LIQUID AUDIO INC
Form 10-Q/A
September 16, 2002
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549

FORM 10-Q/A
(Amendment No. 1)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2002**

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 000-25977

LIQUID AUDIO, INC.
(Exact name of registrant as specified in its charter)

Delaware	**77-0421089**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
800 Chesapeake Drive, Redwood City, CA	**94063**
(Address of principal executive offices)	(Zip Code)

(650) 549-2000
(Registrant s telephone number, including area code)

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) had been subject to such filing requirements for the past 90 days. Yes x No ¨

As of July 31, 2002, there were 22,758,322 shares of registrant s Common Stock outstanding.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

LIQUID AUDIO, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands; unaudited)

	June 30, 2002	December 31, 2001
Assets		
Current assets:		
Cash and cash equivalents	$ 81,018	$ 91,594
Accounts receivable, net	115	130
Other current assets	718	1,099
Total current assets	81,851	92,823
Restricted cash	826	826
Property and equipment, net	2,391	3,603
Other assets	73	163
Total assets	$ 85,141	$ 97,415
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	$ 1,110	$ 1,107
Accrued liabilities	2,140	3,821
Deferred revenue	109	122
Capital lease obligations	11	28
Equipment loan		169
Note payable to related party	376	343
Total current liabilities	3,746	5,590
Stockholders equity:		
Common stock	23	23
Additional paid-in capital	203,065	202,969
Unearned compensation	(9)	(43)
Accumulated other comprehensive loss	(55)	(30)
Accumulated deficit	(121,629)	(111,094)
Total stockholders equity	81,395	91,825
Total liabilities and stockholders equity	$ 85,141	$ 97,415

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LIQUID AUDIO, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts; unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
Net revenues:				
License	$ 40	$ 194	$ 76	$ 484
Services	111	362	210	787
Business development (related party)		468		1,414
Total net revenues	151	1,024	286	2,685
Cost of net revenues:				
License	84	128	181	287
Services	174	364	302	1,075
Non-cash cost of revenue	36	98	69	181
Total cost of net revenues	294	590	552	1,543
Gross profit (loss)	(143)	434	(266)	1,142
Operating expenses:				
Sales and marketing	1,027	3,061	2,185	7,717
Non-cash sales and marketing	(32)	(72)	(21)	(63)
Research and development	2,914	4,731	5,937	9,961
Non-cash research and development	3	(26)	8	(17)
General and administrative	1,905	3,078	3,011	6,272
Non-cash general and administrative		(21)		(16)
Strategic marketing equity instruments		340		652
Restructuring		3,672		3,672
Total operating expenses	5,817	14,763	11,120	28,178
Loss from operations	(5,960)	(14,329)	(11,386)	(27,036)
Other income (expense), net	318	1,176	851	2,835
Net loss in equity investment		(881)		(1,100)
Net loss	$ (5,642)	$ (14,034)	$ (10,535)	$ (25,301)
Net loss per share:				
Basic and diluted	$ (0.25)	$ (0.62)	$ (0.46)	$ (1.12)
Weighted average shares	22,737	22,593	22,723	22,563

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LIQUID AUDIO, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands; unaudited)

	Six Months Ended June 30,	
	2002	**2001**
Cash flows from operating activities:		
Net loss	$ (10,535)	$ (25,301)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,279	2,193
Amortization of unearned compensation	(13)	(101)
Allowance for doubtful accounts and sales returns reserve		1,055
Net loss in equity investment		1,100
Strategic marketing-equity instruments		652
Non-cash cost of revenue	69	186
Loss on disposal of and write-down of property and equipment		1,742
Changes in assets and liabilities:		
Accounts receivable from third parties	15	379
Accounts receivable from related parties		(257)
Other assets	471	176
Accounts payable	3	(1,047)
Accrued liabilities	(1,681)	457
Deferred revenue from third parties	(13)	(139)
Deferred revenue from related parties		(111)
Net cash used in operating activities	(10,405)	(19,016)
Cash flows from investing activities:		
Acquisition of property and equipment	(67)	(689)
Proceeds from sale of fixed assets		25
Sales (purchases) of short-term investments, net		27,384
Equity investment		(165)
Net cash provided by (used in) investing activities	(67)	26,555
Cash flows from financing activities:		
Proceeds from issuance of common stock, net of repurchases	74	163
Payments made under capital leases	(17)	(79)
Payments made under equipment loan	(169)	(295)
Net cash used in financing activities	(112)	(211)
Effect of exchange rates on cash and cash equivalents	8	(81)
Net increase (decrease) in cash and cash equivalents	(10,576)	7,247
Cash and cash equivalents at beginning of period	91,594	96,398
Cash and cash equivalents at end of period	$ 81,018	$ 103,645

Supplemental disclosures:

Cash paid for interest	$	11	$	40
Non-cash investing and financing activities:				
Issuance of warrants in connection with strategic marketing agreements	$	69	$	151

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LIQUID AUDIO, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

NOTE 1 THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

The Company

Liquid Audio, Inc. (the Company) was incorporated in California in January 1996 and reincorporated in Delaware in April 1999. In July 2000, the Company established a wholly-owned subsidiary in the United Kingdom, Liquid Audio Europe PLC, which reregistered in August 2001 as Liquid Audio Europe Limited, to develop sales in Europe. The Company was formed with the goal of becoming the premier provider of software applications and services that enable the secure delivery and sale of digital music over the Internet. The Company s end-to-end solutions enable the secure distribution, promotion and sale of high quality music files while providing consumers with the ability to access, preview and purchase that music via the Internet.

Basis of presentation

The accompanying unaudited condensed consolidated financial statements have been prepared by the Company and reflect all adjustments, which are in the opinion of management, necessary for a fair presentation of the interim periods presented. The results of operations for the three months ended June 30, 2002 are not necessarily indicative of the results to be expected for any subsequent quarter or for the year ending December 31, 2002. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the Securities and Exchange Commission s rules and regulations.

These unaudited condensed consolidated interim financial statements and notes included herein should be read in conjunction with the Company s audited consolidated financial statements and notes as included in the Company s Annual Report on Form 10-K for the year ended December 31, 2001 as filed with the Securities and Exchange Commission (the SEC) on March 29, 2002.

Liquidity and capital resources

The Company has incurred losses and negative cash flows from operations for every year since inception. For the six months ended June 30, 2002, the Company incurred a net loss of approximately $10.5 million and negative cash flows from operations of $10.4 million. As of June 30, 2002, the Company had an accumulated deficit of approximately $121.6 million. The Company expects to incur operating losses and negative cash flows through at least 2003. Failure to generate sufficient revenues, raise additional capital or reduce spending could adversely affect the Company s ability to achieve its intended business objectives.

Reclassifications

Certain reclassifications have been made to the prior periods consolidated financial statements to conform to the current period presentation. The reclassifications had no effect on net loss, stockholders equity or cash flows.

Principles of consolidation

The financial statements include the accounts of the Company and its subsidiary. Significant intercompany transactions and balances have been eliminated. Investments in entities in which the Company can exercise significant influence, but are less than majority owned and not otherwise controlled by the Company, are accounted for under the equity method.

Restricted cash

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LIQUID AUDIO, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(unaudited)

At June 30, 2002, the Company had a cash balance of $826,000 in the form of certificates of deposit, which were restricted from withdrawal. The amount serves as collateral to a letter of credit issued by the Company s bank to the Company s lessor as security deposit on a long-term lease.

Revenue recognition

Software license revenues are recognized when persuasive evidence of an arrangement exists, delivery has occurred, no significant Company obligations with regard to implementation or integration exist, the fee is fixed or determinable and collection is probable as prescribed in SOP No. 97-2, Software Revenue Recognition. For arrangements with multiple elements, the total fee from the arrangement is allocated among each element based upon vendor specific objective evidence (VSOE) of fair value. When VSOE of fair value exist for the undelivered elements, primarily maintenance, the Company accounts for the license portion based on the residual method as prescribed by SOP No. 98-9, Modification of SOP 97-2 with Respect to Certain Transactions. When VSOE of fair value does not exist for the undelivered elements, the total fee from the arrangement is recognized ratably over the period of the contract. The Company recognizes revenue allocated to maintenance ratably over the contract period, which is generally twelve months.

Business development revenue primarily consists of license and maintenance fees from agreements under which the Company gives its strategic partners the right to license and use the Company s digital recorded music delivery technology. These U.S. dollar-denominated, non-refundable fees are allocated among the various elements of the contract based on VSOE of fair value. When VSOE of fair value exist for the undelivered elements, primarily maintenance, the Company accounts for the license portion based on the residual method as prescribed by SOP No. 98-9. When VSOE of fair value does not exist for the undelivered elements, the total fee from the business development arrangement is recognized ratably over the period of the contract. The total fee from business development arrangements is recognized when payment becomes due if extended payment terms exist, assuming all other criteria are met. Extended payment terms are defined as payment terms outside the Company s customary business practice, generally greater than 90 days. Revenue is not recognized if the strategic partners stop making their contractual payments.

The Company also generates license and service revenues from digital music kiosk sales and hosting services. Revenue derived from hosting services include subscription fees from artists for encoding and storing music files, e-commerce services and transaction reporting. Music delivery services revenue include transaction fees from sales of digital recorded music through the Company s website affiliates and fees from music retailers and websites related to the sample digital music clips delivery service. Revenue from kiosk sales consist of software licenses and services revenue from equipment and kiosk-related services. The Company bears full credit risk with respect to substantially all sales.

Recent accounting pronouncement

In October 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. SFAS No. 144 addresses significant issues relating to the implementation of SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of, and develops a single accounting method under which long-lived assets that are to be disposed of by sale are measured at the lower of book value or fair value less cost to sell. Additionally, SFAS No. 144 expands the scope of discontinued operations to include all components of an entity with operations that (1) can be distinguished from the rest of the entity and (2) will be eliminated from the ongoing operations of the entity in a disposal transaction. SFAS No. 144 is effective for financial statements issued for fiscal years beginning after December 15, 2001 and its provisions are to be applied prospectively. The adoption of SFAS No. 144 did not have an impact on the Company s financial position and results of operations.

LIQUID AUDIO, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(unaudited)

In July 2002, the FASB issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. SFAS No. 146 nullifies the guidance of the Emerging Issues Task Force (EITF) in EITF Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring). Under EITF Issue No. 94-3, an entity recognized a liability for an exit cost on the date that the entity committed itself to an exit plan. In SFAS No. 146, the FASB acknowledges that an entity s commitment to a plan does not, by itself, create a present obligation to other parties that meets the definition of a liability and requires that a liability for a cost that is associated with an exit or disposal activity be recognized when the liability is incurred. It also establishes that fair value is the objective for the initial measurement of the liability. SFAS No. 146 will be effective for exit or disposal activities that are initiated after December 31, 2002. The Company does not expect an impact on its financial position and results of operating from the adoption of SFAS No. 146.

In the first quarter of 2002, the Company adopted Emerging Issues Task Force (EITF) Issue No. 00-14, Accounting for Certain Sales Incentives, EITF Issue No. 00-25, Vendor Income Statement Characterization of Consideration Paid to a Reseller of the Vendor s Products, EITF Issue No. 00-22, Accounting for Points and Certain Other Time-or Volume-Based Sales Incentive Offers and Offers for Free Products or Services to be Delivered in the Future and EITF Issue No. 01-09, Accounting for Consideration Given by Vendor to a Customer or a Reseller of the Vendor s Products which all address certain aspects of sales incentives. The adoption of these EITFs did not have a material impact on the Company s financial position and results of operations.

NOTE 2 BALANCE SHEET COMPONENTS:

The components of accounts receivable from third parties, net are as follows (in thousands):

	June 30, 2002	December 31, 2001
Accounts receivable from third parties, net:		
Accounts receivable	$ 435	$ 455
Less: allowance for doubtful accounts	(320)	(325)
	$ 115	$ 130

The allowance for doubtful accounts decreased by $0 and $(51,000) for the six months ended June 30, 2002 and 2001, respectively. Write-offs against the allowance for doubtful accounts were $5,000 and $48,000 for the six months ended June 30, 2002 and 2001, respectively.

The components of accounts receivable from related parties, net are as follows (in thousands):

	June 30, 2002	December 31, 2001
Accounts receivable from related parties, net:		
Accounts receivable	$	$ 1,555
Less: allowance for doubtful accounts		(1,555)
	$	$

The allowance for doubtful accounts increased by $0 and $1,004,000 for the six months ended June 30, 2002 and 2001, respectively. Write-offs against the allowance for doubtful accounts were $1,555,000 and $0 for the six months ended June 30, 2002 and 2001, respectively.

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LIQUID AUDIO, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(unaudited)

The components of property and equipment are as follows (in thousands):

	June 30, 2002	December 31, 2001
Property and equipment:		
Computer equipment and purchased software	$ 11,075	$ 11,016
Website and software development costs	235	235
Furniture and fixtures	555	555
Leasehold improvements	607	599
	12,472	12,405
Less: Accumulated depreciation and amortization	(10,081)	(8,802)
	$ 2,391	$ 3,603

Property and equipment includes $99,000 of equipment under capital leases at June 30, 2002 and December 31, 2001. Accumulated depreciation and amortization for equipment under capital leases was $99,000 and $95,000 at June 30, 2002 and December 31, 2001, respectively. Depreciation expense for the six months ended June 30, 2002 and 2001 was $1,080,000 and $1,934,000, respectively. Amortization expense for purchased software, website and software development costs for the six months ended June 30, 2002 and 2001 was $199,000 and $259,000, respectively. Unamortized purchased software, website and software development costs was $508,000 and $672,000 at June 30, 2002 and December 31, 2001, respectively.

The components of accrued liabilities are as follows (in thousands):

	June 30, 2002	December 31, 2001
Accrued liabilities:		
Compensation and benefits	$ 1,085	$ 1,124
Consulting and professional services	294	1,357
Restructuring (Note 7)	31	523
Other	730	817
	$ 2,140	$ 3,821

NOTE 3 RELATED PARTIES:

Investments in related parties

The Company owns 4.31% of the outstanding shares of Cyber Music Entertainment (CME), formerly Liquid Audio Japan (LAJ), and accounts for its investment under the equity method of accounting. The investment was written down to its fair value of $0 at December 31, 2001.

Licensing and reseller agreements with Liquid Audio Korea Co. Ltd., Liquid Audio Greater China and Liquid Audio South East Asia through the strategic partner were terminated in 2001. No revenue was recorded in the six months ended June 30, 2002 and $1,414,000 was recorded in the six months ended June 30, 2001.

Total business development revenue

Total business development revenues are summarized as follows (in thousands):

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LIQUID AUDIO, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
Cyber Music Entertainment and strategic partner	$	$	$	$ 946
Liquid Audio Greater China and strategic partner		468		468
	$	$ 468	$	$ 1,414

The total fees earned from Cyber Music Entertainment and Liquid Audio Greater China relate to software licensing and maintenance fees in the periods indicated.

NOTE 4 COMPREHENSIVE LOSS:

Comprehensive loss includes net loss and other comprehensive income (loss). Other comprehensive income (loss) includes accumulated translation adjustments. The components of comprehensive loss are as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
Comprehensive loss:				
Net loss	$ (5,642)	$ (14,034)	$ (10,535)	$ (25,301)
Foreign currency translation adjustments	(32)	(3)	(25)	(49)
Unrealized gain on investments				6
	$ (5,674)	$ (14,037)	$ (10,560)	$ (25,344)

NOTE 5 NET LOSS PER SHARE:

Basic and diluted net loss per share is computed by dividing the net loss for the period by the weighted average number of common shares outstanding during the period. The calculation of diluted net loss per share excludes potential common shares if the effect is anti-dilutive. Potential common shares consist of unvested restricted common stock, incremental common shares issuable upon the exercise of stock options and common shares issuable upon the exercise of common stock warrants.

The following table sets forth the computation of basic and diluted net loss per share for the periods indicated (in thousands, except per share amounts):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
Numerator:				
Net loss	$ (5,642)	$ (14,034)	$ (10,535)	$ (25,301)

Denominator:				
Weighted average shares	22,738	22,602	22,724	22,572
Weighted average unvested common shares subject to repurchase	(1)	(9)	(1)	(9)
Denominator for basic and diluted calculation	22,737	22,593	22,723	22,563
Net loss per share:				
Basic and diluted	$ (0.25)	$ (0.62)	$ (0.46)	$ (1.12)

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LIQUID AUDIO, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(unaudited)

The following table sets forth potential shares of common stock that are not included in the diluted net loss per share calculation above because to do so would be anti-dilutive for the periods indicated (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
Common stock options	2,604	3,233	2,604	3,233
Common stock warrants	748	875	748	875
Unvested common stock subject to repurchase	1	9	1	9
	3,353	4,117	3,353	4,117

NOTE 6 STRATEGIC MARKETING EQUITY AGREEMENTS:

In March and April 1999, the Company granted fully vested warrants to purchase 12,000 shares of common stock at $6.56 per share. These warrants were valued at $95,000 using the Black-Scholes option pricing model and were recognized as strategic marketing-equity instruments expense. At June 30, 2002, warrants to purchase 10,200 shares of common stock are outstanding and expire in April 2004.

In June 1999, the Company signed an Advertising Agreement with Amazon.com, Inc. (Amazon.com) to collaborate on event-based advertising using the Company s digital delivery services. In connection with this agreement, the Company issued a fully vested warrant to purchase approximately 254,000 shares of common stock to Amazon.com. The warrant was valued at $2,022,000 and was recognized as strategic marketing-equity instruments expense ratably over the one-year term of the agreement, which ended in June 2000. At June 30, 2002, warrants to purchase approximately 254,000 shares of common stock are outstanding and expire in June 2004.

In August 1999, the Company signed a Digital Audio Co-Marketing and Distribution Agreement with Yahoo! to promote the distribution of digital music on its web site. In connection with this agreement, the Company granted Yahoo! three warrants to purchase a total of 250,000 shares of common stock. The first warrant for 83,334 shares vested immediately. The first warrant was valued at $903,000 and was recognized ratably over the one-year term of the agreement as strategic marketing-equity instruments expense. The second warrant for 83,333 shares vested in August 2000. The second warrant was initially valued at $426,000 and was recognized ratably over the one-year period ending at the vesting date as strategic marketing-equity instruments expense. The second warrant was revalued at each balance sheet date through the vesting date. As a result, the original charge of $426,000 was reduced to $312,000 based on market data during the vesting period. The third warrant for 83,333 shares vested in August 2001. The third warrant was initially valued at $105,000 and was recognized ratably over the one-year period ending at the vesting date. The third warrant was revalued at each balance sheet date through the vesting date. As a result, the original charge of $105,000 was reduced to $54,000 based on market data during the vesting period. In the six months ended June 30, 2001, $61,000 was recognized as strategic marketing-equity instruments expense for the third warrant. At June 30, 2002, warrants to purchase 83,334 and 166,666 shares of common stock are outstanding and expire in September 2002 and 2003, respectively.

In July 2000, the Company signed an agreement with Virgin Holdings, Inc. (Virgin), an affiliate of EMI Recorded Music, to promote the distribution of digital music over the Internet using the Company s technology. Pursuant to this agreement, the Company issued 150,000 shares of common stock to Virgin. These shares were valued at $1,181,000 and were recognized as strategic marketing-equity instruments expense ratably over the one-year term of the agreement. As a result, $591,000 was recognized as strategic marketing-equity instruments expense in the six months ended June 30, 2001.

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LIQUID AUDIO, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(unaudited)

In December 2000, the Company signed an agreement with BMG Entertainment to obtain the right to distribute BMG sound recordings and related artwork through kiosks. In connection with this agreement, the Company issued 50,000 shares of common stock to BMG. These shares were valued at $195,000 and which was recognized as non-cash cost of net revenues ratably over the one-year term of the agreement. As a result, $96,000 was recognized as non-cash cost of net revenues in the six months ended June 30, 2001. Additionally, the Company granted warrants to purchase a total of 233,300 shares of common stock. Of the total, warrants to purchase 77,768 shares vested in December 2001, and the cost was remeasured each quarter until a commitment for performance was reached or the warrant vested based on market data. At December 4, 2001, the 77,768 shares under this warrant were valued at $175,000, of which $90,000 was recognized as non-cash cost of net revenues in the six months ended June 30, 2001. The remaining warrants to purchase common shares vest at 6,481 shares per month commencing December 2001 for one year and 6,480 shares per month commencing December 2002 for one year. We recorded a total of $36,000 as non-cash cost of revenue in the six months ended June 30, 2002 related to the remaining warrants. Such warrants will be valued at the fair market value of the Company s common stock on each reporting date. At June 30, 2002, warrants to purchase 116,654 shares of common stock are outstanding and expire in December 2005.

NOTE 7 RESTRUCTURING:

In May 2001, the Company adopted a corporate restructuring program to reduce expenses to preserve the Company s cash position while the digital music market develops. The restructuring included a worldwide workforce reduction, a consolidation of three Redwood City, California offices into one facility and other expense management initiatives. A restructuring charge of $4,497,000 was recorded in operating expense in the twelve months ended December 31, 2001.

The restructuring charge included involuntary employee separation costs of $1,116,000 for 79 employees worldwide, 20 in sales and marketing, 32 in research and development, 13 in general and administrative and 6 in operations functions in the U.S., and 2 in sales and marketing, 3 in research and development and 3 in operations functions outside the U.S.

Lease costs of $1,214,000 were accrued pertaining to the estimated future obligations for non-cancelable lease payments for excess facilities that were vacated due to reductions in workforce.

Asset impairment costs of $2,167,000 were recorded, primarily for property and equipment, furniture and fixtures, computer software and leasehold improvements for assets no longer in use from de-emphasized business lines, reductions in workforce and excess facilities.

A summary of the restructuring cost is outlined as follows (in thousands):

	Severance and Benefits	Facilities	Asset Impairments	Total
Severance and benefits	$ 1,116	$	$	$ 1,116
Accrued lease costs		1,214		1,214
Property and equipment impairment			2,167	2,167
Total	1,116	1,214	2,167	4,497
Cash paid	(1,116)	(691)		(1,807)
Non-cash			(2,167)	(2,167)
Restructuring reserve balance at December 31, 2001		523		523
Cash paid		(492)		(492)
Restructuring reserve balance at June 30, 2002	$	$ 31	$	$ 31

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LIQUID AUDIO, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(unaudited)

Remaining cash expenditures related to net lease expense due to the consolidation of facilities will be paid over the lease terms through the fourth quarter of 2002.

NOTE 8 CONTINGENCIES AND LEGAL PROCEEDINGS:

On July 23, 2002, MM Companies, Inc. (formerly musicmaker.com, Inc.) filed an action in Delaware Chancery Court against the Company, each member of the Company s board of directors, and Alliance Entertainment Corp. The complaint alleges that the directors of the Company and Alliance violated their fiduciary duties by entering into the merger and approving the Merger Agreement, and that the Company s directors further violated their fiduciary duties by making certain changes to the Company s shareholders rights plan. Alliance is alleged to have aided and abetted the alleged breaches of fiduciary duty by the Company s directors. According to the complaint, the plaintiff is seeking, among other things, to (i) invalidate the Merger Agreement, (ii) prevent the Company or Alliance from taking any actions to effectuate or enforce the Merger Agreement, the merger of the Company or Alliance, or the self tender-offer, (iii) direct the Company s board of directors to restore the trigger of the Company s shareholders rights plan to 15%, (iv) prevent enforcement of the Company s shareholders rights plan to the extent it prohibits the plaintiff and other stockholders from cooperating to assist in the solicitation of proxies for the Company s annual meeting, (v) damages for incidental injuries, and (vi) costs and expenses, including attorneys fee and experts fees. In connection with its complaint, MM Companies, Inc. filed a motion for a preliminary injunction and a motion for expedited proceedings. On July 31, 2002, MM Companies, Inc. withdrew its motion for a preliminary injuction and for expedited proceedings, and stated that it would file an amended complaint. To date, no amended complaint has been filed. If MM Companies, Inc. elects to pursue its claims in this matter, the Company intends to vigorously defend the action.

On May 30, 2002, musicmaker.com, Inc. filed an action in the Delaware Chancery Court to obtain certain stockholder information. The Company has since provided the requested stockholder information to musicmaker.com, Inc. and, as a result, this action is moot.

On May 3, 2002, musicmaker.com filed an action in the Delaware Chancery Court, pursuant to Title 8 Delaware Code section 211, seeking to compel the Company to hold an annual meeting of stockholders. The Company moved to dismiss on the grounds that the court lacked subject matter jurisdiction as 13 months had not elapsed since the Company s last annual stockholder meeting, held on June 1, 2001. On May 10, 2002, the board of directors set July 1, 2002 as the date for the 2002 Annual meeting and the Company s motion to dismiss was held in abeyance. On June 13, 2002, the Company publicly announced the execution of the original merger agreement and announced that, in light of the merger, the Company s board of directors had determined to postpone the 2002 annual meeting. The next day, musicmaker.com filed an amended complaint requesting that the court order the Company to hold its annual meeting on July 1, 2002. The court allowed the parties to take expedited discovery and scheduled a hearing for July 15, 2002. At the hearing and by Order dated July 24, 2002, the court granted the Company s request that the annual meeting be scheduled for September 26, 2002 so that the vote on the election of directors and the vote on the issuance of the Company s stock in the merger could proceed on the same day.

In October 2001, two lawsuits were filed in Delaware Chancery Court naming the Company and certain of its officers and directors as defendants. Both actions related to the Company s response to recent acquisition offers and purported to be class actions brought on behalf of the Company s shareholders. On February 1, 2002, the two complaints were consolidated into a single action, titled *In Re Liquid Audio, Inc., Shareholders Litigation*, Consolidated Civil Action No. 19212-NC. That action was brought against Gerald W. Kearby, Silvia Kessel, Ann L. Winblad and the Company. The complaint alleges that defendants had breached their fiduciary duties owed to the Company s shareholders in connection with the Company s response to acquisition offers from Steel Partners II, LLP and an investor group formed by musicmaker.com, Inc. The complaint seeks, among other things, a court order barring the Company from adopting or maintaining measures that would make the Company less attractive as a takeover candidate or, alternatively, awarding compensatory damages to the purported plaintiff class. To date, the Company has not responded to the complaint, nor has the court set a date for discovery cutoff or trial. The Company intends to vigorously defend the action. There is no assurance concerning the outcome of this action, or whether it will have a material effect on the Company s financial condition or business operations.

On or about September 27, 2001, Network Commerce, Inc. (NCI) filed a Complaint against the Company in the United States District Court for the Western District of Washington (Seattle). The suit alleges that the Company infringes the claims of United States Patent No. 6,073,124. NCI requests that the Company be enjoined from its allegedly infringing activities and seeks unspecified damages. The Company was served with the Complaint on November 2, 2001 and subsequently submitted its answer and included counterclaims.

On August 23, 2001, the Company received a demand letter from a former employee s legal counsel alleging claims for sexual harassment and retaliation. On September 13, 2001, the former employee filed a charge with the California Department of Fair Employment and Housing alleging such claims against the Company and one of its former employees. The Company completed an investigation and believes that there is

no merit to the former employee s allegations. In May 2002, the parties entered into a final settlement regarding this matter. The settlement did not have a material impact on the Company s financial position or results of operations.

On July 20, 2001, a putative securities class action, captioned *Murowa Financial v. Liquid Audio, Inc. et al.*, Civil Action No. 01-CV-6661, was filed against the Company, certain of the Company s officers and directors (the Individual Defendants) and three underwriters in the Company s initial public offering (the IPO), in the United States District Court for the Southern District of New York. The Complaint seeks unspecified damages on behalf of a purported class of purchasers of the Company s common stock between July 8, 1999 and December 6, 2000. Several complaints substantially identical to *Murowa* were later filed against the Company, the Individual Defendants, and several of the IPO underwriters in the Southern District of New York. These cases were consolidated under Civil Action No. 01-CV-6661. On April 19, 2002, an amended complaint was filed in this consolidated action, titled *In re Liquid Audio, Inc. Initial Public Offering Securities Litigation*. The amended complaint generally alleges that various investment bank underwriters engaged in improper and undisclosed activities related to the allocation of shares in the Company s initial public offering and secondary offering of securities. The complaint brings claims for violation of several provisions of the federal securities laws against those underwriters, and also contains claims against the Company and certain of its directors and officers. Various plaintiffs have filed similar actions asserting virtually identical allegations against more than 300 other companies. The lawsuit and all other IPO allocation securities class actions currently pending in the Southern District of New York have been assigned to Judge Shira A. Scheindlin for coordinated pretrial proceedings. The Company believes that it has meritorious defenses to the claims and intends to vigorously defend against such claims.

On or about April 7, 2000, Sightsound, Inc. (Sightsound) filed an amended complaint against one of the Company s customers in the United States District Court for the Western District of Pennsylvania. The suit alleges that the Company s customer infringes one or more of three patents (United States Patent Nos. 5,191,573; 5,675,734 and 5,996,440). Sightsound claims damages of $20 million plus an unspecified royalty. The Company has entered into an agreement with the Company s customer agreeing to assume control of the defense and pay the defense costs, while reserving the Company s rights as to indemnification obligations. The customer filed an answer to the amended complaint on April 27, 2000, denying the material allegations of the complaint, and asserting counterclaims for declaratory judgment of non-infringement and patent invalidity. Following a claims construction hearing in 2001 and an initial report and recommendation on claim construction by the magistrate judge in February 2002 (which ruling is on appeal to the district judge), the Company renegotiated its agreement with the Company s customer concerning the defense of the case going forward. The Company has now ceded control of the defense of the case to the customer/Bertelsmann AG (the customer s ultimate owner), and is splitting the costs of the defense with the customer/Bertelsmann AG. The Company is still reserving its rights as to indemnification issues. A trial date had been set for September 28, 2001 in the matter, but that date will be reset after the Court rules on the claim construction and other pending matters.

NOTE 9 MERGER:

On June 12, 2002, the Company signed a definitive merger agreement with Alliance Entertainment Corp. (Alliance), a privately-held home entertainment product distribution, fulfillment and infrastructure company. On July 14, 2002, the Company and Alliance executed an amended and restated merger agreement that modified certain terms of the previously announced merger agreement.

April Acquisition Corp. was recently incorporated in Delaware solely for the purpose of the merger, and is a wholly-owned subsidiary of the Company. It does not conduct any business and has no material assets. Upon completion of the merger, April Acquisition Corp. will be merged with and into Alliance, and Alliance will continue as the surviving corporation of the merger and a wholly-owned subsidiary of the Company. Upon completion of the merger, each outstanding share of Alliance common stock will be converted into the right to receive a number of shares of the Company s stock which will result in the former stockholders of Alliance holding 74% of the outstanding voting power of the combined organization after the merger, without giving effect to any then outstanding options or warrants.

The Company and Alliance expect to complete the merger when all of the conditions to completions of the merger contained in the merger agreement have been satisfied or waived. The merger will become effective upon the filing of a certificate of merger with the Delaware Secretary of State under applicable Delaware law. The Company and Alliance are working toward satisfying the conditions to the merger, and hope to complete the merger as soon as practicable following the annual stockholder meeting, to be held on September 26, 2002.

In connection with the merger, the Company will make an offer to purchase 10,000,000 shares of its common stock at a purchase price of $3.00 per share. If more than 10,000,000 shares of the Company s common stock are tendered, the Company will purchase 10,000,000 shares of its common stock on a pro rata basis from those stockholders tendering shares. The tender offer will expire on the day of the Company s stockholder meeting. Consummation of the tender offer is conditioned upon, among other things, approval of the issuance of the Company s stock in the merger by the Company s stockholders at the annual stockholder meeting. The approval of the issuance of the Company s stock in the merger will require the affirmative vote of a majority of the outstanding shares of the Company s common stock voting at the annual stockholder meeting.

The merger agreement provides that upon completion of the merger, the board of directors of the Company will be comprised of members designated by the Company to constitute one-third ($^1/_3$) of the board. Members designated by Alliance will constitute two-thirds ($^2/_3$) of the board.

The merger agreement provides that the Company and Alliance may agree by mutual written consent to terminate the merger agreement at any time before the completion of the. Under certain circumstances, either Alliance or the Company may unilaterally terminate the merger

agreement. In certain of these circumstances, a termination fee will be payable by the Company to Alliance if the merger agreement is terminated. The amount of the termination fee will depend on the circumstances giving rise to the termination and may be up to $3,000,000. Under the terms of the merger agreement, the Company will pay a $3,000,000 termination fee to Alliance if:

- the Company or Alliance terminates the merger agreement because the merger was not consummated by December 31, 2002, and within 12 months after such termination, the Company enters into a definitive agreement with respect to, or consummates, any acquisition proposal;

- Alliance terminates the merger agreement because a triggering event occurred prior to the approval of the issuance of the Company s stock in the merger by the required vote of the Company s stockholders; or

- the Company terminates the merger agreement because it enters into a definitive agreement related to an offer from a third party superior to the merger agreement.

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LIQUID AUDIO, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(unaudited)

Under the terms of the merger agreement, the Company will pay to Alliance a $1,000,000 termination fee in the event either Alliance or the Company terminates the merger agreement because the required vote of the Company s stockholders for the issuance of the Company s stock in the merger shall have not been obtained at a meeting of the Company s stockholders or if Alliance or the Company terminates the merger agreement because the SEC shall have declined to grant an exemption from the requirements of Rule 102 of Regulation M in connection with the tender offer and the merger and counsel has not advised the Company that it may proceed in the absence of such exemption. If within 12 months after such termination, the Company enters into a definitive agreement with respect to, or consummates, any acquisition proposal, the Company will pay to Alliance an additional fee of $750,000. If within 6 months after such termination, the Company completes a liquidation or dissolution, the Company will pay to Alliance an additional fee of $750,000.

The Company also announced that its board of directors approved an amendment to its Preferred Stock Rights Agreement to revise the beneficial ownership threshold at which a person or group of persons becomes an acquiring person and triggers certain provisions under the Preferred Stock Rights Agreement. As revised, a person or group would become an acquiring person if that person or group becomes the beneficial owner of 10 percent or more of the outstanding shares of the Company s common stock. Prior to such amendment, the beneficial ownership threshold was 15 percent.

A Registration Statement on Form S-4 was filed with the SEC on July 23, 2002, setting forth the terms of the merger and putting up for vote the issuance of new shares of common stock and other routine matters at the Company s annual meeting of stockholders.

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following Management s Discussion and Analysis contains forward-looking statements within the meaning of Federal securities laws. You can identify these statements because they use forward-looking terminology such as may, will, expect, anticipate, estimate, continue, be intend or other similar words. These words, however, are not the exclusive means by which you can identify these statements. Examples of such forward-looking statements include, but are not limited to: statements about future expectations; statements containing projections of results of operations or of financial conditions; statements characterizing future events or circumstances; statements about the pending merger of the Company and Alliance Entertainment Crop. (the Merger) and statements about the market acceptance of our products and services. Such forward-looking statements involve risks and uncertainties, including, but not limited to, those risks and uncertainties relating to the costs and benefits associated with the Merger, the growth and viability of the digital music market, the adoption of security standards for digital music, the acceptance of our platform by consumers, our ability to obtain content and our history of losses. We have based all forward-looking statements included in Management s Discussion and Analysis on information currently available to us, and we assume no obligation to update any such forward-looking statements. Although we believe that the expectations reflected in such forward-looking statements are based on reasonable assumptions, actual results could differ materially from those projected in the forward-looking statements. Potential risks and uncertainty include, but are not limited to, those set forth under the caption Additional Factors Affecting Future Results included in this Management s Discussion and Analysis of Financial Condition and Results of Operations.

While we believe that the discussion and analysis in this report is adequate for a fair presentation of the information, we recommend that you read this discussion and analysis in conjunction with Management s Discussion and Analysis included in our Annual Report on Form 10-K for the year ended December 31, 2001 filed with the Securities Exchange Commission (SEC).

Overview

We are a leading provider of software products and services that enable artists, record companies and retailers to create, syndicate and sell music digitally over the Internet. Our products and services are based on an open technical architecture that is designed to support a variety of digital music formats. From our inception in January 1996 through early 1997, we devoted substantially all of our efforts to product development, raising capital and recruiting personnel. We first generated revenues in the first quarter of 1997 through the licensing of our Liquifier Pro, Liquid Server and Liquid Player software products. In November 1997, we introduced a subscription-based hosting service for digital recorded music using our technology. In July 1998, to enhance consumer access to the music we were hosting, we launched the Liquid Music Network (LMN), a syndicated network of leading music related and music retailer websites.

In early 1999, we began to place greater emphasis on developing and marketing our digital music delivery services. Since that time, we have invested significant resources to increase our distribution reach by expanding the LMN, building our syndicated music catalog available for sale, actively participating in standards initiatives and establishing our international presence. As a provider of digital music delivery services, we expect our revenue sources to expand beyond software license sales to include sales of digital recorded music and digital music subscriptions. Revenues from digital music sales and transaction fees from our music delivery services represented less than 7%, 6% and 1% of total net revenues in 2001, 2000 and 1999, respectively. Our Liquid Music Network began offering syndicated music through music retailer websites in the third quarter of 1999.

Business Development Revenue

Business development revenues as a percentage of total net revenues were 61%, 63% and 48% in 2001, 2000 and 1999, respectively. Liquid Audio Korea (LAK), Liquid Audio Greater China (LAGC), Liquid Audio South East Asia (LASE) through our strategic partner, Epi Entertainment Group, Ltd., and Liquid Audio Japan (LAJ) stopped making their contractual payments as scheduled in the third quarter of 2000, fourth quarter of 2000, first quarter of 2001 and the second quarter of 2001, respectively, due to deterioration of their financial condition and lack of funds available to meet their contractual payment obligations. We have been unsuccessful in receiving any additional contractual payments from these customers, and, as a result of the financial condition of these customers, we do not anticipate that such customers will be a source of additional revenue or that we will receive payments owed for existing contractual arrangements.

In June 2001, we and LAJ mutually agreed to terminate the licensing and reseller agreements (the Agreements) between us. As a result, LAJ renamed its company to Cyber Music Entertainment (CME) and no longer distributes our technology nor utilizes our digital distribution platform to offer services to the Japanese music market. Effective September 30, 2001, CME ceased using our trademarks, including the company name, and returned all of our products, technology and licenses. We do not believe we have any outstanding obligations in connection with the Agreements. As a result, we recognized the remaining deferred revenue balance of $890,000, which had been paid in cash, from CME in the three months ended September 30, 2001. In October 2001, we established a new office in Tokyo to build new relationships with label, retail and consumer electronic companies directly.

In September 2001, we notified LAK, LAGC and LASE through our strategic partner of their defaults under the licensing and reseller agreements between us and the aforementioned companies due to their failures to make contractual payments as scheduled. LAK, LAGC and our strategic partner of LASE did not cure the defaults during the cure periods. Accordingly, we exercised our rights to terminate the licensing and reseller agreements. Outstanding accounts receivable from LAK, LAGC and our strategic partner of LASE have been fully reserved, and no revenue from LAK, LAGC or LASE through our strategic partner was recorded in the three months ended September 30, 2001. We do not believe we have any outstanding obligations in connection with the Agreements. As a result, we recognized the remaining deferred revenue balance of $569,000, which had been paid in cash, from LAGC in the three months ended December 31, 2001.

Corporate Restructuring

In May 2001, we adopted a corporate restructuring program to reduce expenses to preserve our cash position while the digital music market develops. The restructuring included a worldwide workforce reduction of approximately 40% of our workforce across all functional areas, a consolidation of three Redwood City, California offices into one facility and other expense management initiatives. We have de-emphasized our efforts in less productive, non-core business areas that do not directly support secure digital download opportunities, including digital music kiosks, music hosting for independent artists and labels, music clips service and encoding services. We plan to continue to focus on software licensing and digital music delivery services that complement our secure digital download business. We plan to support the emerging market for digital music subscriptions, enabling major portals, online retailers and secure audio device manufacturers to offer subscription-based digital music download services. This strategy leverages and enhances both our core digital download services and our player software licensing business. At June 30, 2002, we have a remaining $31,000 restructuring accrual balance related to estimated future obligations for non-cancelable lease payments for excess facilities that were vacated due to reductions in workforce. This accrual will be paid over the lease terms through the fourth quarter of 2002.

The Merger with Alliance

On June 12, 2002, we signed a definitive merger agreement with Alliance Entertainment Corp. (Alliance), a privately-held home entertainment product distribution, fulfillment and infrastructure company. On July 14, 2002, we and Alliance executed an amended and restated merger agreement that modified certain terms of the previously announced merger agreement. We and Alliance believe that the combination of our two businesses will permit us to develop effective and efficient means to deliver services to our customers.

April Acquisition Corp. was recently incorporated in Delaware solely for the purpose of the merger, and is our wholly-owned subsidiary. It does not conduct any business and has no material assets. Upon completion of the merger, April Acquisition Corp. will be merged with and into Alliance, and Alliance will continue as the surviving corporation of the merger and our wholly-owned subsidiary. Upon completion of the merger, each outstanding share of Alliance common stock will be converted into the right to receive a number of shares of our stock which will result in the former stockholders of Alliance holding 74% of the outstanding voting power of the combined organization after the merger, without giving effect to any then outstanding options or warrants.

We and Alliance expect to complete the merger when all of the conditions to completions of the merger contained in the merger agreement have been satisfied or waived. The merger will become effective upon the filing of a certificate of merger with the Delaware Secretary of State under applicable Delaware law. We and Alliance are working toward satisfying the conditions to the merger, and hope to complete the merger as soon as practicable following the annual stockholder meeting, to be held on September 26, 2002.

In connection with the merger, we will make an offer to purchase 10,000,000 shares of our common stock at a purchase price of $3.00 per share. If more than 10,000,000 shares of our common stock are tendered, we will purchase 10,000,000 shares of our common stock on a pro rata basis from those stockholders tendering shares. The tender offer will expire on the day of our stockholder meeting. Consummation of the tender offer is conditioned upon, among other things, approval of the issuance of our stock in the merger by our stockholders at the annual stockholder meeting. The approval of the issuance of our stock in the merger will require the affirmative vote of a majority of the outstanding shares of the our common stock voting at the annual stockholder meeting.

The merger agreement provides that upon completion of the merger, our board of directors will be comprised of members designated by us to constitute one-third ($^{1}/_{3}$) of the board. Members designated by Alliance will constitute two-thirds ($^{2}/_{3}$) of the board.

The merger agreement provides that we and Alliance may agree by mutual written consent to terminate the merger agreement at any time before the completion of the merger. Under certain circumstances, either Alliance or we may unilaterally terminate the merger agreement. In certain of these circumstances, a termination fee will be payable by us to Alliance if the merger agreement is terminated. The amount of the termination fee will depend on the circumstances giving rise to the termination and may be up to $3.0 million. Under the terms of the merger agreement, we will pay a $3.0 million termination fee to Alliance if:

- we or Alliance terminate the merger agreement because the merger was not consummated by December 31, 2002, and within 12 months after such termination, we enter into a definitive agreement with respect to, or consummate, any acquisition proposal;

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Alliance terminates the merger agreement because a triggering event occurred prior to the approval of the issuance of our stock in the merger by the required vote of our stockholders; or

we terminate the merger agreement because we enter into a definitive agreement related to an offer from a third party superior to the merger agreement.

Under the terms of the merger agreement, we will pay to Alliance a $1.0 million termination fee in the event either Alliance or we terminate the merger agreement because the required vote of our stockholders for the issuance of our stock in the merger shall have not been obtained at a meeting of our stockholders or if Alliance or we terminate the merger agreement because the SEC shall have declined to grant an exemption from the requirements of Rule 102 of Regulation M in connection with the tender offer and the merger and counsel has not advised us that we may proceed in the absence of such exemption. If within 12 months after such termination, we enter into a definitive agreement with respect to, or consummate, any acquisition proposal, we will pay to Alliance an additional fee of $750,000. If within 6 months after such termination, we complete a liquidation or dissolution, we will pay to Alliance an additional fee of $750,000.

We also announced that our board of directors approved an amendment to our Preferred Stock Rights Agreement to revise the beneficial ownership threshold at which a person or group of persons becomes an acquiring person and triggers certain provisions under the Preferred Stock Rights Agreement. As revised, a person or group would become an acquiring person if that person or group becomes the beneficial owner of 10 percent or more of the outstanding shares of our common stock. Prior to such amendment, the beneficial ownership threshold was 15 percent.

A Registration Statement on Form S-4 was filed with the SEC on July 23, 2002, setting forth the terms of the merger and putting up for vote the issuance of new shares of common stock and other routine matters at our annual meeting of stockholders.

We have a limited operating history upon which investors may evaluate our business and prospects. Since inception we have incurred significant losses, and as of June 30, 2002 we had an accumulated deficit of approximately $121.6 million. We expect to incur additional losses and continued negative cash flow from operations through at least 2003. Our revenues may not increase or even continue at their current levels and we may not achieve or maintain profitability or generate cash from operations in future periods. Our prospects must be considered in light of the risks, expenses and difficulties frequently encountered by companies in their early stages of development, particularly companies in new and rapidly evolving markets such as the digital delivery of recorded music. We may not be successful in addressing these risks, and our failure to do so would harm our business.

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Results of Operations

The following table sets forth, for the periods presented, certain data derived from our unaudited condensed statement of operations as a percentage of total net revenues. The operating results in any period are not necessarily indicative of the results that may be expected for any future period.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
Net revenues:				
License	26%	19%	27%	18%
Services	74	35	73	29
Business development (related party)		46		53
Total net revenues	100	100	100	100
Cost of net revenues:				
License	56	12	63	11
Services	115	36	106	40
Non-cash cost of revenue	24	10	24	7
Total cost of net revenues	195	58	193	58
Gross profit (loss)	(95)	42	(93)	42
Operating expenses:				
Sales and marketing	679	299	763	287
Non-cash sales and marketing	(21)	(7)	(7)	(2)
Research and development	1,930	462	2,076	371
Non-cash research and development	2	(3)	3	(1)
General and administrative	1,262	301	1,053	234
Non-cash general and administrative		(2)		(1)
Strategic marketing-equity instruments		33		24
Restructuring		358		137
Total operating expenses	3,852	1,441	3,888	1,049
Loss from operations	(3,947)	(1,399)	(3,981)	(1,007)
Other income (expense), net	211	114	297	106
Net loss in equity investment		(86)		(41)
Net loss	(3,736)%	(1,371)%	(3,684)%	(942)%

Three Months Ended June 30, 2002 and 2001

Total Net Revenues

Total net revenues decreased 85% to $151,000 for the three months ended June 30, 2002 from $1.0 million in the comparable period of 2001.

License. License revenues consist of fees from licensing our software products to third parties. License revenues decreased 79% to $40,000 for the three months ended June 30, 2002 from $194,000 in the comparable period of 2001. This decrease was due to lower Liquid Player software licensing resulting from the expiration of an OEM bundling agreement with a major consumer electronics company and the transitioning of our Liquid Player software licensing strategy from bundling, for a per-unit fee, with OEM products in the 2001 period, to bundling for free with OEM products in exchange for potential future upgrade licensing revenues from consumers of those OEM products in the 2002 period. We compete with other companies that offer music player software for free to OEMs, and such arrangements usually limit the bundling of a music player to only one vendor. Accordingly, there is no assurance that we will be able to displace existing bundling arrangements that OEMs may have with our competitors.

Services. Services revenues consist of maintenance fees related to our licensed software products, hosting fees, encoding, music delivery and transaction fees, promotion and advertising services and kiosk-related equipment sales from third parties. Services revenues decreased 69% to $111,000 for the three months ended June 30, 2002 from $362,000 in the comparable period of 2001. This decrease was due to decrease in maintenance fees resulting from lower software license fees, decrease in encoding services from the expiration of a contract with Microsoft, decrease in promotion and advertising services resulting from the softness in the Internet advertising market, disappearance of revenue from Liquid Muze Previews service due to the termination of the agreement with Muze, decrease of hosting fees from the de-emphasis of music hosting for independent artists and labels in connection with our corporate restructuring and decrease in kiosk-related equipment sales from the de-emphasis in digital music kiosks in connection with our corporate restructuring.

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Business Development (Related Party). Business development revenues consist of license and maintenance fees from agreements under which we give our strategic related partners the right to license and use our digital recorded music delivery technology. Business development revenues decreased to $0 for the three months ended June 30, 2002 from $468,000 in the comparable period of 2001. The decrease was due to the termination of our agreements in 2001 with Liquid Audio Japan, Liquid Audio Korea, Liquid Audio Greater China and Liquid Audio South East Asia through our strategic partner, Epi Entertainment Group, Ltd. Revenue for the 2001 period relates to software licensing and related maintenance revenues earned from Liquid Audio Japan and Liquid Audio Greater China. We do not expect to derive significant revenue from business development arrangement in the foreseeable future.

In the three months ended June 30, 2002, approximately 12% of total net revenues came from sales to one customer, Country Music Hall of Fame. In the three months ended June 30, 2001, approximately 47% of total net revenues came from sales to one customer, Liquid Audio Greater China. International revenues represented approximately 14% and 48% of total net revenues in the three months ended June 30, 2002 and 2001, respectively.

Total Cost of Net Revenues

Our gross profit (loss) decreased to approximately (95)% of total net revenues for the three months ended June 30, 2002 from approximately 42% of total net revenues in the comparable period of 2001. Total cost of net revenues decreased 50% to $294,000 in the 2002 period from $590,000 in the 2001 period.

License. Cost of license revenues consists of royalties paid to third-party technology vendors and costs of documentation, duplication and packaging. Cost of license revenues decreased 34% to $84,000 for the three months ended June 30, 2002 from $128,000 in the comparable period of 2001. Cost of license revenues decreased due to lower license revenues and product mix differences, partially offset by royalties for additional third-party technologies.

Services. Cost of services revenues consists of compensation for customer service, encoding and professional services personnel, kiosk-related equipment and an allocation of our occupancy costs and other overhead attributable to our services revenues. Cost of services revenues decreased 52% to $174,000 for the three months ended June 30, 2002 from $364,000 in the comparable period of 2001. The decrease in cost of services revenues was due to the reduction in the number of encoding, customer service and professional services personnel from 28 to 8 due to our corporate restructuring and expense management initiatives.

Non-Cash Cost of Revenues. Non-cash cost of revenues consists of expenses associated with the value of common stock and warrants issued to partners as part of our content acquisition agreements and stock-based employee compensation arrangements. Common stock expense is based on the fair value of the stock at the time it was issued. Warrant expense is based on the estimated fair value of the warrants based on the Black-Scholes option pricing model and the provisions of EITF 96-18. In December 2000, we signed an agreement with BMG Entertainment (BMG) to obtain the right to distribute BMG sound recordings and related artwork through kiosks. In connection with this agreement, we issued 50,000 shares of common stock to BMG, valued at $195,000 and which was recognized ratably over the initial one-year term of the agreement; as a result, $49,000 was recognized as non-cash cost of revenues in the three months ended June 30, 2001. Also in connection with this agreement, we granted a warrant for a total of 233,300 shares of common stock. Of the total, warrants to purchase 77,768 shares vested in December 2001, and the cost was remeasured each quarter until a commitment for performance was reached or the warrant vested, based on market data. At December 4, 2001, the 77,768 shares under this warrant were valued at $175,000, of which $55,000 was recognized as non-cash cost of revenues for the three months ended June 30, 2001. The remaining warrants to purchase common shares vest at 6,481 shares per month commencing December 2001 for one year and 6,480 shares per month commencing December 2002 for one year. We recorded a total of $36,000 as non-cash cost of revenue in the three months ended June 30, 2002 related to the remaining warrants. Such warrants are valued at the fair market value of our common stock at each vesting date. Stock compensation expense for customer service, encoding and professional services personnel were $0 and $(6,000) in the three months ended June 30, 2002 and 2001, respectively. We have fully amortized stock compensation expense related to these personnel in 2001, and accordingly no future expense related to these stock options will be incurred.

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Operating Expenses

Sales and Marketing. Sales and marketing expenses consist of compensation for our sales, marketing and business development personnel, compensation for customer service and professional services personnel attributable to sales and marketing activities, advertising, trade show and other promotional costs, design and creation expenses for marketing literature and our website and an allocation of our occupancy costs and other overhead. Sales and marketing expenses decreased 66% to $1.0 million for the three months ended June 30, 2002 from $3.1 million in the comparable period of 2001. This decrease was due to the reduction in compensation and related expenses of approximately $770,000 from decreases in the number of sales and marketing personnel from 59 to 19 due to our corporate restructuring and expense management initiatives, shared project costs with Radio & Records of approximately $676,000, tradeshows of approximately $111,000, travel and entertainment of approximately $110,000, depreciation and amortization of approximately $110,000 and allocation of occupancy costs and other overhead of approximately $192,000.

Research and Development. Research and development expenses consist of compensation for our research and development, network operations and product management personnel, payments to outside contractors and, to a lesser extent, depreciation on equipment used for research and development and an allocation of our occupancy costs and other overhead. Research and development expenses decreased 38% to $2.9 million for the three months ended June 30, 2002 from $4.7 million in the comparable period of 2001. This decrease was due to the reduction in compensation and related expenses of approximately $1.1 million from decreases in the number of personnel from 88 to 51 and outside contractors due to our corporate restructuring and expense management initiatives, travel and entertainment of approximately $100,000, depreciation and amortization of approximately $243,000 and allocation of occupancy costs and other overhead of approximately $183,000.

General and Administrative. General and administrative expenses consist of compensation for personnel and payments to outside contractors for general corporate functions, including finance, information systems, human resources, facilities, legal and general management, fees for professional services, bad debt expense and an allocation of our occupancy costs and other overhead. General and administrative expenses decreased 38% to $1.9 million for the three months ended June 30, 2002 from $3.1 million in the comparable period of 2001. This decrease was due to the reduction in compensation and related expenses of approximately $365,000 from decreases in the number of personnel from 31 to 17 and outside contractors due to our corporate restructuring and expense management initiatives and a decrease in legal fees of approximately $322,000 from lower legal activity in patent infringement matters in the 2002 period and decrease in bad debt expense of approximately $1.0 million, partially offset by fees paid to an investment banker of $400,000.

Strategic Marketing Equity Instruments. Strategic marketing-equity instruments consist of expenses associated with the value of common stock and warrants issued to partners as part of our strategic marketing agreements. Common stock expense is based on the fair value of the stock at the time it was issued. Warrant expense is based on the estimated fair value of the warrants based on the Black-Scholes option pricing model and the provisions of EITF 96-18. Strategic marketing-equity instruments expense was $0 and $340,000 in the three months ended June 30, 2002 and 2001, respectively. In August 1999, we signed a Digital Audio Co-Marketing and Distribution Agreement with Yahoo! to promote the distribution of digital music on its web site. In connection with this agreement, we granted Yahoo! three warrants to purchase a total of 250,000 shares of common stock. The first warrant for 83,334 shares vested immediately. The first warrant was valued at $903,000 and was recognized ratably over the one-year term of the agreement. The second warrant for 83,333 shares vested in August 2000. The second warrant was initially valued at $426,000 and was recognized ratably over the one-year period ending at the vesting date. The second warrant was revalued at each balance sheet date through the vesting date. As a result, the original charge of $426,000 was reduced to $312,000 based on market data during the vesting period. The third warrant for 83,333 shares vested in August 2001. The third warrant was initially valued at $105,000 and was recognized ratably over the one-year period ending at the vesting date. The third warrant was revalued at each balance sheet date through the vesting date. As a result, the original charge of $105,000 was reduced to $54,000 based on market data during the vesting period. In the three months ended June 30, 2001, $0, $0 and $45,000 were recognized as strategic marketing-equity instruments expense for the first, second and third warrants, respectively. In July 2000, we signed an agreement with Virgin Holdings, Inc. (Virgin), an affiliate of EMI Recorded Music, to promote the distribution of digital music over the Internet using our technology. Pursuant to this agreement, we issued 150,000 shares of common stock to Virgin. These shares were valued at $1.2 million and recognized ratably over the one-year term of the agreement. As a result, $295,000 was recognized as strategic marketing-equity instruments expense in the three months ended June 30, 2001.

Non-Cash Sales and Marketing, Research and Development and General and Administrative. Non-cash sales and marketing, research and development and general and administrative expenses relate to stock-based employee compensation arrangements. The total unearned compensation recorded by us from inception to June 30, 2002 was $3.5 million. We recognized $(28,000) and $(119,000) of stock compensation expense for the three months ended

June 30, 2002 and 2001, respectively. We expect quarterly amortization related to those options to be between $5,000 and $3,000 per quarter during the remainder of 2002. These future compensation charges would be reduced if sales and marketing, research and development and general and administrative employees who hold the applicable options terminate employment prior to the expiration of their option vesting period.

Restructuring. Restructuring charge relates to costs associated with our corporate restructuring program adopted in May 2001. The $3.7 million charge in the three months ended June 30, 2001 consists of involuntary employee separation costs of $1.1 million, lease costs of $824,000 pertaining to estimated future obligations for non-cancelable lease payments for excess facilities that were vacated due to reductions in workforce, and asset impairment costs of $1.7 million for property and equipment, furniture and fixtures, computer software and leasehold improvements no longer in use from de-emphasized product lines, reductions in workforce and excess facilities.

Other Income (Expense), Net. Interest income consists of earnings on our cash, cash equivalents and short-term investments. Interest expense consists of expenses related to our financing obligations, which include borrowings under equipment loans and capital lease obligations. Other income (expense), net decreased to $318,000 for the three months ended June 30, 2002 from $1.2 million in the comparable period of 2001. The decrease was due to lower average cash and cash equivalent balances resulting from cash used in operating activities, and lower interest rates.

Loss in Equity Investment. Loss in equity investment consists of our share of losses from our investment in a related party accounted for using the equity method of accounting. Loss in equity investment was $0 and $881,000 for the three months ended June 30, 2002 and 2001, respectively. The net balance of our investments in Cyber Music Entertainment has been reduced to zero at December 31, 2001. We have discontinued recording losses from our investment in Cyber Music Entertainment as we have no contractual or planned obligation to provide funding to Cyber Music Entertainment.

Six Months Ended June 30, 2002 and 2001

Total Net Revenues. Total net revenues decreased 89% to $286,000 for the six months ended June 20, 2002 from $2.7 million in the comparable period of 2001.

License. License revenues decreased 84% to $76,000 for the six months ended June 30, 2002 from $484,000 in the comparable period of 2001. This decrease was due to lower Liquid Player software licensing resulting from the expiration of an OEM bundling agreement with a major consumer electronics company and the transitioning of our Liquid Player software licensing strategy from bundling, for a per-unit fee, with OEM products in the 2001 period, to bundling for free with OEM products in exchange for potential future upgrade licensing revenues from consumers of those OEM products in the 2002 period. We compete with other companies that offer music player software for free to OEMs, and such arrangements usually limit the bundling of a music player to only one vendor. Accordingly, there is no assurance that we will be able to displace existing bundling arrangements that OEMs may have with our competitors.

Services. Services revenues decreased 73% to $210,000 for the six months ended June 30, 2002 from $787,000 in the comparable period of 2001. This decrease was due to decrease in maintenance fees resulting from lower software license fees, decrease in encoding services from the expiration of a contract with Microsoft, decrease in promotion and advertising services resulting from the softness in the Internet advertising market, disappearance of revenue from Liquid Muze Previews service due to the termination of the agreement with Muze, decrease of hosting fees from the de-emphasis of music hosting for independent artists and labels in connection with our corporate restructuring and decrease in kiosk-related equipment sales from the de-emphasis in digital music kiosks in connection with our corporate restructuring.

Business Development (Related Party). Business development revenues decreased to $0 for the six months ended June 30, 2002 from $1.4 million in the comparable period of 2001. The decrease was due to the termination of our agreements in 2001 with Liquid Audio Japan, Liquid Audio Korea, Liquid Audio Greater China and Liquid Audio South East Asia through its strategic partner, Epi Entertainment Group, Ltd. Revenue for the 2001 period relates to software licensing and related maintenance revenues earned from Liquid Audio Japan and Liquid Audio Greater China. We do not expect to derive significant revenue from business development arrangements in the foreseeable future. In the first six months of 2002, approximately 11% of total net revenues came from sales to one customer, Sanyo.

In the first six months of 2001, approximately 53% of total net revenues came from sales to two customers, Cyber Music Entertainment and Liquid Audio Greater China. International revenues represented approximately 14% and 59% of total net revenues in the six months ended June 30, 2002 and 2001, respectively.

Total Cost of Net Revenues. Our gross profit (loss) decreased to approximately (93)% of total net revenues for the six months ended June 30, 2002 from approximately 42% of total net revenues in the comparable period of 2001. Total cost of net revenues decreased 64% to $552,000 in the 2002 period from $1.5 million in the 2001 period.

License. Cost of license revenues decreased 37% to $181,000 for the six months ended June 30, 2002 from $287,000 in the comparable period of 2001. Cost of license revenues decreased due to lower license revenues, partially offset by royalties for additional third-party technologies of

approximately $93,000.

Services. Cost of services revenues decreased 72% to $302,000 for the six months ended June 30, 2002 from $1.1 million in the comparable period of 2001. The decrease in cost of services revenues was due to the reduction in compensation and related expenses of approximately $701,000 from the decrease in the number of encoding, customer service and professional services personnel from 33 to 8 due to our corporate restructuring and expense management initiatives and the write-down of kiosk inventory of approximately $212,000 in the 2001 period due to our de-emphasis in the digital music kiosk business area due to the corporate restructuring.

Non-Cash Cost of Revenues. Non-cash cost of revenues were $69,000 for the six months ended June 30, 2002 and $181,000 in the comparable period of 2001.

Operating Expenses

Sales and Marketing. Sales and marketing expenses decreased 72% to $2.2 million for the six months ended June 30, 2002 from $7.7 million in the comparable period of 2001. This decrease was due to the reduction in compensation and related expenses of approximately $2.1 million from decreases in the number of sales and marketing personnel from 62 to 19 due to the corporate restructuring and expense management initiatives, shared project costs with Radio & Records of approximately $1.2 million, advertising and promotional programs of approximately $227,000, tradeshows of approximately $307,000, travel and entertainment of approximately $335,000, depreciation and amortization of approximately $224,000, customer service and professional services personnel attributable to sales and marketing activities of approximately $375,000, legal fees of approximately $117,000 and allocation of occupancy costs and other overhead of approximately $401,000.

Research and Development. Research and development expenses decreased 40% to $5.9 million for the six months ended June 30, 2002 from $10.0 million in the comparable period of 2001. This decrease was due to the reduction in compensation and related expenses of approximately $2.8 million from decreases in the number of personnel from 86 to 51 and outside contractors due to the corporate restructuring and expense management initiatives, travel and entertainment of approximately $172,000, depreciation and amortization of approximately $449,000 and allocation of occupancy costs and other overhead of approximately $368,000.

General and Administrative. General and administrative expenses decreased 52% to $3.0 million for the six months ended June 30, 2002 from $6.3 million in the comparable period of 2001. This decrease was due to the reduction in compensation and related expenses of approximately $1.0 million from decreases in the number of personnel from 37 to 17 and outside contractors due to the corporate restructuring and expense management initiatives and a decrease in legal fees of approximately $1.5 million from lower legal activity in patent infringement matters in the 2002 period and decrease in bad debt expense of approximately $1.0 million.

Strategic Marketing Equity Instruments. Strategic marketing-equity instruments expense was $0 for the six months ended June 30, 2002 and $652,000 in the comparable period in 2001.

Non-Cash Sales and Marketing, Research and Development and General and Administrative. The total unearned compensation recorded by us from inception to June 30, 2002 was $3.5 million. We recognized $13,000 and $96,000 of stock compensation expense for the six months ended June 30, 2002 and 2001, respectively. We expect quarterly amortization related to those options to be between $5,000 and $3,000 per quarter during the remainder of 2002. These future compensation charges would be reduced if sales and marketing, research and development and general and administrative employees who hold the applicable options terminate employment prior to the expiration of their option vesting period.

Restructuring. The $3.7 million charge in the six months ended June 30, 2001 consists of involuntary employee separation costs of $1.1 million, lease costs of $824,000 pertaining to estimated future obligations for non-cancelable lease payments for excess facilities that were vacated due to reductions in workforce, and asset impairment costs of $1.7 million for property and equipment, furniture and fixtures, computer software and leasehold improvements no longer in use from de-emphasized product lines, reductions in workforce and excess facilities.

Other Income (Expense), Net. Other income (expense), net decreased to $851,000 for the six months ended June 30, 2002 from $2.8 million in the comparable period of 2001. The decrease was due to lower average cash and cash equivalent balances resulting from cash used in operating activities, and lower interest rates.

Loss in Equity Investment. Our share of losses was $0 and $1.1 million for the six months ended June 30, 2002 and 2001, respectively. The net balance of our investments in Cyber Music Entertainment has been reduced to zero at December 31, 2001. We have discontinued recording losses from our investment in Cyber Music Entertainment as we have no contractual or planned obligation to provide funding to Cyber Music Entertainment.

Liquidity and Capital Resources

Since inception, we have financed our operations primarily through the initial and follow-on public offerings of common stock, private placements of our preferred stock, equipment financing, lines of credit and short-term loans. As of June 30, 2002, we had raised $65.9 million

and $93.7 million through our initial and follow-on public offerings of common stock, respectively, and $29.8 million through the sale of our preferred stock. At June 30, 2002, we have approximately $81.0 million of cash and cash equivalents.

Net cash used in operating activities was $10.4 million and $19.0 million for the six months ended June 30, 2002 and 2001, respectively. Net cash used for operating activities in the 2002 period was the result of net losses from operations of $10.5 million, depreciation and amortization of $1.3 million, amortization of unearned compensation of $(13,000), non-cash cost of revenue of $69,000 and a net decrease in working capital items of $1.2 million. The net decrease in working capital items include a decrease in accounts receivable of $15,000, decrease in other assets of $471,000, increase in accounts payable of $3,000, decrease in accrued liabilities of $1.7 million and a decrease in deferred revenue of $13,000. Net cash used for operating activities in the 2001 period was the result of net losses from operations of $25.3 million, depreciation and amortization of $2.2 million, amortization of unearned compensation of $(101,000), strategic marketing equity instruments charges of $652,000, non-cash cost of revenue of $186,000, an increase in the allowance for doubtful accounts and sales returns reserve of $1.1 million, loss in equity investment of $1.1 million, loss on disposal of and write-down of property and equipment of $1.7 million and a net decrease in working capital items of $542,000. The net decrease in working capital items include an increase in accounts receivable of $122,000, decrease in other assets of $176,000, decrease in accounts payable of $1.0 million, increase in accrued liabilities of $457,000 and a decrease in deferred revenue of $250,000.

Net cash provided by (used in) investing activities was $(67,000) and $26.6 million for the six months ended June 30, 2002 and 2001, respectively. Net cash used in investing activities in the 2002 period was primarily due to acquisition of property and equipment. Net cash provided by investing activities in the 2001 period was primarily due to net sales of short-term investments of $27.4 million, partially offset by acquisition of property and equipment of $689,000.

Net cash used in financing activities was $112,000 and $211,000 for the six months ended June 30, 2002 and 2001, respectively. The net cash used in financing activities for both periods is due primarily to payments made under our equipment loan and capital leases.

We had a bank equipment loan facility that provided for advances of up to $3.0 million through November 1999. Borrowings under the equipment loan facility were repayable in monthly installments over three years and bore interest at the bank s prime interest rate plus 0.25%. Borrowings were collateralized by the related equipment and other assets. Under the equipment loan facility, we had borrowed amounts totaling $1.8 million through June 30, 2002, and no amounts are outstanding as of June 30, 2002. Our other significant commitments consist of obligations under non-cancelable operating leases, which totaled $6.4 million, net of rental income of $21,000, as of June 30, 2002 and are payable in monthly installments through 2005 and a note payable to related party in the amount of $376,000 that was issued in the three months ended March 31, 1999. The note payable to related party is repayable in Japanese yen and bears interest at 0.5% above a Japanese bank s prime rate. The principal is due on December 31, 2003, with quarterly interest payments. The terms of the strategic related partner note payable require us to make quarterly interest payments. At June 30, 2002, we were not in compliance with the interest payment requirement. We are currently applying for a waiver from the strategic related partner with respect to our non-compliance with making quarterly interest payments. To obtain a waiver, we may have to make payments of all interest due to date and additional default interest of 10% on unpaid amounts outstanding, which has been accrued at June 30, 2002. As a result of our default of these payments, the strategic related partner has a right to accelerate payment of all amounts outstanding under the note payable and demand immediate full payment of all amounts due, including outstanding interest and penalties. Accordingly, we have classified the outstanding balance under the note payable as a current liability. If we are successful in obtaining a waiver from the strategic partner, then the note payable will be reclassified as a long-term liability.

In the past, we derived a significant portion of our revenues from business development fees from relationships with our international partners, including Liquid Audio Japan, Liquid Audio Korea, Liquid Audio Greater China and Liquid Audio South East Asia through our strategic partner, Epi Entertainment Group, Ltd. We terminated our relationships with these partners in 2001. Consequently, we do not expect additional revenue or cash payments will be generated from them. At June 30, 2002, we held 4.31% of the outstanding stock of Cyber Music Entertainment (CME), formerly Liquid Audio Japan, and had written down our investment to $0 under the equity method of accounting.

We have no material commitments for capital expenditures or strategic investments and anticipate a low rate of capital expenditures. We may use cash to acquire or license technology, products or businesses related to our current

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business. In addition, we anticipate that we will experience low or no growth or a decline in our operating expenses for the foreseeable future and that our operating expenses will be a material use of our cash resources.

Future payments due under debt and lease obligations as of June 30, 2002 are as follows (in thousands):

	Note Payable to Related Party	Equipment Loan	Capital Leases	Operating Leases	Total
2002	$ 376	$	$ 12	$ 1,202	$ 1,590
2003				2,100	2,100
2004				2,163	2,163
2005				904	904
	$ 376	$	$ 12	$ 6,369	$ 6,757

We believe that existing cash and cash equivalents will be sufficient to meet our anticipated cash needs for working capital and capital expenditures for the foreseeable future, although we may seek to raise additional capital during that period. The sale of additional equity or convertible debt securities could result in additional dilution to our stockholders. There can be no assurance that financing will be available in amounts or on terms acceptable to us, if at all.

Market Risk

No material changes exist to our market risk during the six months ended June 30, 2002. For additional information, refer to Management s Discussion and Analysis of Financial Condition and Results of Operations included in our Form 10-K for the year ended December 31, 2001 filed with the SEC.

ADDITIONAL FACTORS AFFECTING FUTURE RESULTS

Before deciding to invest in us or to maintain or increase your investment, you should carefully consider the risks described below, in addition to the other information contained in this report and in our other filings with the SEC, including our Annual Report on Form 10-K filed March 29, 2002 and our Registration Statement on Form S-4 filed July 23, 2002. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also affect our business operations. If any of these risks actually occur, our business, financial condition or results of operations could be seriously harmed. In that event, the market price of our common stock could decline and you may lose all or part of your investment. References to the combined organization in this section entitled Additional Factors Affecting Future Results refer to Liquid Audio, Inc. and Alliance Entertainment Corp. as a combined entity following the proposed merger between the two companies, as more fully described under Item 2 Management s Discussion of Financial Condition and Results of Operations.

If the Merger with Alliance Does Not Occur, We Will Not Receive the Expected Benefits of the Merger

The completion of the merger is subject to a number of conditions, including the approval of both our and Alliance stockholders. If one of the conditions to complete the merger is not satisfied or waived, then the merger may not be completed.

If the merger is not completed, the expected benefits of the merger will not be realized. In addition, in anticipation of the completion of the merger, we have implemented certain changes to our business operations, including a reduction in our workforce. As a result, if the merger is not completed, we may not have sufficient employees to continue our current operations. Failure to complete the merger could have a material adverse effect on our future business, financial condition and operating results.

In the event that the proposed merger with Alliance is terminated by us or if our stockholders fail to approve the proposed merger, we may be obligated to pay a termination fee of up to $3.0 million.

The Combined Organization May Not Realize the Expected Benefits from the Merger and the Market Price of Our Stock May Decline as a Result of the Merger

We believe that the merger of Alliance and us will result in benefits to the combined organization that outweigh the costs and expenses related to the merger and increase stockholder value. Achieving these benefits, however, will depend on a number of factors, including:

- effectively and efficiently integrating the operations, information systems and personnel of the two companies to achieve operating efficiencies;
- beneficially exploiting the increased complexity and diversity of operations of the combined organization;
- retaining key management, marketing, sales and technical personnel;
- averting the potential diversion of management s attention from other business concerns to the combination of the companies;
- retaining key customers;
- increasing the combined organization s customer base and product sales;
- keeping step with industry trends and technological advances;
- adjusting to changing market conditions;

successfully pursuing anticipated revenue opportunities in emerging channels of distribution; and

effectively addressing unanticipated problems or legal liabilities.

In addition, successful integration of the operations of us and Alliance may place a significant burden on the management and internal resources of the combined organization. The diversion of management s attention and any difficulties encountered in the transition and integration process could have a material adverse effect on the future business, financial condition and operating results of the combined organization.

Our Stockholders May Not Realize a Benefit from the Merger Commensurate with the Ownership Dilution They Will Experience in Connection with the Merger

If the combined organization is unable to realize the strategic and financial benefits currently anticipated from the merger, our stockholders will have experienced substantial dilution of their ownership interest without receiving any commensurate benefit. In connection with the merger, we will issue shares of our stock representing 74% of our voting power following the merger. In addition, the exercise of options assumed by us in the merger will further dilute the ownership interests of our current stockholders.

The Tender Offer and the Merger Will Require Substantial Expenditures

We estimate that we will incur aggregate pre-tax costs of approximately $6.6 million associated with the merger, as well as severance costs relating to employees, in addition to the $30 million that will be paid upon completion of the tender offer, assuming that 10 million shares of our common stock are tendered. In addition, the combined organization expects to incur certain costs in connection with the integration of the two companies. Such costs cannot now be reasonably estimated, because they depend on future decisions to be made by management of the combined organization, but they could be material. These costs and expenses will affect results of operations in the quarter in which the merger is completed. Even if the merger is not completed, we will incur our portion of these total costs and expenses, other than the cost of paying the consideration for shares of our common stock tendered in the tender offer. Additionally, if the merger is terminated, we will incur termination fees under certain conditions. See If the Merger with Alliance Does Not Occur, We Will Not Receive the Expected Benefits of the Merger.

The Nasdaq National Market May Delist Our Common Stock Following the Merger

The Nasdaq staff may determine that the proposed merger would constitute a reverse merger under National Association of Securities Dealers Rule 4330(f). Following the announcement of the merger in June 2002, we received correspondence from the Nasdaq staff indicating that the staff believes that the merger may result in a change of control that would require us to submit an initial listing application following the consummation of the merger and, at the time of the application, meet all of the criteria applicable to a company initially requesting inclusion in The Nasdaq National Market. The Nasdaq staff has subsequently indicated that it intends to find that the merger will result in a change of control and that it will constitute a reverse merger. If the Nasdaq staff determines that a change of control has occurred, we will be required to satisfy the requirements, for initial inclusion on The Nasdaq National Market in order for our common stock to remain listed on The Nasdaq National Market. Currently, we would not satisfy these requirements, and it is unlikely such requirements will be satisfied following the consummation of the merger. If we do not meet these requirements upon completion of the merger, we anticipate that our common stock will be delisted from The Nasdaq National Market following the completion of the merger. If we are delisted from The Nasdaq National Market System, we may be allowed to transfer our securities from The Nasdaq National Market to The Nasdaq SmallCap Market.

Any of the foregoing may adversely impact our stock price, as well as our liquidity and the ability of our stockholders to purchase and sell our shares in an orderly manner, or at all. Furthermore, a delisting of our shares could damage our general business reputation and impair our ability to raise additional funds. Any of the foregoing events could have a material adverse effect on our business, financial condition and operating results.

We Have Never Been Profitable, and Alliance Has Recently Incurred Net Losses, and You Cannot Be Sure that We or the Combined Organization Will Achieve Profitability

In each of the years we have been in business, we have experienced net losses. Our net losses were approximately $33.7 million and $37.2 million in 2000 and 2001, respectively, and $10.5 million for the six months ended June 30, 2002. Alliance had net income for the year ended December 31, 2001 but experienced a net loss of approximately $1.0 million for the three months ended March 31, 2002. We expect that our business will continue to incur net losses for the remainder of the 2002 fiscal year. There can be no assurance that our business or the combined organization will achieve profitability.

Several of Our Customers Might Have Difficulty Meeting Their Payment Obligations to Us

As of June 30, 2002, 70% or $327,000 of our accounts receivable from third parties were more than 30 days past due. You should evaluate the ability of these companies to meet their payment obligations to us in light of the risks, expenses and difficulties encountered by such companies. If one or more of our customers were unable to pay for our services in the future, or paid more slowly than we anticipate, recognition of revenue might be delayed and our operating results will be harmed.

We Might Not Be Successful in the Development and Introduction of New Products and Services

We depend in part on our ability to develop new or enhanced products and services, such as our subscription-based service offering and server-based license offering, in a timely manner and to provide new products and services that achieve rapid and broad market acceptance. We may fail to identify new product and service opportunities successfully and develop and bring to market new products and services in a timely manner. In addition, product innovations may not achieve the market penetration or price stability necessary for profitability.

As the online medium continues to evolve, we plan to leverage our technology by introducing complementary products and services as additional sources of revenue. Accordingly, we may change our business model to take advantage of new business opportunities, including business areas in which we do not have extensive experience. For example, we will continue to devote significant resources to the development of digital music delivery services, as well as our software licensing business. If we fail to develop these or other businesses successfully, our business would be harmed.

The Market for Digital Delivery of Music Over the Internet is Highly Competitive, and if We Cannot Compete Effectively, Our Ability to Generate Meaningful Revenues Would Suffer Dramatically

Competition among companies in the business of digital delivery of music over the Internet is intense. We expect that present competitors will increase competitive pressure in the market for digital delivery of music.

Competition is likely to increase further as new companies enter the market and current competitors expand their products and services or merge with other competitors. Many of these potential competitors are likely to enjoy substantial competitive advantages, including the following:

- larger audiences;
- larger technical, production and editorial staffs;
- greater brand recognition;
- access to more recorded music content;
- a more established Internet presence;
- a larger advertiser base; and
- substantially greater financial, marketing, technical and other resources.

If we do not compete effectively or if we experience pricing pressures, reduced margins or loss of market share resulting from increased competition, our business and operating results would be harmed.

We Depend on Proprietary Rights to Develop and Protect Our Technology

Our success and ability to compete substantially depends on our internally developed technologies and trademarks, which we protect through a combination of patent, copyright, trade secret and trademark laws. We hold sixteen existing patents and currently have twelve patents pending in the United States and eleven patents pending in other countries. Our existing patents expire between October 2015 and March 2019. We have had claims allowed on none of our patent applications. We are presently pursuing the registration of our trademarks. Our patent applications or trademark registrations in the United States may not be approved. Even if they are approved, our patents or trademarks may be successfully challenged by others or invalidated. If our trademark registrations in the United States are not approved because third parties own these trademarks, our use of these trademarks would be restricted unless we enter into arrangements with the third-party owners, which might not be possible on commercially reasonable terms or at all.

The primary forms of intellectual property protection for our products and services internationally are patents and copyrights. Patent protection throughout the world is generally established on a country-by-country basis. To date, we have applied for eleven patents outside the United States. Copyrights throughout the world are protected by several international treaties, including the Berne Convention for the Protection of Literary and Artistic Works. Despite these international laws, the level of practical protection for intellectual property varies among countries. In particular, United States government officials have criticized countries such as China and Brazil, two countries in which we do business, for inadequate intellectual property protection. If our intellectual property is infringed in any country in which we do business without a high level of intellectual property protection, our business and operating results could be harmed.

We generally enter into confidentiality or license agreements with our employees, consultants and corporate partners, and generally control access to and distribution of our technologies, documentation and other proprietary information. Despite our efforts to protect our proprietary rights from unauthorized use or disclosure, parties may attempt to disclose, obtain or use our solutions or technologies. The steps we have taken may not prevent misappropriation of our solutions or technologies, particularly in foreign countries where laws or law enforcement practices may not protect our proprietary rights as fully as in the United States.

We have licensed, and we may license in the future, certain proprietary rights to third parties. While we attempt to ensure that the quality of our brand is maintained by our business partners, they may take actions that could impair the value of our proprietary rights or our reputation. In addition, these business partners may not take the same steps we have taken to prevent misappropriation of our solutions or technologies.

We Face and Might Face Intellectual Property Infringement Claims that Might Be Costly to Resolve

Because we digitally deliver recorded music and other music products to third parties, the we might be subject to litigation based on claims of negligence, copyright, trademark infringement, patent infringement or other intellectual property rights. In the past, these types of claims have been brought, sometimes successfully, against our competitors and, in particular, providers of online products and services. Others could also sue us for the content that is accessible from our website through links to other websites. These claims might include, among others, claims that by hosting, directly or indirectly, the websites of third parties, we are liable for copyright or trademark infringement or other wrongful actions by these third parties through these websites. With respect to distribution of video and music product generally, substantially all such products sold are subject to copyright laws and licenses that limit the manner and geographic area in which these products may be sold and provide royalties to the copyright owners. Any sales of these products in violation of these laws and licenses by anyone in the chain of distribution, including our suppliers, may subject us to monetary damages and confiscation of the products. Our insurance may not adequately protect us against these types of claims and, even if these claims do not result in liability, we could incur significant costs and diversion of management resources in investigating and defending against these claims, which could harm our business.

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From time to time, we receive letters from corporations and other entities suggesting that we review patents to which they claim rights or claiming that we infringe on their intellectual property rights. Such claims may result in our being involved in litigation. Although we do not believe we infringe the proprietary rights of any party, we cannot assure you that parties will not assert additional claims in the future or that any claims will not be successful. We could incur substantial costs and diversion of management resources to defend any claims relating to proprietary rights, which could harm our business. In addition, we are obligated under certain agreements to indemnify the other party for claims that we infringe on the proprietary rights of third parties. If we are required to indemnify parties under these agreements, our business could be harmed. If someone asserts a claim against us relating to proprietary technology or information, we might seek licenses to this intellectual property. We might not be able to obtain licenses on commercially reasonable terms, or at all. The failure to obtain the necessary licenses or other rights might harm our business and operating results. See Legal Proceedings.

Additionally, Muze, Inc. has sued Alliance alleging that Alliance s marketing of the AMG business violates California s unfair business practice statutes and federal antitrust law. We cannot estimate the total potential liability to which the combined organization might be exposed as a result of these suits. If these suits result in a judgment against Alliance, its business and results of operations, and that of the combined organization, could be materially adversely affected.

The Growth of Our Business is Dependent on Development of Devices that Play Digitally Downloaded Music that Achieve Mass Customer Acceptance.

The market for digitally recorded music delivered over the Internet is relatively new and may not achieve mass customer acceptance. Several consumer electronics companies have introduced devices that allow digital music delivered over the Internet to be played away from the personal computer. However, if additional devices such as wireless broadband devices and in-home connected set-top boxes are not developed or do not achieve mass customer acceptance or our products and services are incompatible with these devices, our business may not grow or could be otherwise harmed.

Due to the Many Factors that Influence Market Acceptance, Consumers Might Not Accept Our Platform

Our success will depend on growth in consumer acceptance of our platform as a method for digital delivery of recorded music over the Internet. Factors that might influence market acceptance of our platform include the following, over which we have little or no control:

- the availability of sufficient bandwidth on the Internet to enable consumers to download digital recorded music rapidly and easily;
- the willingness of consumers to invest in computer technology that facilitates the downloading of digital music;
- the cost of time-based Internet access;
- the number, quality and variety of digital recordings available for purchase through our system relative to those available through other online digital delivery companies, digital music websites, music swapping or sharing websites or through traditional physical delivery of recordings;
- the availability of portable devices to which digital recorded music can be transferred;
- the fidelity and quality of the sound of the digital recorded music; and
- the level of consumer comfort with the process of downloading and paying for digital music over the Internet, including ease of use and lack of concern about transaction security.

It is too soon to determine whether consumers will accept our platform as their primary application to download, manage and play digital music. A lack of customer acceptance would harm our business and operating results.

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If Standards for the Secure, Digital Delivery of Recorded Music Are Not Adopted, the Piracy Concerns of Record Companies and Artists Might Not Be Satisfied, and They Might Not Use Our Platform for Digital Delivery of Their Music

Because other digital recorded music formats, such as MP3, do not contain mechanisms for tracking the source or ownership of digital recordings, record companies and artists are unable to prevent users from downloading and distributing unauthorized or pirated copies of copyrighted recorded music in these formats over the Internet. This piracy is a significant concern to record companies and artists, and is the primary reason many record companies and artists are reluctant to digitally deliver their recorded music over the Internet. If record companies and artists do not adopt a standard format, however, it may permit unsecure copies of recorded music to continue to be available on the Internet, and as a result record companies and artists might not permit the digital delivery of their music. Additionally, as long as pirated recordings are available, many consumers will choose free pirated recordings rather than paying for legitimate recordings. Accordingly, if a standard format for the secure digital delivery of music is not adopted, our business and operating results might be harmed.

We have designed our current products to be adaptable to different music industry and technology standards. Numerous standards in the marketplace, however, could cause confusion as to whether our products and services are compatible. If a competitor were to establish the dominant industry standard, our business would be harmed. It is too soon to determine whether our standard will be adopted as the dominant industry standard, if a standard is so adopted.

Our Business Might Be Harmed if Challenges Against Intellectual Property Laws by New Digital Music Delivery Technologies Are Successful

New music sharing technologies allowing users to locate and download copies of digital music stored on the hard drives of other users without payment have been introduced into the market. Because some digital recorded music formats, such as MP3, do not contain mechanisms for tracking the source of ownership of digital recordings, users are able to download copies of copyrighted recorded music over the Internet without being required to compensate the owners of these copyrights. These downloads are a significant concern to record companies and artists. The Recording Industry Association of America has filed a suit seeking a permanent injunction against the use of these file-sharing technologies for exchange of copyrighted works. Several recording artists have also taken legal action against companies providing music sharing technology. If the injunction is denied, and it is determined that this file sharing technology is non-infringing, record companies and artists may limit their use of the Internet to sell and distribute their copyrighted materials. Even if the technology is determined to be infringing, it may be difficult to prevent this type of file sharing because of the non-centralized character of these technologies. As long as digital music copies are available through file sharing without payment, legally or illegally, consumers may choose not to pay for downloads from retail and other music delivery sites in our Liquid Music Network, which could harm our business and results of operations.

If Our Platform Does Not Provide Sufficient Rights Reporting Information, Record Companies and Artists Are Unlikely to Digitally Deliver Their Recorded Music Using Our Platform

Record companies and artists must be able to track the number of times their recorded music is downloaded so that they can make appropriate payments to music rights organizations, such as the American Society of Composers, Authors and Publishers, Broadcast Music Incorporated and SESAC, Inc. If our products and services do not accurately or completely provide this rights reporting information, record companies and artists might not use our platform to digitally deliver their recorded music, and our business might be harmed.

We Might Not Have Sufficient Content to Attract Consumers if Artists and Record Labels Are Not Satisfied That They Can Profitably Digitally Deliver Their Music Over the Internet or if Record Labels Enter Into License Agreements with Our Competitors

Our success depends on our ability to aggregate a sufficient amount and variety of digital recorded music for syndication. We currently do not create our own content; rather, we rely on record companies and artists for digital recorded music to be syndicated using our distribution platform. We believe record companies will remain reluctant to distribute their recorded music digitally unless they are satisfied that the digital delivery of their music over the

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Internet will result in overall profitability. If record companies do not believe that recorded music can be profitably delivered over the Internet or that such delivery will cannibalize sales through other channels, they may not allow the digital distribution of their recorded music and we might not have sufficient content to attract consumers. If we cannot offer a sufficient amount and variety of digital recorded music for syndication, our business will be harmed.

The major U.S. record companies have recently formed ventures for the licensing of their digital music subscription services to online music service providers. BMG Entertainment, EMI, Real Networks and Warner Music Group have formed a venture called MusicNet. Also, Universal Music Group (an unit of Vivendi Universal) and Sony Music Entertainment have formed a venture called pressplay. Musicnet and pressplay have recently launched their services, and may license their services to other third party online music service providers. If our competitors obtain licenses for digital music subscription services from MusicNet and pressplay and we are unable to obtain similar content provided by those services on commercially reasonable terms, these competitors may be able to develop a more compelling consumer product and our business could be harmed.

We Might Be Unable to License or Acquire Technology

We rely on certain technologies that we license or acquire from third parties, including Dolby Laboratories Licensing Corporation, Fraunhofer Institut, RSA Data Security, Inc. and Thomson Consumer Electronics Sales GmbH. These technologies are integrated with our internally developed software and used in our products, to perform key functions and to enhance the value of our platform. These third-party licenses or acquisitions may not continue to be available to us on commercially reasonable terms or at all. Any inability to acquire these licenses or software on commercially reasonable terms might harm our business.

Our Business Might Be Harmed if We Fail to Price Our Products and Services Appropriately

We have recently decided to focus on providing a subscription-based service offering and a licensing-based offering for our customers. We have limited experience in pricing such new models, and failure to properly price and adjust these new pricing models may result in a loss of customers which would have an adverse effect on our business and operating results. Moreover, the price of Internet products and services is subject to rapid and frequent change. We may be forced, for competitive or technical reasons, to reduce or eliminate prices for certain of our products or services. If we are forced to reduce or eliminate prices, it would diminish our revenues and impact our margins, which will harm our business.

We Might Experience Delays in the Development of New Products and Services

We must continue to innovate and develop new versions of our software to remain competitive in the market for digital delivery of recorded music solutions. Our software products and services development efforts are inherently difficult to manage and keep on schedule. Our failure to manage and keep those development projects on schedule might harm our business.

We Might Not Be Successful in Our Attempts to Keep Up With Rapid Technological Change and Evolving Industry Standards

The markets for our products and services are characterized by rapidly changing technology, evolving industry standards, changes in customer needs, emerging competition, and frequent new product and service introductions. Our future success will depend, in part, on our ability to:

- use leading technologies effectively;
- continue to develop our strategic and technical expertise;
- enhance our current products and services;
- develop new products and services that meet changing customer needs;
- advertise and market our products and services; and

influence and respond to emerging industry standards and other technological changes.

We may not be successful in effectively using new technologies, developing new products or services, ascertaining customer demand or enhancing our existing products or services on a timely basis. These new technologies or enhancements may not achieve market acceptance. Our pursuit of necessary technological advances may require substantial time and expense. Finally, we may not succeed in adapting our services to new technologies as they emerge.

We Might Not Be Able to Scale Our Technology Infrastructure to Meet Demand for Our Products and Services

Our success will depend on our ability to scale our technology infrastructure to meet the demand for our products and services. Adding this new capacity will be expensive, and we might not be able to do so successfully. In addition, we might not be able to protect our new or existing data centers from unexpected events as we scale our systems. To the extent that we do not address any capacity constraints effectively, our business would be harmed.

Our Products and Services Might Contain Errors

We offer complex products and services that may contain undetected errors when first introduced or when new versions are released. If we market products and services that have errors or that do not function properly, then we may experience negative publicity, loss of or delay in market acceptance, or claims against us by customers, any of which might harm our business and results of operations.

System Failures or Delays Might Harm Our Business

Our operations depend on our ability to protect our computer systems against damage from fire, water, power loss, telecommunications failures, computer viruses, vandalism and other malicious acts, and similar unexpected adverse events. Our corporate headquarters are located in northern California. California has experienced power outages due to a shortage in the supply of power within the state. Although we maintain a comprehensive disaster recovery plan, if the power outages recur or increase in severity, they could disrupt our operations. Interruptions or slowdowns in our services have resulted from the failure of our telecommunications providers to supply the necessary data communications capacity in the time frame we required, as well as from deliberate acts. Despite precautions we have taken, unanticipated problems affecting our systems could in the future cause temporary interruptions or delays in the services we provide. Our customers might become dissatisfied by any system failure or delay that interrupts our ability to provide service to them or slows our response time. Sustained or repeated system failures or delays would affect our reputation, which would harm our business. Slow response time or system failures could also result from straining the capacity of our software or hardware due to an increase in the volume of products and services delivered through our servers. While we carry business interruption insurance, it might not be sufficient to cover any serious or prolonged emergencies, and our business and results of operations might be harmed.

Fluctuations in Our Quarterly Revenues and Operating Results Might Lead to Reduced Prices for Our Stock

Our quarterly results of operations have varied in the past, and you should not rely on quarter-to-quarter comparisons of our results of operations as an indication of our future performance. In some future periods, our results of operations are likely to be below the expectations of public market analysts and investors. In this event, the price of our common stock would likely decline. Factors that have caused our results to fluctuate in the past and that are likely to affect us in the future include the following:

- the timing of individual software licenses to customers;
- competition for consumers from traditional retailers as well as providers of online music services;
- the announcement and introduction of new products and services by us and our competitors;
- distribution of the player through OEM and retail partners;

- the upgrade percentage of our promotional player to the paid Player Plus version;
- our ability to increase the number of websites that will use our platform for digital music delivery;
- the timing of our partners introduction of new products and services for digital music sales; and
- variability and length of the sales cycle associated with our product and service offerings.

In addition, other factors may also affect us, including:

- market adoption and growth of sales of digitally downloaded recorded music over the Internet;
- legal developments with respect to copyright law and downloadable music;
- our ability to attract significant numbers of music recordings to be syndicated in our format;
- our ability to provide reliable and scalable service, including our ability to avoid potential system failures;
- market acceptance of new and enhanced versions of our products and services; and
- the price and mix of products and services we offer.

We Might Need Additional Capital in the Future and Additional Financing Might Not Be Available

We currently anticipate that our available cash resources and financing available under existing lease agreements will be sufficient to meet our anticipated working capital and capital expenditure requirements for the foreseeable future. However, we may need to raise additional funds through public or private debt or equity financing in order to:

- take advantage of opportunities, including acquisitions of complementary businesses or technologies;
- develop new products or services; or
- respond to competitive pressures.

Any additional financing we may need may not be available on terms favorable to us, or at all. If adequate funds are not available or are not available on acceptable terms, we might not be able to take advantage of unanticipated opportunities, develop new products or services, or otherwise respond to unanticipated competitive pressures, and our business could be harmed. Our forecast of the period of time through which our financial resources will be adequate to support our operations is a forward-looking statement that involves risks and uncertainties, and actual results could vary materially as a result of a number of factors, including those set forth in this Additional Factors Affecting Future Results section.

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Our Charter Documents and Delaware Law May Impede Or Discourage A Takeover, Which Could Lower Our Stock Price

Provisions of our restated certificate of incorporation and bylaws, and provisions of Delaware law, may have the effect of making it more difficult for a third party to acquire, or of discouraging a third party from attempting to acquire, control of us. For example, we have a classified board of directors which may tend to discourage a third party from making a tender offer or otherwise attempting to obtain control of us and may maintain the incumbency of our board of directors, as the classification of the board of directors increases the difficulty of replacing a majority of the directors. These provisions may have the effect of deferring hostile takeovers, delaying changes in our control or management, or may make it more difficult for stockholders to take certain corporate actions. Consequently, these provisions could limit the price that certain investors might be willing to pay in the future for shares of our common stock.

Our Rights Plan May Impede Or Discourage a Takeover, Which Could Lower Our Stock Price

Our board of directors has approved a shareholders rights plan, which was amended recently on July 14, 2002. The rights will become exercisable the tenth day after a person or group announces acquisition of 10% or more of our common stock or announces commencement of a tender or exchange offer the consummation of which would result in ownership by the person or group of 10% or more of our common stock. If the rights become exercisable, the holders of the rights (other than the person acquiring 10% or more of our common stock) will be entitled to acquire, in exchange for the rights exercise price, shares of our common stock or shares of any company in which we are merged, with a value equal to twice the rights exercise price. The rights may have the effect of rendering more difficult or discouraging an acquisition of the Company deemed undesirable by the board of directors. As a result, the rights could limit the price that certain investors might be willing to pay in the future for shares of our common stock.

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Risks Related to Our Industry

Internet Security Concerns Could Hinder E-Commerce

A significant barrier to e-commerce and communications over the Internet has been the need for secure transmission of confidential information. Internet usage may not increase at the rate we expect unless some of those concerns are adequately addressed and found acceptable by the market. Internet usage could also decline if any well-publicized compromise of security occurs. We may incur significant costs to protect against the threat of security breaches or to alleviate problems caused by these breaches. Protections may not be available at a reasonable price or at all. If a third person were able to misappropriate a user s personal information, users could bring claims against us.

Government Regulation and Imposition of Sales and Other Taxes On E-Commerce Transactions Might Hinder E-Commerce

The applicability to the Internet of existing laws governing issues such as property ownership, libel and personal privacy is uncertain. In addition, governmental authorities may seek to further regulate the Internet with respect to issues such as user privacy, pornography, acceptable content, e-commerce, taxation, and the pricing, characteristics and quality of products and services. Finally, the global nature of the Internet could subject us to the laws of a foreign jurisdiction in an unpredictable manner. Any new legislation regulating the Internet could inhibit the growth of the Internet and decrease the acceptance of the Internet as a communications and commercial medium, which might harm our business.

The growing use of the Internet has also burdened the existing telecommunications infrastructure and has caused interruptions in telephone service. Telephone carriers have petitioned the government to regulate the Internet and impose usage fees on Internet service providers. Any regulations of this type could increase the costs of using the Internet and impede its growth, which could in turn decrease the demand for our services or otherwise harm our business.

We do not collect sales and other taxes when we sell our products and services over the Internet. State or local governments may seek to impose sales tax collection obligations on out-of-state companies, such as ours, which engage in or facilitate e-commerce. A number of proposals have been made at the state and local level that would impose additional taxes on the sale of products and services through the Internet. These proposals, if adopted, could substantially impair the growth of e-commerce and could reduce our opportunity to derive profits from e-commerce. Moreover, if any state or local government or foreign country were to successfully assert that we should collect sales or other taxes on the exchange of products and services on our system, our business might be harmed.

In 1998, Congress passed the Internet Tax Freedom Act, which imposed a three-year moratorium on state and local taxes on Internet-based transactions. The moratorium was scheduled to expire in October 2001. Recently, Congress extended the Internet Tax Freedom Act until November 1, 2003. We cannot assure you that this moratorium will be extended beyond November 1, 2003. Failure to extend this moratorium beyond that date would allow various states to impose taxes on e-commerce, which might harm our business.

In February 2002, European Finance Ministers announced that beginning July 2003 Value Added Tax (VAT) will be imposed on services delivered electronically over the Internet from suppliers outside the European Union (EU). The tax may substantially impair the growth of e-commerce in the EU and may reduce our opportunity to derive e-commerce in the EU, and our business could be harmed.

Demand for Our Products and Services Might Decrease if Growth in the Use of the Internet Declines

Our future success substantially depends upon the continued growth in the use of the Internet. The number of users on the Internet may not increase and commerce over the Internet may not become more accepted and widespread for a number of reasons, including the following, over which we have little or no control:

- actual or perceived lack of security of information, such as credit card numbers;
- lack of access and ease of use;
- inconsistent quality of service and lack of availability of cost-effective, high speed service;
- possible outages due to damage to the Internet;
- excessive governmental regulation; and
- uncertainty regarding intellectual property rights.

If the necessary infrastructure, products, services or facilities are not developed, or if the Internet does not grow as a commercial medium, our business would be harmed.

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Government Regulation of the Internet Might Harm Our Business

The applicability to the Internet of existing laws governing issues such as property ownership, libel and personal privacy is uncertain. In addition, governmental authorities may seek to further regulate the Internet with respect to issues such as user privacy, pornography, acceptable content, e-commerce, taxation, and the pricing, characteristics and quality of products and services. Finally, the global nature of the Internet could subject us to the laws of a foreign jurisdiction in an unpredictable manner. Any new legislation regulating the Internet could inhibit the growth of the Internet and decrease the acceptance of the Internet as a communications and commercial medium, which might harm our business.

In addition, the growing use of the Internet has burdened the existing telecommunications infrastructure and has caused interruptions in telephone service. Telephone carriers have petitioned the government to regulate the Internet and impose usage fees on Internet service providers. Any regulations of this type could increase the costs of using the Internet and impede its growth, which could in turn decrease the demand for our services or otherwise harm our business.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

See Market Risk in Part I, Item 2, Management s Discussion and Analysis of Financial Condition and Results of Operations.

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PART II. OTHER INFORMATION

ITEM 1. & first well drilled on each prospect. However, we do pay our proportionate cost of any subsequent well drilled on each prospect. Under these arrangements, we usually minimize our cost to drill and also receive a minority interest in revenues from the reserves we discover. On the other hand, we occasionally incur extra expenses for drilling or development that we choose, in our discretion, not to pass on to other venture participants.

In 2005, we acquired a 25% working interest in three (3) oil properties that we believe to be under developed and under exploited oil properties. One property consisted of three separate leases in the Oxnard Oil Field in Ventura County, California and two properties were in Kern County, California.

We also have approximately 6,670-acres of mineral rights, which basically covers what was the Chowchilla Ranch Gas Field in Madera County, California. Currently, the land position is held by a single producing gas well. We believe this land position to be under developed and under exploited and we plan to being re-entering, recompleting and further infill drill the leasehold position.

In addition to these properties, we also hold producing interests in gas leases in the Sacramento Valley of Northern California in the RioVista and Dutch Slough Gas Fields.

During 2007, the Company drilled three step-out wells on the Lundin-Weber lease in the Temblor Project in the South Belridge Oil Field, Kern County, California to further delineate and define the extent of the three producing zones in this 700-acre lease development. The wells drilled where the Lundin-Weber 24,188 and 344 wells. In May 2007, Tri-Valley also initiated a pilot waterflood on this property in the Etchegoin Zone to recover additional reserves. During 2007, an additional 12-wells were returned to production bringing the total wells on production up from 28 to 40 of the 49-wells that existed on the Lease at the time of purchase in December 2005.

The Company also first vertically drilled, and cored, followed by ultimately horizontally drilling 1320-feet, its first SAG-D (Steam Assisted Gravity Drainage) development well in the Vaca Tar Sand in the Oxnard Oil Field in Oxnard, California. The well was successfully steamed with the well initially flowing at an initial flow rate of 288-BOPD the first 24-hrs of production.

The Company also drilled a 10,000' deep exploratory test well below existing previously established production in the Moffat Ranch Gas Field, Madera County, California, 50-miles west of Fresno, California, the Moffat Ranch 48-X-7 well in the Moffat Ranch Gas Field. The well was spudded November 17, 2007. As of December 31, 2007 the well was in the process of being completed. Currently, the well has been successfully tested and completed and we are awaiting a tie-in to a nearby gas line. Tri-Valley currently owns two (2) other existing wells in its approximate 6900-acre land position in the Field which it plans to rework and return to production.

Rig Operations

In 2006 we created two new subsidiaries, Great Valley Production Services (GVPS) and Great Valley Drilling (GVDC). GVPS is owned 90% by Tri-Valley and 10% by third parties. As of year-end 2007 GVDC is 100% owned by Tri-Valley.

GVPS is a production services/well work over company whose services will primarily be contracted to TVOG. Operations began in the third quarter of 2006. However, from time to time GVPS may contract various units to third parties when not immediately needed for TVOG projects.

GVDC is based in Nevada and the majority of its work will be drilling wells for third parties. There may be occasion where TVOG contracts services from GVDC for its own account. GVDC began operation in the first quarter of 2007.

We expect these companies to contribute to our operations in 2008.

Mining Activity

In 2007 our Select staff resigned to take full time positions with Duluth Metals and replacements have yet to be hired. We plan to continue our mining activities on a limited basis by outsourcing and using other staff.

Precious Metals

During 2007, the price of gold has fluctuated between $608 and $841 per ounce continuing the support for the exploration and development of precious metals, including the support of junior exploration ventures. Accordingly, management is advancing its precious metal opportunities.

The 2007 precious metal program consisted largely of continued assessment and compilation of the geologic information collected in previous work programs associated with the Richardson and Shorty Creek properties in Alaska. Select also undertook an on-site reconnaissance for carrying out a 2007 field program for both the Richardson and Shorty Creek properties, including resolving access routing issues.

Select also continued annual repair and maintenance activities associated with the Richardson Roadhouse, 65 miles southeast of Fairbanks on the Alaska Richardson Highway, which is owned by us and has been used in the past as a base camp for Richardson related exploration activities.

Base Metals

Select acquired two copper exploration properties in Nevada. The first property, the FARJK claims, target oxide copper in Nye County and covers roughly one square mile and the claim position can be expanded. Select controls 100% of this claim block. The second property, the Delcer property, with oxide and sulphide copper, covers approximately one square mile in Elko County. This property has experienced limited copper production that dates back to World War I. Select is a joint venture participant in the Delcer property.

We agreed in April 2006 to assist Duluth Metals Limited, a Canadian corporation, in its initial public offering and listing on the Toronto Stock Exchange. Duluth Metals is involved in the acquisition and exploration of copper, nickel and platinum group metals in the Duluth Complex in northern Minnesota. Duluth Metals is providing Select financial remuneration, stock options and assistance by Duluth Metals on the monetizing of Select and its properties as compensation for Select's providing management and technical assistance to Duluth Metals. Duluth Metals' initial offering became listed on the Toronto Stock Exchange on October 10, 2006. Select continued to assist Duluth Metals in 2007 in its early stages of operation as Duluth Metals provides assistance to Select on the monetizing of Select and its properties.

Industrial Minerals

The Admiral Calder calcium carbonate mine in Alaska (100% owned and managed by Select) was on care and maintenance during the fourth quarter. Select continued its market and operational assessment studies for the Admiral Calder quarry product as the mine is in the top 1% of high grade chemical and high brightness calcium carbonate deposits in the world, and one of the few deposits to be directly on tidewater. Repair and maintenance activities at the site were initiated in 2007.

Select had an exclusive agreement with the Trabits Group granting the right to evaluate up to 200 industrial minerals properties within Newmont Mining Corporation's property portfolio. The majority of these properties are located along Nevada rail corridors leading into California and Arizona. The evaluation of these properties continued through 2007. As of the end of 2007, no properties of interest to Select have been identified and this agreement has been concluded.

Results of Operations

We lost approximately $8.6 million in 2007 compared to losses of $0.9 million in 2006 and $9.7 million in 2005. Total revenue was $11.0 million in 2007 compared to revenues of $4.9 million in 2006 and $12.5 million in 2005. In 2007 and 2005 we had comparatively high levels of both revenue and loss due in large part to our execution of large scale drilling projects during those years.

Revenues

The Company identifies reportable segments by product. The Company includes revenues from both external customers and revenues from transactions with other operating segments in its measure of segment profit or loss. The Company also allocates interest revenue and expense, DD&A, and other operating expenses in its measure of segment profit or loss.

Results of Operations (continued)

The following table sets forth our revenues by segment for 2007, 2006 and 2005, in thousands.

	2007			2006			2005		
	$		%	$		%	$		%
Oil and gas									
Sale of oil and gas	$	761	8%	$	1,030	23%	$	901	7%
Royalty income		-	-		-	-		1	-
Partnership income		30	1%		45	1%		30	-
Total oil and gas revenue		791	9%		1,075	24%		932	7%
Rig operations		2,727	28%		873	20%		-	-
Drilling and development		6,132	63%		2,497	56%		11,422	93%
Total revenues	$	9,650	100%	$	4,445	100%	$	12,354	100%

Oil and gas operations include our share of revenues from oil and gas wells on which TVOG serves as operator, royalty income and production revenue from other partnerships in which we have operating or non-operating interests. It also includes revenues for consulting services for oil and gas related activities, which we include in "other income" on the statement of operations, and interest revenue attributable to our oil and gas operations, which we include in interest income on the statement of operations.

Total Revenues from the oil and gas segment were 14% lower in 2007 than in 2006. Sales of oil and gas decreased from $1,030,000 in 2006 to 761,000 in 2007. The decrease of $270,000 in oil revenue was a result of declining production in the Martin-Severins, Webb Tract and Hanson wells being partially offset by an increase in production in the Pleasant Valley and Belridge wells. Revenues from oil and gas operations were 17% higher in 2006 than 2005. Nearly all of this increase resulted from a rise in average gas prices. Other income from consulting increased by $248,000 in 2007 compared to $80,000 in 2006. Interest income increased $210,000 to $283,000 in 2007. This was due to maintaining higher average cash balances. Overall interest income decreased from about $121,000 in 2005 to about $73,000 in 2006. This decrease was due to a decreased average cash balance during the year.

In 2006, we acquired drilling rigs and began rig operations through our subsidiaries, GVPS and GVDC. Our revenue from our rig operations in 2007 was $2.9 million compared to $1.0 million in 2006. We had no rig operations or revenues in 2005.

In each of the past three years, our largest source of revenue has been oil and gas drilling and development. Revenues from drilling and development activities were $6.1 million, an increase of $3.6 million over 2006. This increase was due to an increase in the number of wells drilled in 2007 to seven in our drilling program. In 2006, we drilled two wells and our revenue from drilling and development decreased to about $2.5 million, compared to $11.4 million in 2005. In 2005 we recorded drilling and development revenues of $3.4 million from drilling the Midland Trail well in Nevada, and we spent $3.5 million on a frac job on our Ekho well. We record revenue received by us from joint ventures for drilling and development when we complete drilling wells that have been sold to joint venture partners, including the Opus-I drilling partnership.

In 2007 we earned $573,000 compared to $179,000 in 2006 from consulting services pertaining to our minerals operations, which is included in other income in our operating statement. We earned insignificant revenues from such services in prior years. We earned no significant income from sales of minerals in 2007, 2006 or 2005.

Costs and Expenses

The following table sets forth our operating cost and expenses by segment in thousands:

	2007	2006	2005
Oil and gas	$ 659	$ 397	$ 3,299
Rig operations	2,142	726	-
Minerals	618	644	3,663
Drilling and development	5,011	1,990	9,268
Total cost and expenses	$ 8,430	$ 3,757	$ 16,230

Total operating costs and expenses were $4.8 million more for the year ended December 31, 2007, compared to year end 2006. Minerals operating expenses were $322,000 more for the period ended December 31, 2007 than for the same period in 2006, due to increase expenses due to our minerals consulting. Oil and gas cost and expense was $1.0 million for the year ended December 31, 2007 compared to $0.4 million for the year ended December 31, 2006. The increase was mainly due to activity on the new oil and gas properties drilled during 2007. Costs from drilling and development activities were $3.0 million more this year than in 2006 because of the increased drilling activity (seven wells drilled in 2007 compared to two wells drilled in 2006). Rig operating costs for GVPS and GVDC increased to $1.6 million from $0.4 million in 2006 due to an increased activity level.

The following table summarizes our total operating income (loss) by segment in thousands:

	2007	2006	2005
Oil and gas	$ 132	$ 830	$ (2,248)
Rig operations	585	307	-
Minerals	(618)	(465)	(3,610)
Drilling and development	1,121	507	2,155
Total operating income (loss)	$ 1,220	$ 1,179	$ (3,704)

Nonsegmented Items

General and administrative costs were $4.3 million higher this year than last year due in large part to the increased stock issuance expense and the increased activity in the rig operations segment of the Company. Increased salaries expense, insurance expense and legal and accounting expense were higher due to a general increase in the Company activity level. In 2007, we recognized impairment costs of about $482,000 primarily from the Onyx Ranch and Wildwood prospects. This was a $23,000 increase from 2006. The total Company interest expense for 2007 was $259,000 versus $397,000 during 2006. The decrease was attributed to a decrease in debt. Investment expense was $204,000 during the year. The expense was attributable to additional cost of buying back minority interest in GVPS and GVDC during 2007 above par value. There was no investment expense in 2006 or 2005.

We expect our costs and expenses to increase significantly in 2008 primarily due to proposed drilling and workover activities on the Pleasant Valley, Moffat Ranch and Belridge properties in advance of production revenue.

Total Company costs and expenses were $6.6 million less for the year ended December 31, 2006, compared to year end 2005. Mining exploration expenses were $3.6 million less for the period ended December 31, 2006 than for the same period in 2005, due to decreased mining exploration activity because of 2005 expenses incurred in the purchase of royalties and properties which were immediately expensed. Oil and gas lease activity expense was $388,700 for the year ended December 31, 2006 and $93,429 for the year ended December 31, 2005. The increase was mainly due to activity on the new oil and gas properties acquired at the end of 2005. Costs from drilling and development activities were $7.4 million less this year than in 2005 because of the decreased drilling activity (one well complete in 2005 and one well which drilling was in progress but not completed until January 2006), a $3.5 million frac job on the Ekho well and the redrill of the Sunrise well which was incurred in 2005. Operating costs on our recently formed Great Valley Production Services, LLC and our Great Valley Drilling Company, LLC in 2006 were $566,000. In 2005 it was nothing. General and administrative costs were $2.6 million higher this year than last year due in large part to the increased activity in our minerals segment of the Company. Tri-Western Resources and Select Resources had greatly increased travel costs, start-up expenses, insurance premiums and fees to consulting geologists in 2006. In 2006, we recognized impairment costs of about $459,000, primarily from the Tracy Subthrust. This was a $369,000 increase from 2005.

Revenues from Discontinued Operations in 2006

In 2006, we sold our interest in the Tri-Western Resources, LLC, joint venture and an industrial site used for Tri-Western's mineral operations. These transactions had a total sales price of $13.8 million and resulted in a non-operating gain of about $9.7 million. The Company sold its interest in order to redeploy the capital into ventures it believes will increase share value at a faster rate. The sale also caused us to reclassify certain expenses in 2006 and prior years as losses from discontinued operations, but this reclassification did not change our total net loss in any year. See note 12 to the Consolidated Financial Statements for a schedule of pro forma results.

Financial Condition

Balance Sheet

At December 31, 2007, we had $7.7 million in cash compared to $15.6 million at December 31, 2006. $3.7 million of the cash at year end 2007 is restricted for use by the OPUS I drilling partnership. The decrease was due primarily to an increase in property and equipment of $3.6 million for the current period compared to last year primarily because of the increase of $1.4 million in rigs and a $2.4 million increase in other property and equipment. The increase in OPUS I drilling partnership cash was related to increase funding into our partnership program by investors. Deposits increased about $29 thousand in 2007 compared to 2006. Investment in marketable securities increased by $440 thousand because of the Company receiving Duluth Metals common stock for providing executive and geological services. There were no marketable securities held in previous years. (see Note 13 to the consolidated financial statements)

Notes payable decreased from $1.1 million in 2006 to $0.4 million in 2007. This was due to the payoff and paydown of our notes payable. (see Note 4 to the consolidated financial statements)

Accounts payable and accrued expenses increased to $5.7 million from $2.2 million in 2006. The increase was all due to purchases for our recently accelerated drilling and production activities. Advances from joint venture participants, net decreased $1.7 million, from 5.4 million in 2006 to $3.7 million in 2007. This was due to the increase in drilling activity for our joint venture participants.

Shareholder equity increased from $11.2 million in 2006 to $12.1 million for 2007. This increase was due mainly to the net proceeds from issuance of common stock in the amount of $8.4 million and additional paid in capital from warrants and stock options in the amount of $1.1 million offset by a net loss for 2007 of $8.6 million. In 2007, the

Company bought back interest in GVPS and GVPC. The buyback was recorded at the par value of $5.0 million in the minority interest section of the balance sheet.

Commitments

Generally, our financial commitments arise from selling interests in our drilling prospects to third parties, which result in obligations to drill and develop the prospect. If we are unable to sell sufficient interests in a prospect to fund its drilling and development, we must either amend our agreements to drill the prospect or locate a substitute prospect acceptable to the participants.

Delay rentals for oil and gas leases amounted to $501,000 in 2007. Advance royalty payments and gold mining claims maintenance fees were $247,000 for the same period. We expect that approximately equal delay rentals and fees will be paid in 2008 from operating revenues.

Operating Activities

Net cash used by operating activities was $3.9 million for 2007, compared to $2.1 million in 2006. Net income decreased from a $8.6 million loss in 2007 to a $0.9 million loss in 2006. Stock based compensation costs decreased from $1.3 million in 2006 to $0.9 million in 2007. We adopted SFAS No. 123R “Shared Based Payment” on January 1, 2006 which required expensing of stock options.

Warrant cost increased from $247,000 in 2006 to $384,000 in 2007. In 2007 and 2006, we did not have any expense for property, mining claims & services paid with common stock, and while in 2005 we expensed $5.7 million. We had $3.7 million provided by an increase in accounts payable, compared to $0.6 million used by an increase in accounts payable in 2006. The 2007 increase is due to the increase in accounts payable balances due to the increase drilling activity near year end.

Investing Activities

Cash used by investing activities in 2007 was $11.1 million compared to cash provided of $8.3 million for the same period in 2006. In 2007, $5.0 million in cash was used to buy back 39% of the outside third party interest in GVPS and all of the outside third party interest in GVDC. In 2006, $13.8 million in cash was provided by the sale of our interest in Tri-Western Resources and the sale of our industrial minerals site.

Financing Activities

Cash provided by financing activities was $7.0 million in 2007 compared to $4.5 million for the period ending December 31, 2006. Proceeds from long-term debt decreased to zero to 2007 from $2.2 million in 2006. Principal payments on long term debt used $1.1 million in cash in 2007 compared to $4.9 million in 2006. This change was due primarily to the payoff of long term debt in conjunction with the sale of Tri-Western Resources in 2006. The net proceeds from the issuance of common stock increased from $2.4 million in 2006 to $7.9 million in 2007. The net proceeds from the issuance of warrants increase from zero in 2006 to $268 thousand in 2007 due to the number of warrants issued.

Liquidity and Capital Resources

The recoverability of our oil and gas reserves depends on future events, including obtaining adequate financing for our exploration and development program, successfully completing our planned drilling program, and achieving a level of operating revenues that is sufficient to support our cost structure. At various times in our history, it has been necessary for us to raise additional capital through private placements of equity financing. When such a need has arisen, we have met it successfully. It is management’s belief that we will continue to be able to meet our needs for additional capital as such needs arise in the future. We may need additional capital to pay for our share of costs relating to the drilling prospects and development of those that are successful, and to acquire additional oil and gas

leases, drilling equipment and other assets. The total amount of our capital needs will be determined in part by the number of prospects generated within our exploration program and by the working interest that we retain in those prospects.

During 2008, we expect to expend approximately $25 million on drilling activities. Funds for the majority of these activities will be provided by sales of partnership interests in the Opus-I drilling partnership, which will still be raising funds for development purposes. Tri-Valley's portion is expected to be approximately $6 million. We are evaluating and finalizing results of recently drilled Pleasant Valley and Moffat Ranch in order to design the optimum development plan for the property. We expect to drill several wells there in 2008. Our ability to complete our planned drilling activities in 2008 depends on some factors beyond our control, such as availability of equipment and personnel. Our actual capital commitments for fiscal year 2008 are less than $4 million, but to expend $25 million we will require additional capital from the OPUS partnership or other outside parties.

In 2008, we expect expenditures of approximately $ 0.8 million on mining activities, including mining lease and exploration expenses.

Should we choose to make an acquisition of producing oil and gas properties, such an acquisition would likely require that some portion of the purchase price be paid in cash, and thus would create the need for additional capital. Additional capital could be obtained from a combination of funding sources. The potential funding sources include:

Cash flow from operating activities,
Borrowings from financial institutions (which we typically avoid),
Debt offerings, which could increase our leverage and add to our need for cash to service such debt (which we typically avoid),
Additional offerings of our equity securities, which would cause dilution of our common stock,
Sales of portions of our working interest in the prospects within our exploration program, which would reduce future revenues from its exploration program,
Sale to an industry partner of a participation in our exploration program,
Sale of all or a portion of our producing oil and gas properties, which would reduce future revenues.

Our ability to raise additional capital will depend on the results of our operations and the status of various capital and industry markets at the time such additional capital is sought. Accordingly, there can be no assurances that capital will be available to us from any source or that, if available, it will be on terms acceptable to us. The Company has no off balance sheet arrangements.

ITEM 7A. Quantitative and Qualitative Disclosures about Market Risk

Oil and gas prices. Our financial condition, results of operations and capital resources are highly dependent upon the prevailing market prices of, and demand for, oil and gas. These commodity prices are subject to wide fluctuations and market uncertainties due to a variety of factors that are beyond our control. We cannot predict future oil and gas prices with any degree of certainty. Sustained declines in oil and gas prices may adversely affect our financial condition and results of operations, and may also reduce the amount of net oil and gas reserves that we can produce economically. Based on our year ended December 31, 2007 production, our gross revenues from oil and gas sales would change approximately $45,928 for each $1.00 change in gas prices and $7,006 for each $1.00 change in oil prices.

We do not engage in hedging activities or purchases and sales of commodity futures contracts.

ITEM 8: FINANCIAL STATEMENTS

TRI-VALLEY CORPORATION
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REPORT OF INDEPENDENT REGISTERED
PUBLIC ACCOUNTING FIRM

To the Board of Directors and
Shareholders of Tri-Valley Corporation

We have audited the accompanying balance sheets of Tri-Valley Corporation as of December 31, 2007 and 2006, and the related statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2007. Tri-Valley Corporation's management is responsible for these financial statements. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Tri-Valley Corporation as of December 31, 2007 and 2006, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2007 in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Tri-Valley Corporation's internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 13, 2008 expressed an unqualified opinion.

BROWN ARMSTRONG PAULDEN
McCOWN STARBUCK THORNBURGH & KEETER
ACCOUNTANCY CORPORATION

Bakersfield, California
March 13, 2008

TRI-VALLEY CORPORATION
CONSOLIDATED BALANCE SHEETS

	2007	2006
ASSETS		
Current assets		
Cash	$ 3,955,610	$ 11,457,427
Cash restricted to OPUS I use	3,712,083	4,140,788
Accounts receivable, trade	313,521	377,278
Prepaid expenses	12,029	42,529
Total current assets	7,993,243	16,018,022
Property and equipment, net		
Proved properties	2,143,907	1,407,925
Unproved properties	2,414,843	2,792,340
Rigs	6,731,758	5,371,593
Other property and equipment	4,942,145	2,504,185
Total property and equipment, net (Note 3)	16,232,653	12,076,043
Other assets		
Deposits	338,772	309,833
Investment in marketable securities (Note 13)	440,000	-
Investments in partnerships (Note 5)	17,400	17,400
Goodwill	212,414	212,414
Other	20,413	20,413
Total other assets	1,028,999	560,060
Total assets	$ 25,254,895	$ 28,654,125

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

TRI-VALLEY CORPORATION
CONSOLIDATED BALANCE SHEETS

	December 31, 2007	December 31, 2006
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Notes payable	$ 402,003	$ 619,069
Notes payable – related parties		501,036
Deferred revenue	242,163	-
Accounts payable and accrued expenses	5,699,153	2,237,116
Amounts payable to joint venture participants	281,419	280,815
Advances from joint venture participants, net	3,671,927	5,408,909
Total current liabilities	10,296,665	9,046,945
Non-Current Liabilities		
Due to joint ventures	-	-
Asset Retirement Obligation	240,394	216,714
Long-term portion of notes payable – related parties		698,963
Long-term portion of notes payable	2,355,707	2,047,885
Total non-current liabilities	2,596,101	2,963,562
Total liabilities	12,892,766	12,010,507
Minority interest	249,945	5,410,746
Stockholders' equity		
Common stock, $.001 par value; 100,000,000 shares authorized; 25,077,184 and 23,546,655 issued and outstanding at December 31, 2007, and 2006	25,077	23,407
Less: common stock in treasury, at cost, 100,025 shares at December 31, 2007 and 2006.	(13,370)	(13,370)
Capital in excess of par value	37,090,714	28,692,780
Additional paid in capital – warrants	782,729	247,313
Additional paid in capital – stock options	1,800,642	1,262,404
Accumulated deficit	(27,586,553)	(18,979,662)
Accumulated other comprehensive income	12,945	-
Total stockholders' equity	12,112,184	11,232,872
Total liabilities, minority interest and stockholder's equity	$ 25,254,895	$ 28,654,125

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

TRI-VALLEY CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS

	2007	2006	2005
Revenues			
Sale of oil and gas	$ 761,279	$ 1,029,606	$ 901,159
Rig income	2,726,692	873,368	-
Royalty income	-	-	883
Partnership income	30,000	45,000	30,000
Interest income	282,785	72,707	118,608
Drilling and development	6,131,613	2,497,256	11,422,234
Other income	1,083,738	418,786	53,226
Total revenues	11,016,107	4,936,723	12,526,110
Costs and expenses			
Mining exploration costs	391,255	510,583	4,112,717
Production costs	430,068	388,700	93,429
Drilling and development	5,010,799	1,799,792	9,267,621
Rig operating expenses	1,374,649	566,649	-
General and administrative	10,372,892	6,110,921	3,521,311
Interest	258,829	396,672	118,047
Investment	203,782	-	-
Depreciation, depletion and amortization	1,238,733	585,439	242,527
Impairment of acquisition costs	481,930	459,243	90,165
Total costs and expenses	19,762,937	10,817,999	17,445,817
Loss from continuing operations, before income taxes and discontinued operations	(8,746,830)	(5,881,276)	(4,919,707)
Tax provision	-	-	-
Loss from continuing operations, before discontinued operations	(8,746,830)	(5,881,276)	(4,919,707)
Loss from discontinued operations (Note 12)	-	(4,774,840)	(4,810,364)
Gain on disposal of discontinued operations (Note 12)	-	9,715,604	-
Loss before minority interest	$ (8,746,830)	$ (940,512)	$ (9,730,071)
Minority interest	(139,939)	$ (27,341)	-
Net Loss	$ (8,606,891)	$ (913,171)	$ (9,730,071)
Basic net loss per share:			
Loss from continuing operations	$ (0.35)	$ (0.25)	$ (0.22)
Income (loss) from discontinued operations, net	$ -	$ 0.21	$ (0.21)
Basic loss per common share	$ (0.35)	$ (0.04)	$ (0.43)
Weighted average number of shares outstanding	24,723,766	23,374,205	22,426,580
Potentially dilutive shares outstanding	28,061,401	26,377,537	25,030,468

No dilution is reported since net income is a loss per SFAS 128

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

TRI-VALLEY CORPORATION
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

	Total Common Shares	Treasury Shares	Par Value	Capital in Excess of Par Value	Additional Paid in Warrants & Stock Options	Common Stock Receivable	Accumulated Déficit	Treasury Stock	Other Comprehensive Income	Stockholder Equity
alance at ecember 31, 004	21,836,052	100,025	21,836	15,125,607	-	(750)	(8,336,420)	(13,370)		6,796,90
suance of ommon stock	970,124	-	970	9,199,610	-	-	-	-		9,200,58
ock issuance ost	-			(432,067)	-	-	-	-		(432,06
ommon stock ceivable	-			-	-	750	-	-		75
rilling ogram equity	-			1,736,625	-	-	-	-		1,736,62
et loss	-			-	-	-	(9,730,071)	-		(9,730,07
alance at ecember 31, 005	22,806,176	100,025	$ 22,806	$ 25,629,775	-	-	$ (18,066,491)	$ (13,370)		$ 7,572,72
suance of ommon stock	740,479		601	3,373,745	-	-	-	-		3,374,34
ock issuance ost	-	-	-	(310,740)	-	-	-	-		(310,74
'arrants (see ote 10)	-	-	-	-	$ 247,313	-	-	-		247,31
ock Based ompensation ee note 5)	-	-	-	-	1,262,404	-				1,262,40
et loss	-	-	-	-	-	-	(913,171)			(913,17
Balance at ecember 31, 006	23,546,655	100,025	$ 23,407	$ 28,692,780	$ 1,509,717	-	$ (18,979,662)	$ (13,370)		$ 11,232,87
suance of ommon stock	1,530,529		-	9,479,833	-	-	-	-	-	9,479,83
ock issuance ost	-	-	1,670	(1,081,900)	-	-	-	-	-	(1,080,23
'arrants (see ote 10)	-	-	-	-	$ 1,073,654	-	-	-	-	1,073,65
ock Based ompensation	-	-	-	-	-	-	-		-	

ee note 5)										
ther omprehensive come	-	-	-	-	-	-	-	-	12,945	12,94
et loss	-	-	-	-	-	-	(8,606,891)	-	-	(8,606,89
alance at ecember 31, 007	25,077,184	100,025	$ 25,077	$ 37,090,713	$ 2,583,371	-	$ (27,586,553)	$ (13,370)	12,945	$ 12,112,18

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

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TRI-VALLEY CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the Years Ended December 31,		
	2007	2006	2005
CASH PROVIDED (USED) BY OPERATING ACTIVITIES			
Net loss	$ (8,606,891)	$ (913,171)	$ (9,730,071)
Loss from discontinued operations	-	4,774,840	4,810,364
Gain on disposal of discontinued operations, net	-	(9,715,604)	-
Loss from continuing operations	(8,606,891)	(5,853,935)	(4,919,707)
Adjustments to reconcile net (loss) to net cash provided (used) by operating activities:			
Depreciation, depletion, and amortization	1,238,733	585,439	242,527
Impairment, dry hole and other disposals of property	481,930	459,243	90,165
Minority interest	(139,939)	(27,341)	-
Loss on buyback of minority interest	169,374	-	-
Stock-based compensation costs, net of taxes	831,752	1,262,404	-
Warrant costs from issuance of restricted common stock	384,352	247,313	-
Marketable securities	(380,000)	-	-
(Gain) or loss on sale of property	-	-	131,766
Property, mining claims & services paid with common stock	-	-	5,666,575
Director stock compensation	112,428		
Changes in operating capital:			
(Increase) decrease in accounts receivable	63,757	85,419	(89,862)
(Increase) decrease in prepaids	30,500	-	53,527
(Increase) decrease in deposits and other assets	(28,939)	(19,088)	(14,874)
Increase (decrease) in income taxes payable	-	-	-
Increase (decrease) in accounts payable, deferred revenue and accrued expenses	3,704,199	635,880	(445,454)
Increase (decrease) in amounts payable to joint venture participants and related parties	604	(82,680)	263,380
Increase (decrease) in advances from joint venture participants	(1,736,982)	90,264	(1,003,031)
Net cash provided by (used in) continuing operations	(3,875,122)	(2,617,082)	(24,988)
Net cash provided by (used in) discontinued operations	-	543,073	(4,446,650)
Net Cash Provided (Used) by Operating Activities	(3,875,122)	(2,074,009)	(4,471,638)

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

TRI-VALLEY CORPORATIONCONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

	For the Years Ended December 31,		
	2007	2006	2005
CASH PROVIDED (USED) BY INVESTING ACTIVITIES			
Proceeds from sale of property	-	461,752	-
Buy back of minority interest in GVDC/GVPS	(5,019,440)	-	-
Proceeds from sale of discontinued operations	-	13,838,625	-
Member capital distributions	(170,796)	-	-
Capital expenditures	(5,853,593)	(5,760,034)	(6,494,822)
(Investment in) marketable securities	(47,056)	-	-
Net cash provided by (used in) continuing operations	(11,090,885)	8,540,343	(6,494,822)
Net cash provided by (used in) discontinued operations	-	(225,042)	(4,256,602)
Net Cash Provided (Used) by Investing Activities	(11,090,885)	8,315,301	(10,751,424)
CASH PROVIDED (USED) BY FINANCING ACTIVITIES			
Proceeds from long-term debt	-	1,017,559	-
Proceeds from long-term debt – related parties	-	1,200,000	3,666,765
Principal payments on long-term debt	(1,109,241)	(4,909,204)	(311,673)
Net proceeds from the sale of minority	-	5,438,087	-
Net proceeds from the issuance of warrants	268,197	-	-
Net proceeds from issuance of common stock	7,876,529	2,442,890	3,101,938
Net cash provided by (used in) continuing operations	7,035,485	5,189,332	6,457,030
Net cash provided by (used in) discontinued operations	-	(709,330)	1,830,033
Net Cash Provided (Used) by Financing Activities	7,035,485	4,480,002	8,287,063
Net Increase (Decrease) in Cash and Cash Equivalents	(7,930,522)	10,721,294	(6,935,999)
Cash at Beginning of Year	15,598,215	4,876,921	11,812,920
Cash of End of Year	$ 7,667,693	$ 15,598,215	$ 4,876,921
Interest paid	$ 258,829	$ 352,815	$ 377,943
Income taxes paid	$ -	$ -	$ -
Property purchased with debt	$ 31,948	$ -	$ -
Property & services paid with common stock	$ -	$ 620,716	$ 2,662,075
Stock issued in exchange for mining claims	$ -	$ -	$ 3,004,500

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

TRI-VALLEY CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 – GENERAL

History and Business Activity

Tri-Valley Corporation ("TVC" or the Company), a Delaware corporation formed in 1971, is in the business of exploring, acquiring and developing petroleum and precious metals properties and interests therein. Tri-Valley has five subsidiaries. Tri-Valley Oil & Gas Company ("TVOG") operates the oil & gas activities and derives the majority of its revenue from oil and gas; Select Resources which handles all precious and industrial mineral interests; Great Valley Production Services, Inc., which was formed in February 2006 to operate oil production, rigs, primarily for TVOG; Great Valley Drilling Company which was formed in 2006 to operate oil drilling rigs, primarily for third parties and Tri-Valley Power Corporation which is inactive (see Item 1 Business for detail of GVPS and GVDC). The Company sold its joint venture interest in Tri-Western Resources, LLC on November 15, 2006. GVPS had minority interest of 10% outside ownership by outside third parties as of December 31, 2007. GVDC's is wholly owned by TVC as of year-end 2007.

The Company conducts its oil and gas business primarily through Tri-Valley Oil & Gas Company. TVOG is engaged in the exploration, acquisition and production of oil and gas properties. Substantially all of the Company's oil and gas reserves are located in California.

In 1987, the Company added precious metals exploration. Select conducts precious metals exploration activities. TVC has traditionally sought acquisition or merger opportunities within and outside of petroleum and mineral industries.

For purposes of reporting operating segments, the Company is involved in four areas. These are oil and gas production, rig operations, minerals, and drilling and development.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

This summary of significant accounting policies of Tri-Valley Corporation is presented to assist in understanding the Company's financial statements. The financial statements and notes are representations of the Company's management, which is responsible for their integrity and objectivity. These accounting policies conform to accounting principles generally accepted in the United States of America and have been consistently applied in the preparation of the financial statements.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company, its wholly owned subsidiaries, TVOG, Select, GVDC, Tri-Valley Power Corporation, since their inception. GVPS, where the Company has retained a 90% ownership interest, is also included in the consolidation. Other partnerships in which the Company has an operating or nonoperating interest in which the Company is not the primary beneficiary and owns less than 51%, are proportionately combined. This includes Opus I, Martins-Severin, Martins-Severin Deep, and Tri-Valley Exploration 1971-1 partnerships. All material intra and intercompany accounts and transactions have been eliminated in combination and consolidation.

Use of Estimates in the Preparation of Financial Statements

The preparation of our consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported assets, liabilities, revenues, expenses and some narrative disclosures. Actual results could differ from those estimates. The estimates that are most critical to our consolidated financial statements involve oil and gas reserves, recoverability and impairment of reserves, and useful lives of assets.

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Oil and Gas Reserves. Estimates of our proved oil and gas reserves included in this report are prepared in accordance with GAAP and SEC guidelines and were based on evaluations audited by independent petroleum engineers with respect to our major properties. The accuracy of a reserve report estimate is a function of:

- The quality and quantity of available data;
- The interpretation of that data;
- The accuracy of various mandated economic assumptions; and
- The judgment of the persons preparing the estimate.

Because these estimates depend on many assumptions, all of which may substantially differ from future actual results, reserve estimates will be different from the quantities of oil and gas that are ultimately recovered. In addition, results of drilling, testing and production after the date of an estimate may justify material revisions to the estimate.

It should not be assumed that the present value of future net cash flows included in this Report as of December 31, 2007 is the current market value of our estimated proved reserves. In accordance with SEC requirements, we have based the estimated present value of future net cash flows from proved reserves on prices and costs on the date of the estimate. Actual future prices and cost may be materially higher or lower than the prices and costs as of the date of the estimate.

Estimates of proved reserves materially impact depletion expense. If the estimates of proved reserves decline, the rate at which we record depletion expense will increase, reducing future net income. Such a decline may result from lower market prices, which may make it uneconomic to drill for and produce higher cost fields. In addition, a decline in proved reserve estimates may impact the outcome of our assessment of its oil and gas producing properties for impairment.

Impairment of Proved Oil and Gas Properties. We review our long-lived proved properties, consisting of oil and gas reserves, at least annually and record impairments to those properties, whenever management determines that events or circumstances indicate that the recorded carrying value of the properties may not be recoverable. Proved oil and gas properties are reviewed for impairment by depletable field pool, which is the lowest level at which depletion of proved properties are calculated. Management assesses whether or not an impairment provision is necessary based upon its outlook of future commodity prices and net cash flows that may be generated by the properties. We determine that a property is impaired when prices being paid for oil or gas make it no longer profitable to drill on, or to continue production on, that property. Price increases over the past three years have reduced the instances where impairment of reserves appeared to be required.

Additional production data indicated the initial reserve estimates would not be achievable, so we reduced reserves accordingly. If petroleum prices, particularly natural gas prices, in Northern California begin to fall in the future, more of our proved developed reserves could become impaired, which would reduce our estimates of future revenue, our proved reserve estimates and our profitability.

Asset Retirement Obligations. We adopted SFAS No. 143, "Accounting for Asset Retirement Obligations" effective January 1, 2003. Under this guidance, management is required to make judgments based on historical experience and future expectations regarding the future abandonment cost of its oil and gas properties and equipment as well as an estimate of the discount rate to be used in order to bring the estimated future cost to a present value. The discount rate is based on the risk free interest rate which is adjusted for our credit worthiness. The adjusted risk free rate is then applied to the estimated abandonment costs to arrive at the obligation existing at the end of the period under review. We review our estimate of the future obligation quarterly and accrue the estimated obligation based on the above.

Cash Equivalent and Short-Term Investments

Cash equivalents include cash on hand and on deposit, and highly liquid debt instruments with original maturities of three months or less. The majority of these funds are held at Smith Barney.

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Goodwill

The consolidated financial statements include the net assets purchased of Tri-Valley Corporation's wholly owned oil and gas subsidiary, TVOG. Net assets are carried at their fair market value at the acquisition date. On January 1, 2002, Tri-Valley Corporation adopted Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets" (SFAS 142). Under SFAS 142, goodwill is a non-amortizable asset, and is subject to a periodic review for impairment. Prior to the implementation of SFAS 142, the Company had goodwill of $212,414 that was being amortized. The carrying amount of goodwill is evaluated periodically. Factors used in the evaluation include the Company's ability to raise capital as a public company and anticipated cash flows from operating and non-operating mineral properties.

Advances from Joint Venture Participants

Advances received by the Company from joint venture partners for contract drilling projects, which are to be spent by the Company on behalf of the joint venture partners, are classified within operating inflows on the basis they do not meet the definition of financing or investing activities. When the cash advances are spent, the payable is reduced accordingly. These advances do not contribute to the Company's operating profits and are accounted for or disclosed as balance sheet entries only i.e. within cash and payable to joint venture participants.

Revenue Recognition

Sale of Oil and Gas
Crude oil and natural gas revenues are recognized as production occurs, the title and risk of loss transfers to a third party purchaser, net of royalties, discounts, and allowances, as applicable. Oil and gas revenues from producing wells are recognized when title and risk of loss is transferred to the purchaser of the oil or gas. Oil and gas production is recorded each month based on when the cash is received.

Drilling and Development
Oil and gas prospects are developed by the Company for sale to industry partners and drilling investors. These prospects are usually exploratory, and include costs of leasing, acquisition, and other geological and geophysical costs (hereafter referred to as "GGLA") plus a profit to the Company. Prior to 2002, the Company recognized revenue and profit from prospects sales when sold, irrespective of drilling commencement ("spudding").

Starting 2002 the Company changed its prospect offerings by inclusion of estimated costs of drilling in addition to GGLA costs. This offering is termed a "turnkey" exploratory drilling opportunity because drilling investors are charged only one certain amount in return for Tri-Valley drilling a well to the agreed total depth. The drilling investor only is charged the total "turnkey" amount, and is not liable for any additional costs associated with drilling to the agreed total depth. Once the well is drilled to total depth and revenue has been recognized, the drilling partners own 75% of the well and Tri-Valley owns 25% of the well.

If the well has been spudded and the well is not drilled to total depth or goes unlogged, Tri-Valley is responsible to drill another well to the agreed total depth per the "turnkey" contract. The drilling partners are not obligated for any additional costs to drill another well other than the original "turnkey" amount.

Once the well is spudded, drilling investor money is not refundable. In conformity with the guidelines provided in SEC Staff Accounting Bulletin (SAB) Topic 13, Tri-Valley only recognizes revenue when it is realized and earned. Tri-Valley considers "turnkey" revenue to be earned when the well is logged. Amounts charged are included in an Authority for Expenditure (AFE), which is a budget for each project well. Tri-Valley prepares the AFE and bears all risk of well completion to total depth. If the well is drilled to total depth for actual costs less than the AFE amounts, the Company realizes a profit. Conversely, if actual costs exceed the AFE, Tri-Valley realizes a loss and is

liable for all costs beyond the “turnkey” amount.

Drilling Agreements/Joint Ventures

Tri-Valley frequently participates in drilling agreements whereby it acts as operator of drilling and producing activities. As operator, TVOG is liable for the activities of these ventures. In the initial well in a prospect, the Company owns a carried interest and/or overriding royalty interest in such ventures, earning a working interest upon commencement of drilling. Costs of subsequent wells drilled in a prospect are shared by a pro rata interest.

Receivables from and amounts payable to these related parties (as well as other related parties) have been segregated in the accompanying financial statements. For turnkey projects, amounts received for drilling activities, which have not been spudded are deferred and remain within the joint venture liability, in accordance with the Company's revenue recognition policies. Revenue is recognized upon the completion of drilling operations and the well is logged. Actual or estimated costs to complete the drilling are charged as costs against this revenue.

Impairment of Long-lived and Intangible Assets

The Company evaluates its long-lived assets (property, plant and equipment) and definite-lived intangible assets for impairment whenever indicators of impairment exist, or when it commits to sell the asset. The accounting standards require that if the sum of the undiscounted expected future cash flows from a long-lived asset or definite-lived intangible asset is less than the carrying value of that asset, an asset impairment charge must be recognized. The amount of the impairment charge is calculated as the excess of the asset's carrying value over its fair value, which generally represents the discounted future cash flows from that asset, or in the case of assets the Company evaluates for sale, at fair value less costs to sell. A number of significant assumptions and estimates are involved in developing operating cash flow forecasts for the Company's discounted cash flow model, sales volumes and prices, costs to produce, working capital changes and capital spending requirements. The Company considers historical experience, and all available information at the time the fair values of its assets are estimated. However, fair values that could be realized in an actual transaction may differ from those used to evaluate the impairment of long-lived assets and definite-lived intangible assets. Therefore, assumptions and estimates used in the determination of impairment losses may affect the carrying value of long-lived and intangible assets, and possible impairment expense in the Company's Consolidated Financial Statements.

Oil and Gas Property and Equipment (Successful Efforts)

The Company accounts for its oil and gas exploration and development costs using the successful efforts method. Under this method, costs to acquire mineral interests in oil and gas properties, to drill and complete exploratory wells that find proved reserves and to drill and complete development wells are capitalized. Exploratory dry-hole costs, geological and geophysical costs and costs of carrying and retaining unproved properties are expensed when incurred, except those GGLA expenditures incurred on behalf of joint venture drilling projects, which the Company defers until the GGLA is sold at the completion of project funding and the target prospect is drilled. Expenditures incurred in drilling exploratory wells are accumulated as work in process until the Company determines whether the well has encountered commercial oil and gas reserves.

If the well has encountered commercial reserves, the accumulated cost is transferred to oil and gas properties; otherwise, the accumulated cost, net of salvage value, is charged to dry hole expense. If the well has encountered commercial reserves but cannot be classified as proved within one year after discovery, then the well is considered to be impaired, and the capitalized costs (net of any salvage value) of drilling the well are charged to expense. In 2007, 2006, and 2005 there was $481,930, $459,243and $90,165 respectively, charged to expense for impairment of exploratory well costs. Depletion, depreciation and amortization of oil and gas producing properties are computed on an aggregate basis using the units-of-production method based upon estimated proved developed reserves.

At December 31, 2007 and 2006, the Company carried unproved property costs of $1.80 million and $2.79 million, respectively. Generally accepted accounting principles require periodic evaluation of these costs on a project-by-project basis in comparison to their estimated value. These evaluations will be affected by the results of exploration activities, commodity price outlooks, planned future sales or expiration of all or a portion of the leases, contracts and permits appurtenant to such projects. If the quantity of potential reserves determined by such evaluations is not sufficient to fully recover the cost invested in each project, the Company will recognize non cash charges in the earnings of future periods.

Capitalized costs relating to proved properties are depleted using the unit-of-production method based on proved reserves. Costs of significant non-producing properties, wells in the process of being drilled and development projects are excluded from depletion until such time as the related project is completed and proved reserves are established or, if unsuccessful, impairment is determined.

Upon the sale of oil and gas reserves in place, costs less accumulated amortization of such property are removed from the accounts and resulting gain or loss on sale is reflected in operations. Impairment of non-producing leasehold costs and undeveloped mineral and royalty interests are assessed periodically on a property-by-property basis, and any impairment in value is currently charged to expense.

Oil and Gas Property and Equipment (Successful Efforts, continued)

In addition, we assess the capitalized costs of unproved properties periodically to determine whether their value has been impaired below the capitalized costs. We recognize a loss to the extent that such impairment is indicated. In making these assessments, we consider factors such as exploratory drilling results, future drilling plans, and lease expiration terms. When an entire interest in an unproved property is sold, gain or loss is recognized, taking into consideration any recorded impairment. When a partial interest in an unproved property is sold, the amount is treated as a reduction of the cost of the interest retained, with excess revenue and carrying costs being recognized. Upon abandonment of properties, the reserves are deemed fully depleted and any unamortized costs are recorded in the statement of operations under leases sold, relinquished and impaired.

As of January 1, 2005, the Company adopted FASB Staff Position FAS 19-1, “Accounting for Suspended Well Costs.” Upon adoption of the FSP, the Company evaluated all existing capitalized exploratory well costs under the provisions of the FSP. As a result, the Company determined that there were no capitalized costs of exploratory wells during 2007, 2006 and 2005, and does not include amounts that were capitalized and subsequently expensed in the same period.

Asset retirement obligations. The Company has significant obligations to remove tangible equipment and facilities and to restore land at the end of oil and gas production operations. The Company’s removal and restoration obligations are primarily associated with plugging and abandoning wells and removing and disposing of oil and gas wells. Estimating the future restoration and removal costs is difficult and requires management to make estimates and judgments because most of the removal obligations are many years in the future and contracts and regulations often have vague descriptions of what constitutes removal. Asset removal technologies and costs are constantly changing, as are regulatory, political, environmental, safety and public relations considerations.

On January 1, 2003, the Company adopted the provisions of SFAS 143. SFAS 143 significantly changed the method of accruing for costs an entity is legally obligated to incur related to the retirement of fixed assets. SFAS 143, together with the related FASB Interpretation No. 47, “Accounting for Conditional Asset Retirement Obligations, an Interpretation of FASB Statement No. 143” (“FIN 47”), requires the Company to record a separate liability for the discounted present value of the Company’s asset retirement obligations, with an offsetting increase to the related oil and gas properties on the balance sheet.

Inherent in the present value calculation are numerous assumptions and judgments including the ultimate settlement amounts, inflation factors, credit adjusted discount rates, timing of settlement, and changes in the legal, regulatory, environmental and political environments. To the extent future revisions to these assumptions impact the present value of the existing asset retirement obligations, a corresponding adjustment is made to the oil and gas property balance.

The Company’s asset retirement obligations primarily relate to the future plugging and abandonment of proved properties and related facilities. The Company has no assets that are legally restricted for purposes of settling asset retirement obligations. The following table summarizes the Company’s asset retirement obligation transactions recorded in accordance with the provisions of SFAS 143 during the years ended December 31, 2007, 2006, and 2005.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

	December 31, 2007	December 31, 2006	December 31, 2005
Beginning asset retirement obligations	$ 216,714	$ 92,108	$ 0
Liabilities assumed in acquisitions	2,380(3)	111,364(2)	92,108(1)
Accretion of discount	21,300	13,242	
Ending asset retirement obligations	$ 240,394	$ 216,714	$ 92,108

Oil and Gas Property and Equipment (Successful Efforts, continued)

(1) The Company's portion of the liability for the plugging and abandonment of the wells acquired from the Temblor Valley, Pleasant Valley and previous acquisitions.

(2) The Company's portion of the liability for the plugging and abandonment of the wells acquired from the C & L/Crofton & Coffee lease, the Claflin lease and the SP/Chevron lease.

(3) The Company's portion of the liability for the plugging and abandonment of wells drilled from the Temblor Valley and Pleasant Valley acquisitions.

Gold Mineral Property

The Company has invested in several gold mineral properties with exploration potential. All mineral claim acquisition costs and exploration and development expenditures are charged to expense as incurred. We capitalize acquisition and exploration costs only after persuasive engineering evidence is obtained to support recoverability of these costs (ideally upon determination of proven and/or probable reserves based upon dense drilling samples and feasibility studies by a recognized independent engineer). Currently, no amounts have been capitalized.

Other Properties and Equipment

Properties and equipment are depreciated using the straight-line method over the following estimated useful lives:

Office furniture and fixtures	3 - 7 years
Vehicle, machinery & equipment	5 - 10 years
Building	15 years

Leasehold improvements are amortized over the life of the lease.

Maintenance and repairs, which neither materially add to the value of the property nor appreciably prolong its life, are charged to expense as incurred. Gains or losses on dispositions of property and equipment other than oil and gas are reflected in operations.

Concentration of Credit Risk and Fair Value of Financial Instruments

The Company places its temporary cash investments with high credit quality financial institutions and limits the amount of credit exposure to any one financial institution. Total uninsured cash at year end was $2.3 million.

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NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Fair value of financial instruments is estimated to approximate the related book value, unless otherwise indicated, based on market information available to the Company.

Restriction on Cash in OPUS I partnership

At year-end 2007, there was $3.7 million in cash in the OPUS I partnership, which is restricted for use by the OPUS partnership only.

Stock Based Compensation Plans /Share-Based Payment

In December 2004, the FASB issued SFAS No. 123(R), "Share-Based Payment" ("SFAS No. 123 (R)"). This Statement revises SFAS No. 123 and supersedes APB No. 25. SFAS No. 123(R) focuses primarily on the accounting for transactions in which an entity obtains employee services in share-based payment transactions. SFAS No. 123(R) requires companies to recognize in the statement of operations the cost of employee services received in exchange for awards of equity instruments based on the grant-date fair value of those awards. This Statement is effective and was adopted in the first quarter of 2006. The Company adopted SFAS No. 123(R) using the modified prospective method, whereby the Company expensed the remaining portion of the requisite service under previously granted unvested awards outstanding as of January 1, 2006 and new share-based payment awards granted or modified after January 1, 2006. The Company used the Black-Scholes valuation method to estimate the fair value of its options. The Company calculates that implementation of SFAS No. 123(R) resulted in additional expense related to share-based employee and director compensation of approximately $1,600,000 before tax in 2007. See Note 5 to the Consolidated Financial Statements in Item 8 for a further discussion related to the Company's Stock Incentive Plan.

			December 31, 2007		December 31, 2006		December 31, 2005
Net Income	As reported	$	(8,606,891)	$	(913,171)	$	(9,730,071)
Add: Stock-based compensation expense included in reported net income, net of tax benefit			868,962		1,262,404		—
Deduct: Stock-based compensation expense determined under fair value based method for all awards, net of tax			(868,962)		(1,262,404)		(631,000)
	Pro forma	$	(8,606,891)	$	(913,171)	$	(10,361,071)
Earnings per share	As reported		(0.35)		(0.04)		(0.43)
	Pro forma		(0.35)		(0.04)		(0.46)

Warrants are accounted for under the guidelines established by APB Opinion No. 14 Accounting for Convertible Debt and Debt issued with Stock Purchase Warrants (APB14) under the direction of Emerging Issues Task Force (EITF) 98-5, Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios, (EITF 98-5) EITF 00-27 Application of Issue No 98-5 to Certain Convertible Instruments and (EITF 00-27)

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

The Company calculates the fair value of warrants issued with the convertible instruments using the Black-Scholes valuation method, using the same assumptions used for valuing employee stock options for purposes of SFAS No. 123R, except that the expected life of the warrant is used. Under these guidelines, the Company allocates the value of the proceeds received. The price allocated for the warrants is calculated by subtracting the current market price of the stock from the total proceeds of the sale of the restricted stock with the warrant attached. The allocated fair value is recorded as capital paid in – warrants. This allocated fair value of the proceeds from the sale of warrants is subtracted from the value of the warrants using the Black-Scholes valuation method to calculate the stock issuance expense.

Treasury Stock

The Company records acquisition of its capital stock for treasury at cost. Differences between proceeds for reissuance of treasury stock and average cost are charged to retained earnings or credited thereto to the extent of prior charges and thereafter to capital in excess of par value.

Recently Issued Accounting Pronouncements

Asset Retirement Obligation

In March 2005, the Financial Accounting Standards Board issued FASB Interpretation No. 47, “Accounting for Conditional Asset Retirement Obligations.”, Under the provisions of FIN No. 47, the term conditional asset retirement obligation as used in SFAS No. 143, “Accounting for Asset Retirement Obligations”, refers to a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity while the obligation to perform the asset retirement activity is unconditional. Accordingly, an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. The fair value of a liability for the conditional asset retirement obligation is required to be recognized when incurred—generally upon acquisition, construction, or development and/or through the normal operation of the asset. We have adopted FIN No. 47 as of December 31, 2005. Adoption of this pronouncement did not have a significant effect on our 2005, 2007 or 2007 consolidated financial statements, and we do not expect this pronouncement to have a significant effect on our future reported financial position or earnings.

Accounting for Certain Hybrid Financial Instruments

In February 2006, SFAS No. 155, Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140 was issued. This Statement resolves issues addressed in Statement 133 Implementation Issue No. D1, Application of Statement 133 to Beneficial Interests in Securitized Financial Assets. SFAS No. 155 will become effective for our fiscal year beginning after December 31, 2006. We adopted this Interpretation in the first quarter of 2007 and the adoption did not have a material impact on our financial position or results of operations for the year ended December 31, 2007.

Accounting for Uncertainty in Income Taxes

In July 2006, the Financial Accounting Standards Board (“FASB”) issued Interpretation No. 48, “Accounting for Uncertainty in Income Taxes – An interpretation of FASB Statement No. 109” (“FIN 48”). This Interpretation provides a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. We adopted this Interpretation in the first quarter of 2007 and the adoption to have a material impact on our financial position or results of operations.

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Fair Value Measurements

In September 2006, the FASB issued SFAS No. 157, “Fair Value Measurements.” This Statement replaces multiple existing definitions of fair value with a single definition, establishes a consistent framework for measuring fair value and expands financial statement disclosures regarding fair value measurements. This Statement applies only to fair value measurements that already are required or permitted by other accounting standards and does not require any new fair value measurements. SFAS No. 157 is effective for fiscal years beginning subsequent to November 15, 2007. We will adopt this Statement in the first quarter of 2008 and do not expect the adoption to have a material impact on our financial position or results of operations.

The Fair Value Option for Financial Assets and Financial Liabilities

In February 2007, the FASB issued SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities,” which permits an entity to measure certain financial assets and financial liabilities at fair value. The objective of SFAS No. 159 is to improve financial reporting by allowing entities to mitigate volatility in reported earnings caused by the measurement of related assets and liabilities using different attributes, without having to apply complex hedge accounting provisions. Under SFAS No. 159, entities that elect the fair value option (by instrument) will report unrealized gains and losses in earnings at each subsequent reporting date. The fair value option election is irrevocable, unless a new election date occurs. SFAS No. 159 establishes presentation and disclosure requirements to help financial statement users understand the effect of the entity’s election on its earnings, but does not eliminate disclosure requirements of other accounting standards. Assets and liabilities that are measured at fair value must be displayed on the face of the balance sheet. This statement is effective beginning January 1, 2008 and we do not expect the adoption to have a material impact on our financial position or results of operations.

NOTE 3 – PROPERTY AND EQUIPMENT

Properties, equipment and fixtures consist of the following:

	2007	2006
Oil and gas – California		
Proved properties, gross	$ 3,026,660	$ 2,169,496
Accumulated depletion	(882,753)	(761,571)
Proved properties, net	2,143,907	1,407,925
Unproved properties	2,414,843	2,792,340
Total oil and gas properties	4,558,750	4,200,265
Rigs	7,492,975	5,444,646
Accumulated depreciation	(761,217)	(73,053)
Total Rigs	6,731,758	5,371,593
Other property and equipment		
Land	21,281	21,281
Building	45,124	45,124
Machinery and Equipment	4,875,326	2,414,824
Vehicles	803,296	407,739
Transmission tower	51,270	51,270
Office furniture and equipment	149,229	159,241
	5,945,526	3,099,479
Accumulated depreciation	(1,003,381)	(595,294)
Total other property and equipment, net	4,942,145	2,504,185
Property and equipment, net	$ 16,232,653	$ 12,076,043

Depreciation expense for the year ended December 31, 2007 was $1,096,251 and for the year ended December 31, 2006 was $473,418. Carrying amount of assets pledged as collateral for the year ended December 31, 2007 was $5,027,268. In 2006, the carrying amount of assets pledged as collateral was $5,514,578.

NOTE 4 – NOTES PAYABLE

	December 31, 2007	2006
Note payable to Rabobank dated October 5, 2005, secured by a vehicle, interest at 6.5%, payable in 60 monthly installments of $599.	$ 18,527	$ 25,119
Note payable to Jim Burke Ford dated November 18, 2005; secured by a vehicle; interest at 6.49%; payable in 60 monthly installments of $714.	22,677	30,520
Note payable to Sealaska Corporation dated July 15, 2005; secured by mining machines and equipment; imputed interest at 7.5%; payable in 10 yearly installments of $200,000. Face amount was $2,000,000 before the imputed interest discount of $627,184 which resulted in a principal amount of $1,372,816.	1,171,461	1,275,777
Note payable to Jim Burke Ford dated November 18, 2005 paid in full during 2007; secured by a vehicle; interest at 6.49%; payable in 60 monthly installments of $493.	-	20,351
Note payable to Three Way Chevrolet dated April 03, 2006; secured by a vehicle; interest at 5.90%; payable in 60 monthly installments of $577.	20,926	27,356
Note payable to Three Way Chevrolet dated February 24, 2006; secured by a vehicle; interest at 9.70%; payable in 60 monthly installments of $1,324.	44,018	56,864
Note payable to Moss Family Trust dated February 14, 2006; secured by 100,000 shares of Tri Valley corporation unregistered restricted common stock; interest at 12.00%; payable in 60 monthly installments of $13,747.	442,147	547,108
Note payable to Moss Family Trust dated March 8, 2006; secured by 40,000 shares of Tri Valley corporation unregistered restricted common stock; interest at 12.00%; payable in 60 monthly installments of $5,728	184,228	227,961

NOTE 4 – NOTES PAYABLE (Continued)

	December 31, 2007	2006
Note payable to F. Lynn Blystone and Patricia L Blystone dated March 21, 2006 paid in full during 2007; secured by 6% overriding royalty interest in the Temblor Valley Production; interest at 1.00% per month, paid in full April 2007.	-	150,000
Note payable to Sun Valley Trust dated December 01, 2006 paid in full during 2007; payable in 6 monthly installments of $50,000. Unsecured	-	300,000
Note payable to Three Way Chevrolet dated January 22, 2007; secured by a vehicle; interest at 6.90%; payable in 60 monthly installments of $622.	26,504	-
Note payable to Three Way Chevrolet dated September 11, 2006; secured by a vehicle; interest at 4.90%; payable in 60 monthly installments of $927.	38,000	46,994
Note payable to Three Way Chevrolet dated September 11, 2006; secured by a vehicle; interest at 6.90%; payable in 60 monthly installments of $633.	24,999	30,631
Note payable to Three Way Chevrolet dated October 31, 2006; secured by a vehicle; interest at 9.70%; payable in 60 monthly installments of $1,679.43.	62,259	78,272
Note payable to Gary D, Borgna and Julie R. Borgna, and Equipment 2000 dated December 30, 2006; secured by Rig Equipment; imputed interest at 8.00%; payable in 120 monthly installments of $9,100 and a payment of $300,000 paid January 3, 2007. Face amount was $1,392,000 before the discount of $342,000 which resulted in a principal amount of $1,050,000. (also see note 5 – related party transactions)	698,964	1,050,000
	2,757,710	3,866,953
Less current portion	402,003	1,120,105
Long-term portion of notes payable	$ 2,355,707	$ 2,746,848

Maturities of long-term debt for the years subsequent to December 31, 2007 are as follows:

2008	$ 402,003
2009	440,720
2010	481,970
2011	304,293
2012-2016	1,128,724
	$ 2,757,710

NOTE 5 - RELATED PARTY TRANSACTIONS

Employee Stock Options

The Company has a qualified and a nonqualified stock option plan, which provides for the granting of options to key employees, consultants, and non employee directors of the Company. The 2007 stock option expense was $868,962.

The purpose of the Company's stock option plans is to further the interest of the Company by enabling officers, directors, employees and consultants of the Company to acquire an interest in the Company by ownership of its stock through the exercise of stock options granted under its stock option plan which are vested in one to five years.

The option price, number of shares and grant date are determined at the discretion of the Company's board of directors. The 1998 stock option plan was supplemented with the 2005 plan. All newly issued stock option grants are issued from the 2005 plan. The 2005 plan provides for the issuance of 2,625,000 stock options with 1,831,500 remaining to be issued as of December 31, 2007. Options granted under the plans are exercisable upon vesting. The vesting dates are determined in the stock option award and the contractual life is up to ten years. The plan expires in October 2015.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes American option-pricing model with the following weighted-average assumptions used for grants in 2007.

Year	Expected Life	Expected Dividends	Expected Volatility	Risk-Free Interest Rates
2007	4.28	None	45%	3.7%

The expected exercise life is based on management estimates of future attrition and early exercise rates after giving consideration to recent employee exercise behavior. Expected dividend yield is based on the Company's dividend history and anticipated dividend policy. Expected volatility is based on historical volatility for the Company's common stock. The risk-free interest rate is based on a yield curve of interest rates at the time of the grant based on the contractual life of the option.

The following table summarizes information about fixed stock options outstanding at December 31, 2007:

Range of Exercise Prices	Number Outstanding at December 31, 2007	Number Outstanding & exercisable at December 31, 2007	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Intrinsic Value(1) at December 31, 2007 (in thousands)
$.50 - $10.00	2,967,350	2,417,850	3.8 years	$ 2.64	$ 11,509

(1) Based on the difference between the exercise price per share and the $7.40 market price per share as of December 31, 2007

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NOTE 5 - RELATED PARTY TRANSACTIONS (Continued)

Employee Stock Options (continued)

The following table summarizes information about fixed stock options outstanding at December 31, 2006:

Range of Exercise Prices	Number Outstanding at December 31, 2006	Number Outstanding & exercisable at December 31, 2006	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Intrinsic Value(1) at December 31, 2006 (in thousands)
$.50 - $10.00	2,914,850	2,674,850	3.6 years	$ 2.26	$ 19,340

(1) Based on the difference between the exercise price per share and the $9.49 market price per share as of December 31, 2006

The following table summarizes information about fixed stock options outstanding at December 31, 2005:

Range of Exercise Prices	Number Outstanding at December 31, 2005	Number Outstanding & exercisable at December 31, 2005	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Intrinsic Value(2) at December 31, 2005 (in thousands)
$.50 - $10.00	2,757,600	2,647,600	4.2 years	$ 1.70	$ 16,097

(2) Based on the difference between the exercise price per share and the $7.78 market price per share as of December 31, 2005.

NOTE 5 - RELATED PARTY TRANSACTIONS (continued)

Employee Stock Options (continued)

Unrecognized Compensation Expense. At December 31, 2007 there was $2,095,000 of unrecognized compensation expense related to unvested awards granted under the Company's stock option plan. This amount is expected to be charged to expense over a weighted-average period of 2 years.

A summary of the status of the Company's fixed stock option plan as of December 31, 2007, 2006 and 2005 and changes during the years ending on those dates is presented below:

	2007		2006		2005	
	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price
Fixed Options						
Outstanding at beginning of year	2,914,850	$ 2.67	2,757,600	$ 2.03	2,553,600	$ 1.28
Granted	700,000	$ 7.41	445,000	$ 6.19	271,000	$ 5.82
Exercised	(440,000)	$ 1.99	(287,750)	$ 2.03	(67,000)	$ 1.94
Cancelled	(207,500)	$ 8.26	-	-	-	-
Outstanding at end of year	2,967,350	$ 3.50	2,914,850	$ 2.67	2,757,600	$ 2.03
Options exercisable at year-end	2,417,850	$ 2.64	2,674,850	$ 2.26	2,647,600	$ 1.70
Weighted-average fair value of options granted during the year	$ 4.00		$ 4.78		$ 3.32	
Available for issuance	1,831,500		824,000		119,000	

A summary of the status of the Company's nonvested options as of December 31, 2006 and changes during the year ended December 31, 2007, is presented below:

	Number of Shares	Weighted-Average Grant-Date Fair Value
Nonvested at December 31, 2006	245,000	$ 6.95
Granted	700,000	$ 7.41
Vested	(395,500)	$ 7.31
Nonvested at December 31, 2007	549,500	$ 7.28

NOTE 5 - RELATED PARTY TRANSACTIONS (continued)

Partnerships

Tri-Valley sells oil and gas drilling prospects to partnerships that are sponsored by Tri-Valley and sold to private investors for the purpose of oil and gas drilling and development. The Company accounts for these partnerships on the pro rata combination method. Drilling and development revenue related to the Opus-I partnership for the fiscal year ended December 31, 2007, 2006 and 2005 are as follows:

	December 31,		
	2007	2006	2005
Drilling and development revenue	$ 6,131,613	$ 2,497,256	$ 11,422,234
Drilling and development costs	$ 5,010,799	$ 1,799,792	$ 9,267,621

Oil and gas income from the Tri-Valley Oil & Gas Exploration Programs 1971-1 for fiscal year ended December 31, 2007, 2006 and 2005 are as follows:

	December 31,		
	2007	2006	2005
Partnership income, net of expenses	$ 30,000	$ 45,000	$ 30,000

NOTE 6 – EARNINGS PER SHARE

Year	Full Year Basic Earnings (Loss) Per Share	Weighted-Average Shares Outstanding	Weighted-Average Potentially Dilutive Shares Outstanding
2007	$ (0.35)	24,723,766	28,061,401
2006	$ (0.04)	23,374,205	26,377,537
2005	$ (0.43)	22,426,580	25,030,468

The diluted earnings per share amounts are based on weighted-average shares outstanding plus common stock equivalents. Common stock equivalents include stock options and awards, and common stock warrants. Common stock equivalents excluded from the calculation of diluted earnings per share due to the effect was antidilutive.

NOTE 7 - INCOME TAXES

As of December 31, 2007, the Company had available net operating loss carryforwards for federal and state tax purposes of $21,867,798 and $20,183,091, respectively, which begin to expire in 2025 and 2015, respectively. The Company also had available as of December 31, 2007 federal and state statutory depletion allowance carryforwards of $1,356,441, which do not expire.

The components of deferred tax assets at December 31, 2007, 2006 and 2005 are composed of:

	December 31, 2007	December 31, 2006	December 31, 2005
Net operating loss carryforwards	$ 9,219,236	$ 4,867,050	$ 5,229,460
Statutory depletion carryforwards	540,330	508,050	455,070
	9,759,566	5,375,119	5,684,530
Less: deferred tax asset valuation allowance	(9,759,566)	(5,375,119)	(5,684,530)
Net deferred tax assets	$ -	$ -	$ -

Income tax benefit (provision) is computed as follows:

	December 31, 2007	December 31, 2006	December 31, 2005
Current:			
Federal	$ 0	$ 0	$ 0
State	0	0	0
	$ 0	$ 0	$ 0
Deferred:			
Federal	$ 0	$ 0	$ 0
State	0	0	0
	$ 0	$ 0	$ 0

Total income tax benefit (provision):

	December 31, 2007	December 31, 2006	December 31, 2005
Continuing operations	$ 0	$ 0	$ 0
Discontinued operations	0	0	0
	$ 0	$ 0	$ 0

NOTE 8 - MAJOR CUSTOMERS

Oil and Gas

Substantially all oil and gas sales have occurred in the California market. The Company receives substantially all of its oil and gas revenue from two customers. Our total oil and gas sales amounted to $761,279, $1,029,606 and $901,359 for the year ended December 31, 2007, 2006, and 2005, respectively. We receive about 70% of our revenue from Company A and about 30% from Company B. All of our oil and gas is sold at spot market.

NOTE 9 - FINANCIAL INFORMATION RELATING TO INDUSTRY SEGMENTS

The Company reports operating segments according to SFAS No. 131, “Disclosure about Segments of an Enterprise and Related Information”.

The Company identifies reportable segments by product. The Company includes revenues from both external customers and revenues from transactions with other operating segments in its measure of segment profit or loss. The Company also includes interest revenue and expense, DD&A, and other operating expenses in its measure of segment profit or loss.

The Companies’ total reportable segment revenue and segment net income (loss) do not correspond with the enterprises consolidated revenue and consolidated income (loss) before income taxes. The Company’s segment revenue excludes other income and partnership income which are not affiliated with external customers, when compared to the enterprises consolidated revenue. The company’s segment net income (loss) does not include minority interest when compared to the enterprise’s consolidated income (loss) before income taxes.

The Company’s operations are classified into four principal industry segments:

- Oil and gas operations include our share of revenues from oil and gas wells on which TVOG serves as operator, royalty income and production revenue from other partnerships in which we have operating or non-operating interests. It also includes revenues for consulting services for oil and gas related activities.

- Rig operations began in 2006, when the Company acquired drilling rigs and began operating them through subsidiaries GVPS and GVDC. Rig operations include income from rental of oil field equipment.

- Minerals include the Company’s mining and mineral prospects and operations, and expenses associated with those operations. In 2006, the Company recorded minerals revenue from consulting services performed for the mining and minerals industry, which are included on the operating statement as other income.

- Drilling and development includes revenues received from oil and gas drilling and development operations performed for joint venture partners, including the Opus-I drilling partnership.

NOTE 9 - FINANCIAL INFORMATION RELATING TO INDUSTRY SEGMENTS (Continued)

	Oil and Gas Production	Rig Operations	Minerals	Drilling and Development	Total
Year ended December 31, 2007					
Revenues from external customers	$ 761,279	$ 3,236,990	$ 573,440	$ 6,131,613	$ 10,703,322
Interest revenue	$ 281,502	$ -	$ 1,283	$ -	$ 282,785
Interest expense	$ 101,322	$ 71,859	$ 85,644	$ -	$ 258,829
Operating income (loss)	$ 131,857	$ 585,137	$ (618,130)	$ 1,120,813	$ 1,219,677
Expenditures for segment assets	$ 2,280,187	$ 3,471,352	$ -	$ -	$ 5,751,539
Depreciation, depletion, and amortization	$ 229,354	$ 766,905	$ 242,473	$ -	$ 1,238,732
Total assets	$ 23,033,171	$ (139,739)	$ 2,361,463	$ -	$ 25,254,895
Estimated income tax benefit (expense)	$ -	$ -	$ -	$ -	$ -
Net income (loss)	$ (7,011,433)	$ (2,061,340)	$ (654,932)	$ 1,120,814	$ (8,606,891)
Year ended December 31, 2006					
Revenues from external customers	$ 1,029,606	$ 873,368	$ 178,500	$ 2,497,256	$ 4,578,730
Interest revenue	$ 72,707	$ -	$ -	$ -	$ 72,707
Interest expense	$ 26,834	$ 2,373	$ 267,465	$ -	$ 396,672
Operating income (loss)	$ 830,475	$ 306,719	$ (465,153)	$ 507,465	$ 1,179,506
Expenditures for segment assets	$ 1,146,146	$ 5,444,646	$ 15,000	$ -	$ 6,605,792
Depreciation, depletion, and amortization	$ 159,289	$ 81,530	$ 344,620	$ -	$ 585,439
Total assets	$ 18,517,488	$ 7,853,046	$ 2,283,591	$ -	$ 28,654,125
Estimated income tax benefit (expense)	$ -	$ -	$ -	$ -	$ -
Net income (loss)	$ (4,638,280)	$ (24,002)	$ 3,051,646*	$ 697,465	$ (913,171)

* In the fourth quarter we sold our interest in Tri-Western Resources and an associated industrial site for a net gain of $9,715,604. See note 12 for a pro forma schedule.

NOTE 9 - FINANCIAL INFORMATION RELATING TO INDUSTRY SEGMENTS (Continued)

	Oil and Gas Production	Minerals	Drilling and Development	Total
Year ended December 31, 2005				
Revenues from external customers	$ 901,159	$ 200	$ 11,422,234	$ 12,323,593
Interest revenue	$ 118,609	$ 2,295	$ -	$ 120,904
Interest expense	$ 2,115	$ 375,829	$ -	$ 377,944
Operating income (loss)	$ (2,248,486)	$ (3,610,142)	$ 2,154,613	(3,704,015)
Expenditures for segment assets	$ 1,260,884	$ 9,490,540	$ -	$ 10,751,424
Depreciation, depletion, and amortization	$ 58,319	$ 442,134	$ -	$ 500,453
Total assets	$ 8,427,037	$ 9,614,726	$ 1,696,967	$ 19,738,730
Estimated income tax benefit(expense)	$ -	$ -	$ -	$ -
Net income (loss)	$ (5,615,595)	$ (6,269,089)	$ 2,154,613	$ (9,730,071)

NOTE 10 - COMMON STOCK and WARRANTS and MINORITY INTEREST

Common Stock

During 2007 the Company issued the following shares of common stock. All of these securities were issued pursuant to privately negotiated transactions in reliance on the exemption contained in Section 4(2) of the Securities Act.

- During the year various directors and employees of the Company exercised stock options previously granted. The new shares issued pursuant to the stock option plan amounted to 377,791 shares.
- The Company issued 5,000 shares to one employee in accordance with his employment contract.
- The Company issued 2,000 shares each to six board members for services rendered.
- The remaining 1,135,738 shares were issued in private placements at prices of $6.00 to $9.00 per share for a total consideration of $8,958,430, or a weighted average price of $7.72.
- During the year the common stock issuance cost amounted to approximately $1,081,900.

NOTE 10 - COMMON STOCK and WARRANTS and MINORITY INTEREST (Continued)

During 2006 the Company issued the following shares of common stock. All of these securities were issued pursuant to privately negotiated transactions in reliance on the exemption contained in Section 4(2) of the Securities Act.

- During the year various directors and employees of the Company exercised stock options previously granted. The new shares issued pursuant to the stock option plan amounted to 237,593 shares. Cash consideration received totaled to $318,375.
- The Company pledged 140,000 common shares as security of two notes payable.
- The Company issued 5,000 shares to one employee in accordance with his employment contract.
- The Company issued 16,261 shares as a deposit to Sun Valley Trust. The stock was valued at $6.15 per share. The deposit was subsequently applied to the purchase price of three leases at the date of closing.
- The Company issued 5,280 shares to a consultant for $43,042 in services at an agreed price of $8.15 per share.
- The Company issued 54,870 shares as partial payment to purchase a drilling rig for Great Valley Drilling Company, LLC valued at $9.49 per share for a consideration of $520,716.
- The Company issued 35,000 shares to a director who exercised warrants at $10.00 per share, for total cash consideration of $350,000.
- The remaining 281,475 shares were issued in private placements at prices of $7.00 to $8.60 per share for a total consideration of $2,054,719, or a weighted average price of $7.30.
- During the year the common stock issuance cost amounted to approximately $310,740.

Warrants

During 2007, the Company issued warrants to accredited investors in conjunction with the sale of restricted common stock. 291,443 warrants were attached to these restricted shares. The warrants are exercisable for a period of two years from the date of issuance. The warrants are exercisable at $7.00 to $10.00, depending on when they were issued. The warrants were valued using the Black-Scholes option-pricing model, which resulted in charges to additional paid in capital of $652,549 and resulted in charges to stock issuance expense of $384,352.

Warrants are accounted for under the guidelines established by APB Opinion No. 14 Accounting for Convertible Debt and Debt issued with Stock Purchase Warrants (APB14) under the direction of Emerging Issues Task Force (EITF) 98-5, Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios, (EITF 98-5) EITF 00-27 Application of Issue No 98-5 to Certain Convertible Instruments and (EITF 00-27. The Company calculates the fair value of warrants issued with the convertible instruments using the Black-Scholes valuation method, using the same assumptions used for valuing employee options for purposes of SFAS No. 123R, except that the expected life of the warrant is used. Under these guidelines, the Company allocates the value of the proceeds received. The price allocated for the warrants is calculated by subtracting the current market price of the stock from the total proceeds of the sale of the restricted stock with the warrant attached. The allocated fair value is recorded as capital paid in – warrants. This allocated fair value of the proceeds from the sale of warrants is subtracted from the value of the warrants using the Black-Scholes valuation method to calculate the stock issuance expense.

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NOTE 10 - COMMON STOCK and WARRANTS and MINORITY INTEREST (Continued)

Minority Interest from the Sale and Purchase of Interest in Subsidiaries

During 2006, the Company sold 49% of the interest in GVPS to 35 individuals for $3,881,447. Also during 2006, the Company sold 49% of the interest in GVDC to 15 individuals for $1,556,640. The total minority interest for these two LLC's was $5,438,087, which is being consolidated under FASB Interpretation No. 46R, "Consolidation of Variable Interest Entities". In 2007, the Company bought back all of the minority interest in GVDC making it 100% owned by Tri-Valley at year-end 2007. The Company bought back 39% of the minority interest in GVPS, making it owned 90% by Tri-Valley and a minority interest of 10% owned by outside third parties. The company recorded an investment expense of $203,782 during the year due the buyback of minority interest above par value.

NOTE 11 - COMMITMENTS AND CONTINGENCIES

Contingencies

The Company is subject to possible loss contingencies pursuant to federal, state and local environmental laws and regulations. These include existing and potential obligations to investigate the effects of the release of certain hydro-carbons or other substances at various sites; to remediate or restore these sites; and to compensate others for damages and to make other payments as required by law or regulation. These obligations relate to sites owned by the Company or others, and are associated with past and present oil and gas operations.

The amount of such obligations is indeterminate and will depend on such factors as the unknown nature and extent of contamination, the unknown timing, extent and method of remedial actions which may be required, the determination of the Company's liability in proportion to other responsible parties, and the state of the law.

Natural Gas Contracts

The Company sells its gas under three separate gas contracts. During 2007, 2006, and 2005, the Company sold all of its produced gas under these agreements. The terms of the agreements are identical among the contracts. During 2007, 2006, and 2005, the terms of the agreements were as follows: 100% of the produced gas was sold at the monthly spot price.

Joint Venture Advances

As discussed in Note 1, the Company receives advances from joint venture participants, which represent funds raised to drill exploratory wells. The Company receives a carried working interest if the well is successfully drilled and completed. The Company acts as both the fiduciary agent and Operator during the period required to drill and equip the well, and as Operator while the well is produced. The Company is obligated to use these funds for expenditures of the joint venture prospect. The joint venture agreements specify that the Company must drill the subject well or substitute another prospect. Some agreements require that the interest earned on joint venture advances be credited to the project account. Expenditures of the projects are charged directly against the obligation.

The balance of the joint venture advance represents the sum of amounts contributed for drilling prospects, net of expenditures for the projects. Residual project balances are held until the Company makes a final determination concerning any remedial obligations of the joint ventures. The balance at December 31, 2007 consists primarily of the following projects:

Opus

In May of 2002 the Company began raising funds for a one hundred million dollar wildcat exploration drilling program named OPUS-I. The program originally called for the drilling of 26 prospects, 23 in California and 3 in Nevada. As of December 31, 2006 the program has drilled twenty wells. The drilling portion of these prospects is turn-keyed, meaning the drilling portion is done for a fixed cost and the completion portion is done at the actual cost. However, in 2006, the OPUS I program changed to a development program for the Pleasant Valley, Temblor Valley and Moffat Ranch East properties.

The Opus Drilling Program joint venture status at December 31, 2007 is as follows:

Total Opus Contributions	$	64,763,796
Total Opus Expenditures	$	61,864,663
Remaining advances	$	2,899,133
Interest credited to joint account	$	686,802

Contractual Obligations and Contingent Liabilities and Commitments

The table below presents our fixed, non-cancelable contractual obligations and commitments primarily related to our outstanding purchase orders, certain capital expenditures and lease arrangements as of December 31, 2007

	Payments Due By Period				
	Less than 1 year	1-3 years	3-5 years	After 5 years	Total
Long term debt(1)	$ 402,003	$ 1,324,693	$ 786,267	$ 244,747	$ 2,757,710
Operating lease commitments (2)	185,640	371,280	30,940	-	587,860
Total contractual cash obligations	$ 587,643	1,695,973	$ 817,207	$ 244,747	$ 3,345,570

(1) Represents cash obligations for principal payments and interest payments on various loans that are all secured by the asset financed. For further detail, see Note 4 to the Consolidated Financial Statements.

(2) Lease agreement of corporate headquarters in Bakersfield, California, lease terms are until March 2011 at a monthly payment of $15,470.

NOTE 12 – ACQUISITIONS AND DISPOSITIONS

Sale of interest in Tri-Western Resources, LLC and an industrial minerals site - Pro Forma Information

In 2006, the company had a $9,715,604 gain on disposal of discontinued operations.

The following pro forma unaudited financial information has been prepared by management to present consolidated financial results of operations of the Company to give effect to the loss of control over our interest in Tri-Western Resources, LLC. The pro forma condensed consolidated statement of losses for the years ended December 31, 2007, 2006 and 2005 present pro forma results as if the Company never owned an interest in Tri-Western Resources.

The unaudited pro forma financial information is not necessarily indicative of the actual results of operations or the financial position which would have been attained had the acquisitions been consummated at either of the foregoing dates or which may be attained in the future.

TRI-VALLEY CORPORATION
UNAUDITED PROFORMA CONDENSED CONSOLIDATED STATEMENT OF LOSSES
DECEMBER 31, 2007

	For the year ended December 31, 2007		
	As Presented	Pro Forma Adjustment	Pro Forma
Total Revenue	$ 11,016,107	-	$ 11,016,107
Total Costs and Expenses	$ 19,758,682	-	$ 19,742,749
Net loss from continued operations	$ (8,742,575)	-	$ (8,742,575)
Loss from discontinued operations	$ -	-	$ -
Gain from sell of discontinued operations	$ -	-	$ -
Income (loss) before minority interest	$ (8,742,575)		$ (8,742,575)
Minority interest	(139,939)	-	(133,939)
Net loss	(8,606,891)	-	(8,606,891)
Continued operations loss per common share	$ (0.35)	-	$ (0.35)
Discontinued operations earnings per common share	$ -	-	$ -
Basic loss per common share	$ (0.35)	-	$ (0.35)
Weighted average number of shares outstanding	24,723,766	-	24,723,766
Potentially dilutive shares outstanding	28,061,401	-	28,061,401

	For the year ended December 31, 2006		
	As Presented	Pro Forma Adjustment	Pro Forma
Total Revenue	$ 4,936,723	$ -	$ 4,936,723
Total Costs and Expenses	$ 10,817,999	$ -	$ 10,817,999
Net loss from continued operations	$ (5,881,276)	$ -	$ (5,881,276)
Loss from discontinued operations	$ (4,774,840)	$ (4,774,840)	$ -
Gain from sell of discontinued operations	$ 9,715,604	$ 9,715,604	$ -
Income (loss) before minority interest	$ (940,512)	$ 4,940,764	$ (5,881,276)
Minority interest	(27,341)	-	-
Net loss	(913,171)	$ 4,940,764	$ (5,881,276)
Continued operations loss per common share	$ (0.25)	$ -	$ (0.25)
Discontinued operations earnings per common share	$ 0.21	$ 0.21	$ 0.00
Basic loss per common share	$ (0.04)	$ (0.21)	$ (0.25)
Weighted average number of shares outstanding	23,374,205	-	23,374,205
Potentially dilutive shares outstanding	26,377,537	-	26,377,537
	$ 4,936,723	$ -	$ 4,936,723

	For the year ended December 31, 2005		
	As Presented	Pro Forma Adjustment	Pro Forma
Total Revenue	$ 12,526,110	$ -	$ 12,526,110
Total Costs and Expenses	$ 17,445,817	$ -	$ 17,445,817
Net loss from continued operations	$ (4,919,707)	$ -	$ (4,919,707)
Loss from discontinued operations	$ (4,810,364)	$ (4,810,364)	$ -
Net loss	$ (9,730,071)	$ (4,810,364)	$ (4,919,707)

Continued operations loss per common share	$	(0.43)	$	0.21	$	(0.22)
Basic loss per common share	$	(0.43)	$	0.21	$	(0.22)
Weighted average number of shares outstanding		22,426,580		-		22,426,580
Potentially dilutive shares outstanding		25,030,468		-		25,030,468

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NOTE 13 – INVESTMENT

In the second quarter the Company received 150,000 stock options for Duluth Metals common stock for providing executive and geological services for Duluth Metals. The stock options are exercisable at $0.30 Canadian. During the fourth quarter the options were exercised and converted into stock at a cost of $47,056. The market value of the stock on December 31, 2007 was $3.00 Canadian. The Company follows the provisions of Statement of Financial Accounting Standards No. 115 (SFAS 115), "Accounting for Certain Investments in Debt and Equity Securities." SFAS 115 requires companies to classify their investments as trading, available-for-sale or held-to-maturity. The Company's securities consist of stock which has been classified as available-for-sale. These are recorded in the financial statements at fair market value and any unrealized gains (losses) will be reported as a component of shareholder equity. At December 31, 2007, the cost basis net of write-downs, unrealized gains, unrealized losses and fair market value of the Company's holdings are as follows:

	December 31, 2007	
Net cost of equities	$	427,055
Unrealized Losses		(10,000)
Unrealized Gains		22,945
Fair Market Value	$	440,000

SFAS 115 requires that for each individual security classified as available-for-sale, a company shall determine whether a decline in fair value below the cost basis is other than temporary. If the decline in fair value is judged as such, the cost basis of the individual security shall be written down to fair value as a new cost basis and the amount of the write-down shall be reflected in other comprehensive income of the equity section. At December 31, 2007, the company's marketable securities had a fair market value of $ 440,000. The net unrealized gain of $12,945 is reported as accumulated other income.

This investment was translated into U.S. Dollars in accordance with SFAS No. 52, "Foreign Currency Translation." The investment was translated at the rate of exchange on the balance sheet date.

NOTE 14 – SUBSEQUENT EVENTS

After 23 years of service, Director Milton Carlson, 77, retired from the board of directors effective February 2, 2008. He most recently served on Tri-Valley's audit committee, was chair of the nominating and corporate governance committee and the designated director to receive any employee complaints. In resigning, Mr. Carlson did not report any disagreement with Tri-Valley on any matter relating to the company's operations, policies or practices.

SUPPLEMENTAL INFORMATION (unaudited)

The following estimates of proved oil and gas reserves, both developed and undeveloped, represent interests owned by the Company located solely in the United States.

Disclosures of oil and gas reserves, which follow, are based on estimates prepared by independent petroleum engineers for the years ended December 31, 2007, 2006, and 2005. Such analyses are subject to numerous uncertainties inherent in the estimation of quantities of proved reserves and in the projection of future rates of production and the timing of development expenditures. These estimates do not include probable or possible reserves.

These estimates are furnished and calculated in accordance with requirements of the Financial Accounting Standards Board and the Securities and Exchange Commission ("SEC"). Because of unpredictable variances in expenses and capital forecasts, crude oil and natural gas price changes, largely influenced and controlled by U.S. and foreign government actions, and the fact that the basis for such estimates vary significantly, management believes the usefulness of these projections is limited. Estimates of future net cash flows presented do not represent management's assessment of future profitability or future cash flows to the Company. Management's investment and operating decisions are based upon reserve estimates that include proved reserves as well as probable reserves, and upon different price and cost assumptions from those used here.

It should be recognized that applying current costs and prices and a 10 percent standard discount rate does not convey fair market value. The discounted amounts arrived at are only one measure of the value of proved reserves.

Capitalized costs relating to oil and gas producing activities and related accumulated depletion, depreciation and amortization were as follows:

	December 31, 2007	December 31, 2006	December 31, 2005
Aggregate capitalized costs:			
Proved properties	$ 3,026,660	$ 2,169,496	$ 1,795,653
Unproved properties	2,414,843	2,792,340	3,009,564
Accumulated depletion, depreciation and amortization	(882,753)	(761,571)	(649,550)
Net capitalized assets	$ 4,558,750	$ 4,200,265	$ 4,155,667

Supplemental Information (unaudited)

The following sets forth costs incurred for oil and gas property acquisition, exploration and development activities, whether capitalized or expensed, during:

	December 31, 2007	December 31, 2006	December 31, 2005
Acquisition of producing properties and productive and non-productive acreage	$ -	$ 400,000	$ 1,736,625
Exploration costs and development activities	$ -	$ -	$ -

Supplemental Information (unaudited)

Results Of Operations From Oil And Gas Producing Activities

The results of operations from oil and gas producing activities are as follows:

	December 31, 2007	December 31, 2006	December 31, 2005
Sales to unaffiliated parties	$ 791,279	$ 1,074,606	$ 932,042
Production costs	(430,068)	(388,700)	(93,429)
Depletion, depreciation and amortization	(229,354)	(159,289)	(28,226)
	131,857	526,617	810,387
Income tax expense	-	-	-
Results of operations from activities before extraordinary items (excluding corporate Overhead and interest costs)	$ 131,857	$ 526,617	$ 810,387

Supplemental Information (unaudited)

Changes In Estimated Reserve Quantities

The net interest in estimated quantities of proved developed and undeveloped reserves of crude oil and natural gas at December 31, 2007, 2006, and 2005, and changes in such quantities during each of the years then ended, were as follows:

	December 31, 2007		December 31, 2006		December 31, 2005	
	Oil (BBL)	Gas (MCF)	Oil (BBL)	Gas (MCF)	Oil (BBL)	Gas (MCF)
Proved developed and undeveloped reserves:						
Beginning of year	275,452	787,017	218,030	779,598	162	742,401
Revisions (a), (b), (e), (f)	(44,448)	20,299	(65,673)	88,336	(144)	119,453
Purchases (c), (g), (h)	148,049	-	125,413	-	218,029	-
Improved recovery (d),(i),(j)	-	29,741	4,282	5,260	-	46,346
Production	(7,006)	(45,928)	(6,600)	(86,177)	(17)	(128,602)
End of year	372,047	791,128	275,452	787,017	218,030	779,598
Proved developed reserves:						
Beginning of year	275,452	787,017	154,673	779,598	162	742,401
End of year	372,048	791,128	275,452	787,017	154,673	779,598

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Supplemental Information (Unaudited)

(a) In 2007, 44,448 barrels of oil, previously classified as proved undeveloped, were eliminated from reserves because wells drilled did not justify further development in Kern County, California.

(b) In 2007, our estimated proved developed producing gas reserves were revised upward by 20,299 mcf as a result of improved performance on a producing lease in Solano County, California.

(c) In 2007, we drilled and completed a well, and two offset wells are being completed in Ventura County, California.

(d) In 2007, improved recovery estimates on proved developed producing gas wells resulted from a partially successful recompletion and improved performance from leases in Contra Costa County, California.

(e) In 2006, our estimated proved developed producing gas reserves were revised upward by 175,295 mcf as a result of improved performance on a producing lease in Solano County, California. This was partially offset by a net downward revision of 86,959 mcf to proofed developed non-producing reserves and a minor change in proved developed non-producing oil reserves due to a partially successful recompletion that was not as beneficial as expected in Contra Costa County, California. In 2006, 63,357 barrels of oil, previously classified as proved undeveloped, were eliminated from reserves after two new wells drilled did not justify further development. This drilling activity also resulted in reduction of proved developed non-producing oil reserves by 3,380 barrels and an increase in proved producing oil reserves of 1,065 barrels.

(f) In 2005, our estimated proved developed producing gas reserves were revised upward by 190,451 mcf as a result of improved performance on a producing lease in Solano County. This was partially offset by a net downward revision of 70,988 mcf to proved developed non-producing reserves and a minor change in proved developed non-producing oil reserves due to a partially successful recompletion that was not as beneficial as expected in Contra Costa County.

(g) In the third quarter of 2006, we purchased two properties in Kern County, California, which are estimated to contain 125,413 barrels of proved non-producing oil reserves.

(h) In 2005, we purchased two properties near our existing properties in Kern County containing an estimated 218,029 barrels of proved producing, non-producing and undeveloped oil reserves in Kern County.

(i) In 2006, improved recovery estimates on proved developed producing gas wells resulted from a partially successful recompletion and improved performance from leases in Contra Costa County.

(j) In 2005, improved recovery estimates on proved developed producing gas wells resulted from a partially successful recompletion and improved performance from leases in Contra Costa County.

Standardized Measure Of Discounted Future Net Cash Flows Relating To Proved Oil And Gas Reserves

A standardized measure of discounted future net cash flows is presented below for the year ended December 31, 2007, 2006, and 2005.

The future net cash inflows are developed as follows:

(1) Estimates are made of quantities of proved reserves and the future periods during which they are expected to be produced based on year-end economic conditions.

(2) The estimated future production of proved reserves is priced on the basis of year-end prices.

(3) The resulting future gross revenue streams are reduced by estimated future costs to develop and to produce proved reserves, based on year end cost estimates.

Supplemental Information (Unaudited)

(4) The resulting future net revenue streams are reduced to present value amounts by applying a ten percent discount.

Disclosure of principal components of the standardized measure of discounted future net cash flows provides information concerning the factors involved in making the calculation. In addition, the disclosure of both undiscounted and discounted net cash flows provides a measure of comparing proved oil and gas reserves both with and without an estimate of production timing. The standardized measure of discounted future net cash flows relating to proved reserves reflects income taxes.

	December 31, 2007	December 31, 2006	December 31, 2005
Future cash in flows	$ 36,745,611	$ 19,415,065	$ 19,154,814
Future production and development costs	(12,714,080)	(5,858,187)	(4,292,152)
Future income tax expenses	(1,568,917)	(722,868)	(659,464)
Future net cash flows	22,462,614	12,834,010	14,203,198
10% annual discount for estimated timing of cash flows	10,138,224	6,712,715	7,147,126
Standardized measure of discounted future net cash flow	$ 12,324,390	$ 6,121,295	$ 7,056,072

* Refer to the following table for analysis in changes in standardized measure.

Changes In Standardized Measure Of Discounted Future Net Cash Flow From Proved Reserve Quantities
This statement discloses the sources of changes in the standardized measure from year to year. The amount reported as "Net changes in prices and production costs" represents the present value of changes in prices and production costs multiplied by estimates of proved reserves as of the beginning of the year. The "accretion of discount" was computed by multiplying the ten percent discount factor by the standardized measure as of the beginning of the year. The "Sales of oil and gas produced, net of production costs" is expressed in actual dollar amounts. "Revisions of previous quantity estimates" is expressed at year-end prices.

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Supplemental Information (unaudited)

Changes In Standardized Measure Of Discounted Future Net Cash Flow From Proved Reserve Quantities (Continued)

The "Net change in income taxes" is computed as the change in present value of future income taxes.

	December 31, 2007	December 31, 2006	December 31, 2005
Standardized measure - beginning of period	$ 6,121,295	$ 7,056,072	$ 1,958,238
Sales of oil and gas produced, net of production costs	(690,155)	(640,515)	(807,930)
Revisions of estimates of reserves provided in prior years:			
Net changes in prices	8,801,793	(2,215,972)	1,412,965
Revisions of previous quantity estimates	1,641,446	(2,512,220)	1,630,965
Extensions and discoveries	4,718,914	-	11,345,272
Property acquisition	-	2,370,080	-
Accretion of discount	(15,970,845)	434,411	(6,204,768)
Changes in production and development costs.	6,855,893	1,566,035	(1,580,186)
Net change in income taxes	846,049	63,404	(698,484)
Net increase (decrease)	6,203,095	(934,777)	5,097,834
Standardized measure - end of period	$ 12,324,390	$ 6,121,295	$ 7,056,072

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Supplemental Information (unaudited)

Quarterly Financial Data (unaudited)

	2007			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Operating Revenues	$ 1,516,300	$ 1,299,709	$ 3,912,591	$ 4,004,721
Net Income (Loss)	$ (2,402,019)	$ (2,810,243)	$ (1,038,643)	$ (2,355,986)
Net Income per Common Share - Basic	$ (0.09)	$ (0.11)	$ (0.05)	$ (0.10)

	2006			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Operating Revenues	$ 369,765	$ 978,340	$ 1,356,311	$ 2,532,307
Net Income (Loss)	$ (3,064,107)	$ (3,240,179)	$ (2,673,198)	$ 8,064,313*
Net Income (Loss) per Common Share	$ (0.13)	$ (0.14)	$ (0.11)	$ 0.34

* In the fourth quarter we sold Tri-Western Resources and an associated building for a net gain of $9,715,604.

	2005			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Operating Revenues	$ 202,108	$ 1,846,630	$ 6,781,574	$ 3,698,294
Net Income (Loss)	$ (3,375,111)	$ (717,680)	$ (345,932)	$ (5,291,348)
Net Income (Loss) per Common Share	$ (0.15)	$ (0.03)	$ (0.02)	$ (0.23)

ITEM 9A Controls and Procedures

Evaluation of Disclosure Controls

The Company conducted an evaluation, under the supervision and with the participation of the Company's principal executive officer and principal financial officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in the Securities Exchange Act of 1934 Rules 13a-15(e) and 15d-15(e)) as of December 31, 2007.

Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures as of the end of the period covered by this report were effective as of December 31, 2007 as discussed in Management's Report on Internal Control.

Limitations on the Effectiveness of Controls

Our management, including our CEO and CFO, does not expect that our Disclosure Controls or our internal control over financial reporting will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, but not absolute, assurance that the objectives of a control system are met. Further, any control system reflects limitations on resources, and the benefits of a control system must be considered relative to its costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within Tri-Valley Corporation have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of a control. A design of a control system is also based upon certain assumptions about potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and may not be detected.

Management's Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as defined by SEC rules adopted under the Securities Exchange Act of 1934, as amended. Our internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. It consists of policies and procedures that:

- Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets;

- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of the financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors; and

- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.

Under the supervision and with the participation of management, including the President and Chief Financial Officer, we made an assessment of the effectiveness of our internal control over financial reporting as of December 31, 2007. In making this assessment, we used the criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on our evaluation, we concluded that our internal control over financial reporting was effective as of December 31, 2007.

Changes in Internal Control

There have not been any changes in the Company's internal control over financial reporting during the fiscal quarter ended December 31, 2007 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

REPORT OF INDEPENDENT REGISTERED
PUBLIC ACCOUNTING FIRM

To the Board of Directors and
Stockholders of Tri-Valley Corporation
Bakersfield, California

We have audited Tri-Valley Corporation's internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Tri-Valley Corporation's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying report from management. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

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

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

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

In our opinion, Tri-Valley Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the balance sheets and the related statements of income, stockholders' equity and comprehensive income, and cash flows of Tri-Valley Corporation, and our report dated March 13, 2008 expressed an unqualified opinion.

BROWN ARMSTRONG
PAULDEN
McCOWN STARBUCK
THORNBURGH &
KEETER
ACCOUNTANCY
CORPORATION

March 13, 2008
Bakersfield, California

PART III

ITEM 10 Directors and Executive Officers of the Registrant

All of our directors serve one year terms from the time of their election to the time their successor is elected and qualified. The following information is furnished with respect to each director and executive officer who served as such during the fiscal year ended December 31, 2007:

Name of Director	Age	Year First Became Director or Executive Officer	Position With Company
F. Lynn Blystone	72	1974	President, CEO, Director, TVC CEO and Director, TVOG President, CEO, Director, TVPC CHOB, CEO, Director Select
Milton J. Carlson(1) (3)(4)	77	1985	Director
Loren J. Miller(1)(6)	62	1992	Director
Henry Lowenstein, Ph.D(2)(3)	53	2005	Director
William H.“Mo”Marumoto(2)(3)	72	2005	Director
G. Thomas Gamble(1)(2)(6)	46	2006	Director
Paul W. Bateman(1)	50	2007	Director
Edward M. Gabriel(3)	57	2007	Director
Thomas J. Cunningham(5)	65	1997	VP, CAO, Treasurer and Secretary, TVC, TVOG, and TVPC Director Select
Arthur M. Evans	59	2005	Chief Financial Officer
Joseph R. Kandle	65	1999	President, TVOG