financial data (unaudited)

On April 24, 1997, the Company purchased GulfLink Communications, Inc. and on August 1, 1997, the Company purchased the assets of WITN-TV("WITN")(collectively referred to as the "1997 Acquisitions"). Unaudited pro forma operating data for the three months and nine months ended September 30, 1998 and 1997 is presented below and assumes that the Busse-WALB Transactions and the 1997 Acquisitions were completed on January 1, 1997. The above described unaudited pro forma operating data excludes a pre-tax gain of approximately $70.6 million and estimated deferred income taxes of approximately $27.5 million in connection with the exchange of WALB.

This unaudited pro forma operating data does not purport to represent the Company's actual results of

NOTE B--BUSINESS ACQUISITIONS AND DISPOSITION (continued)

operations had the Busse-WALB Transactions and the 1997 Acquisitions been completed on January 1, 1997, and should not serve as a forecast of the Company's operating results for any future periods. The pro forma adjustments are based solely upon certain assumptions that management believes are reasonable under the circumstances at this time. Unaudited pro forma operating data for the three months and nine months ended September 30, 1998 and 1997, is as follows:

	Three Months Ended September 30,		Nine months Ended September 30,	
	1998	1997	1998	1997
	(dollars in thousands)			
Revenues, net	$ 32,059	$ 28,364	$ 96,659	$ 86,263
Expenses	35,841	31,490	103,430	92,836
Loss before income taxes	$ (3,782)	$ (3,126)	$ (6,771)	$ (6,573)
Net loss available to common stockholders	$ (2,842)	$ (2,413)	$ (5,533)	$ (5,388)
Basic and diluted loss per share available to common stockholders	$ (0.24)	$ (0.21)	$ (0.46)	$ (0.45)

The pro forma results presented above include adjustments to reflect (i) the incurrence of interest expense to fund the respective acquisitions, (ii) depreciation and amortization of assets acquired, (iii) the elimination of the corporate expense allocation net of additional accounting and administrative expenses and (iv) the income tax effect of such pro forma adjustments.

NOTE C--LONG-TERM DEBT

In September 1996, the Company entered into the $125.0 million senior credit facility (the "Senior Credit Facility") with a consortium of banks. The Senior Credit Facility included scheduled reductions in the $125.0 million credit limit which commenced on March 31, 1997, interest rates based upon a spread over LIBOR and/or Prime, an unused commitment fee of 0.50% applied to available funds and a maturity date of June 30, 2003. Effective September 17, 1997, the Senior Credit Facility was modified to reinstate the original credit limit of $125.0 million which had been reduced by the scheduled reductions. The modification also reduced the interest rate spread over LIBOR and/or Prime. The modification also extended the maturity date from June 30, 2003 to June 30, 2004. The modification required a one-time fee of $250,000.

Effective July 31, 1998, the Senior Credit Facility was modified to increase the committed credit limit of $125.0 million to $200.0 million. This modification also allows for an additional uncommitted $100.0 million in available credit which is in addition to the committed $200.0 million credit limit. This $100.0 million in uncommitted available credit can be borrowed by the Company only after unanimous approval of the bank consortium. The modification also extended the maturity date from June 30, 2004 to June 30, 2005. The modification required a one-time fee of approximately $750,000.

Immediately following the acquisition of Busse, the Company exercised its right to satisfy and discharge the Busse 11 5/8% Senior Secured Notes, effectively prefunding the notes at the October 15, 1998 call price of 106 plus accrued interest. The amount necessary to satisfy and discharge the notes was approximately $69.9 million.

At September 30, 1998, the Company had approximately $102.0 million borrowed under the Senior Credit Facility with approximately $98.0 million available under the agreement. The interest rate on the balance outstanding was based on a spread over LIBOR and Prime of 2.00% and 0.25%, respectively.

NOTE D - STOCKHOLDER'S EQUITY

On August 20, 1998, the Board of Directors declared a 50% stock dividend, payable on September 30, 1998, to stockholders of record of the Class A Common Stock and Class B Common Stock on September 16, 1998. This stock dividend effected a three for two stock split. All applicable share and per share data have been adjusted to give effect to the stock split.

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

Results of Operations of Gray Communications Systems, Inc.

Introduction

The following analysis of the financial condition and results of operations of Gray Communications Systems, Inc. (the "Company") should be read in conjunction with the Company's unaudited Condensed Consolidated Financial Statements and notes thereto included elsewhere herein.

The Company derives its revenues from its television broadcasting, publishing and paging operations. On July 31, 1998, the Company completed the purchase of all of the outstanding capital stock of Busse Broadcasting Corporation ("Busse"). The net purchase price was $112 million plus associated transaction costs. The purchase price includes the assumption of Busse's indebtedness, including its 11 5/8% Senior Secured Notes due 2000. Immediately prior to the Company's acquisition of Busse, Cosmos Broadcasting Corporation acquired the assets of WEAU-TV ("WEAU") from Busse and exchanged them for the assets of WALB-TV, Inc. ("WALB"), the Company's NBC affiliate in Albany, Georgia. In exchange for the assets of WALB, the Company received the assets of WEAU, which were valued at $66 million, and approximately $12 million in cash for a total value of $78 million. The Company recognized a pre-tax gain of approximately $70.6 million and estimated deferred income taxes of approximately $27.5 million in connection with the exchange of WALB. Immediately following the acquisition of Busse, the Company exercised its right to satisfy and discharge the Busse 11 5/8% Senior Secured Notes ("Busse Senior Notes"), effectively prefunding the Busse Senior Notes at the October 15, 1998 call price of 106 plus accrued interest. The amount necessary to satisfy and discharge the Busse Senior Notes was approximately $69.9 million. The transactions described above are referred to herein as the "Busse-WALB Transactions."

On August 1, 1997 the Company purchased substantially all of the assets of WITN-TV ("WITN"), the NBC affiliate serving the Greenville-Washington-New Bern, North Carolina market (the "WITN Acquisition"). On April 24, 1997, the Company purchased GulfLink Communications, Inc. (the "GulfLink Acquisition"), which is in the transportable satellite uplink business, a business in which the Company was already engaged. As a result of the higher operating margins associated with the Company's television broadcasting operations, the profit contribution of these operations as a percentage of revenues, has exceeded, and is expected to continue to exceed, the profit contributions of the Company's publishing and paging operations. Set forth below, for the periods indicated, is certain information concerning the relative contributions of the Company's television broadcasting, publishing and paging operations.

	Three Months Ended September 30,			
	1998		1997	
	Amount	Percent of Total	Amount	Percent of Total
	(dollars in thousands)			
Television Broadcasting				
Revenues	$22,346	70.2%	$17,970	69.2%
Operating income (1)(2)	4,833	82.7	4,149	83.1
Publishing				
Revenues	$ 7,379	23.2%	$ 6,278	24.2%
Operating income (1)	847	14.5	460	9.2
Paging				
Revenues	$ 2,120	6.6%	$ 1,736	6.6%
Operating income (1)	164	2.8	385	7.7

Results of Operations of Gray Communications Systems, Inc. (continued)

Introduction (continued)

	Nine months Ended September 30,			
	1998		1997	
	Amount	Percent of Total	Amount	Percent of Total
	(dollars in thousands)			
Television Broadcasting				
Revenues	$64,548	70.2%	$51,738	69.7%
Operating income (1) (2)	15,971	82.8	13,430	79.7
Publishing				
Revenues	$21,295	23.2%	$17,585	23.7%
Operating income (1)	2,647	13.7	2,382	14.1
Paging				
Revenues	$ 6,044	6.6%	$ 4,921	6.6%
Operating income (1)	663	3.5	1,042	6.2

(1)Represents income before miscellaneous income (expense), allocation of corporate overhead, interest expense and income taxes.

(2)For the three month and nine month periods ended September 30, 1998, operating income does not include the pre-tax gain on exchange of WALB of approximately $70.6 million.

The operating revenues of the Company's television stations are derived primarily from broadcast advertising revenues and, to a much lesser extent, from compensation paid by the networks to the stations for broadcasting network programming. The operating revenues of the Company's publishing operations are derived from retail advertising, circulation and classified revenue. Paging revenue is derived primarily from the leasing and sale of pagers.

In the Company's broadcasting operations, broadcast advertising is sold for placement either preceding or following a television station's network programming and within local and syndicated programming. Broadcast advertising is sold in time increments and is priced primarily on the basis of a program's popularity among the specific audience an advertiser desires to reach, as measured by Nielsen Media Research ("Nielsen"). In addition, broadcast advertising rates are affected by the number of advertisers competing for the available time, the size and demographic makeup of the market served by the station and the availability of alternative advertising media in the market area. Broadcast advertising rates are the highest during the most desirable viewing hours, with corresponding reductions during other hours. The ratings of a local station affiliated with a major network can be affected by ratings of network programming.

Most broadcast advertising contracts are short-term, and generally run only for a few weeks. Approximately 50.9% of the gross revenues of the Company's television stations for the nine months ended September 30, 1998 were generated from local advertising, which is sold primarily by a station's sales staff directly to local accounts, and the remainder represented primarily national advertising, which is sold by a station's national advertising sales representative. The stations generally pay commissions to advertising agencies on local, regional and national advertising. The stations also pay commissions to the national sales representative on national advertising.

Broadcast advertising revenues are generally highest in the second and fourth quarters each year, due in part to increases in consumer advertising in the spring and retail advertising in the period leading up to and including the holiday season. In addition, broadcast advertising revenues are generally higher during even numbered election years due to spending by political candidates and other political advocacy groups, which spending typically is heaviest during the fourth quarter.

Introduction (continued)

The Company's publishing operations' advertising contracts are generally entered into annually and provide for a commitment as to the volume of advertising to be purchased by an advertiser during the year. The publishing operations' advertising revenues are primarily generated from local advertising. As with the broadcasting operations, the publishing operations' revenues are generally highest in the second and fourth quarters of each year.

The Company's paging subscribers either own pagers, thereby paying solely for the use of the Company's paging services, or lease pagers, thereby paying a periodic charge for both the pagers and the paging services. Of the Company's pagers currently in service, approximately 75% are owned and maintained by subscribers with the remainder being leased. The terms of the lease contracts are month-to-month, three months, nine months or twelve months in duration. Paging revenues are generally equally distributed throughout the year.

The broadcasting operations' primary operating expenses are employee compensation, related benefits and programming costs. The publishing operations' primary operating expenses are employee compensation, related benefits and newsprint costs. The paging operations' primary operating expenses are employee compensation and telephone and other communications costs. In addition, the broadcasting, publishing and paging operations incur overhead expenses, such as maintenance, supplies, insurance, rent and utilities. A large portion of the operating expenses of the broadcasting, publishing and paging operations is fixed, although the Company has experienced significant variability in its newsprint costs in recent years.

Media Cash Flow

The following table sets forth certain operating data for the broadcast, publishing and paging operations for the three months and nine months ended September 30, 1998 and 1997:

	Three Months Ended September 30,		Nine months Ended September 30,	
	1998	1997	1998	1997
	(in thousands)			
Operating income (1)	$ 5,020	$ 4,271	$ 17,099	$ 14,731
Add:				
Amortization of program license rights	1,113	891	3,012	2,510
Depreciation and amortization	5,045	3,850	12,888	10,610
Corporate overhead	811	717	2,128	2,091
Non-cash compensation and contributions to the Company's 401(k) plan, paid in common stock	112	94	344	304
Less:				
Payments for program license liabilities	(1,009)	(1,067)	(2,963)	(2,897)
Media Cash Flow (2)	$ 11,092	$ 8,756	$ 32,508	$ 27,349

(1) For the three month and nine month periods ended September 30, 1998, operating income does not include the pre-tax gain on exchange of WALB of approximately $70.6 million.

Results of Operations of Gray Communications Systems, Inc. (continued)

Media Cash Flow (continued)

(2) Of Media Cash Flow for the three months ended September 30, 1998 and 1997, $9.1 million and $7.0 million, respectively, was attributable to the Company's broadcasting operations; $1.4 million and $1.0 million, respectively, was attributable to the Company's publishing operations; and $629,000 and $778,000, respectively, was attributable to the Company's paging operations. Of Media Cash Flow for the nine months ended September 30, 1998 and 1997, $26.6 million and $21.4 million, respectively, was attributable to the Company's broadcasting operations; $3.9 million and $3.8 million, respectively, was attributable to the Company's publishing operations; and $2.0 million and $2.1 million, respectively was attributable to the Company's paging operations.

"Media Cash Flow" is defined as operating income, plus depreciation and amortization (including amortization of program license rights), non-cash compensation and corporate overhead, less payments for program license liabilities. The Company has included Media Cash Flow data because such data are commonly used as a measure of performance for media companies and are also used by investors to measure a company's ability to service debt. Media Cash Flow is not, and should not be used as, an indicator or alternative to operating income, net income or cash flow as reflected in the Company's unaudited Condensed Consolidated Financial Statements, and is not a measure of financial performance under generally accepted accounting principles and should not be considered in isolation or as a substitute for measures of performance prepared in accordance with generally accepted accounting principles.

Cash flow provided by (used in) operating, investing and financing activities

The following table sets forth certain cash flow data for the Company for the nine months ended September 30, 1998 and 1997.

	Nine months Ended September 30, 1998	Nine months Ended September 30, 1997
	(in thousands)	
Cash flows provided by (used in)		
Operating activities	$ 19,677	$ 10,790
Investing activities	(53,063)	(53,913)
Financing activities	32,954	43,833

Broadcasting, Publishing and Paging Revenues

As discussed in the Introduction, the Company exchanged the assets of WALB for the assets of WEAU, acquired Busse which included KOLN-TV("KOLN") and KGIN-TV ("KGIN") during 1998 and completed the WITN Acquisition and the GulfLink Acquisition during 1997. WEAU, KOLN and KGIN are collectively referred to as the "Busse Stations." The financial results of the Company reflect increases between the three month and nine month periods ended September 30, 1998 and 1997 in substantially all broadcast line items.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Results of Operations of Gray Communications Systems, Inc. (continued)

Broadcasting, Publishing and Paging Revenues (continued)

Set forth below are the principal types of operating revenues earned by the Company's broadcasting, publishing and paging operations for the periods indicated and the percentage contribution of each to the Company's total revenues:

	Three Months Ended September 30,			
	1998		1997	
	Amount	Percent of Total	Amount	Percent of Total
	(dollars in thousands)			
Broadcasting				
Net revenues:				
Local	$ 11,285	35.5%	$ 10,165	39.1%
National	5,911	18.6	5,156	19.8
Network compensation	1,208	3.8	1,362	5.2
Political	2,243	7.0	(109)	(0.4)
Production and other	1,699	5.3	1,396	5.4
	$ 22,346	70.2%	17,970	69.1%
Publishing				
Net revenues:				
Retail advertising	$ 3,448	10.8%	$ 2,885	11.1%
Classified	2,410	7.6	1,967	7.6
Circulation	1,343	4.2	1,306	5.0
Other	178	0.6	121	0.5
	$ 7,379	23.2%	$ 6,279	24.2%
Paging				
Net revenues:				
Paging lease and service	$ 2,120	6.6%	$ 1,735	6.7%
	$ 31,845	100.0%	$ 25,984	100.0%

Results of Operations of Gray Communications Systems, Inc. (continued)

Broadcasting, Publishing and Paging Revenues (continued)

	Nine months Ended September 30,			
	1998		1997	
	Amount	Percent of Total	Amount	Percent of Total
	(dollars in thousands)			
Broadcasting Net revenues:				
Local	$33,350	36.3%	$29,081	39.2%
National	18,011	19.6	15,387	20.7
Network compensation	3,781	4.1	3,643	4.9
Political	4,429	4.8	44	0.1
Production and other	4,977	5.4	3,583	4.8
	$64,548	70.2%	$51,738	69.7%
Publishing Net revenues:				
Retail advertising	$ 9,872	10.8%	$ 8,269	11.1%
Classified	6,908	7.5	5,434	7.3
Circulation	3,962	4.3	3,523	4.7
Other	553	0.6	359	0.6
	$21,295	23.2%	$17,585	23.7%
Paging Net revenues:				
Paging lease and service	$ 6,044	6.6%	$ 4,921	6.6%
	$91,887	100.0%	$74,244	100.0%

Three Months Ended September 30, 1998 compared to Three Months Ended September 30, 1997

Revenues. Total revenues for the three months ended September 30, 1998 increased $5.8 million, or 22.3%, over the same period of the prior year, from $26.0 million to $31.8 million. This increase was primarily attributable to the net effect of (i) increased revenues resulting from the Acquisition of the Busse Stations, (ii) increased political revenue, (iii) increased publishing revenues and (iv) increased paging revenues. The acquisition of the Busse Stations and the WITN Acquisition accounted for $3.4 million and $872,000 of the broadcast net revenue increase, respectively. This increase in total revenues was partially offset by the disposition of WALB which reduced total revenues by approximately $1.4 million.

Broadcast net revenues increased $4.4 million, or 24.4%, over the same period of the prior year, to $22.3 million from $18.0 million. The acquisition of the Busse Stations and the WITN Acquisition accounted for $3.4 million and $872,000 of the broadcast net revenue increase, respectively. On a pro forma basis, assuming the Busse-WALB Transactions had been effective on January 1, 1997, broadcast net revenues for the Busse Stations for the three months ended September 30 1998, increased $399,000, or 9.1%, over the same period of the prior year, to $4.8 million from $4.4 million. On a pro forma basis, assuming the WITN Acquisition had been effective on January 1, 1997, broadcast net revenues for WITN for the three months ended September 30, 1998 increased $342,000, or 18.9%, over the same period of the prior year, to $2.1 million from $1.8 million. Broadcast net revenues, excluding the acquisition of the Busse Stations, the WITN Acquisition and the GulfLink Acquisition and excluding the operating results of WALB, increased $1.3 million, or 9.4%, over the same period of the prior year, to $15.0 million from $13.7 million. This increase was due primarily to an increase in political advertising revenue of $1.5 million

Three Months Ended September 30, 1998 compared to Three Months Ended September 30, 1997 (continued)

partially offset by a decrease in local advertising. The disposition of WALB resulted in a decrease in net broadcast revenue of approximately $1.4 million.

Publishing revenues increased $1.1 million, or 17.5%, over the same period of the prior year, to $7.4 million from $6.3 million. The increase in revenues was due primarily to an increase in retail advertising, classified advertising, circulation and other revenue of $563,000, $442,000 $38,000 and $57,000, respectively. The increase in retail advertising and classified advertising revenue was due primarily to linage increases.

Paging revenue increased $383,000 or 22.0%, over the same period of the prior year, to $2.1 million from $1.7 million. The increase was attributable primarily to an increase in the number of pagers in service. The Company had approximately 86,000 pagers and 61,000 pagers in service at September 30, 1998 and 1997, respectively.

Operating expenses. Operating expenses for the three months ended September 30, 1998 increased $5.1 million, or 23.5%, over the same period of the prior year, to $26.8 million from $21.7 million, due primarily to the acquisition of the Busse Stations, the WITN Acquisition, increased expenses at the Company's existing television stations (exclusive of the Busse Stations and WALB) and the expense associated with the increase in circulation at the Gwinnett Daily Post. The acquisition of the Busse Stations, the WITN Acquisition, increased expenses at existing television stations and the cost associated with the increase in circulation at the Gwinnett Daily Post accounted for $1.5 million, $595,000, $1.0 million and $613,000 (exclusive of depreciation and amortization), respectively, of the operating expense increase. The increase in operating expenses was partially offset by the disposition of WALB which reduced operating expenses by approximately $598,000.

Broadcast expenses increased $2.6 million, or 23.7%, over the three months ended September 30, 1998, to $13.4 million from $10.9 million. The Acquisition of the Busse Stations and the WITN Acquisition accounted for $1.5 million and $595,000 of the broadcast expenses increase, respectively. On a pro forma basis, assuming the Busse-WALB Transactions had been effective on January 1, 1997, broadcast expenses for the Busse Stations for the three months ended September 30 1998, increased $220,000, or 10.2%, over the same period of the prior year, to $2.4 million from $2.2 million. On a pro forma basis, assuming the WITN Acquisition had been effective on January 1, 1997, broadcast expenses for WITN for the three months ended September 30, 1998 increased $326,000, or 33.6%, over the same period of the prior year, to $1.3 million from $1.0 million. Broadcast expenses, excluding the acquisition of the Busse Stations, the WITN Acquisition and the GulfLink Acquisition and excluding the operating results of WALB, increased $1.0 million, or 11.9%, over the same period of the prior year, to $9.6 million from $8.6 million. This increase was due primarily to an increase in payroll expense and other expense of $581,000 and $369,000, respectively. The increase in broadcast expenses was partially offset by the disposition of WALB which reduced broadcast expenses by approximately $598,000.

Publishing expenses for the three months ended September 30, 1998 increased $711,000, or 13.4%, from the same period of the prior year, to $6.0 million from $5.3 million. This increase resulted primarily from an increase in the expense associated with the increase in circulation at the Gwinnett Daily Post to 67,000 at September, 30 1998 from 50,000 at September 30, 1997 and higher newsprint pricing. Average newsprint costs increased approximately 6.4% while newsprint consumption increased approximately 6.9%.

Paging expenses increased $534,000 or 55.3%, over the same period of the prior year, to $1.5 million from $965,000. The increase was attributable primarily to an increase in payroll and other costs associated with an increase in the number of pagers in service.

Corporate and administrative expenses increased $94,000 or 13.1%, over the same period of the prior year, to $811,000 from $717,000.

Three Months Ended September 30, 1998 compared to Three Months Ended September 30, 1997 (continued)

Depreciation of property and equipment and amortization of intangible assets was $5.0 million for the three months ended September 30, 1998, as compared to $3.8 million for the same period of the prior year, an increase of $1.2 million, or 31.1%. This increase was primarily the result of higher depreciation and amortization costs resulting from the WITN Acquisition and the acquisition of the Busse Stations.

Gain on exchange of television station. The Company recognized a pre-tax gain of approximately $70.6 million and estimated deferred income taxes of approximately $27.5 million in connection with the exchange of WALB.

Interest expense. Interest expense increased $897,000, or 15.7%, to $6.6 million for the three months ended September 30, 1998 from $5.7 million for the three months ended September 30, 1997. This increase was attributable primarily to increased levels of debt resulting from the financing of the acquisition of the Busse Stations and WITN.

Income tax expense (benefit). Income tax expense for the three months ended September 30, 1998 primarily reflects the provision of approximately $27.5 million of deferred income taxes recognized in conjunction with the exchange of WALB.

Net income (loss) available to common stockholders. Net income available to common stockholders of the Company was $41.5 million for the three months ended September 30, 1998, as compared with a net loss to common stockholders of $1.5 million for the same period of the prior year, reflecting the $43.1 million gain net of related tax provisions on the exchange of WALB.

Nine months Ended September 30, 1998 compared to Nine months Ended September 30, 1997

Revenues. Total revenues for the nine months ended September 30, 1998 increased $17.6 million, or 24.4%, over the same period of the prior year, to $91.9 million from $74.2 million. This increase was primarily attributable to the net effect of (i) increased revenues resulting from the acquisition of the Busse Stations, the WITN Acquisition and the GulfLink Acquisition, (ii) increased publishing revenues (iii) increased political broadcast revenue and (iv) increased paging revenues. The acquisition of the Busse Stations, the WITN Acquisition and the GulfLink Acquisition accounted for $3.4 million, $5.0 million and $1.2 million of the revenue increase, respectively. The increase in total revenues was partially offset by the disposition of WALB which reduced total revenues by approximately $671,000.

Broadcast net revenues increased $12.8 million, or 24.7%, over the same period of the prior year, to $64.5 million from $51.7 million. The acquisition of the Busse Stations, the WITN Acquisition and the GulfLink Acquisition accounted for $3.4 million, $5.0 million and $1.2 million of the broadcast net revenue increase, respectively. On a pro forma basis, assuming the Busse-WALB Transactions had been effective on January 1, 1997, broadcast net revenues for the Busse Stations for the nine months ended September 30 1998, increased $1.1 million, or 7.7%, over the same period of the prior year, to $15.0 million from $13.9 million. On a pro forma basis, assuming the WITN Acquisition had been effective on January 1, 1997, broadcast net revenues for WITN for the nine months ended September 30, 1998 increased $466,000, or 8.0%, over the same period of the prior year, to $6.3 million from $5.8 million.. Broadcast net revenues, excluding the acquisition of the Busse Stations, the WITN Acquisition and the GulfLink Acquisition and excluding the operating results of WALB, increased $3.8 million, or 9.1%, over the same period of the prior year, to $46.0 million from $42.2 million. This increase was due primarily to an increase in political and national advertising revenue of $3.1 million and $944,000, respectively. The disposition of WALB resulted in a decrease in net broadcast revenue of approximately $671,000.

Publishing revenues increased $3.7 million, or 21.1%, over the same period of the prior year, to $21.3 million from $17.6 million. The increase in revenues was due primarily to an increase in retail advertising, classified advertising and circulation revenue of $1.6 million, $1.5 million, and $439,000, respectively. The increase in retail and classified advertising revenue was due primarily to linage increases.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Nine months Ended September 30, 1998 compared to Nine months Ended September 30, 1997 (continued)

Paging revenue increased $1.1 million or 22.8%, over the same period of the prior year, to $6.0 million from $4.9 million. The increase was attributable primarily to an increase in the number of pagers in service. The Company had approximately 86,000 and 61,000 pagers in service at September 30, 1998 and 1997, respectively.

Operating expenses. Operating expenses for the nine months ended September 30, 1998 increased $15.3 million, or 25.7%, over the same period of the prior year, to $74.8 million from $59.5 million, due primarily to the acquisition of the Busse Stations, WITN Acquisition, the GulfLink Acquisition, and the expense associated with the increase in circulation at the Gwinnett Daily Post. The acquisition of the Busse Stations, WITN Acquisition, the GulfLink Acquisition and the cost associated with the increase in circulation at the Gwinnett Daily Post accounted for $1.5 million, $3.1 million, $856,000 and $2.6 million (exclusive of depreciation and amortization), respectively, of the operating expense increase. The increase in operating expenses was partially offset by the disposition of WALB which reduced operating expenses by approximately $321,000.

Broadcast expenses increased $8.1 million, or 26.7%, over the nine months ended September 30, 1998, to $38.2 million from $30.2 million. The acquisition of the Busse Stations, the WITN Acquisition and the GulfLink Acquisition accounted for $1.5 million, $3.1 million and $856,000 of the broadcast expenses increase, respectively. On a pro forma basis, assuming the Busse-WALB Transactions had been effective on January 1, 1997, broadcast expenses for the Busse Stations for the nine months ended September 30 1998, increased $382,000, or 5.9%, over the same period of the prior year, to $6.8 million from $6.5 million. On a pro forma basis, assuming the WITN Acquisition had been effective on January 1, 1997, broadcast expenses for WITN for the nine months ended September 30, 1998 increased $372,000, or 10.9%, over the same period of the prior year, to $3.8 million from $3.4 million. Broadcast expenses, excluding the acquisition of the Busse Stations, the WITN Acquisition and the GulfLink Acquisition and excluding the operating results of WALB, increased $2.9 million, or 11.4%, over the same period of the prior year, to $28.4 million from $25.5 million. This increase was due primarily to an increase in payroll expense and other expense of $1.7 million and $1.1 million, respectively. The increase in broadcast expenses was partially offset by the disposition of WALB which reduced broadcast expenses by approximately $321,000.

Publishing expenses for the nine months ended September 30, 1998 increased $3.6 million, or 26.2%, from the same period of the prior year, to $17.5 million from $13.8 million. This increase resulted primarily from an increase in the expense associated with the increase in circulation at the Gwinnett Daily Post to 67,000 at September 30, 1998 from 50,000 at September 30, 1997 and higher newsprint pricing. Average newsprint costs increased approximately 8.7% while newsprint consumption increased approximately 21.0%.

Paging expenses increased $1.3 million or 45.7%, over the same period of the prior year, to $4.1 million from $2.8 million. The increase was attributable primarily to an increase in payroll and other costs associated with an increase in the number of pagers in service.

Corporate and administrative expenses for the nine months ended September 30, 1998 increased $37,000, or 1.8%, over the same period of the prior year, to $2,128,000 from $2,091,000.

Depreciation of property and equipment and amortization of intangible assets for the nine months ended September 30, 1998, increased $2.3 million, or 21.5%, over the same period of the prior year, to $12.9 million from $10.6 million. This increase was primarily the result of higher depreciation and amortization costs related to the acquisition of the Busse Stations, WITN Acquisition and the GulfLink Acquisition.

Gain on exchange television station. The Company recognized a pre-tax gain of approximately $70.6 million and estimated deferred income taxes of approximately $27.5 million in connection with the exchange of WALB.

Interest expense. Interest expense increased $2.8 million, or 17.8%, to $18.6 million for the nine months ended September 30, 1997 from $15.8 million for the nine months ended September 30, 1998. This increase was

Nine months Ended September 30, 1998 compared to Nine months Ended September 30, 1997 (continued)

attributable primarily to increased levels of debt resulting from the financing of the acquisition of the Busse Stations, the WITN Acquisitions and the GulfLink Acquisition.

Net income (loss) Available to Common Stockholders. Net income available to common stockholders of the Company was $40.1 million for the nine months ended September 30, 1998, as compared with a net loss available to common stockholders of $2.1 million for the same period of the prior year, reflecting the $43.1 million gain net of related tax provisions on the exchange of WALB.

Liquidity and Capital Resources

On August 20, 1998, the Board of Directors declared a 50% stock dividend, payable on September 30, 1998, to stockholders of record of the Class A Common Stock and Class B Common Stock on September 16, 1998. This stock dividend effected a three for two stock split. All applicable share and per share data have been adjusted to give effect to the stock split.

In September 1996, the Company entered into the $125.0 million senior credit facility (the "Senior Credit Facility") with a consortium of banks. The Senior Credit Facility included scheduled reductions in the $125.0 million credit limit which commenced on March 31, 1997, interest rates based upon a spread over LIBOR and/or Prime, an unused commitment fee of 0.50% applied to available funds and a maturity date of June 30, 2003. Effective September 17, 1997, the Senior Credit Facility was modified to reinstate the original credit limit of $125.0 million which had been reduced by the scheduled reductions. The modification also reduced the interest rate spread over LIBOR and/or Prime. The modification also extended the maturity date from June 30, 2003 to June 30, 2004. The modification required a one-time fee of $250,000.

Effective July 31, 1998, the Senior Credit Facility was modified to increase the committed credit limit of $125.0 million to $200.0 million. This modification also allows for an additional uncommitted $100.0 million in available credit which is in addition to the committed $200.0 million credit limit. This $100.0 million in uncommitted available credit can be borrowed by the Company only after unanimous approval of the bank consortium. The modification also extended the maturity date from June 30, 2004 to June 30, 2005. The modification required a one-time fee of approximately $750,000.

As discussed in the Introduction, on July 31, 1998, the Company completed the Busse-WALB Transactions. These transactions resulted in a net increase in long term debt of approximately $43.4 million. At September 30, 1998, the Company had approximately $102.0 million borrowed under the Senior Credit Facility with approximately $98.0 million available under the agreement. The interest rate on the balance outstanding was based on a spread over LIBOR and Prime of 2.00% and 0.25%, respectively.

The Company's working capital was $2.7 million and $10.1 million at September 30, 1998 and December 31, 1997, respectively. The Company's cash provided from operations was $19.7 million and $10.8 million for the nine months ended September 30, 1998 and 1997, respectively. Management believes that current cash balances, cash flows from operations and the available funds under its Senior Credit Facility will be adequate to provide for the Company's capital expenditures, debt service, cash dividends and working capital requirements for the forseeable future. The Senior Credit Facility contains certain restrictive provisions, which, among other things, limit additional indebtedness and require minimum levels of cash flows. Additionally, the effective interest rate of the Senior Credit Facility can be changed based upon the Company's maintenance of certain operating ratios as defined in the Senior Credit Facility, not to exceed the lender's prime rate plus 0.5% or LIBOR plus 2.25%. The Senior Credit Facility contains restrictive provisions similar to the provisions of the Company's 10 5/8% Senior Subordinated Notes due 2006.

The Company's cash used in investing activities was $53.1 million and $53.9 million for the nine months ended September 30, 1998 and 1997, respectively. Net cash used in investing activities for the nine months ended

Liquidity and Capital Resources (continued)

September 30, 1998 was primarily due to the net effect of the Busse-WALB Transactions which were completed on July 31, 1998 and capital expenditures. For the nine months ended September 30, 1998 net cash used in the Busse-WALB Transactions and capital expenditures was $44.1 million and $7.3 million, respectively.

It is anticipated that significant capital expenditures may be required in the future to implement advanced television ("ATV"), at the Company's television stations. The Federal Communication Commission ("FCC") has determined the technical standards, the channel assignments and a time table for implementation of ATV.

Generally, under the FCC's implementation schedule, the Company must apply for ATV construction permits for each of its present television stations by November 1, 1999 and then commence ATV operations by May 1, 2002. Under the current FCC implementation schedule the Company would generally be required to surrender to the government either the current channel or the ATV channel by December 31, 2006 and continue its digital operations thereafter on the retained channel. Recent legislation requires the FCC to extend the December 31, 2006 surrender date with respect to certain stations within a given television market if (i) at least one network affiliate is not broadcasting a digital service in the given market and has exercised "due diligence" in meeting the ATV buildout requirements for that market or (ii) digital to analog converter technology is not generally available in the given market or (iii) 15 percent or more of the television households in a given market do not subscribe to a multichannel video programming distributor that carries the digital service of each local station and those television households do not have at least one advanced television set or at least one digital to analog converter. The foregoing implementation schedule is subject to review by the FCC every two years and may also be subject to future legislation or judicial review, the effect of which cannot be predicted by the Company.

The Company is currently studying the ATV channel assignments for its television stations as well as the technical and capital expenditure requirements to implement ATV at these television stations. The Company currently intends to implement ATV at its television stations within the FCC mandated implementation period. The Company cannot presently predict the cost of such implementation but, based upon general industry estimates, currently believes that such costs will be material and will require several million dollars per station to commence initial ATV operations.

The Company's cash provided by financing activities for the nine months ended September 30, 1998 and 1997 was $33.0 million and $43.8 million, respectively. Net cash provided by financing activities for the nine months ended September 30, 1998 resulted primarily from increased net borrowings of long-term debt related to the Busse-WALB Transactions of $43.4 milllion partially offset by the payment of $1.1 million in dividends and the purchase of $2.6 million in preferred stock. During the nine months ended September 30, 1998, the Company issued 47,100 shares of Class A Common Stock and 105,283 shares of Class B Common Stock from treasury to fulfill obligations under its employee benefit plan, non-employee director stock purchase plan and long-term incentive plan. During the nine months ended September 30, 1998, the Company purchased 15,750 shares of Class A Common stock at a cost of $311,063.

The Company regularly enters into program contracts for the right to broadcast television programs produced by others and program commitments for the right to broadcast programs in the future. Such programming commitments are generally made to replace expiring or canceled program rights. Payments under such contracts are made in cash or the concession of advertising spots for the program provider to resell, or a combination of both. During the nine months ended September 30, 1998, the Company paid $3.0 million for such program broadcast rights.

The Company and its subsidiaries file a consolidated federal income tax return and such state or local tax returns as are required. As of September 30, 1998, the Company anticipates that it will generate taxable operating losses for the foreseeable future.

Management does not believe that inflation in past years has had a significant impact on the Company's

Liquidity and Capital Resources (continued)

results of operations nor is inflation expected to have a significant effect upon the Company's business in the near future.

Impact of Year 2000

Some of the Company's older computer programs were written using two digits rather than four to define the applicable year. As a result, those computer programs have time-sensitive software that recognize a date using "00" as the year 1900 rather than the year 2000. This could cause a system failure, miscalculations or disruptions of operations, including, among other things, a temporary inability to process transactions, send invoices, or engage in similar normal business activities.

The Company is continuing an assessment of its software and computer systems and will have to modify or replace portions of its software so that its computer systems will function properly with respect to dates in the year 2000 and thereafter. The Company is also in the process of assessing the Year 2000 compliance status of its significant suppliers and customers. The Company does not presently believe that the estimated total Year 2000 project cost will exceed $750,000. Most of this cost will be realized over the estimated useful lives of the new hardware and software. To date, the Company has identified several minor systems that are not Year 2000 compliant and these systems are in the process of being replaced. However, the Company has not incurred significant expenses associated with the Year 2000 issue.

This project is approximately 60% complete and the Company estimates that it will be completed no later than September 30, 1999, which is prior to any anticipated impact on its operating systems. The Company believes that with modifications to existing software and conversions to new software, the Year 2000 issue will not pose significant operational problems for its computer systems. However, if such modifications and conversions are not made, or are not completed timely, the Year 2000 issue could have a material impact on the operations of the Company.

The costs of the project and the date on which the Company believes it will complete the Year 2000 modifications are based on management's best estimates, which were derived utilizing numerous assumptions of future events, including the continued availability of certain resources and other factors. However, there can be no guarantee that these estimates will be achieved and actual results could differ materially from those anticipated. Specific factors that might cause such material differences include, but are not limited to, the availability and cost of personnel trained in this area, the ability to locate and correct all relevant computer codes, and similar uncertainties.

Cautionary Statements for Purposes of the "Safe Harbor" Provisions of the Private Securities Litigation Reform Act

This quarterly report on Form 10-Q contains "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. When used in this report, the words "believes," "expects," "anticipates," "estimates" and similar words and expressions are generally intended to identify forward-looking statements. Statements that describe the Company's future strategic plans, goals, or objectives are also forward-looking statements. Readers of this Report are cautioned that any forward-looking statements, including those regarding the intent, belief or current expectations of the Company or management, are not guarantees of future performance, results or events and involve risks and uncertainties, and that actual results and events may differ materially from those in the forward-looking statements as a result of various factors including, but not limited to, (i) general economic conditions in the markets in which the Company operates, (ii) competitive pressures in the markets in which the Company operates, (iii) the effect of future legislation or regulatory changes on the Company's operations and (iv) other factors described from time to time in the Company's filings with the Securities and Exchange Commission. The forward-looking statements included in this report are made only as of the date hereof. The Company undertakes no obligation to update such forward-looking statements to reflect subsequent events or circumstances.

PART II. OTHER INFORMATION

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

None

27- Financial Data Schedule

(b) Reports on Form 8-K

A report on Form 8-K was filed on August 14, 1998, reporting the exchange of the assets of WALB-TV for the assets of WEAU-TV. This report on Form 8-K also reported the acquisition of all of the outstanding common and preferred stock of Busse Broadcasting Corporation. A current report on Form 8K/A was filed on October 14, 1998 as an amendment to the current report on Form 8-K that as filed on August 14, 1998.

SIGNATURES

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

GRAY COMMUNICATIONS SYSTEMS, INC.
(Registrant)

Date: November 13, 1998

By: /s/ James C. Ryan
James C. Ryan
Vice President and
Chief Financial Officer

This schedule contains summary financial information extracted from the September 30,1998 unaudited condensed consolidated financial statements of Gray Communications Systems, Inc. and is qualified in its entirety by reference to such financial statements.

0000043196
GRAY COMMUNICATIONS SYSTEMS, INC.

US DOLLARS

9-MOS
DEC-31-1998
JAN-01-1998
SEP-30-1998
1
1,934,777
0
21,828,127
1,802,000
1,153,868
31,472,598
78,275,501
(25,676,551)
471,196,762
28,792,789
262,555,097
0
18,500,000
64,113,460
45,957,669
471,196,762
91,887,292
91,887,292
0
74,788,665
(70,222,552)
547,475
18,591,538
68,729,641
27,545,657
41,183,984
0
0
0
40,120,306
3.37
3.23

Includes pre-tax gain recognized on the exchange of WALB, one of the Company's NBC affiliated television stations, of approximately $70.6 million.