Orchard Enterprises, Inc.
Form 10-Q
August 14, 2009

# 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 June 30, 2009** |

## OR

| | |
|---|---|
| o | **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** |
| | **For the Transition Period from to** |

## (Commission File Number) 000-51761

# THE ORCHARD ENTERPRISES, INC.

(Exact Name of Registrant As Specified in Its Charter)

| | |
|---|---|
| Delaware<br>(State or Other Jurisdiction of Incorporation) | 20-3365526<br>(IRS Employer Identification No.) |

**23 East 4th Street, 3rd Floor**
**New York, NY**

(Address of Principal Executive Offices)

**10003**

(Zip Code)

**(212) 201-9280**

(Registrant s Telephone Number, Including Area Code)

**Not Applicable**

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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

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

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

| | | | |
|---|---|---|---|
| Large accelerated filer o | Accelerated filer o | Non-accelerated filer o<br>(Do not check if a smaller reporting company) | Smaller reporting company x |

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

# APPLICABLE ONLY TO CORPORATE ISSUERS

The number of shares of common stock, par value $0.01 per share, outstanding as of August 12, 2009 was 6,396,115.

# THE ORCHARD ENTERPRISES, INC.

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# PART I

# *FINANCIAL INFORMATION*

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# PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

# THE ORCHARD ENTERPRISES, INC.

# CONDENSED CONSOLIDATED BALANCE SHEETS

| | June 30, 2009 (Unaudited) | December 31, 2008 |
|---|---|---|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | $4,197,212 | $4,521,027 |
| Accounts receivable net | 10,646,303 | 12,576,934 |
| Inventory | 115,564 | 133,404 |
| Royalty advances | 4,079,246 | 2,720,119 |
| Prepaid expenses and other current assets | 917,873 | 980,226 |
| Total current assets | 19,956,198 | 20,931,710 |
| Royalty advances, less current portion | 1,974,673 | 2,152,169 |
| Music and audio content net | 5,085,252 | 5,604,500 |
| Property and equipment net | 2,518,358 | 1,609,467 |
| Intangible assets net | 848,944 | 907,472 |
| Goodwill | 26,463,900 | 26,463,900 |
| Other assets | 495,169 | 410,284 |
| Total assets | $57,342,494 | $58,079,502 |
| LIABILITIES, REDEEMABLE PREFERRED STOCK, AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | $1,695,211 | $907,661 |
| Accrued royalties | 18,552,243 | 17,756,902 |
| Accrued expenses | 805,321 | 1,223,717 |
| Deferred revenue | 1,295,790 | 1,534,702 |
| Total current liabilities | 22,348,565 | 21,422,982 |
| Commitments and Contingencies | | |
| Redeemable preferred stock: | | |
| Series A convertible preferred stock, $0.01 par value 448,833 shares designated and issued; 448,707 shares outstanding; liquidation preference of $24,992,980 as of June 30, 2009 and December 31, 2008 | 7,015,276 | 7,015,276 |
| Stockholders equity: | | |
| Preferred stock, $0.01 par value 1,000,000 shares authorized and 448,833 shares designated; 551,167 shares undesignated; no undesignated shares issued and outstanding as of June 30, 2009 and | | |

| | | |
|---|---|---|
| December 31, 2008 | | |
| Common stock, $0.01 par value 30,000,000 shares authorized; 6,396,115 and 6,276,609 shares issued and outstanding as of June 30, 2009 and December 31, 2008 | 63,961 | 62,766 |
| Additional paid-in capital | 56,472,319 | 55,926,156 |
| Accumulated deficit | (28,494,272) | (26,347,793) |
| Accumulated other comprehensive (loss) income | (63,355) | 115 |
| Total stockholders equity | 27,978,653 | 29,641,244 |
| Total liabilities, redeemable preferred stock, and stockholders equity | $57,342,494 | $58,079,502 |

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

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# THE ORCHARD ENTERPRISES, INC.

# CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2009 | 2008 | 2009 | 2008 |
| | (Unaudited) | | (Unaudited) | |
| Revenues | $15,057,536 | $13,402,530 | $30,385,512 | $26,558,300 |
| Cost of revenues | 11,059,097 | 9,859,667 | 22,136,605 | 19,462,347 |
| Gross profit | 3,998,439 | 3,542,863 | 8,248,907 | 7,095,953 |
| Operating expenses | 5,144,202 | 4,422,790 | 10,827,188 | 9,146,043 |
| Loss from operations | (1,145,763) | (879,927) | (2,578,281) | (2,050,090) |
| Other income (expense): | | | | |
| Interest income | 2,054 | 56,227 | 4,993 | 140,927 |
| Interest expense | (15,467) | | (27,555) | |
| Loss from disposal of property and equipment | | | | (21,767) |
| Other income | 70,649 | 38,208 | 454,364 | 41,053 |
| Total other income | 57,236 | 94,435 | 431,802 | 160,213 |
| Net loss | $(1,088,527) | $(785,492) | $(2,146,479) | $(1,889,877) |
| Loss per share basic and diluted | $(0.18) | $(0.12) | $(0.35) | $(0.30) |
| Weighted average shares outstanding basic and diluted | 6,155,816 | 6,292,143 | 6,129,749 | 6,244,734 |

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

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# THE ORCHARD ENTERPRISES, INC.

# CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

| | For the Six Months Ended June 30, | |
|---|---|---|
| | 2009 (Unaudited) | 2008 |
| Cash flows from operating activities: | | |
| Net loss | $(2,146,479) | $(1,889,877) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | |
| Depreciation and amortization | 917,667 | 610,067 |
| Bad debt expense | 320,000 | 102,735 |
| Loss on disposition and writedowns of property and equipment | | 21,767 |
| Share-based compensation | 547,358 | 365,196 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 1,610,631 | (1,972,604) |
| Inventory | 17,840 | |
| Royalty advances | (1,181,631) | 1,003,668 |
| Prepaid expenses and other current assets | 62,353 | (331,307) |
| Other assets | (251,551) | (122,106) |
| Accounts payable | 787,550 | 395,043 |
| Accrued royalties | 795,341 | 2,172,814 |
| Accrued expenses | (418,398) | (88,209) |
| Deferred revenue | (238,912) | 548,600 |
| Net cash provided by operating activities | 821,769 | 815,787 |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (1,248,780) | (162,839) |
| Repayment of loan receivable | 166,666 | |
| Acquisition deposit (TVT assets) | | (400,000) |
| Increase in goodwill associated with Digital Music Group, Inc | | (465,541) |
| Net cash used in investing activities | (1,082,114) | (1,028,380) |
| Effect of exchange rate changes on cash and cash equivalents | (63,470) | (34,557) |
| Decrease in cash and cash equivalents | (323,815) | (247,150) |
| Cash and cash equivalents Beginning of period | 4,521,027 | 10,636,618 |
| Cash and cash equivalents End of period | $4,197,212 | $10,389,468 |
| Supplemental cash flow information: | | |
| Interest paid | $27,555 | $ |

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

THE ORCHARD ENTERPRISES, INC. CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

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# THE ORCHARD ENTERPRISES, INC.

# NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

## 1. Organization and Basis of Presentation

On November 13, 2007, The Orchard Enterprises, Inc. (formerly known as Digital Music Group, Inc. ( DMGI ), a Delaware corporation formed in April 2005, and hereinafter referred to as the Company ) consummated a business combination with Orchard Enterprises NY, Inc. (formerly known as The Orchard Enterprises Inc., a New York corporation formed in September 2000) ( Orchard NY ) through a merger of a wholly-owned subsidiary of the Company with and into Orchard NY pursuant to the terms of the Second Amended and Restated Merger Agreement dated October 5, 2007, as amended on November 7, 2007 (the Merger ). Pursuant to the terms of the Merger, all of the outstanding common and preferred stock of Orchard NY was cancelled and the former stockholders of Orchard NY received an aggregate of 2,862,910 shares of the Company s common stock (after giving effect to a one-for-three reverse stock split of the Company s common stock that took effect on November 14, 2007) and 446,918 shares of the Company s Series A convertible preferred stock (the Series A Preferred Stock ). In addition, the Company assumed the obligations of Orchard NY under its outstanding deferred common and preferred stock awards, which, pursuant to the terms of the Merger, now represent the right to receive 157,683 shares of the Company s common stock (on a post-split basis) and 1,915 shares of Series A Preferred Stock. In connection with the Merger, Orchard NY became a wholly-owned subsidiary of the Company, with the former stockholders of Orchard NY collectively owning shares of the Company s common and preferred stock representing approximately 60% of the voting power of the Company s outstanding capital stock.

For accounting purposes, the Merger was treated as a reverse acquisition with Orchard NY being the accounting acquirer. Accordingly, the historical financial results prior to the Merger are those of Orchard NY and its consolidated subsidiaries. The results of operations for DMGI and its pre-Merger consolidated subsidiaries are included in the Company s consolidated financial results beginning on November 13, 2007.

The accompanying unaudited condensed consolidated financial statements of the Company have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 8 of Regulation S-X. Accordingly, they do not include all of the information and notes required by U.S. 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 three and six month periods ended June 30, 2009 are not necessarily indicative of the results that may be expected for the year ending December 31, 2009.

The consolidated balance sheet at December 31, 2008 has been derived from the audited financial statements at that date but does not include all of the information and notes required by U.S. generally accepted accounting principles for complete financial statements.

For further information, refer to the audited consolidated financial statements and accompanying notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2008, filed with the Securities and Exchange Commission ( SEC ) on March 30, 2009.

## 2. Liquidity and Capital Resources

The Company has incurred losses from operations since its inception and requires significant resources to fund its operations. The Company incurred net losses of $1,088,527 and $2,146,479 for the three and six months ended June 30, 2009, respectively. Management believes cash balances on-hand and cash flow generated from operations will be sufficient to fund the Company s net cash requirements for the next twelve months. In addition, on February 5, 2009, the Company entered into a secured revolving credit facility with Peninsula Bank Business Funding, a division of the Private Bank of the Peninsula. Under the terms of the agreement, the Company can borrow an amount that does not exceed 80% of its eligible accounts up to a maximum of $3 million, secured by accounts receivable and inventory. The term of the facility is for one year.

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# THE ORCHARD ENTERPRISES, INC.

# NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

## 2. Liquidity and Capital Resources (continued)

For additional information relating to the secured revolving credit facility, see Note 9. Should additional resources be required, management may seek to raise funds through additional financing or the issuance of debt or equity securities.

## 3. Significant Accounting Policies

*Loss per Share* Basic earnings per share is computed by dividing net income (loss) available to common stockholders by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share is determined in the same manner as basic earnings per share, except that the number of shares is increased to include potentially dilutive securities using the treasury stock method. Because the Company incurred a net loss in all periods presented, all potentially dilutive securities were excluded from the computation of diluted loss per share because the effect of including them is anti-dilutive.

The Merger with Orchard NY in November 2007 was, for financial reporting purposes, treated as a reverse acquisition. Because the number of shares outstanding following a reverse acquisition is significantly different from the number of shares outstanding prior to the combination, the weighted average shares outstanding for purposes of presenting net loss per share on a comparative basis has been retroactively restated to the earliest period presented in order to reflect the effect of the reverse acquisition. In effect, the reverse acquisition is similar to a stock split for the accounting acquirer, and retroactively restating the weighted average shares outstanding is consistent with the accounting required by SFAS No. 128, *Earnings Per Share*, for stock splits, stock dividends, and reverse stock splits. Basic net loss per share is computed by dividing net loss by the weighted average number of shares of common stock outstanding during the reporting period. There is no dilutive effect on net loss per share in the periods presented.

The following table summarizes the number of common shares outstanding attributable to potentially dilutive securities.

| | June 30, | |
|---|---|---|
| | 2009 | 2008 |
| Series A Preferred Stock | 1,494,194 | 1,494,614 |
| Stock options | 589,132 | 555,379 |
| Warrants | 91,000 | 91,000 |
| Non-vested Restricted Stock Awards | 173,837 | 264,828 |
| Total | 2,348,163 | 2,405,821 |

*Convertible Instruments* The Company evaluates and accounts for conversion options embedded in its convertible instruments in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* ( SFAS 133 ), and Emerging Issues Task Force ( EITF ) Issue No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in a Company s Own Stock* ( EITF 00-19 ).

SFAS 133 generally provides three criteria that, if met, require companies to bifurcate conversion options from their host instruments and account for them as free standing derivative financial instruments in accordance with EITF 00-19. These three criteria include circumstances in which (a) the economic characteristics and risks of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of the host contract, (b) the hybrid instrument that embodies both the embedded derivative instrument and the host contract is not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur and (c) a separate instrument with the same terms as the embedded derivative instrument would be considered a derivative instrument subject to the requirements of SFAS 133. SFAS 133 and EITF 00-19 also provide an exception to this rule

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# THE ORCHARD ENTERPRISES, INC.

# NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

## 3. Significant Accounting Policies (continued)

when the host instrument is deemed to be conventional (as that term is described in the implementation guidance to SFAS 133 and further clarified in EITF Issue No. 05-2, *The Meaning of Conventional Convertible Debt Instrument* in Issue No. 00-19).

The Company accounts for convertible instruments (when it has determined that the embedded conversion options should not be bifurcated from their host instruments) in accordance with the provisions of EITF Issue No. 98-5, *Accounting for Convertible Securities with Beneficial Conversion Features* ( EITF 98-5 ), and EITF Issue No. 00-27, *Application of EITF 98-5 to Certain Convertible Instruments.* Accordingly, the Company records, when necessary, discounts to convertible notes for the intrinsic value of conversion options embedded in debt instruments based upon the differences between the fair value of underlying common stock at the commitment date of the note transaction and the effective conversion price embedded in the note. Debt discounts under these arrangements are amortized over the term of the related debt to their earliest date of redemption. The Company also records, when necessary, deemed dividends for the intrinsic value of conversion options embedded in preferred stock based upon the differences between the fair value of the underlying common stock at the commitment date of the note transaction and the effective conversion price embedded in the note.

*Preferred Stock* The Company applies the guidance in SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* ( SFAS 150 ), and EITF Topic D-98, *Classification and Measurement of Redeemable Securities* ( EITF D-98 ), when determining the classification and measurement of its preferred stock. Preferred stock subject to mandatory redemption (if any) is classified as liability instruments and is measured at fair value in accordance with SFAS 150. All other issuances of preferred stock are subject to the classification and measurement principles of EITF D-98. Accordingly, the Company classifies conditionally redeemable preferred stock (if any), which includes preferred stock that features redemption rights that are either within the control of the holder or subject to redemption upon the occurrence of uncertain events not solely within the Company s control, as temporary equity. At all other times, the Company classifies its preferred stock as a component of stockholders equity.

### Fair Value of Financial Instruments

The Company s financial instruments are cash, accounts receivable and accounts payable. The recorded values of cash, accounts receivable and accounts payable approximate their fair values based on their short-term nature.

## Foreign Currency and Hedging

All balance sheet accounts of foreign operations are translated into U.S. dollars at the period-end rate of exchange and statements of operations items are translated at the weighted average exchange rates for the period. The resulting translation adjustments are made directly to accumulated other comprehensive income in stockholders equity. Gains and losses from foreign currency transactions, such as those resulting from the settlement of foreign receivables or payables, are included in the consolidated statements of operations.

From time to time, the Company enters into forward exchange contracts in anticipation of future movements in certain foreign exchange rates and to hedge against foreign currency fluctuations. Realized and unrealized gains and losses on these contracts are included in the consolidated statements of operations. As of June 30, 2009, the Company had no open currency hedge contracts.

## Subsequent Events

Management has evaluated subsequent events or transactions occurring through August 14, 2009, the date the financial statements were issued.

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# THE ORCHARD ENTERPRISES, INC.

# NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

## 3. Significant Accounting Policies (continued)

### Recent Accounting Pronouncements

In December 2007, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 141(R), *Business Combinations* ( SFAS 141(R) ), which replaces SFAS No. 141, *Business Combinations*. SFAS 141(R) establishes principles and requirements for determining how an enterprise recognizes and measures the fair value of certain assets and liabilities acquired in a business combination, including non-controlling interests, contingent consideration, and certain acquired contingencies. SFAS 141(R) also requires acquisition-related transaction expenses and restructuring costs be expensed as incurred rather than capitalized as a component of the business combination. SFAS 141(R) is applicable to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. SFAS 141(R) would have an impact on the accounting for any businesses acquired by the Company after the effective date of the pronouncement. In April 2009, the FASB issued FASB Staff Position FAS 141(R)-1, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies* ( FSP FAS 141(R)-1 ). FSP FAS 141(R)-1 amends SFAS No. 141(R) and is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Management has reviewed FSP FAS 141(R)-1 and will continue to monitor its applicability. The Company has not entered into any business combinations in 2009 to which these pronouncements would apply.

In December 2007, the FASB issued SFAS No. 160, *Non-controlling Interests in Consolidated Financial Statements An Amendment of ARB No. 51* ( SFAS 160 ). SFAS 160 establishes accounting and reporting standards for the non-controlling interest in a subsidiary (previously referred to as minority interests). SFAS 160 also requires that a retained non-controlling interest upon the deconsolidation of a subsidiary be initially measured at its fair value. Upon adoption of SFAS 160, the Company would be required to report any non-controlling interests as a separate component of stockholders equity (deficit). The Company would also be required to present any net income (loss) allocable to non-controlling interests and net income (loss) attributable to the stockholders of the Company separately in its consolidated statements of operations. SFAS 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. SFAS 160 requires retroactive adoption of the presentation and disclosure requirements for existing minority interests. All other requirements of SFAS 160 shall be applied prospectively. SFAS 160 would have an impact on the presentation and disclosure of the non-controlling interests of any non wholly-owned businesses acquired by the Company in the future.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133* ( SFAS 161 ). SFAS 161 changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity s financial position, financial performance and cash flows. The guidance in SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. This Statement encourages, but does not require, comparative disclosures for earlier periods at initial adoption. The adoption of SFAS 161 did not have a material impact on the Company s consolidated financial position, results of operations or cash flows.

In April 2008, the FASB issued FASB Staff Position FAS 142-3, *Determination of the Useful Life of Intangible Assets* ( FSP FAS 142-3 ). FSP FAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, *Goodwill and Other Intangible Assets* ( SFAS 142 ). The objective of this FSP is to improve the consistency between the useful life of a recognized intangible asset under SFAS 142

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# THE ORCHARD ENTERPRISES, INC.

# NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

## 3. Significant Accounting Policies (continued)

and the period of expected cash flows used to measure the fair value of the asset under SFAS 141(R) and other U.S. generally accepted accounting principles ( GAAP ). FSP FAS 142-3 is effective for fiscal years beginning after December 15, 2008. The adoption of FSP FAS 142-3 was effective January 1, 2009 and did not have a material impact on the Company s consolidated financial statements.

Effective January 1, 2009, the Company adopted the provisions of Emerging Issues Task Force Issue No. 07-05, *Determining Whether an Instrument (or Embedded Feature) is Indexed to an Entity s Own Stock* ( EITF 07-05 ). EITF 07-05 applies to any freestanding financial instruments or embedded features that have the characteristics of a derivative, as defined by SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*, and to any freestanding financial instruments that are potentially settled in an entity s own common stock. The adoption of EITF 07-05 did not have any impact on the Company s consolidated financial position, results of operations and cash flows as the Company does not have any financial instruments with characteristics which meet the definition of a derivative instrument in accordance with the provisions of this pronouncement.

In April 2009, the FASB issued FASB Staff Position FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments* ( FSP FAS 107-1 and APB 28 ). This FSP amends SFAS No. 107, *Disclosures about Fair Value of Financial Instruments* ( SFAS 107 ), to require entities to provide disclosures about the fair value of financial instruments in interim financial information. This FSP also amends APB Opinion No. 28, *Interim Financial Reporting*, to require those disclosures in summarized financial information at interim reporting periods. In addition, an entity must disclose in the body or in the accompanying notes of its summarized financial information for interim reporting periods and in its financial statements for annual reporting periods the fair value of all financial instruments for which it is practicable to estimate that value, whether recognized or not recognized in the statement of financial position, as required by SFAS 107. The Company has adopted FSP FAS 107-1 and APB 28-1 for the quarter ended June 30, 2009. Management has determined that the adoption of FSP FAS 107-1 and APB 28-1 does not have a material impact on the Company s consolidated financial statements.

In April 2009, the FASB issued FASB Staff Position FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* ( FSP FAS 115-2 and FAS 124-2 ). This FSP changes existing guidance for determining whether an impairment to debt securities is other than temporary; replaces the existing requirement that management assert it has both the intent and ability to hold an impaired security until recovery with a requirement that management assert, (a) it does not have the intent to sell the security; and (b) it is more likely than not it will not have to sell the security before recovery of its cost basis; requires that an entity recognize noncredit losses on held-to-maturity debt securities in other comprehensive income and amortize that amount over the remaining life of the security in a prospective manner by offsetting the recorded value of the asset unless the security is subsequently sold or there are additional credit losses; and requires entities to present the total other-than-temporary impairment in the statement of earnings with an offset for the amount recognized in other comprehensive income. When adopting FSP FAS 115-2 and FAS 124-2, entities are required to record a cumulative-effect adjustment as of the beginning of the period of adoption to reclassify the noncredit component of a previously recognized other-than-temporary impairment from retained earnings to accumulated other comprehensive income if the entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery. The Company has adopted FSP FAS 115-2 and FAS 124-2 for the quarter ended June 30, 2009. Management has determined that the adoption of FSP FAS 115-2 and FAS 124-2 does not have a material impact on the Company s consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* and in February 2008, the FASB amended SFAS No. 157 by issuing FASB Staff Position FAS 157-1, *Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13*, and FASB Staff Position

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# THE ORCHARD ENTERPRISES, INC.

# NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

## 3. Significant Accounting Policies (continued)

FAS 157-2, *Effective Date of FASB Statement No. 157* (collectively SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosure of fair value measurements. SFAS 157 is applicable to other accounting pronouncements that require or permit fair value measurements, except those related to lease accounting, and accordingly does not require any new fair value measurements. SFAS 157 was effective for financial assets and liabilities in fiscal years beginning after November 15, 2007, and for non-financial assets and liabilities in fiscal years beginning after November 15, 2008 except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis. The Company s adoption of the provisions of SFAS 157 on January 1, 2008, with respect to financial assets and liabilities measured at fair value, did not have an effect on the Company s financial statements for the year ended December 31, 2008. In October 2008, the FASB issued FASB Staff Position FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active* ( FSP FAS 157-3 ). FSP FAS 157-3 clarifies the application of SFAS 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. FSP FAS 157-3 became effective immediately upon issuance and its adoption did not have an effect on the Company s financial statements. The Company currently determines the fair value of its property and equipment when assessing long-lived asset impairments and SFAS 157 was effective for these fair value assessments as of January 1, 2009.

In April 2009, the FASB issued FASB Staff Position FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* ( FSP FAS 157-4 ). This FSP affirms that the objective of fair value when the market for an asset is not active is the price that would be received upon selling the asset in an orderly transaction, clarifies and includes additional factors for determining whether there has been a significant decrease in market activity for an asset when the market for that asset is not active and eliminates the proposed presumption that all transactions are distressed (not orderly) unless proven otherwise. FSP FAS 157-4 instead requires an entity to base its conclusion about whether a transaction was not orderly on the weight of the evidence. The Company has adopted FSP FAS 157-4 for the quarter ended June 30, 2009. Management has determined that the adoption of FSP FAS 157-4 does not have a material impact on the Company s consolidated financial statements.

In May 2009, the FASB issued SFAS No. 165, *Subsequent Events* ( SFAS 165 ), which provides guidance on events that occur after the balance sheet date but prior to the issuance of the financial statements. SFAS 165 distinguishes events requiring recognition in the financial statements and those that may require disclosure in the financial statements. Furthermore, SFAS 165 requires disclosure of the date through which subsequent events were evaluated. SFAS 165 is effective for interim and annual periods ending after June 15, 2009. The adoption of SFAS 165 did not have any impact on the Company s condensed consolidated financial statements.

In July 2009, the FASB issued SFAS No. 168, *The FASB Accounting Codification and the Hierarchy of Generally Accepted Accounting Principles* ( SFAS 168 ). SFAS 168 supersedes SFAS No. 162 issued in May 2008. SFAS 168 will become the source of authoritative U.S. GAAP recognized by the FASB to be applied by nongovenmental entities. Rules and interpretive releases of the SEC under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. On the effective date of SFAS 168, the Codification will supersede all then-existing non-SEC accounting and reporting standards. All other nongrandfathered non-SEC accounting literature not included in the Codification will become nonauthoritative. SFAS 168 is effective for the Company s quarterly reporting period ending September 30, 2009. The adoption of SFAS 168 is not expected to have any impact on the Company s consolidated financial position or results of operations.

# THE ORCHARD ENTERPRISES, INC.

# NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

## 4. Business Combination

On July 3, 2008, the Company acquired substantially all of the assets of TeeVee Toons, Inc. and/or its affiliates ( TVT Records ) record label business operations, including but not limited to, master recordings, artists agreements, certain inventory, accounts receivable and a real property lease (the Assets ) and assumed certain liabilities of TVT Records related to the Assets that the Company elected to acquire (the Acquisition ). The aggregate purchase price for the Assets was $5,050,000 (subject to reduction).

The Acquisition has been accounted for as a business acquisition using the purchase method of accounting as required by SFAS No. 141, *Business Combinations*. Under the purchase method of accounting, the total purchase price is allocated to the acquired tangible and intangible assets and assumed liabilities of TVT Records based on their estimated fair values as of the closing date of the Acquisition. The excess of the purchase price over the fair value of assets acquired and liabilities assumed is allocated to goodwill.

The composition of the purchase price consideration is as follows:

| | |
|---|---|
| Fair value of the net assets of TVT Records | $ 5,050,000 |
| Direct acquisition-related costs | 1,017,268 |
| Total purchase price consideration | $ 6,067,268 |

The allocation of the purchase price to the cash consideration of the net assets acquired is as follows:

| | |
|---|---|
| Accounts receivable | $ 1,000,000 |
| Royalty advances | 1,319,000 |
| Inventory | 145,000 |
| Assumed lease | 700,000 |
| Digital distribution agreements | 2,262,500 |
| Master recordings | 82,500 |
| Goodwill | 1,317,268 |
| Intangible assets corporate trade names | 266,000 |
| Cure liabilities payable | (1,025,000) |
| Total net assets acquired | $ 6,067,268 |

Unaudited pro forma combined financial information is presented below as if the Acquisition occurred as of January 1, 2008. The results have been adjusted to account for the depreciation and amortization of assumed lease, digital distribution agreements, master recordings and intangible assets. The pro forma financial information presented below does not purport to present what actual results would have been if the Acquisition had occurred at such date, nor does the information project results for any future period.

The unaudited pro forma combined financial information for the six months ended June 30, 2008 is as follows:

| | |
|---|---|
| Revenues | $29,992,281 |
| Net loss | $(3,645,805 ) |
| Loss per share basic and diluted | $(0.58 ) |
| Weighted average shares outstanding basic and diluted | 6,244,734 |

Management believes that the above pro forma combined financial information may not provide meaningful comparative information, given that the Company only acquired certain assets and liabilities of TVT Records and, in addition, TVT Records filed for bankruptcy on February 13, 2008.

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# THE ORCHARD ENTERPRISES, INC.

# NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

## 5. Inventory

Inventory consists of cassettes, CDs, vinyl, finished CDs and component parts totaling $115,564 and $133,404 at June 30, 2009 and December 31, 2008, respectively.

## 6. Royalty Advances

The Company has the exclusive right to distribute certain music and video content in certain geographic areas pursuant to short-term and long-term agreements with the content owners. These distribution agreements primarily have initial terms ranging from three to ten years and, in certain cases, grant the Company the right to extend the agreement for an additional term. Pursuant to certain of these agreements, generally those with longer or more favorable terms, the Company has paid royalty advances that are to be recouped from the content owners share of future revenues. Royalty advances that management estimates are reasonably likely to be recouped through revenues over the next 12 months are classified as a current asset in the accompanying balance sheets.

Royalty advances comprise the following:

| | June 30, 2009 | December 31, 2008 |
|---|---|---|
| Balance, beginning of period | $4,872,288 | $4,766,220 |
| Royalty advances paid to content owners | 4,998,704 | 5,464,292 |
| Purchased from TVT Records | | 1,319,000 |
| Less: recoupment of royalty advances | (3,817,073) | (6,677,224) |
| Balance, end of period | 6,053,919 | 4,872,288 |
| Less: current portion of royalty advances | 4,079,246 | 2,720,119 |
| Long-term portion of royalty advances | $1,974,673 | $2,152,169 |

## 7. Music and Audio Content

Music and audio content consists of the following:

| Weighted Average Remaining Amortization | June 30, 2009 | | | December 31, 2008 | |
|---|---|---|---|---|---|
| | Gross Amount | Accumulated Amortization | Net | Gross Amount | Accumula |

Period
(Years)