

LIQUID AUDIO INC
Form 10-Q
August 14, 2002
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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549**

FORM 10-Q

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

(State or other jurisdiction of
incorporation or organization)

77-0421089

(I.R.S. Employer
Identification No.)

800 Chesapeake Drive, Redwood City, CA

(Address of principal executive offices)

94063

(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 No

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

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Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****LIQUID AUDIO, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**
(in thousands; unaudited)

	June 30, 2002	December 31, 2001
	<u> </u>	<u> </u>
Assets		
Current assets:		
Cash and cash equivalents	\$ 81,018	\$ 91,594
Accounts receivable, net	115	130
Other current assets	718	1,099
	<u> </u>	<u> </u>
Total current assets	81,851	92,823
Restricted cash	826	826
Property and equipment, net	2,391	3,603
Other assets	73	163
	<u> </u>	<u> </u>
Total assets	\$ 85,141	\$ 97,415
	<u> </u>	<u> </u>
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
	<u> </u>	<u> </u>
Total current liabilities	3,746	5,590
	<u> </u>	<u> </u>
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)
	<u> </u>	<u> </u>
Total stockholders' equity	81,395	91,825
	<u> </u>	<u> </u>
Total liabilities and stockholders' equity	\$ 85,141	\$ 97,415
	<u> </u>	<u> </u>

Table of Contents**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

Table of Contents**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:

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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.

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(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.

Table of Contents**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

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

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	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)

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Denominator for basic and diluted calculation	22,737	22,593	22,723	22,563
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Net loss per share:				
Basic and diluted	\$ (0.25)	\$ (0.62)	\$ (0.46)	\$ (1.12)
	<u> </u>	<u> </u>	<u> </u>	<u> </u>

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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 strat