RITA MEDICAL SYSTEMS INC
Form 10-Q
May 10, 2005
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2005

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 000-30959

RITA MEDICAL SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**94-3199149**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

46421 Landing Parkway

Fremont, CA 94538

(Address of principal executive offices, including zip code)

510-771-0400

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes x No ¨

As of April 29, 2005, there were 41,496,759 shares of the registrant s common stock outstanding.

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PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements

RITA MEDICAL SYSTEMS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, unaudited)

	March 31, 2005	December 31, 2004
Assets		
Current assets:		
Cash and cash equivalents	$ 5,906	$ 12,978
Marketable securities	251	880
Accounts and note receivable, net	6,480	6,410
Inventories	6,881	7,126
Prepaid and other current assets	1,219	792
Total current assets	20,737	28,186
Long term note receivable, net	140	177
Property and equipment, net	1,865	1,966
Goodwill	91,339	91,339
Intangible assets	29,885	30,600
Other assets	139	41
Total assets	$ 144,105	$ 152,309
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 3,700	$ 2,572
Accrued liabilities	2,929	4,159
Current portion of long term debt	708	7,200
Total current liabilities	7,337	13,931
Long term debt, less current portion	9,452	9,632
Other long term liabilities	82	90
Total liabilities	16,871	23,653
Stockholders equity		
Common stock	41	41

Additional paid-in capital	217,158	216,893
Accumulated other comprehensive loss		(2)
Accumulated deficit	(89,965)	(88,276)
Total stockholders equity	127,234	128,656
Total liabilities and stockholders equity	$ 144,105	$ 152,309

The accompanying notes are an integral part of the condensed consolidated financial statements.

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RITA MEDICAL SYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data, unaudited)

	Three months ended March 31,	
	2005	**2004**
Sales	$ 11,205	$ 4,644
Cost of goods sold	4,805	1,615
Gross profit	6,400	3,029
Operating expenses:		
Research and development	1,039	843
Selling, general and administrative	6,768	4,366
Restructuring charges	60	
Total operating expenses	7,867	5,209
Loss from operations	(1,467)	(2,180)
Interest expense	(287)	
Interest income and other expense, net	65	10
Net loss	$ (1,689)	$ (2,170)
Net loss per common share, basic and diluted	$ (0.04)	$ (0.12)
Shares used in computing net loss per common share, basic and diluted	41,457	17,998

The accompanying notes are an integral part of the condensed consolidated financial statements.

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RITA MEDICAL SYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands, unaudited)

	Three months ended March 31,	
	2005	**2004**
Cash flows from operating activities:		
Net loss	$ (1,689)	$ (2,170)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	970	410
Loss on disposal of property and equipment		13
Amortization of stock-based compensation		107
Allowance for (recovery of) doubtful accounts receivable	(178)	27
Provision for obsolete inventories	101	86
Changes in operating assets and liabilities:		
Accounts and note receivable	108	(43)
Inventories	144	329
Prepaid and other current assets	(427)	232
Accounts payable and accrued liabilities	(102)	(439)
Deferred maintenance revenue	(4)	2
Net cash used in operating activities	(1,077)	(1,446)
Cash flows from investing activities:		
Purchase of property and equipment	(154)	(98)
Purchase of marketable securities	(60)	(404)
Sales and maturities of marketable securities	691	3,770
Note receivable, other assets and other long term liabilities	(65)	23
Net cash provided by investing activities	412	3,291
Cash flows from financing activities:		
Principal payments on debt	(6,672)	
Proceeds from issuance of common stock, net of issuance costs	265	97
Net cash provided by (used in) financing activities	(6,407)	97
Net decrease in cash and cash equivalents	(7,072)	1,942
Cash and cash equivalents at beginning of period	12,978	3,780
Cash and cash equivalents at end of period	$ 5,906	$ 5,722

The accompanying notes are an integral part of the condensed consolidated financial statements.

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RITA MEDICAL SYSTEMS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of presentation

The accompanying unaudited condensed consolidated financial statements have been prepared by RITA Medical Systems, Inc. (the Company) in accordance with accounting principles generally accepted in the United States of America for interim financial information. These principles are consistent in all material respects with those applied in the Company s financial statements contained in the Company s annual report on Form 10-K for the fiscal year ended December 31, 2004, as amended, and pursuant to the instructions to Form 10-Q and Article 10 of Regulation S-X promulgated by the Securities and Exchange Commission. However, interim financial statements do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments (all of which are of a normal recurring nature, including the elimination of intercompany accounts) necessary to present fairly the financial position, results of operations and cash flows of the Company for the periods indicated. Interim results of operations are not necessarily indicative of the results to be expected for the full year or any other interim periods. These unaudited condensed consolidated financial statements should be read in conjunction with the financial statements and footnotes thereto for the year ended December 31, 2004 contained in the Company s annual report on Form 10-K.

2. Business Combination

On July 29, 2004, the Company merged with Horizon Medical Products, Inc. (Horizon) in a transaction accounted for under the purchase method of accounting. None of Horizon s results of operations prior to that date are included in the Company s condensed consolidated statements of operations. However, the Company has prepared pro forma financial information showing sales and net loss for the combined entity for the three month period ended March 31, 2004, as if the merger occurred as of January 1, 2004. This unaudited pro forma financial information is presented below in comparison to the Company s unaudited sales and net loss for the three month period ended March 31, 2005, but is not intended to represent or be indicative of the consolidated results of operations of the Company that would have been reported had the acquisition been completed as of January 1, 2004, and should not be taken as representative of the future consolidated results of operations or financial condition of the Company (in thousands, except per share amounts):

	Three months ended March 31,	
	Actual 2005	**Pro forma 2004**
Sales	$ 11,205	$ 11,730
Net loss	$ (1,689)	$ (3,528)
Net loss per common share, basic and diluted	$ (0.04)	$ (0.10)

Restructuring costs of $1,369,000, consisting entirely of severance related to the termination of employees to eliminate certain duplicative activities, have been incurred since completion of the merger. Of this amount, $60,000 was incurred during the three months ended March 31, 2005 (see Note 11, Restructuring).

3. Liquidity

As of March 31, 2005, the Company s total assets were $144.1 million, total tangible assets were $22.9 million, total liabilities were $16.9 million, working capital was $13.4 million and cash, cash equivalents and marketable securities totaled $6.2 million. Current and anticipated demand for the Company s products as well as procurement and production affect the need for capital. Changes in these or other factors could have a material impact on capital requirements and may require the Company to raise additional capital. While the Company believes that its existing cash resources, including marketable securities, will be sufficient to fund its operating needs for the next twelve months, additional financing may be required for the Company s currently envisioned long term needs. If the Company needs to raise additional financing, it will seek to sell additional equity or debt securities, obtain an additional credit facility or renegotiate debt repayment terms. There can be no assurance that any additional financing will be available on terms acceptable to the Company, or at all. In addition, future equity financings could result in dilution to shareholders, and future debt financings could result in certain financial and operational restrictions. Failure to obtain sufficient funds on acceptable terms when needed, to make timely debt payments, or to achieve our growth or profitability objectives may require us to curtail operations, perhaps to a significant extent.

4. Reclassifications

Certain prior year balances have been reclassified to conform to current year presentation. In the Company s quarterly report on Form 10-Q for the three month period ended March 31, 2004, investments in variable rate debt obligations with interest rate reset

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intervals of less than 90 days were classified as cash equivalents. The Company s Consolidated Statement of Cash Flows for the three months ended March 31, 2004 has been modified from past presentation to give effect to purchases and sales or maturities of such securities in the determination of net cash provided by investing activities. For the three months ended March 31, 2004, net cash provided by investing activities increased by $400,000. The Company s Consolidated Statements of Operations and Comprehensive Loss for the three months ended March 31, 2005 and 2004 were not affected by this reclassification.

5. Net loss per share

Basic earnings per share figures are calculated based on the weighted-average number of common shares outstanding during the period less the weighted-average number of any common shares subject to repurchase by the Company. Diluted earnings per share further include the dilutive effect of potentially dilutive securities consisting of stock options and warrants provided that the inclusion of such securities is not antidilutive; the Company has reported net losses and therefore has excluded such potentially dilutive securities from its calculation of diluted earnings per share. The following numbers of shares represented by stock options and warrants (prior to application of the treasury stock method) were excluded from the computation of diluted net loss per share as their effect was antidilutive (in thousands):

	March 31,	
	2005	**2004**
Effect of potentially dilutive securities:		
Options	7,256	2,743
Warrants	78	25
Total potentially dilutive securities excluded from the computation of net loss per common share as their effect was antidilutive	7,334	2,768

6. Accounting for stock-based compensation

During the year ended December 31, 2002, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 148, Accounting for Stock-Based Compensation Transition and Disclosure. The Company accounts for stock-based employee compensation arrangements in accordance with provisions of Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees and Financial Accounting Standards Board Interpretations (FIN) No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans.

Under APB Opinion No. 25, compensation expense is based on the difference, if any, on the date of the grant between the fair value of the Company s stock and the exercise price. SFAS No. 123 defines a fair value based method of accounting for an employee stock option or similar equity instruments.

The following table illustrates the effect on net loss and net loss per common share for the three month periods ended March 31, 2005 and 2004, respectively, if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation granted under all of its stock option plans and its Employee Stock Purchase Plan (in thousands, except per share amounts):

	Three months ended March 31,	
	2005	2004
Net loss, as reported	$ (1,689)	$ (2,170)
Add: Stock-based employee compensation expense included in reported net loss		107
Deduct: Total stock-based employee compensation determined under the fair value based method for all awards	(518)	(809)
Net loss, pro-forma	$ (2,207)	$ (2,872)
Basic and diluted net loss per common share:		
As reported	$ (0.04)	$ (0.12)
Pro-forma	$ (0.05)	$ (0.16)

The determination of stock-based employee compensation, as relating to stock option plans, under the fair value based method used the following weighted average assumptions:

	Three months ended March 31,	
	2005	2004
Volatility	78%	75%
Risk-free interest rate	3.83%	3.13%
Expected life	5 years	5 years
Expected dividends	0%	0%

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The corresponding assumptions for the Employee Stock Purchase Plan were as follows:

	Three months ended March 31,	
	2005	2004
Volatility	60%	60%
Risk-free interest rate	1.73%	1.01%
Expected life	0.5	0.5
Expected dividends	0%	0%

7. Inventories

The components of the Company s inventories at March 31, 2005 and December 31, 2004, respectively, were as follows (in thousands):

	March 31, 2005	December 31, 2004
Raw materials	$ 2,686	$ 2,776
Work-in-process	578	682
Finished goods	3,617	3,668
	$ 6,881	$ 7,126

8. Intangible assets and related amortization

The Company s intangible assets and related accumulated amortization at March 31, 2005 and December 31, 2004, respectively, were as follows (in thousands):

	March 31, 2005			December 31, 2004		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Capitalized patent defense litigation costs	$ 2,755	$ (654)	$ 2,101	$ 2,755	$ (593)	$ 2,162
Capitalized patent license agreements	2,650	(641)	2,009	2,650	(561)	2,089
Intangible assets recorded at merger with Horizon:						

Customer relationships	16,600	(738)	15,862	16,600	(461)	16,139
Product technology	6,900	(383)	6,517	6,900	(239)	6,661
Trademarks	3,000	(200)	2,800	3,000	(125)	2,875
Isomed distribution contract	700	(117)	583	700	(73)	627
Loan closing costs	73	(60)	13	73	(32)	41
Non-compete contracts	36	(36)		36	(30)	6
	$ 32,714	$ (2,829)	$ 29,885	$ 32,714	$ (2,114)	$ 30,600

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The amortization periods of our intangible assets as of March 31, 2005 are as follows:

	Amortization periods of intangible assets
Capitalized patent defense litigation costs	9 years
Capitalized patent license agreements	4 -10 years
Customer relationships	14 years
Product technology	11 years
Trademarks	9 years
Isomed distribution contract	3 years
Loan closing costs	4 months

Aggregate amortization expense for the three months ended March 31, 2005, estimated amortization expense for the nine months ending December 31, 2005, and estimated amortization expense for each of the five years ended December 31, 2006 through 2010 is as follows (in thousands):

Aggregate amortization expense:	
For the three months ended March 31, 2005	$ 715
Estimated amortization expense:	
For the nine months ended December 31, 2005	$ 2,052
For the twelve months ended December 31, 2006	$ 2,720
For the twelve months ended December 31, 2007	$ 2,720
For the twelve months ended December 31, 2008	$ 2,647
For the twelve months ended December 31, 2009	$ 2,457
For the twelve months ended December 31, 2010	$ 2,335

9. Goodwill

In accordance with the Company s policy, the potential impairment of the Company s goodwill is reviewed at least annually, or more often if changes in business conditions so dictate. The Company s market capitalization as of March 31, 2005 was approximately $124.0 million, $3.2 million less than the carrying value of the Company s net assets. As of December 31, 2004, the Company s market capitalization exceeded the carrying value of its assets by approximately $31.4 million. The Company believes its market capitalization to be temporarily depressed, reflecting market uncertainty regarding the integration of operations following our merger with Horizon and generally lower valuations of companies in our market sector over the last nine months.

Therefore, the Company does not consider this temporary depression in the market capitalization to be an event or circumstance that would more likely than not reduce the fair value of the Company below the carrying amount. However, if the Company s market capitalization remains at current levels, or decreases, an interim review will be performed for the potential impairment of goodwill, in addition to the Company s annual review performed as of September 30.

10. Debt

The Company has the following debts:

Senior Subordinated Convertible Notes (the Senior Notes): As of March 31, 2005, $8,262,000 was due under the Senior Notes. This balance reflects a prepayment of $6.5 million that the Company made during the quarter ended March 31, 2005. The balance due under the Senior Notes is due in July 2008. The Senior Notes currently bear interest, payable quarterly, at 8.0% per annum. This interest rate will increase to 14% per annum on July 29, 2005. The Company may prepay the Senior Notes without a penalty prior to their respective maturity dates.

Junior Promissory Note (the Junior Note): As of March 31, 2005, $1,460,000 was due under the Junior Note. The Junior Note bears interest at a rate of 6% per annum, is payable monthly and matures in March 2007. The monthly principal payment is $22,500 until maturity at which time a balloon payment of $920,000 is due.

A note payable for the Stepic business purchase (the Stepic Note): As of March 31, 2005, $437,601 was due under the Stepic Note. The Stepic Note bears interest at 8% and calls for monthly interest and principal payments of approximately $38,000. The Stepic Note is due and scheduled to be fully repaid in March 2006.

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None of the Company s note agreements is collateralized. The principal covenants of the note agreements relate to events of default which include, but are not limited to, failure to pay an obligation when due, breach of any covenant which remains uncured for 15 days, bankruptcy and a change of control. Generally, upon an event of default, the holders of a majority of the aggregate principal amount of the notes outstanding may declare the unpaid principal and interest on the notes immediately due and payable.

Future maturities of debt outstanding as of March 31, 2005 are as follows (in thousands):

Nine months ending December 31, 2005	$ 527
Three months ending March 31, 2006	180
Nine months ending December 31, 2006	203
Twelve months ending December 31, 2007	988
Twelve months ending December 31, 2008	8,262
Twelve months ending December 31, 2009 and thereafter	
	$ 10,160

11. Restructuring

In the three month period ended March 31, 2005, in connection with the merger of RITA and Horizon, the Company recorded a restructuring charge of $60,000 related to the termination of employees to eliminate certain duplicative activities, primarily in the sales, accounting and operations areas. The total of such charges since July 29, 2004, the day the merger was completed, is $1,369,000. These charges were accounted for in accordance with SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. As of March 31, 2005, approximately $1,238,000 of the severance amounts had been paid and $131,000 remained accrued. The Company expects to pay remaining accrued severance amounts by June 30, 2005.

12. Segment information

As a result of the merger with Horizon, the Company expanded its customer base and portfolio of products, which resulted in two groups of medical oncology products: radiofrequency ablation (RFA) systems, which consist largely of products sold by the Company prior to the merger, and specialty access catheter products, which are the products sold by Horizon prior to the merger.

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the Company s chief operating decision maker in deciding how to allocate resources and in assessing performance. The Company s chief operating decision maker reviews financial information on a consolidated basis, accompanied by disaggregated information about sales by groups of similar products for purposes of making operating decisions and assessing financial performance. However, significant expenses such as research and development and corporate administration are not allocated to product groups or geographical regions but, rather, are employed by the entire enterprise. For this reason, the Company s chief operating decision maker evaluates resource allocation on an enterprise-wide basis and not on a product or geographic basis. Accordingly, the Company has concluded that it operates in only one reportable segment, the medical oncology products business.

Sales for the Company s two medical oncology product groups for the three month periods ended March 31, 2005 and 2004 are as follows (in thousands):

	Three months ended March 31,	
	2005	2004
Radiofrequency ablation products	$ 4,529	$ 4,644
Specialty access catheter products	6,676	
Total medical oncology product sales	$ 11,205	$ 4,644

Sales for the Company s two domestic and international selling regions for the three month periods ended March 31, 2005 and 2004 are as follows (in thousands):

	Three months ended March 31,	
	2005	2004
Domestic	$ 9,649	$ 3,671
International	1,556	973
Total medical oncology product sales	$ 11,205	$ 4,644

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13. Comprehensive income (loss)

Comprehensive income (loss) generally represents all changes in stockholders equity except those resulting from investments or contributions by stockholders. The Company s unrealized gains and losses on available-for-sale securities represent the only components of comprehensive loss that are excluded from the Company s net loss. These components are not significant individually, or in the aggregate, and therefore, no separate statement of comprehensive loss has been presented.

14. Recent accounting pronouncements

In March 2004, the FASB issued EITF Issue No. 03-1 (EITF 03-1), The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments which provides new guidance for assessing impairment losses on investments. Additionally, EITF 03-1 includes new disclosure requirements for investments that are deemed to be temporarily impaired. In September 2004, the FASB delayed the accounting provisions of EITF 03-1; however, the disclosure requirements remain effective for annual periods ending after June 15, 2004. The Company will evaluate the impact of EITF 03-1 once the final guidance is issued.

In November 2004, the Financial Accounting Standards Board issued SFAS No. 151, Inventory Costs, an amendment of ARB No. 43, Chapter 4. SFAS No. 151 clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning in the second quarter of fiscal 2006. The Company does not believe the adoption of SFAS No. 151 will have a material effect on its consolidated financial position, results of operations or cash flows.

In December 2004, the Financial Accounting Standards Board issued Statement of Accounting Standards (SFAS) No. 123R, Share-Based Payment , which replaces SFAS No. 123. SFAS No. 123R requires public companies to recognize an expense for share-based payment arrangements including stock options and employee stock purchase plans. The statement eliminates a company s ability to account for share-based compensation transactions using APB 25, and generally requires instead that such transactions be accounted for using a fair- value based method. SFAS No. 123R requires an entity to measure the cost of employee services received in exchange for an award of equity instruments based on the fair value of the award on the date of grant, and to recognize the cost over the period during which the employee is required to provide service in exchange for the award. SFAS No. 123R is effective for the Company in the quarter ending March 31, 2006. Upon adoption of SFAS 123R, companies are allowed to select one of three alternative transition methods, each of which has different financial reporting implications. Management is currently evaluating the transition methods, valuation methodologies and other assumptions for employee stock options in light of SFAS No. 123R. Current estimates of option values using the Black-Scholes method may not be indicative of results from valuation methodologies ultimately implemented the Company upon adoption of SFAS No. 123R. Although the Company has not yet fully quantified the impact this standard will have on its financial statements, it is likely that the adoption of SFAS No. 123R will have a material impact on the Company s financial position and results of operations.

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15. Commitments and contingencies

The Company has commitments for operating leases related to facility rental, including an operating lease signed in February 2005 on a facility to house the Company s headquarters, effective in May 2005. Future minimum payments under operating leases are as follows (in thousands):

Nine months ending December 31, 2005	$ 358
Year ending December 31, 2006	404
Year ending December 31, 2007	383
Year ending December 31, 2008	350
Year ending December 31, 2009	355
Year ending December 31, 2010 and thereafter	116
Total of future minimum operating lease payments	$ 1,966

The Company is, and may in the future be, involved in litigation relating to claims arising from the ordinary course of business. Management is not currently aware of any matters that will have a material adverse effect on the financial position, results of operations or cash flows of the Company.

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

This Management s Discussion and Analysis of Financial Condition and Results of Operations and other parts of this quarterly report on Form 10-Q contain forward-looking statements that involve risks and uncertainties. Words such as anticipates , expects , intends , plans , believes , s estimates , should , and similar expressions identify such forward-looking statements. These statements are not guarantees of future performance and are subject to risks and uncertainties that could cause actual results to differ materially from those expressed or forecasted. Factors that might cause such a difference include, but are not limited to, those discussed in the section entitled Factors That May Affect Future Results and those appearing elsewhere in this quarterly report on Form 10-Q and in our annual report on Form 10-K for the fiscal year ended December 31, 2004, as amended. Readers are cautioned not to place undue reliance on these forward-looking statements that reflect management s analysis only as of the date hereof. We assume no obligation to update these forward-looking statements to reflect actual results or changes in factors or assumptions affecting such forward-looking statements.

Overview

We develop, manufacture and market innovative products for cancer patients, including radiofrequency ablation (RFA) systems for treating cancerous tumors as well as percutaneous vascular and spinal access systems. In 2001, we commercially launched our StarBurst XLi family of disposable devices and significantly expanded our direct domestic sales organization and our international distribution network. In 2002, the XLi family of disposable devices gained wide acceptance with our customers in the United States. In 2003, we introduced our next generation in infusion technology, the Xli-Enhanced (Xlie) disposable device. The Xlie device builds upon our established infusion expertise, making the ablation process easier and more efficient than it was with previous generations of our devices.

On July 29, 2004, the Company merged with Horizon Medical Products, Inc. (Horizon) in a transaction accounted for under the purchase method of accounting. None of Horizon s results of operations prior to that date are included in the Company s condensed consolidated statements of operations. We believe the merger will lead to higher sales and greater profitability than either or both of the pre-merger companies on a standalone basis due to a larger, more effective sales group, consolidation of manufacturing resulting in lower product costs, and reduced administrative expenses.

Horizon operated as a specialty medical device company focused on manufacturing and marketing vascular products, particularly oncology product lines including implantable vascular ports, tunneled catheters and stem cell transplant catheters used in cancer treatment protocols (collectively, specialty access catheter or SAC products). Each Horizon common stockholder received 0.4212 of a share of the Company s common stock for each share of Horizon common stock held. The Company thereby issued approximately 18.7 million shares of its common stock to acquire all issued and outstanding shares of Horizon common stock, and further assumed all outstanding Horizon options and warrants that, upon exercise, will result in the issuance of approximately 3.9 million shares of the Company s common stock. The fair value of shares issued by the Company was approximately $91.6 million based on a price per share of $4.896, the Company s average closing price the day the proposed merger was announced (May 13, 2004), the two business days preceding the announcement and the two business days following the announcement. The fair value of options and warrants, all of which were fully vested when assumed by the Company was determined to be approximately $15.4 million using the Black-Scholes valuation model. Costs incurred to effect the merger and to be included as a component of purchase price were $2.3 million. The total purchase price was approximately $109.3 million. The fair value of assets acquired, net of liabilities assumed, was approximately $18.0 million, resulting in goodwill of $91.3 million.

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Management relies on certain statistical measurements to assess trends in sales growth and the effectiveness of our selling strategies. The following table, derived from our Consolidated Statements of Operations and other unaudited data for the three months ended March 31, 2005 and 2004, and for the years ended December 31, 2004, 2003 and 2002, sets forth some of these measurements:

	Three months ended March 31,		Years ended December 31,		
	2005	**2004**	**2004**	**2003**	**2002**
Total sales (in thousands)	$ 11,205	$ 4,644	$ 28,215	$ 16,607	$ 17,393
Percentage of sales: United States	86%	79%	84%	80%	74%
Percentage of sales: International	14%	21%	16%	20%	26%
Percentage of sales: Radiofrequency products	40%	100%	62%	100%	100%
Percentage of sales: Vascular access products	60%	0%	38%	0%	0%
Gross margin	57%	65%	60%	63%	60%

Consolidation of Horizon s results did not begin until the closing date of the merger, July 29, 2004. Therefore, the percentages shown for historical periods must be used with caution, as they may not be indicative of future results. In particular, the percentage of sales attributable to vascular access products is expected to be higher in future periods.

Prior to completion of the Horizon merger, our products were sold in the United States exclusively through our direct sales force and internationally through distribution partners. Horizon, in contrast, made use of domestic distribution partners in selected areas of the United States. Since completion of the merger, we have begun to distribute our radiofrequency ablation products through two of these domestic distribution partners. However, direct sales will remain our predominant mode of domestic distribution for the foreseeable future.

Our sales in the United States are more profitable than our sales in international markets because direct selling, which avoids distributor discounts, permits higher average selling prices for our products. Accordingly, we have made significant investments in our domestic sales force in an effort to increase sales growth in the United States, and we introduced our premium-priced Starburst Xli and Xlie families of disposable needles in this region earlier than in Europe or other regions. These actions have resulted in a growing percentage of sales derived from the domestic market. The merger with Horizon should permit wider and even more efficient coverage of the domestic market, further strengthening this trend. In contrast, our international markets in Europe and Japan have relatively more restrictive reimbursement conditions than those in the United States, which combined with our distributor discounts, limit our average selling prices in these markets. We expect 2005 sales growth in the United States to continue to outpace international growth because we believe the principle impact of the Horizon merger will be upon the domestic market and because introduction of premium products to our international distributors will have a relatively small impact on growth due to pricing limitations.

Prior to completion of the Horizon merger, essentially all of our sales came from the sale of our disposable devices and radiofrequency generators used in the treatment of cancerous liver tumors. The merger with Horizon expanded our product offering and has resulted in additional sales, primarily from the specialty access catheter and port product lines used in cancer treatment protocols. Going forward, we expect that nearly 95% of our sales will be derived from our RFA and SAC disposable products, with the balance of our sales coming from hardware products. We believe that the broader product line and larger sales group resulting from the merger will enable us to increase the efficiency of our selling effort in 2005 and beyond.

Our manufacturing costs consist of raw materials, including generators and ancillary hardware components produced for us by third-party suppliers, labor to produce our disposable devices and to inspect incoming, in-process and finished goods, sterilization performed by an outside service provider and general overhead expenses. Our manufacturing costs are volume-dependent, and our unit costs should decrease as our production volumes increase. The ongoing integration of our manufacturing operations in our Manchester, Georgia location should result in lower costs in the future from the use of less expensive labor and economies of scale. However, the process of integration resulted in costs during the first quarter of 2005, including training costs and the expense of duplicate facilities that resulted in a 57% margin rate for the quarter, lower than management s long-term expectations for the business. This integration process will continue during the second quarter of 2005, negatively affecting margins for the period. We also believe we have the opportunity to reduce the cost of our vendor-supplied hardware products through higher order volumes or product redesign. Besides manufacturing costs, our cost of goods sold for the three months ended March 31, 2005 reflects amortization of intangible assets relating to product technology acquired in the merger. Our cost of goods sold for both of the three month periods ended March 31, 2005 and 2004 reflect amortization charges arising from the 2003 settlement of patent litigation. We expect these amortization charges to continue through 2016. Further, our cost of goods sold also includes provisions to our reserve for obsolete inventory. Technology in our marketplace has evolved rapidly and we have, from time to time, recognized relatively high expenses related to obsolete inventory as our product line has changed. We may experience similar product changes and related obsolete inventory provisions in the future.

Our gross margins reflect our selling prices, our domestic / international mix percentages, our product mix percentages, our production volumes, the prices we pay for vendor manufactured product and our provisions for obsolete inventory. Our gross margin

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for the quarter ended March 31, 2005, was 57%, compared to a gross margin of 65% for the quarter ended March 31, 2004. We believe that the 57% gross margin in the first quarter of 2005 reflects unusual costs associated with the integration of our manufacturing operations and is therefore lower than our long-term expectations for the business. However, historically, the gross margin rate for our specialty access catheter products has been lower than that of our radiofrequency ablation products. Also, amortization of our product technology related intangible assets will negatively impact cost of goods sold. Future gross margins may, therefore, be lower than our historical gross margin rates because of inclusion of these products and expenses in our results.

In addition to the selling statistics discussed above, management relies on certain measurements to assess the effectiveness of our operations. The following tables sets forth some of these measurements, derived from our Unaudited Condensed Consolidated Statements of Operations for the three months ended March 31, 2005 and 2004, our Consolidated Statements of Operations for the years ended December 31, 2004, 2003 and 2002, our Unaudited Condensed Consolidated Balance Sheets as of March 31, 2005 and 2004 and our Consolidated Balance Sheets as of December 31, 2004, 2003 and 2002 (in thousands):

	Three months ended March 31,		Years ended December 31,		
	2005	2004	2004	2003	2002
Research and development expense	$ 1,039	$ 843	$ 3,787	$ 4,294	$ 5,052
Selling, general and administrative expense	6,768	4,366	20,637	17,418	19,366
Restructuring charges	60		1,309		
Total operating expenses	$ 7,867	$ 5,209	$ 25,733	$ 21,712	$ 24,418

	March 31,	December 31,		
	2005	2004	2003	2002
Cash and cash equivalents	$ 5,906	$ 12,978	$ 4,580	$ 6,888
Marketable securities, current and long term	251	880	4,955	5,947
Total cash and marketable securities	$ 6,157	$ 13,858	$ 9,535	$ 12,835

If we are to become profitable, we must continue to manage our operating expenses. Our operating expenses consist of product development costs, clinical trial expenses, patent litigation expenses, sales and marketing expenses related to our selling efforts in the United States, Europe and Asia, and administrative expenses, including the costs associated with our status as a public company, professional service expenses and our provisions for uncollectible accounts. Changes in these expenses are determined by the breadth of our new product development portfolio, the number of headcount we maintain in our selling and administrative functions, the scope of our marketing efforts, the costs we incur in defense of our patents and intellectual property rights and the extent to which credit issues and economic conditions constrain our ability to collect our receivables.

Research spending in the quarter ended March 31, 2005 was $1.0 million, compared to $0.8 million in the quarter ended March 31, 2004. Research spending in 2005 is expected to increase modestly, driven by programs aimed at technical innovation of our radiofrequency ablation products and the introduction of new implantable ports and access catheters.

Selling, general and administrative in quarter ended March 31, 2005 was $6.8 million, compared to $4.4 million in the quarter ended March 31, 2004. The primary reasons for the increase were the consolidation of Horizon results and the expenses incurred in the integration of the two companies. Also, the merger resulted in recognition of intangible assets relating to trademarks, customer relationships and our distribution contract with Medtronic, amortization of which will result in charges to selling, general and administrative expense of $1.4 million to $1.6 million per year through 2014. Furthermore, we incurred significant costs related to compliance with the Sarbanes-Oxley Act of 2002. We incurred restructuring expenses of $60,000 during the quarter ended March 31, 2005, consisting of severance related to the termination of employees to eliminate certain duplicative activities. The total of such restructuring charges since the merger is $1,369,000, and we believe our restructuring is now essentially complete.

In addition to management of our operating expenses, we must continue to conserve our cash. Our combined total of cash, cash equivalents and marketable securities was $6.2 million as of March 31, 2005, compared to $13.9 million at December 31, 2004. Our net cash used in operating activities for the quarter ended March 31, 2005 was $1.1 million. We had approximately $10.2 million in short term and long term debt as of March 31, 2004. This figure reflects our payment of $6.5 million of our outstanding debt, plus accrued interest, in February 2005. We may in the future need to raise additional cash through borrowing or sale of equity securities or to renegotiate the payment terms of our debt.

We incurred a net loss of $1.7 million for quarter ended March 31, 2005 compared to $2.2 million for the quarter ended March 31, 2004. Profitability further depends on, among other things, our success in expanding product usage in our current markets and in developing new markets, as well as the successful integration of Horizon s operations. To the extent current or new markets do not materialize in accordance with our expectations, our sales could be lower than expected and we may be unable to achieve or sustain profitability.

In the first quarter of 2006, we expect to implement SFAS No. 123R. We have not yet been able to determine the impact of SFAS No. 123R on our results in 2006, or in subsequent years, but we expect to incur significant charges as a result of adoption of the standard.

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Critical Accounting Policies and Estimates

Our critical accounting policies and estimates were discussed in our annual report on Form 10-K for the fiscal year ended December 31, 2004. All of the policies and estimates discussed at that time remain unchanged.

Results of Operations

The following table sets forth the percentage of net revenue represented by certain items in our Condensed Consolidated Statements of Operations for the quarter ended March 31, 2005 and the four preceding fiscal quarters:

	Q1 2005	Q4 2004	Q3 2004	Q2 2004	Q1 2004
Domestic sales	86%	86%	86%	80%	79%
International sales	14%	14%	14%	20%	21%
Total sales	100%	100%	100%	100%	100%
Cost of goods sold	43%	47%	35%	36%	35%
Gross profit	57%	53%	65%	64%	65%
Operating expenses:					
Research and development	9%	9%	11%	21%	18%
Selling, general and administrative	60%	56%	78%	86%	94%
Restructuring charges	1%	2%	14%	0%	0%
Total operating expenses	70%	67%	103%	107%	112%
Loss from operations	(13)%	(14)%	(38)%	(43)%	(47)%
Interest expense	(3)%	(3)%	(3)%	0%	0%
Interest income and other expense, net	1%	0%	0%	0%	0%
Net loss	(15)%	(17)%	(41)%	(43)%	(47)%

Three months ended March 31, 2005 and 2004

The following table, which sets forth key comparisons of our sales results for the first quarter of 2005 compared to the first quarter of 2004, provides additional information on the impact of the consolidation of our acquired vascular access products upon our results (in thousands):

	Three months ended March 31,

	2005	2004	Growth	%
Domestic sales:				
Radiofrequency ablation products	$ 3,602	$ 3,671	$ (69)	-2%
Specialty access catheter products	6,047		6,047	
Total domestic sales	$ 9,649	$ 3,671	$ 5,978	163%
International sales:				
Radiofrequency ablation products	$ 927	$ 973	$ (46)	-5%
Specialty access catheter products	629		629	
Total international sales	$ 1,556	$ 973	$ 583	60%
Total radiofrequency ablation sales	$ 4,529	$ 4,644	$ (115)	-2%
Total specialty access catheter products	6,676		6,676	
Total sales	$ 11,205	$ 4,644	$ 6,561	141%

For the quarter ended March 31, 2005, sales totaled $11.2 million, an increase of 141% or $6.6 million from $4.6 million in the first quarter of 2004. Sales of specialty access catheter products acquired in the merger with Horizon explained all of this increase,

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adding $6.7 million to our sales, while sales of our radiofrequency ablation products decreased $0.1 million or 2% compared to the quarter ended March 31, 2004. Domestic sales of radiofrequency ablation products were also 2% lower in 2005 than in 2004. International sales of radiofrequency ablation products were 5% lower in 2005 than in 2004. For the quarter ended March 31, 2005, domestic sales represented 86% of total sales, compared to 79% in the first quarter of 2004.

Cost of goods sold for the quarter ended March 31, 2005 was $4.8 million, up from $1.6 million for the quarter ended March 31, 2004, primarily reflecting inclusion of $2.8 million in cost associated with SAC product sales. The remainder of the cost increase was due to a $0.1 million increase in patent-related amortization and $0.3 million in net costs associated with integration of our manufacturing operations following the Horizon merger. Our gross margin rate was 57% in the first quarter of 2005, compared to 65% in the prior period. We believe that the 57% gross margin in the first quarter of 2005 reflects unusual costs associated with the integration of our manufacturing operations and is therefore lower than our long-term expectations for the business. However, historically, the gross margin rate for our specialty access catheter products has been lower than that of our radiofrequency ablation products. Also, amortization of our product technology related intangible assets will negatively impact cost of goods sold. Future gross margins may, therefore, be lower than our historical gross margin rates because of inclusion of these products and expenses in our results.

Research and development expenses for the quarter ended March 31, 2005 were $1.0 million, compared to $0.8 million in the first quarter of 2004. This increase was primarily due to inclusion of research and development expenses for specialty access products that totaled $0.2 million for the quarter. Expenses associated with clinical trial work, specifically investigations into the use of our technology in the fields of kidney and breast cancer, also increased modestly.

Selling, general and administrative expenses for the quarter ended March 31, 2005 were $6.8 million, compared to $4.4 million in the first quarter of 2004. Of this $2.4 million increase, approximately $0.5 million is due to increased audit expenses, including costs incurred in compliance with the Sarbanes-Oxley Act of 2002. Increased sales and marketing expenses reflecting headcount increases and programs after the Horizon merger totaled $1.1 million for the firs quarter of 2005, including the $60,000 in restructuring expense. Another $0.4 million of the increase for the period resulted from amortization of merger-related intangible assets. Corporate expenses, including public company expenses, rent and insurance, were $0.4 million higher in the first quarter of 2005 than in the preceding period, again due to operational changes stemming from the Horizon merger. Our bad debt expense was about $0.2 million lower in the first quarter of 2005, compared to the first quarter of 2004.

Interest expense, net of interest and other income, for the first quarter ended March 31, 2005 was $0.2 million. We had no net interest expense in the prior year period.

Liquidity and Capital Resources

Prior to August 2000, we financed our operations principally through private placements of convertible preferred stock, raising approximately $37.9 million net of expenses. On August 1, 2000, we completed our initial public offering of 3.6 million common shares at a price of $12 per share, raising approximately $39.0 million net of expenses. All outstanding convertible preferred shares were converted to common shares at that time. To a lesser extent, we also financed our operations through equipment financing and other loans that were fully repaid as of December 31, 2002. In January of 2003, we raised an additional $8.3 million, net of expenses, through a private placement of our common shares. In November of 2004, we raised an additional $11.1 million, net of expenses, through a second private placement of our common shares and warrants to purchase our common shares. As of March 31, 2005, we had $5.9 million of cash and cash equivalents, $0.3 million of marketable securities and $13.4 million of working capital.

For the quarter ended March 31, 2005, net cash used in operating activities was $1.1 million principally due to our net loss of $1.7 million, offset by non-cash charges of $0.9 million, including depreciation and amortization, stock-based compensation and provisions to reserves for uncollectible accounts receivable and inventory. Stock-based compensation for the quarter was essentially zero, resulting from the impact of decreases in our stock price on the revaluation of consultant options. Approximately $0.3 million in cash was used in the quarter by changes in working capital accounts, primarily a $0.4 million increase in prepaid expenses offset by cash provided in other working capital accounts. During the quarter, $0.4 million was provided by investing activities, with net sales of marketable securities providing $0.6 million offset by $0.2 million used in purchase of property and equipment. Financing activities for the quarter used $6.4 million in cash, primarily reflecting $6.7 million in debt payments made during the quarter. The impact of debt payment on our cash used in financing activities was offset by $0.3 million raised by the issuance of common stock in conjunction with the exercise of stock options.

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We have, from time to time, financed equipment through capital and operating leases. Also, in the course of the Horizon merger, we acquired debt, the balance of which was $10.2 million as of March 31, 2005. As of March 31, 2005, we had no future minimum payments due under capital leases. Future minimum payments due under operating leases, including the 2005 operating lease we have entered regarding our new headquarters space in Fremont, California, and debt agreements were as follows (in thousands):

	Operating Leases	Debt	Total
Nine months ending December 31, 2005	$ 358	$ 527	$ 885
Year ending December 31, 2006	404	383	787
Year ending December 31, 2007	383	988	1,371
Year ending December 31, 2008	350	8,262	8,612
Year ending December 31, 2009	355		355
Year ending December 31, 2010 and thereafter	116		116
Total of future minimum operating lease payments	$ 1,966	$ 10,160	$ 12,126

Our capital requirements depend on numerous factors including our research and development expenditures, expenses related to selling, general and administrative operations and working capital to support business growth. Our net cash used in operating activities was $1.1 million for the quarter ended March 31, 2005. We expect that our net cash used in operating activities will not increase, on a quarterly basis, for the remaining quarters of 2005. Our cash used in the purchase of property and equipment was $154,000 for the three months ended March 31, 2005. We expect cash used in the purchase of property and equipment to be approximately $0.8 million for the year ended December 31, 2005. Our balance of cash, cash equivalents and marketable securities on March 31, 2005 was $6.2 million. Although it is difficult for us to predict future liquidity requirements with certainty, we believe that our current balances of cash, cash equivalents and marketable securities will satisfy our cash requirements for at least the next 12 months. During or after this period, if cash generated by operations is insufficient to satisfy our liquidity requirements, we may need to sell additional equity or debt securities, obtain an additional credit facility or renegotiate debt repayment terms. There can be no assurance that additional financing will be available to us or, if available, that such financing will be available on terms favorable to us and our stockholders, or that we will be successful in renegotiating debt repayment terms. Failure to obtain sufficient funds on acceptable terms when needed, to make timely debt payments, or to achieve our growth or profitability objectives may require us to curtail operations, perhaps to a significant extent.

Recent Accounting Pronouncements

In March 2004, the FASB issued EITF Issue No. 03-1 (EITF 03-1), The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments which provides new guidance for assessing impairment losses on investments. Additionally, EITF 03-1 includes new disclosure requirements for investments that are deemed to be temporarily impaired. In September 2004, the FASB delayed the accounting provisions of EITF 03-1; however, the disclosure requirements remain effective for annual periods ending after June 15, 2004. The Company will evaluate the impact of EITF 03-1 once the final guidance is issued.

In November 2004, the Financial Accounting Standards Board issued SFAS No. 151, Inventory Costs, an amendment of ARB No. 43, Chapter 4. SFAS No. 151 clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning in the second quarter of fiscal 2006. The Company does not believe the adoption of SFAS No. 151 will have a material effect on its consolidated financial position, results of operations or cash flows.

In December 2004, the Financial Accounting Standards Board issued Statement of Accounting Standards (SFAS) No. 123R, Share-Based Payment , which replaces SFAS No. 123. SFAS No. 123R requires public companies to recognize an expense for share-based payment arrangements including stock options and employee stock purchase plans. The statement eliminates a company s ability to account for share-based compensation transactions using APB 25, and generally requires instead that such transactions be accounted for using a fair- value based method. SFAS No. 123R requires an entity to measure the cost of employee services received in exchange for an award of equity instruments based on the fair value of the award on the date of grant, and to recognize the cost over the period during which the employee is required to provide service in exchange for the award. SFAS No. 123R is effective for the Company in the quarter ending March 31, 2006. Upon adoption of SFAS 123R, companies are allowed to select one of three alternative transition methods, each of which has different financial reporting implications. Management is currently evaluating the transition methods, valuation methodologies and other assumptions for employee stock options in light of SFAS No. 123R. Current estimates of option values using the Black-Scholes method may not be indicative of results from valuation methodologies ultimately implemented the Company upon adoption of SFAS No. 123R. Although we have not yet fully quantified the impact this standard will have on its financial statements, it is likely that the adoption of SFAS No. 123R will have a material impact on our financial position and results of operations.

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Factors That May Affect Future Results

In addition to the other information in this report, the following factors should be considered carefully in evaluating our business and prospects:

We may be unable to integrate our operations successfully and realize all of the anticipated benefits of our merger with Horizon Medical Products.

Our merger with Horizon involves the integration of two companies that previously have operated independently, which is a complex, costly and time-consuming process. The difficulties of combining the companies operations include, among other things:

- Coordinating geographically disparate organizations, systems and facilities;
- Integrating personnel with diverse business backgrounds;
- Consolidating corporate and administrative functions;
- Consolidating research and development, and manufacturing operations;
- Coordinating sales and marketing functions;
- Retaining key employees; and
- Preserving research and development, collaboration, distribution, marketing, promotion and other important relationships of the companies.

The process of integrating our operations with Horizon s has caused and could cause an interruption of, or loss of momentum in, the activities of the combined company s business and the loss of key personnel. The diversion of our management s attention and any delays or difficulties encountered in connection with the integration of our operations with those of Horizon could harm our business, results of operations, financial condition or prospects.

We have limited experience manufacturing our RFA and SAC disposable devices in substantial quantities, and if we are unable to hire sufficient additional personnel or to purchase additional equipment or are otherwise unable to meet customer demand, our business could suffer. Also, we are consolidating our manufacturing operations at our Manchester, Georgia location and, prior to September 30, 2004, personnel at that location had essentially no experience in manufacturing our radiofrequency ablation disposable devices.

To be successful, we must manufacture our products in substantial quantities in compliance with regulatory requirements at acceptable costs. If we do not succeed in manufacturing quantities of our disposable devices that meet customer demand, we could lose customers and our business could suffer. At the present time, we have limited high-volume manufacturing experience. Our manufacturing operations are currently focused on the in-house assembly of our disposable devices. As we increase our manufacturing volume and the number of product designs for our disposable devices, the complexity of our manufacturing processes will increase. Because our manufacturing operations are primarily dependent upon manual assembly, if demand for our system increases we will need to hire additional personnel and may need to purchase additional equipment. If we are unable to sufficiently staff and equip our manufacturing operations, particularly considering our plans to consolidate our manufacturing operations in our Manchester, Georgia location by the end of the second quarter of 2005, or are otherwise unable to meet customer demand for our products, our business could suffer.

If we become unable to meet customer demand through disruption of manufacturing operations, our business could suffer.

We are in the process of transitioning of our California-based manufacturing operations to our Manchester, Georgia location. We have incurred normal and customary moving costs and have also incurred integration costs, including training expenses and low product yields in our initial production runs of RFA products in Georgia. If we become unable to meet customer demand for our products, or if the costs associated with moving our RFA manufacturing to Georgia do not abate, our business could suffer.

We have identified material weaknesses in our internal control over financial reporting. Failure to remediate these weaknesses could impact the reliability of our financial reporting.

To date, we have identified material weaknesses in our procurement process which did, prior to adjustment, or could otherwise, result in a material misstatement of our annual or interim financial statements. As a result of these material weaknesses, we have determined that we did not maintain effective internal control over financial reporting as of December 31, 2004. See our disclosure in Status of Management s Report on Internal Control over Financial Reporting included in our annual report on Form 10-K, as amended, for the year ended December 31, 2004 for further discussion of these material weaknesses.

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We will be heavily dependent on the RITA system and our line of specialty access catheters in order to achieve our sales goals and our profitability targets. Failure to achieve and grow market acceptance for either product line could harm our business.

The majority of our sales will come from the sale of the RITA system and our line of specialty access catheters. Our financial performance will depend upon physician adoption and patient awareness of these products. If we are unable to convince physicians to use these products, we may not be able to generate sales because we do not have alternative products.

We have a history of losses and may never achieve profitability.

We incurred net losses of $1.7 million during the first quarter of 2005, $9.3 million in 2004, $11.1 million in 2003, $13.5 million in 2002, $13.0 million in 2001, $12.8 million in 2000 and $7.5 million in 1999. At March 31, 2005, we had an accumulated deficit of $90.0 million. To become profitable we must increase our sales and continue to limit the growth of our operating expenses. If our sales do not grow, or if expenses grow excessively, we may not be able to achieve or maintain profitability in the future.

Because we face significant competition from companies with greater resources than we have, we may be unable to compete effectively.

The market for our products is intensely competitive, subject to rapid change and significantly affected by new product introductions and other market activities of industry participants.

In the market for radiofrequency ablation products, we compete directly with two companies both domestically and internationally: RadioTherapeutics Corporation, a division of Boston Scientific, and Radionics, Inc., a division of Tyco Healthcare, which is a division of Tyco International. Boston Scientific and Tyco International are publicly traded companies with substantially greater resources than we have. Both RadioTherapeutics and Radionics sell products that use radiofrequency energy to ablate soft tissue. Furthermore, in April 2003, we entered into a license agreement with Boston Scientific, its affiliates and licensors, pursuant to which we granted Boston Scientific rights to manufacture and sell products using our infusion technology after October 5, 2004. As a result, Boston Scientific may develop and sell some competing products that would, in the absence of this license agreement, infringe our patents.

In the market for specialty access catheters and ports, we compete directly with C.R. Bard Inc. C.R. Bard is a publicly traded company with substantially greater resources than we have.

We are also aware of several companies in international markets that sell products that compete directly with ours. These companies are affecting our international market share and may erode that share in the future. In addition, one of these companies, Berchtold Corporation, has received FDA clearance for using radiofrequency energy to ablate soft tissue.

Alternative therapies could prove to be superior to the RITA radiofrequency ablation system or implantable specialty access products, and physician adoption of our products could be negatively affected.

In addition to competing against other companies offering products that use radiofrequency energy to ablate soft tissue or implantable vascular products, we also compete against companies developing, manufacturing and marketing alternative therapies that address solid cancerous and benign tumors. If these alternative therapies prove to offer treatment options that are perceived to be superior to our products or to have less severe side effects than those resulting from our products, physician adoption of our products could be negatively affected and our sales could decline.

We currently lack long-term data regarding the safety and efficacy of our radiofrequency ablation products and may find that long-term data does not support our short-term clinical results or that further short or long-term studies do not support the safety and efficacy of our radiofrequency ablation products in various applications. If the safety or efficacy of our radiofrequency ablation products is questioned, our sales could decline.

Our radiofrequency ablation products are supported by clinical follow-up data in published clinical reports or scientific presentations covering periods from five months to five years after radiofrequency ablation. If additional studies in liver cancer or in other applications fail to confirm or demonstrate the effectiveness of our radiofrequency ablation products, our sales could decline. If longer-term patient follow-up or clinical studies indicate that our procedures cause unexpected, serious complications or other unforeseen negative effects, we could be subject to significant liability. Further, because some of our data has been produced in studies that were retrospective, not randomized, or included small patient populations and because, in certain circumstances, we rely on clinical data developed by independent third party physicians, our clinical data may not be reproduced in wider patient populations.

If we are unable to protect our intellectual property rights or if we are found to infringe the rights of others, we may lose market share to our competitors and our business could suffer.

Our success depends significantly on our ability to protect our proprietary rights to the technologies used in our products, and yet we may be unable to do so. A number of companies in our market, as well as universities and research institutions, have issued patents and have filed patent applications that relate to the use of radiofrequency energy to ablate soft tissue or to the design or manufacture of implantable vascular products. Under certain circumstances these could result in lawsuits against us. Our pending United States and foreign patent applications may not issue or may issue and be subsequently successfully challenged by others. In addition, our pending patent applications include claims to material aspects of our products that are not currently protected by issued patents. Both the patent application process and the process of managing patent disputes can be time consuming and expensive.

In the event a competitor infringes on our patent or other intellectual property rights, enforcing those rights may be difficult and time consuming. Even if successful, litigation to enforce our intellectual property rights or to defend our patents against challenge could be expensive and time consuming and could divert management s attention. We may not have sufficient resources to enforce our intellectual property rights or to defend our patents against a challenge. In addition, confidentiality agreements executed by our employees, consultants and advisors may not be enforceable or may not provide meaningful protection for our trade secrets or other proprietary information in the event of unauthorized use or disclosure. If we are unable to protect our intellectual property rights, we could lose market share to our competitors and our business could suffer.

Our dependence on international revenues, which account for a significant portion of our total revenues, could harm our business.

Because our future profitability will depend in part on our ability to increase product sales in international markets, we are exposed to risks specific to business operations outside the United States. These risks include:

- the challenge of managing international sales without direct access to the end customer;
- lower average selling prices for our products, due to distributor discounts;
- the risk of inventory build-up by our distributors which could negatively impact sales in future periods;
- obtaining reimbursement for procedures using our devices in some foreign markets;
- the burden of complying with complex and changing foreign regulatory requirements;
- longer accounts receivable collection time;
- significant currency fluctuations, which could cause our distributors to reduce the number of products they purchase from us because the cost of our products to them could increase relative to the price they could charge their customers;
- reduced protection of intellectual property rights in some foreign countries; and
- contractual provisions governed by foreign laws.

We are substantially dependent on our Italian distributor and if we lose this distributor, or if this distributor significantly reduces its product demand, our international and total sales could decline.

We are substantially dependent on M.D.H. s.r.l. Forniture Ospedaliere, our distributor in Italy, which accounted for 20% of our international sales in the first quarter of 2005 and 19% of our international in 2004. International sales accounted for 14% of our total sales in the first quarter of 2005 and 16% of our total sales for the year ended December 31, 2004. The loss of this distributor, or a significant decrease in demand from this distributor, could cause our sales to decline substantially.

Our relationships with third-party distributors could negatively affect our sales.

We sell our products in international markets and selected domestic markets through third-party distributors over whom we have limited control, and, if they fail to adequately support our products, our sales could decline. In the past, we have terminated agreements with distributors and although we contracted with replacement distributors, we expended significant time and resources in doing so, and our sales in the affected markets suffered during the transition period that lasted approximately nine months. If our distributors or we terminate other distributor agreements, we could incur similar or more burdensome expenses, we could expend significant time and resources in finding replacement distributors or in establishing a direct sales force, and our sales could decrease during any related transition period.

We are aware that some of our distributors have built up inventory of our products. As a result, future sales to these distributors could be negatively impacted. Sales to our Japanese distributor in 2004 and 2003 and to a domestic distributor in the three months ended September 30, 2004 were so affected. In addition, while our distributors have no price protection and may only return undamaged products per our return policies, if we permit the return of products in excess of our provision for returns, we will have to adjust our revenues relating to these products. This may also impact our revenue recognition policy on future distributor sales.

In 2002, we significantly increased our allowance for doubtful accounts to address the risk associated with longer collection periods that have arisen principally with our European distributors. Although the deterioration we experienced in international collections in 2002 stabilized in 2003, and remained stable in 2004, we may encounter new difficulties with collections that require

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further increases in our allowance for doubtful accounts in the future, and we may require specific accounts to post letters of credit or pay in advance to minimize our credit risk. Further, we may, in the future, terminate relationships with some of our distributors, making collection of accounts receivable from these customers difficult. We believe our allowance for doubtful accounts sufficiently reflects this possibility, but additional provisions to the allowance for doubtful accounts are could be required. Additional future increases in our allowance for doubtful accounts would reduce our profits.

If customers in markets outside the United States experience difficulty obtaining reimbursement for procedures using our products, international sales could decline.

Certain of the markets outside the United States in which we sell our products require that specific reimbursement codes be obtained before reimbursement for procedures using our products can be approved. As a result, in countries where specific reimbursement codes are strictly required and have not yet been issued, reimbursement has been denied on that basis. If our distributors or we are unable to either obtain the required reimbursement codes or develop an effective strategy to resolve the reimbursement issue, physicians in foreign markets may be unwilling to purchase our products, negatively impacting our international revenues.

Our business is dependent upon reimbursement from government programs, such as Medicare and Medicaid, and we may face limitations on such third-party reimbursement, which could harm our operating results.

In the United States, our products are purchased primarily by hospitals and medical clinics, which then bill various third-party payors, such as Medicare, Medicaid and other government programs and private insurance plans, for the healthcare services provided to patients. Government agencies, private insurers and other payors determine whether to provide coverage for a particular procedure and reimburse hospitals for medical treatment at a fixed rate based on the diagnosis-related group, or DRG, established by the United States Centers for Medicare and Medicaid Services, or CMS. The fixed rate of reimbursement is based on the procedure performed and is unrelated to the specific devices used in that procedure. If a procedure is not covered by a DRG, payors may deny reimbursement. In addition, third-party payors may deny reimbursement if they determine that the device used in a treatment was unnecessary, inappropriate or not cost-effective, experimental or used for a non-approved indication.

There can be no assurance that reimbursement for the use of our products will continue at current levels, or that future reimbursement policies of third-party payors will not adversely affect our ability to sell our products on a profitable basis. Failure by hospitals and other users of our products to obtain reimbursement from third-party payors, or changes in government and private third-party payors   policies toward reimbursement for procedures employing our products, would have a material adverse effect on our business, results of operations and financial condition.

We depend on key employees in a competitive market for skilled personnel and without additional employees we cannot grow or achieve profitability.

We are highly dependent on the principal members of our management team, including our Chief Executive Officer and Chief Financial Officer, as well as key staff in the areas of finance, operations and research and development. Our future success will depend in part on the continued service of our staff and our ability to identify, hire and retain additional personnel. The markets for qualified management personnel in Northern California, where our headquarters are located, and Georgia, where are primary operating facilities are located, are competitive and expected to remain so. Because the environment for good personnel is so competitive, costs related to compensation may increase significantly. If we are unable to attract and retain both the management team and key personnel we need to support and grow our business, our business will suffer.

We are subject to, and may in the future be subject to, costly and time-consuming product liability actions.

We manufacture medical devices that are used on patients in both minimally invasive and open surgical procedures and, as a result, we are and may in the future be subject to product liability lawsuits. Any product liability claim brought against us, with or without merit, could result in the increase of our product liability insurance rates or the inability to secure coverage in the future. In addition, we could have to pay any amount awarded by a court in excess of policy limits. Finally, even a meritless or unsuccessful product liability claim could be time consuming and expensive to defend and could result in the diversion of management s attention from managing our core business.

Any failure in our physician training efforts could result in lower than expected product sales.

It is critical to our sales effort to train a sufficient number of physicians and to instruct them properly in the procedures that utilize our products. We have established formal physician training programs and rely on physicians to devote adequate time to understanding how and when our products should be used. If physicians are not properly trained, they may misuse or ineffectively use our products. Such use may result in unsatisfactory patient outcomes, patient injury and related liability or negative publicity that could have an adverse effect on our product sales.

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We may incur significant costs related to a class action lawsuit due to the likely volatility of our stock.

Our stock price is likely to fluctuate owing to market uncertainty about our ability to successfully integrate the operations of Horizon and manage our cash during the process of integration. Our stock price may also fluctuate for a number of other reasons including:

- our ability to repay debt;
- our ability to successfully commercialize our products;
- our ability to comply with Section 404 of the Sarbanes-Oxley Act of 2002;
- conclusions that our internal control over financial reporting are ineffective;
- announcements regarding patent litigation or the issuance of patents to us or our competitors;
- quarterly fluctuations in our results of operations;
- announcements of technological or competitive developments by us or our competitors;
- product liability claims;
- regulatory developments regarding us or our competitors;
- acquisitions or strategic alliances by us or our competitors;
- changes in estimates of our financial performance or changes in recommendations by securities analysts; and
- general market conditions, particularly for companies with small market capitalizations.

Securities class action litigation is often brought against a company after a period of volatility in the market price of its stock. If our future quarterly operating results are below the expectations of securities analysts or investors, the price of our common stock would likely decline. Stock price fluctuations may be exaggerated if the trading volume of our common stock is low. Any securities litigation claims brought against us could result in substantial expense and divert management s attention from our core business.

We are dependent on two suppliers as the only sources of a component that we use in our radiofrequency ablation disposable devices, and any disruption in the supply of this component could negatively affect our business.

Until 2003, there was only one supplier available to provide us with a component that we include in our disposable devices. During the quarter ended September 30, 2003, we qualified a second supplier. However, a disruption in the supply of this component is still possible and could negatively affect revenues. If we were unable to remedy a disruption in supply of this component within twelve months, we could be required to redesign the handle of our RFA disposable devices, which could divert engineering resources from other projects or add to product costs. In addition, a new or supplemental filing with applicable regulatory authorities may require clearance prior to our marketing a product containing new materials. This clearance process may take a substantial period of time, and we may be unable to obtain necessary regulatory approvals for any new material to be used in our products on a timely basis, if at all.

We are dependent on one supplier as our only source of an accessory device used in conjunction with our Starburst XLi and Xlie lines of disposable devices, and any disruption in the supply of this device could negatively affect our sales.

In the past, we have experienced shortages in the supply of accessory infusion pumps used in conjunction with our Starburst Xli and Starburst Xlie lines of disposable radiofrequency devices. We currently have one supplier for our accessory infusion pumps and, although we believe this supplier to be reliable, future disruptions in supply are possible. In that event, our business could suffer through lower sales or higher costs.

We are dependent on two third-party contractors for the supply of our generators, and any failure to deliver generators to us could result in lower than expected sales.

We are dependent on two third-party suppliers to produce our RFA generators. While we have agreements with both of these suppliers, any delay in shipments of generators to us could result in our failure to ship generators to customers and could negatively affect sales.

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Complying with the FDA and other domestic and foreign regulatory authorities is an expensive and time-consuming process, and any failure to comply could result in substantial penalties.

We are subject to a host of federal, state, local and foreign regulations regarding the manufacture and marketing of our products. In particular, our failure to comply with FDA regulations could result in, among other things, seizures or recalls of our products, an injunction, substantial fines and/or criminal charges against our employees and us. The FDA s medical device reporting regulations require us to report any incident in which our products may have caused or contributed to a death or serious injury, or in which our products malfunctioned in a way that would be likely to cause or contribute to a death or serious injury if the malfunction recurred.

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Sales of our products outside the United States are subject to foreign regulatory requirements that vary from country to country. The time required to obtain approvals from foreign countries may be longer than that required for FDA approval or clearance, and requirements for foreign licensing may differ from FDA requirements. For example, some of our newer RFA products have not received approval in Japan. Any failure to obtain necessary regulatory approvals for our new products in foreign countries could negatively affect revenues.

Product introductions or modifications may be delayed or canceled as a result of the FDA regulatory process, which could cause our revenues to be below expectations.

Unless we are exempt, we must obtain the appropriate FDA approval or clearance before we can sell a new medical device in the United States. Obtaining this approval or clearance can be a lengthy and time-consuming process. To date, all of our products have received clearances from the FDA through premarket notification under Section 510(k) of the Federal Food, Drug and Cosmetic Act. However, if the FDA requires us to submit a new premarket notification under Section 510(k) for modifications to our existing products, or if the FDA requires us to go through a lengthier, more rigorous examination than we now expect, our product introductions or modifications could be delayed or canceled which could cause our revenues to be below expectations. The FDA may determine that future products will require the more costly, lengthy and uncertain premarket approval process.

In addition, modifications to medical device products cleared via the 510(k) process may require a new 510(k) submission. We have, in the past, made minor modifications to the RITA system and to our implantable vascular products. Using the guidelines established by the FDA, we have determined that some of these modifications do not require us to file new 510(k) submissions. If the FDA disagrees with our determinations, we may not be able to sell the RITA system or our implantable vascular products until the FDA has cleared new 510(k) submissions for these modifications, or it may require us to recall previously sold products. In addition, we intend to request additional label indications, such as approvals or clearances for the ablation of tumors in additional organs, including lung, uterus and breast, for our current products. The FDA may either deny these requests outright, require additional extensive clinical data to support any additional indications or impose limitations on the intended use of any cleared product as a condition of approval or clearance. Therefore, obtaining necessary approvals or clearances for these additional applications could be an expensive and lengthy process. In addition, in the course of the FDA process leading to clearance or approval for a new indication, the FDA may request an advisory panel meeting or meetings to discuss the clinical data, the appropriate study design or other criteria for clearance or approval. In the event that the advisory panel advises FDA that the clinical data are inadequate or the study design or other criteria are inappropriate, and the FDA concurs, the FDA clearance or approval process could be lengthened and anticipated revenues from that new indication would be delayed.

We may acquire technologies or companies in the future, which could result in the dilution of our stockholders and disruption of our business, and reduce our revenues.

We are continually evaluating business alliances and external investments in technologies related to our business. Acquisitions of companies, divisions of companies, businesses or products entail numerous risks, any of which could materially harm our business in several ways, including:

- diversion of management s attention from our core business objectives and other business concerns;
- failure to integrate efficiently businesses or technologies acquired in the future with our pre-existing business or technologies;
- potential loss of key employees from either our pre-existing business or the acquired business;

- dilution of our existing stockholders as a result of issuing equity securities; and
- assumption of liabilities of the acquired company.

Some or all of these problems may result from future acquisitions or investments. Furthermore, we may not realize any value from such acquisitions or investments.

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We may need to raise additional capital in the future resulting in dilution to our stockholders.

We may need to raise additional funds for our business operations and to execute our business strategy. We may seek to sell additional equity or debt securities or to obtain an additional credit facility. The sale of additional equity or convertible debt securities could result in additional dilution to our stockholders. If additional funds are raised through the issuance of debt securities, these securities could have rights that are senior to holders of common stock and could contain covenants that would restrict our operations. Any additional financing may not be available in amounts or on terms acceptable to us, if at all. Failure to obtain sufficient funds on acceptable terms when needed or to make timely debt payments may require us to curtail operations, perhaps to a significant extent.

Our executive officers and directors could exert significant influence over matters requiring stockholder approval.

Our executive officers and directors, and their respective affiliates, own approximately 4% of our outstanding common stock as of March 31, 2005. These stockholders may, as a practical matter, be able to exert significant influence over matters requiring approval by our stockholders, including the election of directors and the approval of mergers or other business combinations. This concentration of voting stock could have the effect of delaying or preventing a merger or acquisition or other change of control that a stockholder may consider favorable.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We assumed fixed rate borrowings in conjunction with our merger with Horizon Medical Products. These borrowings will increase our interest expense. Also, changes in interest rates will affect the fair market value of these borrowings. Except for these factors, our market risk disclosures have not changed significantly from those set forth in Management s Discussion and Analysis of Financial Condition and Results of Operations in our Form 10-K for the year ended December 31, 2004, as amended.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company s Securities Exchange Act reports is recorded, processed, summarized, and reported within the time periods specified in the Securities Exchange Commission s rules and forms, and that such information is accumulated and communicated to the Company s management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required financial disclosure.

As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of Company management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to the Securities Exchange Act of 1934 Rules 13a-15(b) and 15d-15(b). Based upon, and as of the date of this evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that our disclosure controls and procedures were not effective, because the material weaknesses discussed in the Company s annual report on Form 10-K for the year ended December 31, 2004, as amended, have not yet been fully remediated. In light of these material weaknesses, the Company performed additional analysis and other post-closing procedurestom" width="1%" style="border-bottom: white;">

142

150,692

(117,650
)

33,184

Common stock issued for cash at $0.001 per share

2,357,895

2,359

-

-

2,359

Net loss - FYE 12/31/95

-

-

-

(49,097
)

(49,097
)
Balances at Dec. 31, 1995

2,500,326

2,500

150,692

(166,747
)

(13,555
)

Common stock issued for cash at $0.001 per share

120,000

120

-

-

120

Net loss - FYE 12/31/96

-

-

-

(1,681
)

(1,681
)
Balances at Dec. 31, 1996

2,620,326

2,620

150,692

(168,428
)

(15,116
)

Net loss - FYE 12/31/97

-

-

-

(3,517
)

(3,517
)
Balances at Dec. 31, 1997

2,620,326

2,620

150,692

(171,945
)

(18,633
)

Net loss - FYE 12/31/98

-

-

-

(2,479
)

(2,479
)
Balances at Dec. 31, 1998

2,620,326

2,620

150,692

(174,424
)

(21,112
)

Net loss - FYE 12/31/99

-

-

-

(6,307
)

(6,307
)
Balances at Dec. 31, 1999

2,620,326

2,620

150,692

(180,731
)

(27,419
)

Net loss - FYE 12/31/00

-

-

-

(9,011
)

(9,011
)
Balances at Dec. 31, 2000

2,620,326

2,620

150,692

(189,742
)

(36,430
)

Net loss - FYE 12/31/01

-

-

-

(19,461
)

(19,461
)
Balances at Dec. 31, 2001

2,620,326

2,620

150,692

(209,203
)

(55,891
)

Contributed capital for rent and other compensation

-

-

1,950

-

1,950

Net loss - FYE 12/31/02

-

-

-

(13,960
)

(13,960
)
Balances at Dec. 31, 2002

2,620,326

2,620

152,642

(223,163
)

(67,901
)

Contributed capital for rent and officer compensation

-

-

488

-

488

Capital contributed by shareholders through forgiveness

of accounts payable and interest

-

77,415

-

77,415

Common stock issued for services $0.025 per share

13,389,932

13,390

321,358

-

334,748

Common stock issued for legal services at $0.61 per sh.

100,000

100

60,900

-

61,000

Common stock issued for consulting services at $0.47

10,000

10

4,690

-

4,700

Net loss - FYE 12/31/03

-

-

-

(592,962
)

(592,962
)
Balances at Dec. 31, 2003

16,120,258

16,120

617,493

(816,125
)

(182,512
)

Common stock issued for services at $0.16 per share

1,000,000

1,000

159,000

-

160,000

Common stock issued for services at $0.17 per share

1,800,000

1,800

304,200

-

306,000

Common stock issued for services at $0.165 per share

800,000

800

131,200

-

132,000

Common stock issued for services at $0.215 per share

30,000

30

6,420

-

6,450

Common stock issued for debt at $0.45 per share

150,000

150

67,350

-

67,500

Common stock issued for services at $0.40 per share

300,000

300

119,700

-

120,000

Common stock issued for services at $0.34 per share

700,000

700

237,300

-

238,000

Common stock issued for services at $0.41 per share	300,000	300	122,700	-	123,000
Common stock issued for services at $0.27 per share	300,000	300	80,700	-	81,000
Common stock issued for services at $0.22 per share	600,000	600	131,400	-	132,000
Net loss - FYE 12/31/04				(1,606,057)	(1,606,057)
Balances at Dec. 31, 2004	22,100,258	22,100	1,977,463	(2,422,182)	(422,619)
Contributed capital for general and administrative expenses			138,701		

	138,701
Common stock issued for services at $0.03 per share	
	19,860,000
	19,860
	575,940
	595,800
Net loss for the year ended December 31, 2005	
	(1,323,775)
	(1,323,775)
Balances at December 31, 2005	
	41,960,258
	41,960
	2,692,104
	(3,745,957)
	(1,011,893)
Common stock issued for services at $0.09 per share	
	17,583,334
	17,584
	459,916
	477,500
Common stock issued for debt at $0.06 per share	
	5,000,000
	5,000
	295,000
	300,000
Common stock issued for services at $0.03 per share	
	2,500,000
	2,500
	72,500
	75,000

Common stock issued for services at $0.05 per share

500,000

500

24,500

25,000

Net loss for the six months ended June 30, 2006

(1,156,852
)

(1,156,852
)
Balances at June 30, 2006

67,543,592

$
67,544

$
3,544,020

($4,902,809
)

($1,291,245
)

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

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VICTORY ENERGY CORPORATION AND SUBSIDIARIES
(A Development Stage Company)
Consolidated Statements of Cash Flows

	For the Three Months Ended June 30, 2006	For the Three Months Ended June 30, 2005	For the Six Months Ended June 30, 2006	For the Six Months Ended June 30, 2005	From Inception on Jan. 7, 1982 Through Jun. 30, 2006
CASH FLOWS FROM OPERATING ACTIVITIES:					
Net Loss	$ (380,974)	$ (349,804)	$ (1,156,852)	$ (349,804)	$ (4,827,809)
Adjustments to reconcile net loss to net cash used by operating activities:					
Depreciation	599	229	599	229	1,797
Loss on extinguishment of debt					48,363
Issuance of common stock for services	400,000		877,500		2,976,343
Increase in Short Term Receivables	88,300		(122,684)		
Decrease (Increase) in Prepaid Expenses		247		247	
Increase in Deposits		(2,020)		(2,020)	
Increase in Prepaid Subscriptions	153,500		50,000		203,500
Increase (Decrease) in accounts payable	(330,970)	312,900	(330,970)	312,900	
Increase (Decrease) in accounts payable -related		24,252			
Increase (Decrease) in accrued liabilities			4,590		16,006
Increase in Accrued Payroll and Payroll Taxes	(300,000)		450,970	24,252	690,970
Increase in Deposits			153,500		
Increase in Short Term Receivables	(210,984)				(210,984)
Repayment of long term debt	(146,431)				(13,569)
Increase in Accrued Liabilities - Related	690,970		(2,500)	481	121,000
Non-cash contributed capital					(524)
Net Cash provided by (used by) Operating Activities	$ (35,990)	$ (14,196)	$ (75,847)	$ (13,715)	$ (994,907)
CASH FLOWS FROM INVESTING ACTIVITIES					
Purchase of Fixed Assets		(14,941)		(14,941)	(2,294)
Purchase of Marketable Securities		(88,300)		(88,300)	
Investment in Joint Venture	(50,000)		(50,000)		(50,000)
Net Cash (used by) Investing Activities	$ (50,000)	$ (103,241)	$ (50,000)	$ (103,241)	$ (52,294)
CASH FLOWS FROM FINANCING ACTIVITIES					
Proceeds of Note Payable			3,027		114,664
Proceeds from Loans		160,000		160,000	
Proceeds of Loan from Officer	58,310		116,664		200,031
Proceeds (Repayment) of Note Payable-Related Party	(2,500)	481			169,679
Contributed capital for rent and officers' compensation					2,438
Issuance of Common Stock for Cash					41,960
Proceeds from the sale of Common Stock					300,231
Contributed Capital by shareholders				-	216,116
Net Cash provided by Financing Activities	$ 55,810	$ 160,481	$ 119,691	$ 160,000	$ 1,045,119
NET INCREASE IN CASH	(30,180)	43,044	(6,156)	43,044	(2,082)
CASH AT BEGINNING OF PERIOD	28,098	-	4,074	-	-
CASH AT END OF PERIOD	$ (2,082)	$ 43,044	$ (2,082)	$ 43,044	$ (2,082)

CASH PAID FOR:					
Interest	$ -	$ -	$ -	$ -	$ -
Income Taxes	$ -	$ -	$ -	$ -	$ -
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION					
Proceeds from the sale of Common Stock	$ -	$ -	$ -	$ -	$ 342,191
Contributed Capital by shareholders		$ -	$ -	$ 138,701	$ 216,116
Stock issued for services	$ 400,000	$ -	$ 877,500	$ -	$ 2,930,418
Contributed capital for rent, officer compensation	$ -	$ -	$ -	$ -	$ 2,438
Other contributed capital	$ -	$ -	$ -	$ -	$ 45,401

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 - BASIS OF PRESENTATION

The accompanying interim unaudited consolidated financial statements have been prepared by Victory Energy Corporation “the Company”, without audit. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission. The consolidated financial statements include our accounts and those of our subsidiaries, Global Card Services, Inc. and On Demand Communications. All inter-company balances have been eliminated in consolidation.

During 2005 the Company changed its focus to the oil and gas industry, specifically oil and gas drilling projects on oil field leases. The first oil field leases were identified during 2005 but rejected. In the first three months of 2006, the company entered into a farm-out agreement with the owner of certain oil and gas leases for a 100% working interest in an oil field in Montana, subject to overriding royalties. The Company also identified an additional prospect in Oklahoma and continues to search for new prospects. In May of 2006 the company entered into a joint venture with Geo Surveys for exploration in the Mesa Gas Prospect located in New Mexico.

On May 3, 2006 the name of the company was changed to Victory Energy Corporation.

In the opinion of our management, the unaudited financial information for the interim periods presented reflects all adjustments necessary for a fair presentation of our financial position, results of operations and cash flows. The results reported in these condensed consolidated financial statements are not necessarily indicative of results that may be expected for the entire year.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Going Concern

The Company’s financial statements are prepared using accounting principles generally accepted in the United States of America applicable to a going concern which contemplates the realization of assets and liquidation of liabilities in the normal course of business. The Company has not yet established an ongoing source of revenues sufficient to cover its operating costs and to allow it to continue as a going concern. In addition, the Company has a working capital deficit of $701,574 and a stockholders’ deficit of $1.291,245 at June 30, 2006. The ability of the Company to continue as a going concern is dependent on the Company obtaining adequate capital to fund operating losses until it becomes profitable. If the Company is unable to obtain adequate capital, it could be forced to cease development of operations.

In order to continue as a going concern, develop a reliable source of revenues, and achieve a profitable level of operations the Company will need, among other things, additional capital resources. Management’s plans to continue as a going concern include raising additional capital through sales of common stock. In the interim, shareholders of the Company are committed to meeting its minimal operating expenses. However, management cannot provide any assurances that the Company will be successful in accomplishing any of its plans.

The ability of the Company to continue as a going concern is dependent upon its ability to successfully accomplish the plans described in the preceding paragraph and eventually secure other sources of financing and attain profitable operations. The accompanying financial statements do not include any adjustments that might be necessary if the Company is unable to continue as a going concern.

Development-Stage Company

The Company is considered a development-stage company, with de minimus operating revenues during the periods presented, as defined by Statement of Financial Accounting Standards (“SFAS”) No. 7. SFAS No. 7 requires companies to report their operations, shareholders deficit and cash flows since inception through the date that revenues are generated from management’s intended operations, among other things. Management has defined inception as January 7, 1982. Since inception, the Company has incurred operating losses totaling $4.9 million, much of which relates to stock-based compensation to officers, directors and consultants as a means to preserve working capital. The Company’s working capital has been generated through the sales of common stock, loans made by officers of the Company and a third party loan. Management has provided financial data since January 7, 1982 “Inception” in the financial statements, as a means to provide readers of the Company’s financial information to make informed investment decisions.

Use of Estimates

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

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Loss Per Share

Basic earnings per share ("Basic EPS") is computed by dividing net loss available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share ("Diluted EPS") gives effect to all dilutive potential common shares outstanding during a period. In computing Diluted EPS, the treasury stock method is used in determining the number of shares assumed to be purchased from the conversion of common stock equivalents. Securities that could potentially dilute Basic EPS in the future, that were not included in the computation of Diluted EPS because to do so would have been anti-dilutive for the periods presented, consist of options, warrants, convertible notes and debentures.

The following is a reconciliation of the numerators and denominators of the basic and diluted earnings per share computations for the six months ended June 30, 2006 and 2005:

	2006	2005
Numerator:		
Basic and diluted net loss per share:		
Net Loss	$ (1,156,852)	$ (349,803)
Denominator		
Basic and diluted weighted average number of shares outstanding	54,191,382	22,100,258
Basic and Diluted Net Loss Per Share	$ (0.021)	$ (0.016)

Equipment and Fixtures

Equipment and fixtures are recorded at cost. Depreciation is provided using accelerated and straight-line methods over the estimated useful lives of the related assets as follows:

Description	Years
Furniture and fixtures	7
Computer hardware and software	3-5

Recent Accounting Pronouncements

In March 2004, the Emerging Issues Task Force ("EITF") reached a consensus on Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments." The EITF reached a consensus about the criteria that should be used to determine when an investment is considered impaired, whether that impairment is other-than-temporary, and the measurement of an impairment loss and how that criteria should be applied to investments accounted for under SFAS No. 115, "ACCOUNTING IN CERTAIN INVESTMENTS IN DEBT AND EQUITY SECURITIES." EITF 03-01 also included accounting considerations subsequent to the recognition of other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. Additionally, EITF 03-01 includes new disclosure requirements for investments that are deemed to be temporarily impaired. In September 2004, the Financial Accounting Standards Board (FASB) delayed the accounting provisions of EITF 03-01; however, the disclosure requirements remain effective for annual reports ending after June 15, 2004. The Company will evaluate the impact of EITF 03-01 once final guidance is issued.

In December 2004, the FASB issued FASB Statement No. 123R, "Share-Based Payment, an Amendment of FASB Statement No. 123" ("FAS No. 123R"). FAS No. 123R requires companies to recognize in the statement of operations the grant- date fair value of stock options and other equity-based compensation issued to employees. FAS No. 123R is effective beginning in the Company's second quarter of fiscal 2006. The Company is evaluating the effects adoption of SFAS 123R will have on its financial statements.

In December 2004, the FASB issued SFAS No.123 (revised 2004), "Share-Based Payment". Statement 123(R) will provide investors and other users of financial statements with more complete and neutral financial information by requiring that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the fair value of the equity or liability instruments issued. Statement 123(R) covers a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. Statement 123(R) replaces FASB Statement No. 123, Accounting for Stock-Based Compensation, and supersedes APB Opinion No. 25, Accounting for Stock Issued to

Employees. Statement 123, as originally issued in 1995, established as preferable a fair-value-based method of accounting for share-based payment transactions with employees. However, that Statement permitted entities the option of continuing to apply the guidance in Opinion 25, as long as the footnotes to financial statements disclosed what net income would have been had the preferable fair-value-based method been used. Public entities (other than those filing as small business issuers) will be required to apply Statement 123(R) as of the first interim or annual reporting period that begins after June 15, 2005. The Company adopted Statement 123(R) in December of 2005.

In March 2005, the SEC released Staff Accounting Bulletin No. 107, “Share-Based Payment” (“SAB 107”), which provides interpretive guidance related to the interaction between SFAS 123(R) and certain SEC rules and regulations. It also provides the SEC staff’s views regarding valuation of share-based payment arrangements. In April 2005, the SEC amended the compliance dates for SFAS 123(R), to allow companies to implement the standard at the beginning of their next fiscal year, instead of the next reporting period beginning after June 15, 2005. Management is currently evaluating the impact SAB 107 will have on our consolidated financial statements.

In February of 2006, the FASB issued SFAS No. 155, “Accounting for Certain Hybrid Financial Instruments”, which is intended to simplify the accounting and improve the financial reporting of certain hybrid financial instruments (i.e., derivatives embedded in other financial instruments). The statement amends SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities”, and SFAS No. 140, “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125.” SFAS No. 155 is effective for all financial instruments issued or acquired after the beginning of an entity's first fiscal year that begins after September 15, 2006.. The Company is currently evaluating the impact SFAS No. 155 will have on its consolidated financial statements, if any.

Stock Based Compensation

The Company has elected to follow Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (“APB 25”), and related interpretations in accounting for its employee stock options because the alternative fair value accounting provided under FASB Statement No. 123, Accounting for Stock-Based Compensation, (“SFAS 123”) requires the use of option valuation models that were not developed for use in valuing employee stock options. As permitted, the Company adopted the disclosure alternative of SFAS 123 and SFAS 148, which require pro forma disclosure of net income and earnings per share as if the fair value method of accounting had been applied. Since the Company has no significant stock options outstanding, the pro forma financial data is not meaningful.

Under APB 25, when the exercise price of the Company’s stock options equals or exceeds the fair value of the underlying stock on the date of grant, no compensation expense is recorded.

There were no options granted during the fiscal years ended December 31, 2005 and 2004.

NOTE 3 - RELATED PARTY TRANSACTIONS

In 2005 loans to the company totaling $83,367, were made due on demand which does not accrue any interest. In the first quarter of 2006 loans to the company totaling an additional $58,354 were made to the company, the total of which is $141,721.

In March 2006 the company issued a promissory note to a group of stockholders for consideration of $141,458 in cash. The terms are repayable in one year at an interest rate of 10%, payable quarterly. Interest was deferred for six months.

NOTE 4 - COMMITMENTS AND CONTINGENCIES

Employment Agreement

The company formed a wholly owned subsidiary named Papadog, Inc. Papadog since changed its name to Global Card Services, Inc., and then to Global Card Incorporated (Global). In October 2003, Global entered into an employment agreement with an individual to serve as its Chief Executive Officer. The annual salary was to be $96,000 per annum beginning October 7, 2003. Additionally, the Company was to issue the CEO 1,000,000 free trading shares of the Company’s common stock on the date of six months from when employment commenced. In addition the CEO was granted options to purchase 1,000,000 freely traded shares at an exercise price of $0.50 per share on a date that is 12 months from the date that employment commenced and options to purchase 1,000,000 freely trades shares at an exercise price of $1.00 per share 18 months after employment commenced. Global was to grant to the CEO common stock equal to 5% of the outstanding shares of Global with said shares to be vested 12 months from the date the employment commenced, additionally Global was to grant to the CEO, options to purchase an additional 5% of the outstanding shares of Global at an exercise price of $0.10 per share. These options were to vest 18 months after the employment commenced. In March 2004, the employment agreement was terminated and all related stock options were cancelled. The Company has accrued $48,000 in wages payable and $3,672 in related taxes payable for the term of the employment.

Share Exchange Agreement

On March 8, 2005, the Company entered into a Share Exchange Agreement with Union Media News (“Union”), a Nevada corporation whereby the Company exchanged 20% of the outstanding shares of its wholly-owned subsidiary Victory Communication Services, Inc. for 100% of the outstanding shares of Union. After the close of the agreement, Union would become a wholly-owned subsidiary of the Company. The agreement calls for Union and the Company to cooperate in various joint ventures. If any joint ventures are launched, the agreement requires Union to pay the Company the greater of (i) fifteen-percent (15%) of Union’s net revenues or (ii) ten thousand dollars ($10,000) per month beginning the third month after the formation of any joint ventures. The agreement also requires the Company to assist in obtaining $300,000 in financing for Union within sixty days of the closing. In the event that the Company is unable to obtain the necessary financing the agreement is cancelled. At the date of this report, the agreement had not been closed nor any financing obtained for Union.

Note Receivable

The company borrowed $160,000 from Treetop Investments Inc. in July, 2005 at an interest rate of 10% payable upon demand. A moratorium on interest was negotiated with the lender. Repayments of $13,569 were made in 2005. In June of 2006 an accommodation was made wherein 5,000,000 shares were issued to Treetop Investments at a price of 6 cents per share, having a value of $300,000. The stock issue combined the retirement of the loan with a stock purchase. The stock purchase was paid for partially in cash. The balance of the purchase price, $210,984, is recorded as a demand Note Receivable with no fixed interest.

NOTE 5 - COMMON STOCK TRANSACTIONS

Common Stock Transactions During the year ended December 31, 2004

On January 5, 2005, the Company authorized the issuance of shares of the Company's common stock owed under an employment agreement to the current president and CEO. As of the date of this report, the shares have not been issued.

In February 2004, the Company issued a total of 3,600,000 shares of its common stock to various consultants for services rendered. The shares were valued using the closing price of the stock at the date of issuance at a total of $598,000 or an average of $0.17 per share.

On March 16, 2004, the Company issued 150,000 shares of its common stock in payment of amounts owed to a vendor. The shares were valued using the closing price of the stock at the date of issuance of $67,500 or $0.45 per share. In connection with this, a loss on extinguishment of debt of $48,363 was recorded.

On March 23, 2004, the Company issued 300,000 shares of its common stock for services rendered in accordance with an employment agreement. The shares were valued using the closing price of the stock at the date of issuance of $120,000 or $0.40 per share.

In March, 2004, the Company issued a total of 1,030,000 shares of its common stock to various consultants for services rendered. The shares were valued using the closing price of the stock at the date of issuance of $367,450 or an average of $0.36 per share.

In May , 2004 the Company issued a total of 900,000 shares of its common stock to various consultants for services rendered. The shares were valued using the closing price of the stock at the date of issuance of $213,000 or an average of $0.24 per share.

Common Stock Transactions During the Year Ended December 31, 2005

On January 5, 2005, the Company authorized the issuance of shares of the Company's common stock owed under an employment agreement to the current president and CEO.

Common Stock Transactions During the Six Months Ended June 30, 2006

During the three months ended March 31, 2006 the company issued 17,583,334 shares of common stock, of which 2,583,334 were restricted under Rule 4 (2), to company officers and consultants for services. Under FASB SFAS No.123 (revised 2004), the value of the services is measured by the fair value of the stock. The fair value of the stock was established by the trading price at closing on the date of issue January 6, 2006, $0.03 per share. The value of services rendered was therefore recorded as $527,500.

On May 10, 5,000,000 shares were issued to Treetop Investments, Inc. at a price of $0.06 per share in a transaction that combined retiring a loan with sale of stock.

On May 15, 2,500,000 shares were issued for services. The fair value of the stock was established by the market price on that day of $0.03 per share. The value of the services was recorded as $75,000.

On June 1, 500,000 shares were issued for consulting services. The fair value of the stock was established by the market price on that day of $0.05 per share. The value of the services was recorded as $75,000.

On March 12, 2006, the Board of Directors effected a change to the articles of the corporation, increasing the number of shares authorized to be issued from 100,000,000 to 200,000,000.

Additional Common Stock

As of December 31, 2005, there were 10,666,667 shares of common stock that had been issued in a prior period in anticipation of a proposed transaction which was never consummated. The shares are being held in the Company's name. Since the shares were issued without consideration nor as a result of an economic transaction, they have no basis in value and are not being shown as issued and outstanding or treasury shares in the accompanying financial statements. The total of issued and outstanding shares and shares held in the Company's name is 70,210,259.

NOTE 6 - LINOTE 6 - LITIGATION

On November 19, 2004 RingCentral Inc. filed a complaint for breach of contract against the Company asserting they were owed by the Company $10,000 due to under the terms of their contract. On February 15, 2005, the Company reached a settlement with the plaintiff and agreed to pay RingCentral a total of $11,000 in several installments. This amount has been recorded as an accrued liability in the accompanying consolidated financial statements. Final payment will be made in August of 2006.

On December 28, 2004, the Company was served with an action for breach of contract with a former CEO claiming compensation due. On July 24, 2006, all litigation was settled between the company and the former CEO. The Company settled the case for an estimated value of $280,000, to be realized over a 10-month period ending in May of 2007.

NOTE 7 - RESTATEMENT

The Statement of Operations for the three months ended June 30, 2005 was restated to correct the reported amounts. The following disclosures are made in accordance with SFAS (Statement of Financial Accounting Standards) No. 154:

(1) The error affected only the reporting of the three month period ended June 30, 2005. An adjustment of the cumulative effect on prior periods was not necessary.

(2) The error does no affect net income. An offsetting adjustment to components of equity and net assets is not required.

(3) Adjustment of financial statements of prior periods was not required.

Item 2. Management's Discussion and Analysis or Plan of Operation

The following discussion includes certain forward-looking statements within the meaning of the safe harbor protections of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Statements that include words such as "believe," "expect," "should," "intend," "may," "anticipate," "likely," "contingent," "could," "may," or other future-oriented statements, are forw statements. Such forward-looking statements include, but are not limited to, statements regarding our business plans, strategies and objectives, and, in particular, statements referring to our expectations regarding our ability to continue as a going concern, generate increased market awareness of, and demand for, our current products, realize profitability and positive cash flow, and timely obtain required financing. These forward-looking statements involve risks and uncertainties that could cause actual results to differ from anticipated results. The forward-looking statements are based on our current expectations and what we believe are reasonable assumptions given our knowledge of the markets; however, our actual performance, results and achievements could differ materially from those expressed in, or implied by, these forward-looking statements. Factors within and beyond our control that could cause or contribute to such differences include, among others, the following: those associated with drilling and subsequent sale of oil and gas, our critical capital raising efforts in an uncertain and volatile economical environment, our ability to maintain relationship with strategic companies, our cash preservation and cost containment efforts, our ability to retain key management personnel, our relative inexperience with advertising, our competition and the potential impact of technological advancements thereon, the impact of changing economic, political, and geo-political environments on our business, as well as those factors discussed elsewhere in this Form 10-QSB and in "Item 1 - Our Business," "Item 6 - Management's Discussion and Analysis," and elsewhere in our most recent Form 10-KSB, filed with the United States Securities and Exchange Commission.

Readers are urged to carefully review and consider the various disclosures made by us in this report and those detailed from time to time in our reports and filings with the United States Securities and Exchange Commission that attempt to advise interested parties of the risks and factors that are likely to affect our business.

Our fiscal year ends on December 31. References to a fiscal year refer to the calendar year in which such fiscal year ends.

Our Business

Victory Energy Corporation (OTC symbol VTYE), formerly known as Victory Capital Holdings Corporation (our "Company") was organized under the laws of the State of Nevada on January 7, 1982, under the name All Things, Inc. On March 21, 1985, our Company's name was changed to New Environmental Technologies Corporation; on April 28, 2003, our name was changed to Victory Capital Holdings Corporation and on May 3, 2006, it was changed to Victory Energy Corporation. Our Company was formed for the purpose of engaging in all lawful businesses. Our Company's initial authorized capital consisted of 100,000,000 shares of $0.001 par value common voting stock and as of the date of this filing our authorized capital is 200,000,000 shares of $.001 par value common stock.

Our Company has had no material business operations since 1989. In 2004, we began the search for the acquisition of assets, property or businesses that may benefit our Company and our shareholders. Our goal has been to bring value to the Company and to our shareholders through such acquisitions. Each merger and acquisition we approach is done with the intention to position us in markets and sectors where excellent growth is anticipated. We plan to retain a percentage of stock ownership in each subsidiary while spinning them out as their own new public company if such transaction is economically feasible. The balance of the stock will be distributed to the Company's shareholders at the time of spin out of the new public company. This is a non-dilutive method to increase shareholder value as we grow and maintain a position in the market segments selected.

Current Business of the Company

Management has determined that the Company will focus on projects in the oil and gas industry. This is based upon a belief that this industry is becoming an economically viable sector in which to conduct business operations. We have targeted specific prospects and intend to engage in the drilling for oil and gas. Jon Fullenkamp, our President, has a great deal of experience in the oil and gas industry and has already recruited additional experience with the addition of a new director and advisory board member.

We have no other employees at this time and will seek to retain independent contractors to assist in operating and managing the prospects as well as to carry out the principal and necessary functions incidental to the oil and gas business. With the intended acquisition of oil and natural gas, we intend to establish ourselves as an industry partner within the industry. Once we can establish a revenue base with cash flow, we will seek opportunities more aggressive in nature.

During the fourth quarter of 2005, we evaluated two opportunities in Scott Oil & Gas and Thunder Oil & Gas. As we progressed into the due diligence of these prospects and the potential production, management determined that the development of the prospect was not worth the required investment capital. Even with the potential reduction in investment dollars, the prospects had an unacceptable pay back time for the initial investment. At that point, management felt the shareholders would be better served by seeking other prospects.

In the second quarter of 2006, we have continued with the two prospects previously reported and have taking a minority ownership position in a joint venture participation in the New Mexico based Glasgow gas project consisting of approximately 11,000 acres. In the event any of these prospects do not go forward for any reason, a replacement prospect will immediately be sought. The initial two prospects are described below.

The first prospect is a prospective oil field known as N.E. Glasgow Prospect located in Montana. We have entered into a Farmout Agreement with Laser Exploration, Inc. ("Laser") whereby Laser has farmed out certain leases through Rocky Mountain Exploration for drilling an exploratory well to a depth of an estimated 6,500 feet to test the various formations for potential commercial development. Rocky Mountain Exploration has assigned approximately 1,960 acres to the Company for 100% working interest reserving on to Rocky Mountain Exploration a 5% overriding royalty and a 12% total overriding royalty depending on specific retained landowner royalties. The second known prospect is the Skedee Prospect located in Oklahoma. We intend to develop these prospects in one of the two following ways:

1. A percentage of the Company's ownership interest may be sold off until we own a percentage of the prospect with no out-of-pocket expenses required from us; or

2. We may seek to raise between $1 million and $4 million to finance each respected prospect in its entirety.

In the second quarter of 2006, we continued to investigate potential projects in the oil and gas industry.

Plan of Operation

Our plan of operation for the next 12 months will be the continued acquisition of economically viable oil and gas prospects. Once acquired, we intend to develop and produce the prospects assuming they are commercially economical to produce based on a complete due diligence process. In that case, we can expect to derive revenues from operations. We intend to diversify our holdings in both oil and gas producing wells to take advantage of what we believe is a potentially strong window of opportunity that currently exists in the oil and gas industry for the next several years.

Our first project is an oil field known as the N.E. Glasgow Prospect in Montana. We have the opportunity to develop Federal and State leases consisting of 1,960 acres where we initially intend to drill an exploratory well to an estimated depth of 6,500 feet for the purpose of testing various formations for production. We intend to complete similar exploratory drilling on the Skedee prospect in Oklahoma. The most recent project is our joint venture, minority ownership participation in the New Mexico Mesa prospect which is a gas prospect on approximately 11,000 acres.

We completed due diligence on other projects which ultimately proved to be too expensive to pursue. We have continued to seek out other viable opportunities.

Results of Operations for Period Ended June 30, 2006

As of June 30, 2006, the Company has not earned any revenues and has incurred a net loss to date of $4,902,809. Operations have been primarily seeking potential opportunities in the oil and gas industry through the location of commercially economical prospects, and raising capital and developing revenue generating opportunities and strategic relationships.

During the three month period ended June 30, 2006, we incurred operating expenses in the amount of $380,975. These operating expenses included due diligence expenses, consulting fees, professional fees, land leases, oil and gas leases, and office and general expenses.

Liquidity and Capital Resources

To date, we have financed our operations from funds put into the Company by our CEO. We intend to raise future capital from the sale of a percentage of our prospects to fund development and production or through the sale of our common stock to raise from $1 million to $4 million to finance the prospects in their entirety.

Item 3. Controls and Procedures

Our management is responsible for establishing and maintaining adequate internal control over financial reporting for the Company. Under the supervision and with the participation of our management, including the Principal Executive Officer and Principal Financial Officer, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rules 13a-15 and 15d-15 as of the end of the period covered by this report. Based on that evaluation, the Principal Executive Officer and Principal Financial Officer have concluded that these disclosure controls and procedures were effective such that the material information required to be filed in our SEC reports is recorded, processed, summarized and reported within the required time periods specified in the SEC rules and forms. There were no changes in our internal control over financial reporting during the quarter ended June 30, 2006 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting. Potential investors should be aware that the design of any system of controls and procedures is based in part upon certain assumptions about the likelihood of future events. There can be no assurance that any system of controls and procedures will succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

On July 24, 2006, all litigation was settled between the Company and the former CEO. The Company settled the case for an estimated value of $280,000 to be realized over a 10-month period ending in May of 2007.

In May 2006, we settled a past debt with Treetop Investments for 5,000,000 shares of our restricted common stock in a transaction combining settlement of debt and purchase of stock.

Neither the Company nor any of our officers or directors is involved in any other litigation either as plaintiffs or defendants and we have no knowledge of any threatened or pending litigation against us or any of our officers or directors.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

During the three months ended June 30, 2006, we issued 8,000,000 shares of common stock for services pursuant to Section 4(2).

Item 3. Defaults Upon Senior Securities

During the three months ended June 30, 2006, we were not in default on any of our indebtedness.

Item 4. Submission of Matters to a Vote of Security Holders

During the three months ended June 30, 2006, we did not submit any matters to a vote of our security holders.

Item 5. Other Information.

None

Item 6. Exhibits and Reports on Form 8-K

(a) Index to Exhibits

Exhibit No. Description of Exhibit

31 Certification of Chief Executive/Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32 Certification of Chief Executive/Financial Officer pursuant to Section 906

(b) A report on Form 8-K was filed May 8, 2006

SIGNATURE

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, hereunto duly authorized.

	Victory Energy Corporation
Date: August 17, 2006	By: /s/ Jon Fullenkamp
	Principal Executive Officer Principal Financial Officer Principal Accounting Officer and Director

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