

Digital Music Group, Inc.  
Form 10-Q  
August 14, 2007  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

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**Form 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended June 30, 2007

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: 000-51761

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**Digital Music Group, Inc.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**2151 River Plaza Drive, Suite 200**

**Sacramento, CA 95833**

(Address of principal executive offices, including ZIP Code)

**(916) 239-6010**

(Registrant's telephone number, including area code)

**20-3365526**  
(I.R.S. Employer  
Identification No.)

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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  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer:

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

As of August 10, 2007, the registrant had 9,121,939 shares of Common Stock outstanding.

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**DIGITAL MUSIC GROUP, INC.**

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**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. FINANCIAL STATEMENTS****DIGITAL MUSIC GROUP, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(Unaudited)**

|   | <b>June 30, 2007</b> | <b>December 31, 2006</b> |
|---|----------------------|--------------------------|
| <b>Assets</b>   |                      |                          |
| Current assets:   |                      |                          |
| Cash and cash equivalents   | \$ 13,968,883        | \$ 20,505,674            |
| Accounts receivable   | 1,835,638            | 1,687,492                |
| Current portion of advance royalties  | 1,983,679            | 1,326,379                |
| Prepaid expenses and other current assets   | 601,844              | 492,799                  |
| <b>Total current assets</b>   | <b>18,390,044</b>    | <b>24,012,344</b>        |
| Furniture and equipment, net  | 1,020,541            | 803,203                  |
| Digital rights, net   | 3,546,393            | 3,033,239                |
| Master recordings, net  | 2,122,843            | 1,777,480                |
| Royalty advances, less current portion  | 7,205,769            | 4,230,403                |
| Goodwill  | 5,355,944            | 4,429,782                |
| Other assets  | 42,563               | 39,289                   |
| <b>Total assets</b>   | <b>\$ 37,684,097</b> | <b>\$ 38,325,740</b>     |
| <b>Liabilities and Stockholders Equity</b>  |                      |                          |
| Current liabilities:  |                      |                          |
| Accounts payable  | \$ 99,957            | \$ 204,468               |
| Accrued liabilities   | 1,127,536            | 496,833                  |
| Royalties payable   | 2,204,311            | 1,952,342                |
| Accrued compensation and benefits   | 141,704              | 115,817                  |
| Current portion of capital lease obligations  | 34,090               | 50,496                   |
| <b>Total current liabilities</b>  | <b>3,607,598</b>     | <b>2,819,956</b>         |
| Capital lease obligations, less current portion   | 1,719                | 9,335                    |
| Other long-term liabilities   | 89,285               | 92,461                   |
| <b>Total liabilities</b>  | <b>3,698,602</b>     | <b>2,921,752</b>         |
| Commitments and contingencies   |                      |                          |
| Stockholders equity:  |                      |                          |
| Preferred stock, \$.01 par value, 1,000,000 shares authorized: none issued and outstanding  |                      |                          |
| Common stock, \$.01 par value, 30,000,000 shares authorized: 9,121,939 shares issued and outstanding at June 30, 2007 and 9,034,941 issued and outstanding at December 31, 2006 | 91,219               | 90,350                   |
| Additional paid-in capital  | 40,564,757           | 40,138,284               |
| Accumulated deficit   | (6,670,481)          | (4,824,646)              |
| <b>Total stockholders equity</b>  | <b>33,985,495</b>    | <b>35,403,988</b>        |

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|  |               |               |
|--|---------------|---------------|
| <b>Total liabilities and stockholders equity</b> | \$ 37,684,097 | \$ 38,325,740 |
|--|---------------|---------------|

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

**Table of Contents****DIGITAL MUSIC GROUP, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(Unaudited)**

|  | For the Three Months Ended June 30, |              | For the Six Months Ended June 30, |                |
|--|-------------------------------------|--------------|-----------------------------------|----------------|
|  | 2007                                | 2006         | 2007                              | 2006           |
| Revenue  | \$ 3,151,264                        | \$ 839,539   | \$ 6,543,811                      | \$ 1,560,187   |
| Cost of revenue:   |                                     |              |                                   |                |
| Royalties and payments to content owners                     | 2,142,353                           | 386,799      | 4,593,191                         | 735,325        |
| Amortization of digital rights and master recordings         | 215,934                             | 82,813       | 394,451                           | 134,848        |
| Gross profit   | 792,977                             | 369,927      | 1,556,169                         | 690,014        |
| Operating, general and administrative expenses               | 1,757,429                           | 1,344,198    | 3,482,509                         | 2,294,862      |
| Merger-related expenses                                      | 328,844                             |              | 328,844                           |                |
| Loss from operations   | (1,293,296)                         | (974,271)    | (2,255,184)                       | (1,604,848)    |
| Interest income  | 201,907                             | 388,386      | 441,516                           | 608,006        |
| Interest expense   | (2,147)                             | (3,080)      | (3,924)                           | (6,066)        |
| Other expense  | (15,952)                            |              | (27,443)                          |                |
| Loss before income taxes                                     | (1,109,488)                         | (588,965)    | (1,845,035)                       | (1,002,908)    |
| Income taxes   |                                     | (400)        | (800)                             | (400)          |
| Net loss   | \$ (1,109,488)                      | \$ (589,365) | \$ (1,845,835)                    | \$ (1,003,308) |
| Net loss per common share basic and diluted                  | \$ (0.12)                           | \$ (0.07)    | \$ (0.20)                         | \$ (0.14)      |
| Weighted average common shares outstanding basic and diluted | 9,036,205                           | 8,599,941    | 9,030,880                         | 7,266,804      |

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

**Table of Contents****DIGITAL MUSIC GROUP, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)**

|   | <b>For the Six Months Ended June 30,</b> |                      |
|---|--|----------------------|
|   | <b>2007</b>                              | <b>2006</b>          |
| <b>Cash flows from operating activities:</b>  |  |                      |
| Net loss  | \$ (1,845,835)                           | \$ (1,003,308)       |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities:                           |  |                      |
| Non-cash charges to operations:   |  |                      |
| Depreciation of furniture and equipment   | 176,219                                  | 47,183               |
| Amortization of digital rights and master recordings  | 394,451                                  | 134,848              |
| Recoupment of royalty advances  | 590,033                                  | 249,393              |
| Share-based compensation related to stock options, warrants and restricted shares issued                            | 196,200                                  | 159,883              |
| Loss on asset sales   | 10,856                                   |                      |
| Changes in operating assets and liabilities:  |  |                      |
| Accounts receivable   | (148,146)                                | (58,331)             |
| Prepaid expenses and other current assets   | (109,045)                                | (396,124)            |
| Accounts payable  | (104,511)                                | 276,377              |
| Accrued liabilities   | (74,305)                                 | (170,495)            |
| Royalties payable   | 251,969                                  | 246,951              |
| Accrued compensation and benefits   | 25,887                                   | 27,562               |
| <b>Net cash used in operating activities</b>  | <b>(636,227)</b>                         | <b>(486,061)</b>     |
| <b>Cash flows from investing activities:</b>  |  |                      |
| Purchases of furniture and equipment  | (406,713)                                | (196,731)            |
| Purchases of digital rights and master recordings   | (1,252,968)                              | (1,812,127)          |
| Payments of advance royalties   | (4,222,699)                              | (1,070,813)          |
| Proceeds from asset sales   | 2,300                                    |                      |
| Change in other assets and long-term liabilities, net   | 3,238                                    | (27,068)             |
| <b>Net cash used in investing activities</b>  | <b>(5,876,842)</b>                       | <b>(3,106,739)</b>   |
| <b>Cash flows from financing activities:</b>  |  |                      |
| Proceeds from initial public offering of common stock   |  | 33,232,055           |
| Proceeds from the exercise of Digital Musicworks International, Inc. options and warrants prior to recapitalization |  | 43,873               |
| Proceeds from issuance of restricted stock  | 300                                      | 150                  |
| Payments on capital lease obligations   | (24,022)                                 | (39,231)             |
| <b>Net cash (used in) provided by financing activities</b>  | <b>(23,722)</b>                          | <b>33,236,847</b>    |
| <b>Net (decrease) increase in cash and cash equivalents</b>   | <b>(6,536,791)</b>                       | <b>29,644,047</b>    |
| Cash and cash equivalents, beginning of period  | 20,505,674                               | 468,490              |
| <b>Cash and cash equivalents, end of period</b>   | <b>\$ 13,968,883</b>                     | <b>\$ 30,112,537</b> |
| <b>Supplemental cash flow information:</b>  |  |                      |
| Interest paid   | \$ 3,924                                 | \$ 6,066             |

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### Supplemental disclosure of non-cash investing and financing transactions:

|  |    |            |
|--|----|------------|
| Increase in goodwill resulting from issuance of earn-out consideration for DRA acquisition     | \$ | 935,850    |
| Issuance of warrant to underwriters  | \$ | \$ 620,529 |
| Purchase of certain assets of Rio Bravo Entertainment LLC through the issuance of common stock | \$ | \$ 243,750 |
| Reduction in contract for digital rights   | \$ | \$ 115,320 |
| Purchase of furniture and equipment under capital lease obligations                            | \$ | \$ 77,791  |
| Holdback for purchase of master recordings   | \$ | \$ 75,000  |
| Merger between Digital Music Group, Inc. and Digital Musicworks International, Inc.            | \$ | \$ 73,305  |

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



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**DIGITAL MUSIC GROUP, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. ORGANIZATION AND BASIS OF PREPARATION**

Digital Music Group, Inc. ( DMGI ) was incorporated in Delaware on April 11, 2005 for the purpose of pursuing digital music opportunities. In February 2006, DMGI completed its initial public offering (the IPO ). Concurrent with the closing of the IPO, DMGI acquired all of the outstanding common stock of Digital Musicworks International, Inc., a California corporation ( DMI ), and certain assets of Rio Bravo Entertainment LLC, a Delaware limited liability company doing business as Psychobaby ( Rio Bravo ). The financial statements for DMGI prior to February 7, 2006 are the financial statements of DMI, which has been designated DMGI s acquiror for accounting purposes. The historical shareholders equity of DMI has been restated for all periods prior to February 7, 2006 to give retroactive effect to the acquisition by DMGI. The results of operations of the Rio Bravo assets and of DMGI are included in the financial statements beginning on February 7, 2006.

On September 8, 2006, DMGI entered into an Agreement and Plan of Merger with Digital Rights Agency, LLC, a California limited liability company ( DRA ), and DRA became a wholly-owned subsidiary of DMGI. The consolidated financial statements include the accounts of DMGI and its wholly-owned subsidiary. All intercompany accounts and transactions have been eliminated.

The accompanying unaudited condensed consolidated financial statements are presented pursuant to the rules and regulations of the United States Securities and Exchange Commission in accordance with the disclosure requirements for the quarterly report on Form 10-Q. In the opinion of management of DMGI, the unaudited condensed consolidated financial statements reflect all adjustments (consisting of normal recurring adjustments) necessary to fairly state the results for the interim periods presented. Operating results for the three and six months ended June 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007. These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes of DMGI included in DMGI s Annual Report on Form 10-K for the year ended December 31, 2006.

Certain reclassifications have been made to the prior period s financial statements in order to conform to the current period s presentation.

**2. ACQUISITIONS AND INITIAL PUBLIC OFFERING**

On February 7, 2006, DMGI completed its initial public offering of common stock, selling 3,900,000 shares at \$9.75 per share and generating net cash proceeds (after fees and expenses) of approximately \$33,200,000. On the same date, in connection with the closing of the IPO, DMGI issued to the underwriters in the offering warrants to purchase an aggregate of 273,000 shares of DMGI s common stock. Each of the warrants has an exercise price of \$12.1875 per share, and is exercisable at any time from February 7, 2007 until February 6, 2011. The underwriters paid an aggregate of \$100 for the warrants. The warrants had an estimated fair value at the date of issuance of \$620,529 as determined in accordance with Statement of Financial Accounting Standards No. 123R, *Share-Based Compensation*, assuming a dividend yield of 0%, expected volatility of 35%, risk free rate of return of 4.52%, and an expected term to exercise of 4.6 years. The fair value of the warrants was recorded as an offering cost. Accordingly, the total net proceeds from DMGI s IPO were approximately \$32,600,000.

Also on February 7, 2006, DMGI concurrently acquired DMI and certain assets of Rio Bravo in exchange for 2,249,941 and 25,000 shares, respectively, of DMGI s common stock. DMI has been deemed the acquiror for financial reporting purposes. DMGI had net liabilities and a stockholders deficit of \$73,305 on the date of its acquisition of DMI. The purchase price of the Rio Bravo assets on February 7, 2006 totaled \$243,750, which has been allocated to digital rights. Such rights are being amortized over 24 months, the estimated remaining life of the assets.

On September 8, 2006, DMGI acquired all of the ownership interests in DRA in exchange for \$3,200,000 in cash, 420,000 shares of DMGI common stock and a warrant issued to the former Managing Director of DRA to purchase 150,000 shares of DMGI s common stock at an exercise price of \$5.57 per share. The warrant had an estimated fair value at the date of issuance of \$97,350 as determined in accordance with Statement of Financial Accounting Standards No. 123R, assuming a dividend yield of 0%, expected volatility of 35%, risk free rate of return of 4.7%, and an expected term to exercise of 4.75



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years. The fair value of the warrant was recorded as acquisition consideration. The warrant is exercisable in various installments beginning in September 2007, is fully exercisable by September 2009, and expires in September 2013 or upon a change in control of DMGI. The shares and warrant were issued in a private placement under federal and state securities law and are subject to restrictions on resale thereunder, and a substantial majority of the shares are subject to contractual restrictions on resale, short selling and other forms of hedging for varying terms ranging from one to two years from the acquisition date.

The estimated purchase price of DRA consisted of the following:

|  |                     |
|--|---------------------|
| Cash consideration                                       | \$ 3,905,008        |
| Common stock issued (420,000 shares at \$4.14 per share) | 1,738,800           |
| Common stock issued (57,000 shares at \$4.04 per share)  | 230,842             |
| Liabilities assumed                                      | 1,929,667           |
| Acquisition costs  | 131,466             |
| Estimated fair value of common stock warrant issued      | 97,350              |
|  | <b>\$ 8,033,133</b> |

The total purchase price was allocated to DRA's assets and liabilities based on their estimated fair values as of the acquisition date. A summary of the preliminary purchase price allocation, which is subject to finalization, is as follows:

|                         |                     |
|-------------------------|---------------------|
| Cash                    | \$ 438,374          |
| Accounts receivable     | 948,335             |
| Other current assets    | 399,680             |
| Furniture and equipment | 115,800             |
| Digital rights          | 775,000             |
| Goodwill                | 5,355,944           |
|                         | <b>\$ 8,033,133</b> |

On June 21, 2007, DMGI entered into an amendment to the DRA acquisition agreement whereby it agreed to pay the former members of DRA \$705,008 in cash and 56,998 shares of DMGI common stock in lieu of any payments that would otherwise become due under the earn-out provisions of the acquisition agreement, pursuant to which DMGI would have been obligated to pay up to \$1,155,000 in cash and to issue up to 87,000 shares of DMGI common stock if certain financial targets were achieved through December 31, 2007. This amendment resulted in an increase in goodwill of \$935,850, with the cash portion recorded as a liability at June 30, 2007 and paid in full in July 2007.

The unaudited pro forma combined statements of operations for the three and six months ended June 30, 2006 presented below assume that the acquisitions of DMI, Rio Bravo and DRA were closed on January 1, 2006:

|  | For the three months ended<br>June 30, 2006 | For the six months ended<br>June 30, 2006 |
|--|---|---|
| Revenue  | \$ 2,339,460                                | \$ 4,865,545                              |
| Cost of revenue                                | 1,773,533                                   | 3,732,727                                 |
| Gross profit                                   | 565,927                                     | 1,132,818                                 |
| Operating, general and administrative expenses | 1,567,607                                   | 2,791,602                                 |
| Loss from operations                           | (1,001,680)                                 | (1,658,784)                               |
| Interest income                                | 392,154                                     | 613,929                                   |
| Interest and other income (expense)            | (4,714)                                     | (12,240)                                  |

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|  |    |           |    |             |
|--|----|-----------|----|-------------|
| Loss before income taxes                                     |    | (614,240) |    | (1,057,095) |
| Income taxes   |    | (400)     |    | (400)       |
| Net loss   | \$ | (614,640) | \$ | (1,057,495) |
| Net loss per common share basic and diluted                  | \$ | (0.07)    | \$ | (0.13)      |
| Weighted average common shares outstanding basic and diluted |    | 9,019,941 |    | 8,201,169   |

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Weighted average shares used in the calculation of the unaudited pro forma combined basic and diluted net loss per share for the three and six months ended June 30, 2006 include the shares issued in connection with the acquisitions of DMI and Rio Bravo on February 7, 2006 and the shares issued in connection with the acquisition of DRA on September 8, 2006, as if these acquisitions had all occurred on January 1, 2006.

The adjustments used in the preparation of this unaudited pro forma combined statement of operations are based on estimates, available information and certain assumptions, as they relate to DRA, which may be revised as additional information becomes available. The pro forma financial data do not purport to represent what DMGI's combined results of operations would actually have been if such acquisitions had in fact occurred at the beginning of the period, and are not necessarily representative of DMGI's results of operations for any future period since the companies were not under common management or control during the period presented.

**3. RECENT ACCOUNTING PRONOUNCEMENTS**

In September 2006, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* ( SFAS No. 157 ), which addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under generally accepted accounting principles ( GAAP ). As a result of SFAS No. 157, there is now a common definition of fair value to be used throughout GAAP. The FASB believes that the new standard will make the measurement of fair value more consistent and comparable and improve disclosures about those measures. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. Management is currently evaluating the impact of this statement on DMGI.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115* ( SFAS No. 159 ). SFAS No. 159 permits entities to choose to measure eligible assets and liabilities at fair value with changes in value recognized in earnings. Fair value treatment for eligible assets and liabilities may be elected either prospectively upon initial recognition, or if an event triggers a new basis of accounting for an existing asset or liability. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. Management is currently evaluating the impact of this statement on DMGI.

**4. ACCOUNTING POLICIES**

The accounting policies of DMGI are set forth in Note 2 of the Notes to Consolidated Financial Statements included in the Annual Report on Form 10-K for the year ended December 31, 2006. There have been no changes to these policies other than the adoption of FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes*, on January 1, 2007. See Note 9 below.

**5. CASH AND CASH EQUIVALENTS**

DMGI considers all highly liquid investments with an original maturity or remaining maturity from date of purchase of three months or less to be cash equivalents. Based upon its investment policy, DMGI may invest its cash primarily in demand deposits with major financial institutions, in highly rated commercial paper, United States treasury obligations, United States and municipal government agency securities, United States government sponsored enterprises, money market funds and highly liquid debt securities of corporations. DMGI held approximately \$12,100,000 and \$6,500,000 in cash equivalents at June 30, 2007 and December 31, 2006, respectively.

DMGI maintains its cash and cash equivalents at financial institutions. The combined account balances at several institutions exceed Federal Deposit Insurance Corporation ( FDIC ) insurance coverage and, as a result, there is a concentration of credit risk related to amounts on deposit in excess of FDIC insurance coverage. DMGI has not incurred losses on these deposits to date and does not expect to incur any losses based on the credit ratings of the financial institutions.

**Table of Contents****6. DIGITAL RIGHTS**

Digital rights comprise the following at:

|                               | <b>June 30,<br/>2007</b> | <b>December 31,<br/>2006</b> |
|-------------------------------|--------------------------|------------------------------|
| Digital rights                | \$ 4,218,355             | \$ 3,405,605                 |
| Less accumulated amortization | (671,962)                | (372,366)                    |
|                               | <b>\$ 3,546,393</b>      | <b>\$ 3,033,239</b>          |

Amortization expense was \$167,407 and \$72,361 for the three months ended June 30, 2007 and 2006, respectively, and was \$299,596 and \$124,396 for the six months ended June 30, 2007 and 2006, respectively.

**7. MASTER RECORDINGS**

Master recordings comprise the following at:

|                               | <b>June 30,<br/>2007</b> | <b>December 31,<br/>2006</b> |
|-------------------------------|--------------------------|------------------------------|
| Master recordings             | \$ 2,293,379             | \$ 1,853,161                 |
| Less accumulated amortization | (170,536)                | (75,681)                     |
|                               | <b>\$ 2,122,843</b>      | <b>\$ 1,777,480</b>          |

Amortization expense was \$48,527 and \$10,452 for the three months ended June 30, 2007 and 2006, respectively, and was \$94,855 and \$10,452 for the six months ended June 30, 2007 and 2006, respectively.

**8. ROYALTY ADVANCES**

Royalty advances comprise the following at:

|  | <b>June 30,<br/>2007</b> | <b>December 31,<br/>2006</b> |
|--|--------------------------|------------------------------|
| Total royalty advances                         | \$ 10,880,637            | \$ 6,657,938                 |
| Less cumulative recoupment of royalty advances | (1,691,189)              | (1,101,156)                  |
|  | <b>9,189,448</b>         | <b>5,556,782</b>             |
| Current portion of royalty advances            | (1,983,679)              | (1,326,379)                  |
|  | <b>\$ 7,205,769</b>      | <b>\$ 4,230,403</b>          |

**9. INCOME TAXES**

DMGI adopted FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes* ( FIN 48 ), on January 1, 2007. FIN 48 provides a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or

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expected to be taken in income tax returns. There was no impact on DMGI's consolidated financial statements as a result of the adoption of FIN 48.

DMGI has incurred net losses since its inception and has fully offset the deferred income tax benefit of such losses by a valuation allowance due to the uncertainty of the ultimate realization of such tax benefits. DMGI has substantial net operating losses available for carryforward to reduce future taxable income for federal and state income tax reporting purposes. The federal net operating loss carryforwards begin to expire in 2024 and the state net operating loss carryforwards begin to expire in 2014. In addition to potential expiration, there are other factors that could limit DMGI's ability to use these federal and state tax loss carryforwards. Under Section 382 of the Internal Revenue Code of 1986 (Section 382), as amended, use of prior net operating loss carryforwards can be limited after an ownership change. DMGI's ability to fully utilize DMI's net operating loss carryforward will be subject to limitation under Section 382 as a result of its merger with DMGI and other transactions, and may be subject to further limitations as a result of future sales of securities, if any. Accordingly, it is not certain how much of the existing net operating loss carryforward will be available for use by DMGI.

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DMGI's future tax benefits as of June 30, 2007 and 2006 have been fully offset by a valuation allowance due to the uncertainty of their ultimate realization. If DMGI generates taxable income in the future, the use of net operating loss carryforwards that have not expired would have the effect of reducing DMGI's tax liability and increasing after-tax net income.

**10. CONCENTRATION OF CREDIT RISK**

Accounts receivable from DMGI's largest digital entertainment service comprised approximately 40% and 51% of DMGI's consolidated accounts receivable at June 30, 2007 and December 31, 2006, respectively. Based on its previous cash collection experience and knowledge of the digital entertainment service, DMGI does not believe there is significant collection risk associated with this account.

**11. COMMITMENTS AND CONTINGENCIES**

At June 30, 2007, DMGI is contractually obligated to pay up to \$3.4 million over the next twelve months in additional advance royalties and digital rights and master recordings purchase consideration. These payments are due under various digital rights agreements as music and video recordings and related metadata and artwork are received from the content owners for processing by DMGI. DMGI is also obligated to pay a total of \$348,750 in equal quarterly installments through February 2016 as additional advances against future royalties under one long-term agreement.

**12. SHARE-BASED COMPENSATION**

DMGI recorded non-cash charges of \$113,130 and \$79,149 as a component of operating, general and administrative expense related to share-based arrangements for the three months ended June 30, 2007 and 2006, respectively, and \$196,200 and \$159,883 for the six months ended June 30, 2007 and 2006, respectively. The share-based compensation charge for the six months ended June 30, 2006 included \$38,834 associated with the accelerated vesting of DMI stock options due to the merger of DMI with DMGI.

DMGI has an Amended and Restated 2005 Stock Plan (the "Plan") under which 1,102,000 shares of its common stock have been reserved for issuance at June 30, 2007. All options granted to employees since inception of the Plan have a four-year vesting period. Annual option grants to non-employee directors are automatic pursuant to a formula within the Plan which establishes the number of shares and terms of such grants.

In accordance with Statement of Financial Accounting Standards No. 123R, *Share-Based Compensation*, DMGI utilizes the Trinomial Lattice Model to measure the fair value of stock option grants. The following weighted-average assumptions were used in estimating the fair value per share of the options granted under the Plan for the six months ended June 30, 2007 and 2006:

|                            | 2007  | 2006  |
|----------------------------|-------|-------|
| Risk-free rate of return   | 4.75% | 4.66% |
| Expected volatility        | 50.0% | 35.0% |
| Expected life (in years)   | 5.0   | 5.3   |
| Suboptimal exercise factor | 2     | 2     |
| Exit rate post-vesting     | 19.9% | 22.8% |
| Exit rate pre-vesting      | 15.9% | 19.0% |

DMGI calculates the expected volatility for stock-based awards using the historical volatility for its peer group public companies because sufficient historical trading data does not yet exist for DMGI's common stock. DMGI estimates the forfeiture rate for stock-based awards based on historical data. The risk-free rate for stock options granted is determined by using a zero-coupon U.S. Treasury rate for the period that coincides with the expected option terms. It is further assumed that there are no dividend payments.



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Stock option activity for the six months ended June 30, 2007 is summarized as follows:

|                                  | Number of |                  | Weighted-Average<br>Exercise Price | Weighted-Average                 |                                 |
|----------------------------------|-----------|------------------|------------------------------------|----------------------------------|---------------------------------|
|                                  |           |                  |                                    | Remaining<br>Contractual<br>Term | Aggregate<br>Intrinsic<br>Value |
|                                  |           |                  |                                    |                                  |                                 |
| Outstanding at December 31, 2006 | 366,500   | \$ 4.02 - \$9.75 |                                    |                                  |                                 |
| Granted                          | 137,500   | \$ 4.02 - \$4.99 |                                    |                                  |                                 |
| Exercised                        |           |                  |                                    |                                  |                                 |
| Forfeited                        | (51,000)  | \$ 4.13 - \$9.66 |                                    |                                  |                                 |
| Outstanding at June 30, 2007     | 453,000   | \$ 4.02 - \$9.75 | \$ 7.45                            | 7.33                             | \$ 1,270                        |
| Exercisable at June 30, 2007     | 139,000   | \$ 6.38 - \$9.75 | \$ 9.51                            | 7.91                             | \$                              |

The aggregate intrinsic value shown in the table above was calculated as the difference between the exercise price of the underlying awards and the quoted price of DMGI's common stock for the 63,500 options that were in-the-money at June 30, 2007. The weighted average estimated grant-date fair value per share for the 1,354 vested and 49,646 unvested options forfeited during the six months ended June 30, 2007 was \$1.17 per share.

Restricted stock activity is summarized as follows:

|                                | Weighted-Average |            |
|--------------------------------|------------------|------------|
|                                | Number of        | Grant-Date |
|                                | Shares           | Fair Value |
| Nonvested at December 31, 2006 | 143,334          | \$ 0.68    |
| Issued                         | 30,000           | \$ 4.98    |
| Vested                         | (121,668)        | \$ 0.40    |
| Nonvested at June 30, 2007     | 51,666           | \$ 3.83    |

Subsequent to June 30, 2007, 16,666 non-vested restricted shares became vested upon the resignation and termination of the employment of a former executive as required under the restricted stock agreement with such executive.

As of June 30, 2007, the future pre-tax share-based compensation expense for stock option grants is \$540,919 to be recognized in the remainder of 2007 through 2011. Future pre-tax share-based compensation expense for restricted stock is \$156,800 to be recognized in the remainder of 2007 through 2008. However, in the event of a change in control as described in Note 14 below, all of the unvested options will become fully vested in accordance with the terms of the Plan and all restrictions on restricted shares will lapse, and DMGI will recognize all of the future share-based compensation expense.

**13. NET LOSS PER SHARE**

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Basic and diluted net loss per share has been computed using the weighted-average number of shares of common stock outstanding for the three months ended June 30, 2007 and 2006 of 9,036,205 and 8,599,941, respectively, and 9,030,880 and 7,266,804 for the six months ended June 30, 2007 and 2006, respectively. As of June 30, 2007, common stock equivalents included outstanding stock options, warrants and non-vested restricted stock totaling 453,000, 423,000 and 35,000 shares, respectively. Common stock equivalents have been excluded from the calculation of the weighted-average number of shares outstanding in all periods presented due to their antidilutive effect. Restricted stock vesting over two years which was issued to three executives in August 2005 were nominal issuances and all such shares are included in basic and diluted weighted-average shares outstanding for the three and six months ended June 30, 2007 and 2006.

### **14. SUBSEQUENT EVENT**

On July 10, 2007, DMGI entered into a merger agreement with The Orchard Enterprises, Inc. ( Orchard ), a leading global digital distributor and marketer of music, under which Orchard will become a wholly-owned subsidiary of DMGI following the merger, and DMGI will change its name to The Orchard Inc. The combined company will be headquartered in New York, New York. The terms of the merger agreement obligate DMGI to issue in a private placement an aggregate of 9,064,941 shares of common stock of DMGI and 4,488,330 shares of a newly created series of preferred stock in exchange for all outstanding shares of common

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and preferred stock of Orchard and all outstanding derivative instruments to acquire shares of Orchard. Each share of DMGI preferred stock will be convertible into, and will have voting rights equivalent to, one share of DMGI's common stock, with a liquidation preference of \$5.57 per share.

Completion of the merger is subject to customary closing conditions, including, but not limited to, approval by DMGI's and Orchard's shareholders. DMGI is currently preparing a proxy statement that will be filed in preliminary form with the SEC. Once the proxy statement is finalized, it will be presented to shareholders with a request for approval of the merger. DMGI cannot provide any assurance that all conditions to the merger with Orchard will be satisfied or that the merger will be consummated. The merger agreement contains certain restrictions on the operation of the business of each of DMGI and Orchard through the closing. It also contains certain termination rights for DMGI and Orchard, and further provides that if the merger agreement is terminated under certain circumstances, DMGI or Orchard will be required to pay the other a termination fee of up to approximately \$1.6 million.

In connection with the merger, DMGI implemented a retention bonus plan for key employees under which DMGI is obligated to pay up to a total of \$330,000 in one-time retention bonuses to eligible employees who remain continuously employed by DMGI through the closing date of the merger.

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**Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**  
**Forward-Looking Statements**

*This Quarterly Report on Form 10-Q contains statements that are considered to be forward-looking statements within the meaning of federal securities law. These statements contain forward-looking information relating to the potential merger with The Orchard Enterprises, Inc. ( Orchard ) and the financial condition, results of operations, plans, objectives, future performance and business of Digital Music Group, Inc. These statements (often using words such as believes , expects , likely , intends , estimates , plans , appear , should and similar words) involve risks and uncertainties that could cause actual results to differ materially from those projected by us. You should not place undue reliance on these forward-looking statements, which are based on our current views and assumptions. Actual results could differ materially from those anticipated in such forward-looking statements as a result of many reasons, including risks, uncertainties and factors which include, but are not limited to:*

*we cannot assure you that all conditions to the merger with Orchard will be satisfied and the merger consummated;*

*revenue and earnings expectations which are difficult to predict because of our limited operating history and emerging nature of the digital media industry;*

*our limited operating history in the acquisition, processing and sale of digital video content;*

*acceptance and adoption of the digital format by consumers and potential changes in consumers' tastes and preferences in music and video, and the extent to which our content will appeal to consumers;*

*our ability to successfully identify, acquire for a commercially reasonable valuation, and process additional catalogs of music and video content;*

*competitive and economic conditions in our industry;*

*our ability to renew multi-year agreements for digital rights to music and video content as they expire;*

*our limited ability to influence the pricing models of digital entertainment services;*

*we may not have proper legal title to the digital rights associated with music and video content that we purchase or license, or others may claim to have such rights;*

*potentially long delays in receiving the master music and video recordings that we acquire rights to;*

*our dependence on digital entertainment services to review, process and make all of our digital offerings available on a comprehensive and timely basis for purchase by consumers;*

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*music and video piracy;*

*availability, terms and use of capital to continue to grow our business;*

*our dependence on Apple iTunes Store for the majority of our revenue;*

*our ability to successfully enter into new sales channel relationships;*

*the differing interpretations of and potential ambiguities in U.S. copyright laws; and*

*maintaining adequate internal operating and financial controls over our business and financial reporting.*

*The following discussion of our financial condition and results of operations should be read in conjunction with our audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2006 and our unaudited condensed consolidated financial statements and related notes included in this Quarterly Report on Form 10-Q.*

### **Overview**

#### *Our Business*

Digital Music Group, Inc. ( DMGI ) is a content owner and global leader in the digital distribution of independently owned music and video content, including music recordings and music, television, film and other video content. At June 30, 2007, we had approximately 353,000 individual music recordings and more than 4,000 hours of video content under management that we expect to make available for sale. We acquire or license the digital rights to music and video content from record labels, artists, television and film production companies, and other content owners. We digitally encode the content into multiple formats for distribution to digital entertainment services operating over the Internet and wireless, cable and mobile networks. Consumers can then listen, view and/or purchase the content for use on their personal computers, digital music and video players, and music and video-enabled mobile phones.

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During the first half of 2007, we acquired digital rights to approximately 28,000 additional music recordings and adjusted downward by 10,000 the total number of music recordings under management as a result of one content owner's inability to deliver all tracks under contract and certain other adjustments. As a result, at June 30, 2007, we owned or had rights under digital distribution agreements to approximately 353,000 individual music recordings that we expect to be able to make available for sale. Of these recordings, 261,600, or 74%, were available for sale at that date. The remaining music recordings under contract had either (i) been processed and transmitted to one or more digital entertainment services where they were awaiting review and processing by the services before being posted for sale, (ii) were in various stages of our digitization process, or (iii) had not yet been delivered to us by the content owners. In addition, at June 30, 2007, we had more than 4,000 hours of video content under long-term distribution agreements.

Our digital entertainment service partners make our content available to consumers through two primary business models—permanent copies of entire albums, individual recordings or ringtones on a pay-per-download basis, or broad access to a substantial quantity of content on a subscription basis. We receive revenue from the digital entertainment services based on the number of times our content is downloaded or streamed by consumers. For music recordings for which we are the owner of the digital rights or master recordings, we pay a royalty from our revenue to the artist and the publisher of the music recording. For each licensed or distributed music recording, we pay a negotiated portion of the revenue to the content owner and, if applicable under our contract with the content owner, we may also pay the royalty owed to the artist and/or the publisher of the music recording. For licensed video content, we pay a negotiated portion of the revenue to the content owner. Beginning in 2007, we are delivering portions of our video content to certain advertising-supported Internet sites which are currently in a test-marketing environment. Video content will be available on these sites without charge to consumers, and we will share in a percentage of the advertising revenue generated by these digital entertainment services based on the number of times our video content is viewed by consumers.

Over the past three years, the recorded music industry has experienced increasing demand for the distribution of music in digital format, driven by the proliferation of personal music players and music-enabled mobile phones and the ability to offer large selections of music recordings available for consumption at any time. Like the music industry in 2003, we believe the television and film industries have recently begun a migration from sales and rental of content in physical formats such as digital video discs to digital distribution. However, only a relatively small percentage of known music and video content is currently available for purchase in digital format. We believe that many content owners have yet to make their content available in digital format because of the time, effort and cost involved. In addition, we believe many digital entertainment services are reluctant to enter into relationships with smaller content owners because of the administrative costs involved.

We actively seek out the owners of music and video content to acquire their digital rights through purchase, long-term license or short-term distribution agreements. Such acquisitions are pursued based upon the quality and commercial marketability of the content, our ability to negotiate appropriate consideration and terms, and our available financial resources. We have acquired digital rights to music and video content that represents a wide variety and mix of genres and time periods to appeal to many different interest groups. The music recordings that we own or control under long-term agreements are generally not current mainstream and popular hits, but consist primarily of back catalog, out-of-print recordings, past hits, world music, classical music performances, previously unreleased music recordings, live performances, and other music that may not be readily available from traditional music retailers. The music recordings that we distribute under short-term arrangements consist primarily of more contemporary recordings by independent record label artists. The video content we have acquired consists of classic episodic television shows no longer in wide syndication, vintage feature and short films, cartoons and other animated features, music videos, live music and stand-up comedy performances, action shorts, reality programming, sports events, and programs focused on children or special-interest groups.

Our strategy is to fulfill the basic needs of each of our market participants in the rapidly growing and evolving digital media industry. We provide consumers with access to music and video content, music of which is not readily accessible in traditional brick-and-mortar retailers or otherwise available in digital format. In addition, we provide a means for content owners to make their content available to consumers at digital entertainment services with minimal effort on their behalf. Further, we reduce the burden for digital entertainment services of managing individual relationships with many smaller content owners.

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### *Recent Developments*

On July 10, 2007, we entered into a merger agreement with The Orchard Enterprises, Inc. (Orchard), a leading global digital distributor and marketer of music, under which Orchard will become our wholly-owned subsidiary following the merger, and we will change our name to The Orchard Inc. The combined company will be headquartered in New York City. The terms of the merger agreement obligate us to issue in a private placement an aggregate of 9,064,941 shares of our common stock and 4,488,330 shares of a newly created series of preferred stock in exchange for all outstanding shares of common and preferred stock of Orchard and all outstanding derivative instruments to acquire shares of Orchard. Each share of our preferred stock will be convertible into, and will have voting rights equivalent to, one share of our common stock, with a liquidation preference of \$5.57 per share.

Completion of the merger is subject to customary closing conditions, including, but not limited to, approval by DMGI's and Orchard's shareholders. We are currently preparing a proxy statement that will be filed in preliminary form with the SEC. Once the proxy statement is finalized, it will be presented to shareholders along with a request for approval of the merger. We cannot provide any assurance that all conditions to the merger with Orchard will be satisfied or that the merger will be consummated. The merger agreement contains certain restrictions on the operation of our business and the business of Orchard through the closing. It also contains certain termination rights for us and Orchard, and further provides that if the merger agreement is terminated under certain circumstances, we or Orchard will be required to pay the other a termination fee of up to approximately \$1.6 million.

Concurrent with our entering into the merger agreement, Mitchell Koulouris resigned as our chief executive officer. Karen Davis, our chief financial officer, will serve as our interim chief executive officer until the closing of the merger. At that time, Greg Scholl, the chief executive officer of Orchard, will assume that role for the combined company.

### *Key Business Metrics*

Since our inception through June 30, 2007, our revenue has been derived almost entirely from the sale or distribution of digital music content. Apple iTunes, the most popular digital music retailer accounted for approximately 56%, 89%, 63% and 89% of our revenue during the three months ended June 30, 2007 and 2006 and six months ended June 30, 2007 and 2006, respectively. Our digital music revenue is derived from the following sources:

*Permanent downloads.* Our permanent download revenue is driven by the number of music recordings we have available for downloading at digital music retailers, times the average number of times our music recordings are downloaded, multiplied by the fee paid to us by each retailer. The download rates for our music recordings are driven primarily by popularity and demand for the recordings, the number and nature of the digital entertainment services through which we make the recordings available to consumers, and the territorial distribution rights we have. The fee we receive per download is negotiated in advance at the time we enter into an agreement with a digital music retailer. Under our agreements with Apple iTunes, we currently receive \$0.70 per download for distribution in the United States and up to approximately \$0.86 (at current translation rates) per download for distribution outside the United States. For permanent downloads sold through subscription-based services, we receive a percentage of each retailer's total revenue based on the number of times our music recordings are downloaded as a percentage of each retailer's total downloads. The overall average download rate paid to us by all digital music retailers was approximately \$.56 and \$.72 for the three months ended June 30, 2007 and 2006 and \$.57 and \$.72 for the six months ended June 30, 2007 and 2006, respectively. Revenue from permanent downloads comprised approximately 72% and 95% for the three months ended June 30, 2007 and 2006 and 78% and 96% for the six months ended June 30, 2007 and 2006 of our total revenue, respectively.

*Subscription fees.* Certain digital music retailers distribute our music recordings on a subscription basis. Our subscription revenue is a percentage of each retailer's total subscription revenue based on the number of times our music recordings are listened to by subscribers as compared to the total for all music recordings listened to during the relevant time period. Following the termination of their subscription, consumers are not able to play our music recordings. Subscription-based revenue comprised approximately 9% and 4% for the three months ended June 30, 2007 and 2006 and 8% and 4% for the six months ended June 30, 2007 and 2006 of our total revenue, respectively.

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*Mobile services.* With the acquisition of DRA in September 2006, we gained relationships with numerous mobile distribution services. Over 15% of DRA's stand-alone revenue was derived from mobile services for the year ended December 31, 2006. On a consolidated basis, approximately 6% of our revenue for 2006 was derived from mobile services, and we expect the sale of our music recordings and certain video content through mobile services to become a more significant portion of our revenue in the future. Our revenue from mobile services is derived primarily from downloads of full-length music recordings and ringtones. During the six months ended June 30, 2007, we received an average of \$.76 per full-length download and \$.82 per ringtone from our mobile service partners, respectively. Most mobile ringtone services generally make available to consumers a limited selection of ringtones due to the limited space on mobile handset screens and higher per track processing costs related to the many formats that are required for various mobile handset makes and models. Mobile services revenue comprised approximately 13% and 0% for the three months ended June 30, 2007 and 2006 and 12% and 0% for the six months ended June 30, 2007 and 2006 of our total revenue, respectively.



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*Other.* Our other revenue is comprised mainly from the licensing of physical distribution rights to our master recordings to third parties.

We believe, as the digital entertainment marketplace continues to mature and as we begin to realize meaningful revenue from our video content, the composition of our revenue will shift from being predominantly driven by permanent downloads of music content from digital music retailers to a more diversified revenue mix consisting of music and video downloads, subscription fees, mobile-sourced revenue and advertising revenue. Due to the disparate nature of these distribution models and the revenue and gross profit results they produce, we believe that appropriate key metrics to measure our results will continue to evolve.

Cost of revenue consists of:

royalties to artists and publishers;

revenue sharing payments based on long-term or short-term distribution agreements with content owners of music and video content;

amortization of costs to acquire master recordings or digital rights to music and video content; and

reserves or write-downs capitalized digital rights, master recordings or royalty advances that may be deemed necessary from time-to-time.

Our cost of revenue and corresponding gross profit is determined by the revenue earned on our music and video content and the manner in which we own or distribute the content. When we purchase or license the digital rights to recorded music or music videos we have no influence over the terms as stipulated in the original recording contract between the content owner and artists or publishers. Our experience is that these artist royalty obligations for music recordings have historically been between zero and 15% of the revenue attributable to a specific track or album. Beginning in January 2006, publisher royalties for music recordings are a statutory rate of \$0.091 in the United States of America. The royalties for music video recordings, or synchronization rights, are negotiated by contract with the artist or publisher and typically range between \$0.10 and \$0.15 per video download. When we acquire the master recordings or digital rights to music or music video content, we usually pay certain or all of these artist, publisher and synchronization royalties. We capitalize the acquisition costs, including the purchase price and direct ancillary costs, of our perpetual and long-term digital rights and our master recordings. We amortize these amounts over the shorter of seven years or the length of the contract for digital rights and ten years for master recordings, which we believe reasonably relates the amount of amortization to the revenue expected to be generated. When we have acquired our digital rights through long-term license agreements with music and video content owners, our cost of revenue typically includes a revenue sharing arrangement whereby the content owner receives 25% to 57% of the gross or net revenue, as defined, over the term of the agreement. As an inducement to enter into the long-term license agreement, we will make a royalty advance against the content owner's share of future royalties under this revenue sharing arrangement. All such advance royalties are capitalized as a prepaid asset that is amortized as cost of revenue as the related revenue is earned and the cash advances are recouped. In short-term distribution agreements, which typically have terms of two to three years, we are not responsible for any artists, publisher or synchronization royalties and we generally make no upfront or fixed payments to the content owner at the time we enter into the agreement. The revenue sharing percentage retained by the content owner (generally 80% to 85% for music recordings and 70% for video recordings) is substantially higher than under long-term license agreements. Accordingly, higher gross profit margins are achieved from revenue generated from owned content and content controlled under perpetual and long-term license agreements and lower gross profit margins are achieved through short-term distribution agreements.

Operating, general and administrative expenses include all costs associated with processing music and video content and operating the business. These expenses increased substantially during 2006, primarily because of salary costs associated with additional personnel dedicated to business development, accounting and operations, cost incurred as a result of becoming a public-reporting company in February 2006, and from the addition of our DRA subsidiary on September 8, 2006.

### *Seasonality*

The early-stage nature of the entire digital distribution industry and our limited operating history have not allowed us to categorically identify seasonality in our business, although we suspect that the first and fourth quarters of the calendar year may have seasonally higher sales, just as this is the peak time for sales of music and video content in physical format. Based on our brief history, our music content that is represented by older, back-catalog and out-of-print recordings has not experienced the same degree of seasonality as our more contemporary content from

current artists.

**Table of Contents***Significant Customer*

Revenue from Apple iTunes accounted for approximately 56% and 89% for the three months ended June 30, 2007 and 2006 and 63% and 89% for the six months ended June 30, 2007 and 2006 of our revenue, respectively.

*Critical Accounting Policies*

There have been no significant changes in or additions to our critical accounting policies during the six months ended June 30, 2007, as compared to the previous disclosures in Management's Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the year ended December 31, 2006, as filed with the SEC on March 30, 2007.

*Recent Accounting Pronouncements*

In September 2006, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* ( SFAS No. 157 ), which addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under generally accepted accounting principles ( GAAP ). As a result of SFAS 157 there is now a common definition of fair value to be used throughout GAAP. The FASB believes that the new standard will make the measurement of fair value more consistent and comparable and improve disclosures about those measures. SFAS 157 is effective for fiscal years beginning after November 15, 2007. We are currently evaluating the impact of this statement on our consolidated financial statements.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115* ( SFAS No. 159 ). SFAS No. 159 permits entities to choose to measure eligible assets and liabilities at fair value with changes in value recognized in earnings. Fair value treatment for eligible assets and liabilities may be elected either prospectively upon initial recognition, or if an event triggers a new basis of accounting for an existing asset or liability. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. We are currently evaluating the impact of this statement on our consolidated financial statements.

**Results of Operations**

The following table sets forth items in our Condensed Consolidated Statements of Operations as a percentage of revenue, as well as certain additional revenue and operating data regarding our sources of revenue; music and video recordings available for sale and paid downloads data for the periods indicated:

|  | For the Three Months Ended June 30, |                     |              |                     |
|--|-------------------------------------|---------------------|--------------|---------------------|
|  | 2007                                | 2006                | 2007         | 2006                |
|  | Amount                              | Percentage of Total | Amount       | Percentage of Total |
| Revenue  | \$ 3,151,264                        | 100.0%              | \$ 839,539   | 100.0%              |
| Cost of revenue:                                     |                                     |                     |              |                     |
| Royalties and payments to content owners             | 2,142,353                           | 68.0%               | 386,799      | 46.0%               |
| Amortization of digital rights and master recordings | 215,934                             | 6.9%                | 82,813       | 9.9%                |
| Gross profit   | 792,977                             | 25.2%               | 369,927      | 44.1%               |
| Operating, general and administrative expenses       | (1,757,429)                         | (55.8)%             | (1,344,198)  | (160.1)%            |
| Merger-related expenses                              | (328,844)                           | (10.4)%             |              |                     |
| Interest, taxes and other, net                       | 183,808                             | 5.8%                | 384,906      | 45.8%               |
| Net loss   | \$ (1,109,488)                      | (35.2)%             | \$ (589,365) | (70.2)%             |

**Key Revenue and Operating Data:**

## Digital music revenue by source:

|                 |              |       |            |       |
|-----------------|--------------|-------|------------|-------|
| Downloads       | \$ 2,281,062 | 72.4% | \$ 797,520 | 95.0% |
| Mobile services | 415,319      | 13.2% |            | 0.0%  |
| Subscriptions   | 292,035      | 9.3%  | 30,655     | 3.6%  |

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|   |              |        |            |        |
|---|--------------|--------|------------|--------|
| Other   | 160,622      | 5.0%   | 11,364     | 1.4%   |
| Total digital music revenue   | 3,149,037    | 99.9%  | 839,539    | 100.0% |
| Digital video and other revenue   | 2,227        | 0.1%   |            |        |
| Total revenue   | \$ 3,151,264 | 100.0% | \$ 839,539 | 100.0% |
| Digital music revenue from:   |              |        |            |        |
| Owned and controlled music recordings                                   | \$ 970,485   | 30.8%  | \$ 644,353 | 76.8%  |
| Music recordings under short-term distribution agreements               | 2,178,552    | 69.1%  | 195,186    | 23.2%  |
| Total digital music revenue   | 3,149,037    | 99.9%  | 839,539    | 100.0% |
| Digital video and other revenue   | 2,227        | 0.1%   |            |        |
| Total revenue   | \$ 3,151,264 | 100.0% | \$ 839,539 | 100.0% |
| Average number of music recordings available for sale during the period |              |        |            |        |
|   | 249,900      |        | 69,700     |        |
| Number of music recordings available for sale at the end of the period  |              |        |            |        |
|   | 261,600      |        | 73,000     |        |
| Number of paid downloads (1)  |              |        |            |        |
|   | 4,092,000    |        | 1,101,000  |        |

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|   | For the Six Months Ended June 30, |                     | 2006           |                     |
|---|-----------------------------------|---------------------|----------------|---------------------|
|   | 2007                              | Percentage of Total | 2006           | Percentage of Total |
|   | Amount                            |                     | Amount         |                     |
| Revenue   | \$ 6,543,811                      | 100.0%              | \$ 1,560,187   | 100.0%              |
| Cost of revenue:  |                                   |                     |                |                     |
| Royalties and payments to content owners                                | 4,593,191                         | 70.2%               | 735,325        | 47.2%               |
| Amortization of digital rights and master recordings                    | 394,451                           | 6.0%                | 134,848        | 8.6%                |
| Gross profit  | 1,556,169                         | 23.8%               | 690,014        | 44.2%               |
| Operating, general and administrative expenses                          | (3,482,509)                       | (53.2)%             | (2,294,862)    | (147.1)%            |
| Merger-related expenses   | (328,844)                         | (5.0)%              |                |                     |
| Interest, taxes and other, net  | 409,349                           | 6.3%                | 601,540        | 38.6%               |
| Net loss  | \$ (1,845,835)                    | (28.2)%             | \$ (1,003,308) | (64.3)%             |
| <b>Key Revenue and Operating Data:</b>                                  |                                   |                     |                |                     |
| Digital music revenue by source:  |                                   |                     |                |                     |
| Downloads   | \$ 5,075,237                      | 77.6%               | \$ 1,491,443   | 95.6%               |
| Mobile services   | 762,244                           | 11.6%               |                | %                   |
| Subscriptions   | 528,253                           | 8.1%                | 57,081         | 3.7%                |
| Other   | 174,891                           | 2.7%                | 11,663         | 0.7%                |
| Total digital music revenue   | 6,540,625                         | 100.0%              | 1,560,187      | 100.0%              |
| Digital video and other revenue   | 3,186                             |                     |                |                     |
| Total revenue   | \$ 6,543,811                      | 100.0%              | \$ 1,560,187   | 100.0%              |
| Digital music revenue from:   |                                   |                     |                |                     |
| Owned and controlled music recordings                                   | \$ 1,974,467                      | 30.2%               | \$ 1,231,760   | 78.9%               |
| Music recordings under short-term distribution agreements               | 4,566,158                         | 69.8%               | 328,419        | 21.1%               |
| Total digital music revenue   | 6,540,625                         | 100.0%              | 1,560,648      | 100.0%              |
| Digital video and other revenue   | 3,186                             |                     |                |                     |
| Total revenue   | \$ 6,543,811                      | 100.0%              | \$ 1,560,648   | 100.0%              |
| Average number of music recordings available for sale during the period | 241,400                           |                     | 55,600         |                     |
| Number of music recordings available for sale at the end of the period  | 261,600                           |                     | 73,000         |                     |
| Number of paid downloads (1)  | 8,874,200                         |                     | 2,085,000      |                     |

- (1) Does not include the number of times our music recordings were streamed or played on subscription-based digital music retailers or downloaded through mobile services.

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**Table of Contents*****Comparison of Three Months Ended June 30, 2007 to 2006***

*Revenue.* Revenue increased to \$3,151,264 for the three months ended June 30, 2007, from \$839,539 for the three months ended June 30, 2006. Total paid music downloads increased to 4,092,000 from 1,101,000 for the same periods, respectively. The increase in the number of paid music downloads was driven by the increase in music recordings made available for sale, while the average monthly download rate of 5.5 times during the second quarter of 2007 remained relatively constant compared to 5.3 times during the second quarter of 2006. The average number of music recordings available for sale was approximately 249,900 during the second quarter of 2007 and 69,700 during the second quarter of 2006. The increase in the average number of music recordings available reflects the increase in music recordings under contract which have been delivered to and processed by us and made available for sale by our digital entertainment service partners and the acquisition of DRA which added approximately 53,000 music recordings in September 2006. In addition, our revenue from subscription services and other sources such as physical rights licensing increased to \$292,035 in the second quarter of 2007, from \$30,655 in the second quarter of 2006. Revenue from mobile distribution was \$415,319 in the second quarter of 2007 and \$0 in the second quarter of 2006, primarily as a result of our acquisition of DRA. We commenced the digital distribution of our video content during 2007 on a limited and, in several cases, a test-marketing basis, and our revenue for the period from this source was \$2,227.

*Cost of revenue.* Our royalties and payments to content owners increased to \$2,142,353 for the three months ended June 30, 2007, compared to \$386,799 for the three months ended June 30, 2006. The increase is related to the overall increase in revenue and the acquisition of DRA. During the second quarter of 2007, our royalties and payments to content owners amounted to 68.0% of our total revenue as compared to 46.0% of total revenue in the same period last year. During the second quarter of 2006, 76.8% of our revenue was derived from music recordings either (i) owned by us which require no external payments to content owners or (ii) distributed by us under long-term distribution agreements which typically carry revenue sharing rates of 25% to 50% paid to the content owner. The acquisition of DRA in September 2006 had a significant effect on our revenue mix and gross profit margins, as revenue derived from digital music distributed under short-term agreements increased to 69.1% of our total revenue in the second quarter of 2007 as compared to 23.2% in the second quarter of 2006. DRA's short-term distribution agreements have revenue sharing arrangements that typically result in payments to content owners ranging from 80% to 85% of revenue. In addition, the amortization of digital rights and master recordings increased to \$215,934 in the second quarter of 2007, compared to \$82,813 in the second quarter of 2006. We have used a portion of the net proceeds from our initial public offering in February 2006 to acquire additional digital rights and master recordings. As

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of June 30, 2007, we are amortizing digital rights and master recordings with a cost basis of approximately \$6.5 million compared to approximately \$3.2 million at June 30, 2006. As a result of these factors, gross profit increased to \$792,979 in the second quarter of 2007, as compared to \$369,927 in the second quarter of 2006, but gross profit margins decreased to 25.2% of total revenue in the current period, compared to 44.1% in the second quarter of 2006.

*Operating, general and administrative expenses.* The following table sets forth the individual components of operating, general and administrative expenses for the three months ended June 30, 2007 and 2006:

|                               | For the Three Months Ended June 30,<br>2007 |                        | 2006         |                        |
|-------------------------------|---|------------------------|--------------|------------------------|
|                               | Amount                                      | Percentage<br>of Total | Amount       | Percentage<br>of Total |
| Personnel-related expenses    | \$ 736,333                                  | 41.9%                  | \$ 644,946   | 48.0%                  |
| Professional fees             | 295,388                                     | 16.8%                  | 135,599      | 10.1%                  |
| Corporate governance expenses | 178,035                                     | 10.1%                  | 179,002      | 13.3%                  |
| Share-based compensation      | 113,130                                     | 6.5%                   | 79,149       | 5.9%                   |
| Depreciation and amortization | 93,072                                      | 5.3%                   | 29,297       | 2.2%                   |
| Rent                          | 72,643                                      | 4.1%                   | 52,119       | 3.9%                   |
| Travel expenses               | 58,270                                      | 3.3%                   | 41,476       | 3.0%                   |
| Media and investor relations  | 52,375                                      | 3.0%                   | 66,493       | 5.0%                   |
| Other                         | 158,183                                     | 9.0%                   | 116,117      | 8.6%                   |
| Total                         | \$ 1,757,429                                | 100.0%                 | \$ 1,344,198 | 100.0%                 |

Operating, general and administrative expenses increased to \$1,725,429 for the three months ended June 30, 2007 from \$1,344,198 for the three months ended June 30, 2006 primarily due to (i) our acquisition of DRA in September 2006 and (ii) increased professional fees to assist in the documentation and testing of internal controls as required by the Sarbanes-Oxley Act, and (iii) depreciation on computer and other capital equipment additions.

*Merger related expenses.* Through June 30, 2007, we had incurred \$328,844 of expenses related to the pending merger with Orchard as described above, primarily professional fees. In this transaction, Orchard will be deemed the acquiror for financial reporting purposes and, as such, all of our merger related costs and expenses must be charged to expense as incurred.

*Interest income and interest, taxes and other expense, net.* Interest income was \$201,907 in the three months ended June 30, 2007, compared to \$388,386 for the three months ended June 30, 2006, due to the temporary investment of the net cash proceeds from our initial public offering. Our initial public offering closed on February 7, 2006 and we received net cash proceeds of \$33.2 million.

**Comparison of Six Months Ended June 30, 2007 to 2006**

*Revenue.* Revenue increased to \$6,543,811 for the six months ended June 30, 2007, from \$1,560,187 for the six months ended June 30, 2006. Total paid downloads increased to 8,874,200 from 2,085,000 for the same periods, respectively. The increase in the number of paid downloads was driven by the increase in music recordings made available for sale, partially offset by a decline in the average monthly download rate to 6.1 times during the first six months of 2007 from 6.3 times during the first six months of 2006. The average number of music recordings available for sale was approximately 241,400 during the first six months of 2007 and 55,600 during the first six months of 2006. The increase in the average number of music recordings available reflects the increase in music recordings under contract which have been delivered to and processed by us and made available for sale by our digital entertainment service partners and the acquisition of DRA which added approximately 53,000 music recordings in September 2006. In addition, our revenue from subscription services and other sources such as physical rights licensing increased to \$528,253 in the first six months of 2007, from \$57,081 in the first six months of 2006. Revenue from mobile distribution was \$762,244 in the first six months of 2007 and \$0 in the first six months of 2006, primarily as a result of our acquisition of DRA. We commenced the digital distribution of our video content during 2007 on a limited and, in several cases, a test-marketing basis, and our revenue for the period from this source was \$3,186.

*Cost of revenue.* Our royalties and payments to content owners increased to \$4,593,191 for the six months ended June 30, 2007, compared to \$735,325 for the six months ended June 30, 2006. The increase is related to the overall increase in revenue and the acquisition of DRA. During

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the first six months of 2007, our royalties and payments to content owners amounted to 70.2% of our total revenue as compared to 47.2% of total revenue in the same period last year. During the first six months of 2006, 78.9% of our



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revenue was derived from music recordings either (i) owned by us which require no external payments to content owners or (ii) distributed by us under long-term distribution agreements which typically carry revenue sharing rates of 25% to 50% paid to the content owner. The acquisition of DRA in September 2006 had a significant effect on our revenue mix and gross profit margins, as revenue derived from digital music distributed under short-term agreements increased to 69.8% of our total revenue in the first six months of 2007 as compared to 21.1% in the first six months of 2006. DRA's short-term distribution agreements have revenue sharing arrangements that typically result in payments to content owners ranging from 80% to 85% of revenue. In addition, the amortization of digital rights and master recordings increased to \$394,451 in the first six months of 2007, compared to \$134,848 in the first six months of 2006. We have used a portion of the net proceeds from our initial public offering in February 2006 to acquire additional digital rights and master recordings. As of June 30, 2007, we are amortizing digital rights and master recordings with a cost basis of approximately \$6.5 million compared to approximately \$3.2 million at June 30, 2006. As a result of these factors, gross profit increased to \$1,556,169 in the first six months of 2007, as compared to \$690,014 in the first six months of 2006, but gross profit margins decreased to 23.8% of total revenue in the current period, compared to 44.2% in the first six months of 2006.

*Operating, general and administrative expenses.* The following table sets forth the individual components of operating, general and administrative expenses for the six months ended June 30, 2007 and 2006:

|                               | For the Six Months Ended June 30,<br>2007 |                        | 2006         |                        |
|-------------------------------|---|------------------------|--------------|------------------------|
|                               | Amount                                    | Percentage<br>of Total | Amount       | Percentage<br>of Total |
| Personnel-related expenses    | \$ 1,526,818                              | 43.8%                  | \$ 1,087,511 | 47.5%                  |
| Professional fees             | 508,143                                   | 14.6%                  | 321,382      | 14.0%                  |
| Corporate governance expenses | 332,960                                   | 9.6%                   | 269,548      | 11.7%                  |
| Share-based compensation      | 196,200                                   | 5.6%                   | 159,884      | 7.0%                   |
| Depreciation and amortization | 178,147                                   | 5.0%                   | 47,183       | 2.1%                   |
| Rent                          | 145,198                                   | 4.2%                   | 71,787       | 3.1%                   |
| Travel expenses               | 130,298                                   | 3.7%                   | 85,943       | 3.7%                   |
| Media and investor relations  | 111,558                                   | 3.2%                   | 69,237       | 3.0%                   |
| Other                         | 356,187                                   | 10.2%                  | 182,388      | 7.9%                   |
| Total                         | \$ 3,482,509                              | 100.0%                 | \$ 2,294,863 | 100.0%                 |

Operating, general and administrative expenses increased to \$3,482,509 for the six months ended June 30, 2007, from \$2,294,863 for the six months ended June 30, 2006. Our operating, general and administrative expenses for the first six months of 2007 include the expenses of our DRA subsidiary which was acquired in September 2006. In addition, operating, general and administrative expenses increased after our initial public offering in February 2006 because of an increase in (i) employees and the resulting payroll costs and share-based compensation attributable to the granting of stock options and restricted stock incentives, partially offset by \$38,384 of share-based compensation recognized in the first quarter of 2006 associated with the accelerated vesting of DMI stock options, (ii) professional fees, including assistance in the documentation and testing of internal controls as required by the Sarbanes-Oxley Act, (iii) corporate governance expenses which include board fees, director and officer insurance, stock transfer, printing and filing fees, (iv) media and investor relations which includes advertising costs for acquired content, (v) travel-related expenses, (vi) office rent, and (vii) other expenses as we acquired equipment and expanded our infrastructure to acquire rights to additional music and video recordings, to process an increasing number of music recordings, to develop competencies in digitally encoding video content, and to meet our obligations as a public company.

*Merger related expenses.* Through June 30, 2007, we had incurred \$328,844 of expenses related to the pending merger with Orchard, primarily professional fees. In this transaction, Orchard will be deemed the acquirer for financial reporting purposes and, as such, all of our merger related costs and expenses must be charged to expense as incurred.

*Interest income and interest, taxes and other expense, net.* Interest income was \$441,516 in the six months ended June 30, 2007, compared to \$608,006 for the six months ended June 30, 2006, due to the temporary investment of the net cash proceeds from our initial public offering. Our initial public offering closed on February 7, 2006 and we received net cash proceeds of \$33.2 million.

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### **Liquidity and Capital Resources**

#### *Cash Flows for the Six Months Ended June 30, 2007*

Our operating activities resulted in a net cash outflow of \$636,227 during the six months ended June 30, 2007. The primary components of the reconciliation of net loss of \$1,845,835 to net cash used by operations included non-cash charges relating to the recoupment of royalty advances of \$590,033, share-based compensation of \$196,200, depreciation of furniture and equipment of \$176,219 and the amortization of digital rights and master recordings of \$394,451. In addition, changes in working capital components used \$158,151 in operating cash flow as receivables and prepaid expenses increased by a greater amount than royalties and accounts payable and accruals.

Our investing activities resulted in net cash outflows of \$5,876,842 during the six months ended June 30, 2007, which was principally comprised of \$406,713 for the purchase of furniture and equipment, \$1,252,968 for the purchase of digital rights and master recordings, and \$4,222,699 for cash advances to acquire digital license rights to music and video recordings.

Our financing activities during the six months ended June 30, 2007 resulted in a net use of cash of \$23,722 primarily for payments on capital lease obligations.

As of June 30, 2007, we had cash and cash equivalents of approximately \$14.0 million and a working capital surplus of approximately \$14.8 million. At June 30, 2007, we were contractually obligated to pay approximately \$3.4 million in additional advance royalties and digital rights and master recordings purchase consideration, due under various digital rights agreements generally as music and video recordings and related metadata and artwork are received from the content owners for processing by us. We are also obligated to pay a total of \$348,750 in equal quarterly installments through February 2016 as additional advances against future royalties under one long-term agreement.

Our principal sources of liquidity are our cash and cash equivalents. We believe that our existing cash reserves will be sufficient to fund our operations, working capital requirements, capital expenditure requirements, contractual obligations and content acquisition objectives during 2007. However, we may seek to raise additional capital through a future debt or equity financing to provide for greater flexibility to fund any such acquisitions and licensing activities

### **Off Balance Sheet Arrangements**

As of June 30, 2007, we had no off-balance sheet arrangements.

### **Factors Affecting Future Results**

We have incurred losses since inception and our ability to achieve profitability in the near term is primarily dependent on increasing our revenue while controlling and limiting our expenses at current levels. Some of the current industry conditions and factors that we expect could have a significant impact on our future results are discussed below.

*Music industry conditions.* The digital music industry is still evolving and subject to rapid change. The previously strong quarter-over-quarter growth in digital music sales reported industry-wide has slowed recently, which is natural as an industry matures and the base on which percentage growth is measured becomes larger. There was an industry-wide decline in sales of physical product (pre-recorded music CDs) experienced during the first six months of 2007 which was larger than the increase in digital music sales for the same period. The early-stage nature of the digital transition presently occurring in the music industry and our limited operating history have not allowed us to definitively identify specific consumer trends or factors in our business that may affect the timing and extent of digital downloading as a replacement for purchases of music CDs and the resulting impact on our revenue.

Because of the lengthy interval between the time we acquire digital rights or enter into license or distribution agreements for music recordings and the time that such recordings are received, processed, delivered to digital entertainment services and ultimately processed and approved for sale by the services, only a relatively small amount of the music content we have acquired or licensed since the IPO was available for sale at June 30, 2007. We are working to reduce the time it takes to get our recordings to market and to deliver more of our music recordings to other digital music retailers and especially to mobile distribution services in order to improve our download rates and revenue per music recording.

We have observed a continued increase in the competitive environment for the acquisition of digital rights to music recordings owned by active independent record labels from our competitors engaged in the short-term distribution of digital music and from subsidiaries of the four major

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record label groups. In particular, major record label groups which have always aggressively competed to provide physical distribution for independent labels, have become increasingly active in the digital market segment. During the first half of 2007, we were notified by three independent record labels digitally distributing their music through our DRA subsidiary that they intend to shift distribution of their catalogs from us to a subsidiary of a major record label. In addition, our direct competitors, which have typically engaged in the digital distribution of music with no upfront advance cash payments, have begun making cash royalty advances or reduced their gross profit margins to attract or retain high-quality independent music catalogs. While we do not expect the decrease in revenue and gross profit from the three labels we have lost to subsidiaries of the major record label groups to be material, the aggressive competition from our direct competitors, as well as from major record label groups and other independent physical distributors with the ability to offer reduced physical distribution fees in order to gain the digital distribution rights from independent labels and other content owners, may cause us to experience a higher rate of non-renewal than we have experienced in the past and may adversely impact our ability to enter into new agreements.

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Apple iTunes and EMI Music recently announced an agreement to sell a broad selection of EMI music recordings without digital rights management, or DRM. Such recordings would be made available in a higher quality format and at a higher price to the consumer than music recordings currently offered on Apple iTunes. During the third quarter of 2007, we expect Apple iTunes will make this distribution option available to us and we will likely make certain of our content available without DRM, in a higher-quality format and at a higher price. We believe that the availability of non-DRM music downloads may lead to accelerated growth in the digital music industry.

*Revenue from video content.* As of June 30, 2007, we had more than 4,000 hours of music, television and film video content under contract. As of that date, we had processed and delivered over 3,500 episodes of video content to 18 online and mobile video retailers. Because most of our distribution partners are still in the process of launching and establishing their digital entertainment services for video or are in the testing phase for advertising-supported business models, the revenue we have received from video sales to-date has been negligible. We have been participating in the testing phase of a number of our partners' services. Based on the preliminary results of these tests and on the stated plans of certain of our partners to launch their advertising-supported models during the third quarter of 2007, we believe our revenue from video content will continue to increase from current levels, although we are unlikely to realize any meaningful revenue from digital video distribution until, at the earliest, the fourth quarter of 2007.

*Business development.* As of June 30, 2007, we had cash and cash equivalents of approximately \$14 million, the majority of which is earmarked for digital content acquisitions, including up to approximately \$3.8 million we are contractually obligated to pay under content acquisitions and long-term license arrangements. Negotiating and consummating digital rights agreements for entertainment content is a complex and time consuming process, and we cannot predict how quickly we will be able to deploy our capital and add to the music and video content we have available to consumers. We are seeking to acquire additional digital rights and to enter into additional long-term license agreements for both music and video content. We also are seeking to enter into additional short-term distribution agreements for both music and video content as they provide a method for achieving revenue growth without investing our capital in the form of cash royalty advances or purchase price. However, depending on competitive market conditions, we may offer cash advances to certain substantial content owners under existing short-term distribution agreements as an inducement to extend their agreements with us.

**Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK****Foreign Exchange Risk**

We receive payments from digital entertainment services in U.S. dollars for all sales to consumers in the United States. For those digital entertainment services which sell our music and video content to consumers in foreign countries, the monthly or quarterly sales and payments to us are based on local currency, which we convert to U.S. dollars at the market-based foreign exchange rate at time of receipt. For the six months ended June 30, 2007, approximately 17% of our revenue was derived on this basis from consumers outside of the U.S. As a result, we have foreign currency exposure to fluctuations in foreign currency exchange rates with respect to a portion of our revenue. Our foreign currency net loss for the six months ended June 30, 2007 was \$16,688.

**Interest Rate Risk**

The primary objective of our investment activities is to preserve principal. We do not use derivative financial instruments in our investment portfolio and have no foreign exchange contracts. Our financial instruments consist of cash and cash equivalents, marketable securities, trade accounts and contracts receivable, accounts payable, royalties payable and long-term obligations. Based on our investment policy, we may invest our cash primarily in a variety of financial instruments, consisting principally of investments in highly-rated commercial paper, United States treasury obligations, United States and municipal government agency securities, United States government sponsored enterprises, demand deposit accounts with financial institutions, money market funds and highly liquid debt securities of corporations. We consider investments in highly liquid instruments purchased with an original maturity or remaining maturity of 90 days or less at the date of purchase to be cash equivalents. Based on our cash and cash equivalents of approximately \$14 million at June 30, 2007, a one percent per annum change in interest rates could cause a change in our interest income of approximately \$140,000 per year. Due to the investment grade level of our investments, we anticipate minimal market rate risk exposure.

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**Item 4. CONTROLS AND PROCEDURES**

Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms. Our disclosure controls and procedures are designed to provide reasonable assurance that such information is accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. There was no change in our internal control over financial reporting that occurred during the three months ended June 30, 2007 that has materially affected or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II OTHER INFORMATION**

**Item 1. LEGAL PROCEEDINGS**

From time to time our Company becomes involved in commercial and contractual disputes, disagreements and legal proceedings arising in the ordinary course of business, which we typically seek to resolve through direct negotiations with the principals or representatives of the party involved. Management does not believe that the outcome of these disputes, disagreements or legal proceedings, individually, or in the aggregate, will have a materially adverse effect on our financial condition, results of operations or cash flows.

**Item 1A. RISK FACTORS**

A restated description of the risk factors associated with our business is set forth below. This description includes any material changes to and supersedes the description of the risk factors associated with our business as previously disclosed in Part 1A of our Annual Report on Form 10-K for the year ended December 31, 2006.

In addition to the other information contained in this Quarterly Report on Form 10-Q, we have identified the following risks and uncertainties that may have a material adverse effect on our business, financial condition, or results of operation. Investors should carefully consider the risks described below before making an investment decision. The trading price of our common stock could decline due to any of these risks, and investors may lose all or part of their investment.

*We cannot assure you that all conditions to the merger with The Orchard Enterprises, Inc. will be completed and the merger consummated.*

The merger is subject to the satisfaction of closing conditions, including the approval of our stockholders, and we cannot assure you that the merger will be completed. In the event the merger is not completed, we may be subject to many risks, including the costs related to the proposed merger, such as legal, accounting, and advisory fees, which must be paid even if the merger is not completed, or the payment of the previously described termination fee to Orchard under specified circumstances. If the merger is not completed, the market price of our common stock could decline.

*We have a limited operating history, have experienced net losses to date and may not be able to become profitable or generate positive cash flow in the future.*

You should consider our business and prospects in light of the risks, expenses and difficulties encountered by companies in their early stage of development in a rapidly evolving industry. Digital Music Group, Inc. was formed in April 2005 and had no revenue producing operations until February 2006. We have experienced net losses of approximately \$6.7 million from inception through June 30, 2007, and we have not yet been able to consistently generate positive cash flow from operations. We cannot be certain that we will be able to generate net income and positive cash flow from operations in the future.

*As a result of our limited operating history, we may fail to meet our forecasts or the expectations of securities analysts or investors, which could cause our stock price to decline.*

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Our limited operating history and the rapidly evolving nature of our industry make forecasting quarterly and annual operating results difficult. We may not be able to quickly reduce spending if our revenue is lower than we project. Any

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significant increase in our expenses or shortfall in our revenue would be detrimental to our business, operating results and financial condition and could cause our results of operation to fall below the expectations of public market analysts and investors. As a result, you should not rely on our historical results as an indicator of our future performance.

***We have limited operating history in the acquisition, processing and distribution of digital video content and we may not be able to successfully acquire, process and market our video content.***

The approach we have taken to date in acquiring, processing and marketing music content may not work as well for video content. The distribution of digital video content through digital entertainment services is a relatively new extension of the digital entertainment marketplace. During the second half of 2006, we entered into our first long-term agreements to digitally distribute video content. Because this is a new area of the market for us and the industry, we may not be able to determine the proper valuation for the acquisition or licensing of digital rights to video content. We are substantially dependent on digital entertainment services for the distribution of our video content and we currently have only a limited number of such distribution agreements in place. If we are unable to enter into additional video distribution agreements on commercially favorable terms, this could limit our revenue. Additionally, our agreements with certain digital entertainment services are based on sharing advertising revenue associated with the video content we make available through such partners. Advertising-supported revenue models associated with the distribution of video content are evolving, with many of our partners still in the test-marketing phase of developing their video distribution services. There can be no assurances as to the potential revenue that we may receive under these models. In addition, our success in digitally distributing video content depends on the market demand for digital video recordings and our ability to acquire and offer for purchase or advertising-supported viewing, video content that appeals to consumers' tastes and preferences. Consumers' tastes are subject to frequent, significant and sometimes unpredictable changes. We cannot accurately assess or control consumer demand for our digital video content. In addition, digital video distribution is in its infancy and technical requirements are evolving. The process for digitally encoding video content and packaging it for delivery to meet the technical requirements of our digital entertainment service partners is more complex and time consuming than processing music content. The technical requirements continue to evolve and we may encounter unexpected difficulties in adapting our processes or in meeting the technical requirements of the digital entertainment services as they continue to be refined. If this is the case, we may have to make significant investments in our technology and operating cost structure to meet evolving technical requirements. Any delay in processing and delivering video content to the digital entertainment services may cause delays in expected revenue growth and any significant changes to our current processing requirements could increase our costs and delay or impede our ability to achieve a profit from the distribution of our video content. Additionally, based on our experience to-date, a number of our digital entertainment service partners have initially limited the amount and type of video content they will accept from us based on their capacity constraints and/or content selection criteria. If digital entertainment services continue to limit the types or amount of video content they will accept from us and we are unable to exploit all of the video content we have under contract, our revenue potential could be significantly reduced and we may have to record write-downs of certain royalty advances made to secure long-term video distribution agreements.

***If the music and video content we provide to digital entertainment services does not appeal to consumers' tastes and preferences, our revenue will decrease.***

Our success depends on our ability to acquire and offer to consumers, music and video content that appeals to consumers' tastes and preferences. Consumers' tastes are subject to frequent, significant and sometimes unpredictable changes. We cannot accurately assess or control consumer demand for our music and video content. Our historical revenue is based on the number of music recordings available for purchase, which remained relatively small in numbers until late in 2006, and which overall have been available for only a short amount of time at the digital entertainment services. Seasonality and other trends have been difficult to assess from this limited historical data. In the future, our current music and video content and the additional music and video content we make available to consumers may not experience similar demand. Any reduction in the popularity of our music and video content with consumers will cause a reduction in our revenue.

***Our business involves identifying and locating the holders of digital rights to additional music and video content, and failure to do so will limit our revenue growth.***

Our goal is to continue to acquire digital rights to music and video content in order to increase our revenue. Ownership of music and video content is highly fragmented and not organized in a common marketplace. There is no registry or directory of the holders of content owners and finding them can be difficult and time-consuming. We currently rely on our network of relationships and market research to locate content owners. In the future, our ability to continue to identify and locate such content owners will have a significant impact on the amount of content we are able to acquire.

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***Our inability to enter into agreements to acquire additional digital rights to music and video content on commercially favorable terms could impede our growth and increase our expenses.***

Our business is dependent on our ability to acquire digital rights to additional music and video content. Even if we are able to locate additional content owners, they may not be willing to sell or license their digital rights or we may not be able to negotiate terms that are commercially favorable to us. While we believe that our experience and knowledge in the music industry and our operating history, and our reliance on consultants with expertise in the television and film video industries, allows us to determine commercially reasonable prices for music and video content, we may be unable to objectively determine fair market value for the digital rights to the content that we acquire because of unknown consumer demand for such content, unknown number of additional owners of digital rights to such content in certain cases and absence of independent valuations for music and video content. If content owners are unwilling to sell or license their rights on terms that we have determined are commercially favorable to us, we will not be able to substantially increase our revenue.

***We face competition from companies seeking to acquire the digital rights to music and video content, which could negatively impact our ability to acquire additional digital rights.***

The market for acquiring digital rights from content owners is competitive, especially for the distribution of music catalogs owned by independent labels. The number of commercialized music and video recordings available for acquisition is large, but limited, and many of the more desirable music recordings are already subject to digital distribution agreements or have been directly placed with digital entertainment services. We face competition in our pursuit to acquire additional music and video content, which may limit the amount of available music and video content for sale or license and may lead to higher acquisition prices. Our competitors may from time to time offer better terms of acquisition to content owners. Several of our competitors have longer operating histories, larger customer bases, greater brand recognition and greater financial, marketing and other resources than we do. Recently, subsidiaries of the four major record labels, which have always aggressively competed to provide physical distribution for independent labels, have become increasingly active in the digital market segment. These companies have the ability to offer the consolidation of both physical and digital distribution through a major record label, while we are focused only on the digital distribution of music and video content. Some of our competitors have adopted, and may continue to adopt, aggressive pricing policies and devote substantially more resources to acquiring digital rights to music and video recordings. In addition, our competitors may form strategic alliances with record labels and digital entertainment services that could result in increased competition for the acquisition of music recordings, service offerings or favorable terms with the digital entertainment services. Increased competition for the acquisition of digital rights to music and video recordings may result in a reduction in our operating margins, market share and brand.

***We have entered into multi-year agreements for digital rights to music and video content and if we are unable to renew these agreements on commercially favorable terms once they expire, our revenue could materially decrease.***

Our long-term success depends upon, among other things, our ability to renew our non-perpetual rights to music and video content once they expire. As of June 30, 2007, approximately 35% of our music content was distributed under short-distribution agreements that expire in one to three years depending on certain factors. We are aware that our competitors have solicited a number of the record labels we have under short-term distribution agreements, just as we have solicited their record label clients in this highly competitive market. While we do not expect any material decrease in revenue and gross profit from these activities, if our competition becomes increasingly aggressive or our level of service provided to our record label clients is not superior to our competition, we may experience a higher rate of non-renewal than we have in the past for our short-term digital distribution agreements. If any of our competitors offer better terms, it could cause us to spend more money or grant better terms, or both, to renew the digital rights we currently hold. If we are unable to renew the non-perpetual rights to our music and video content on commercially favorable terms, our revenue could materially decrease.

***The digital music industry is evolving and we are vulnerable to discounting, price-reductions, pricing structure and stocking changes that may evolve in the industry and as a result, cause a reduction in our revenue.***

We receive revenue based on the wholesale prices determined by the digital music retailers based, to a large extent, on the price they charge to consumers. Currently, the largest digital music retailer, Apple iTunes, charges consumers \$0.99 to \$1.29 per music recording downloaded in the United States and at comparable rates in local currency for consumers outside the United States. We have limited ability to influence the pricing models of the digital entertainment services. While the major record labels were unsuccessful in their recent attempt to change the pricing structure, there is no assurance that they will not attempt to change the pricing structure in the future or that the digital music retailers will not initiate such a change that could result in lower pricing or tiered pricing that could reduce the amount of revenue we receive. In addition, the popularity of digital music retailers that offer digital music through subscription and other pricing models is increasing. For example, eMusic, a subscription-based music service





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is now the second largest digital music retailer in the world. The revenue we earn per individual music recording is generally less under these models than what we receive from Apple iTunes, although we expect it will increase as more subscribers are added. Additionally, digital music services at present generally accept all the music content that we and other distributors deliver to them. However, if the digital music services in the future decide to limit the types or amount of music recordings they will accept from content owners and distributors like us, or limit the number of music recordings they will post for sale, or change their current stocking plans, for instance by removing music recordings that do not meet minimum sales thresholds or other criteria, our revenue could be significantly reduced.

***Other parties may have digital rights, or claim to have such rights, to our music content, which may result in duplicates of the music recordings we sell to be available for purchase at the digital music services and cause a reduction in our revenue.***

We generally acquire all of the digital rights that the owner of music content has available to grant; however, the holders of such rights may not possess exclusive rights to those music recordings. We are unable to determine the number of additional holders of rights to our music recordings. Aside from copyright law, the rights to music recordings are contractual in nature. There is no central registry that evidences the chain of title to the rights of music recordings other than copyright registration, which is voluntary. Given the age of many of the music recordings we have or may acquire, there is often a lack of documentation to evidence the chain of title of rights we acquire. In addition, there is a common practice in the music industry of licensing rights in various formats or in certain compilations and to grant the same rights to different parties for the same or different geographic regions. Our content acquisition agreements contain representations, warranties and indemnities only with respect to the digital rights granted to us and not with respect to the rights held by other parties. More than one party may have the right to sell the same music recording we have acquired, and we may in the future acquire rights to multiple copies of the same music recording. In such instances, we become entitled to payment for download activity for both copies, to the extent they are both purchased by consumers at the digital music services. Additionally, we are aware of numerous instances where other parties have digital rights to the same music recordings to which we have digital rights. If copies of our music recordings are available at the digital music services from alternative sources, our revenue will be reduced to the extent these copies are purchased instead of ours.

***We may not receive legal title to the digital rights of music content that we have paid to acquire, and any determination that we do not hold such rights may subject us to damages for revenue received.***

Our acquisition and distribution agreements with content owners contain representations, warranties and indemnities with respect to the digital rights granted to us. In at least one instance, we purchased digital rights that were determined not to be held by the holder from whom we acquired those rights. If we were to acquire and make available for purchase music recordings from a person who did not actually own such rights and we were unable to enforce or collect on the representations, warranties and indemnities made by such person, our business would be adversely affected. We would lose the rights to sell such music and might be subject to copyright infringement lawsuits for selling such music recordings without the right to do so. Finally, it could materially impact our reputation with content owners and our relationships with digital music services, which could adversely affect our business.

***If content owners fail to deliver, or if there are long delays in the time it takes to receive the music and video content that we acquire rights to, our revenue growth will be negatively impacted and our cash flow will be affected adversely.***

Implementation of our business plan and growth strategy depends on increasing the amount of music and video content we have available to consumers at digital entertainment services. Our purchase and long-term distribution agreements typically require the owners to deliver to us their music and video content under an agreement delivery timetable. Under our short-term distribution agreements, there are no delivery terms. Some of the content we acquire may be in older physical formats such as audio tape or vinyl records in the case of music recordings, or film, tape or other incompatible digital format in the case of video recordings, that require processing onto compact disc or digital video disc prior to being delivered to us. In addition, our agreements require that certain descriptive information required by the digital entertainment services for each music and video be delivered with the content, such as recording title, album title, artist name, genre, copyright information, label name, unique product identifier, artwork, biographical information, sales information and date of release. Historically, it has, at times, taken several months or longer after we have entered into an agreement before we have received delivery of the music and video content acquired. In addition, in some cases the quality of the music and videos and metadata initially delivered is not sufficient or the data is not complete and follow-up work and effort is required to receive proper and complete delivery, although even with such extra efforts there are no assurances such problems can be cured. Although we generally specify delivery dates and make cash payments by us conditional upon delivery, we do not control the timing for complete receipt of the music and video content we have acquired. In addition, in certain cases, content owners have over

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delivered and in other have been unable to deliver all of the content specified in our agreements. During the first quarter of 2007, we determined that one content owner that has granted us long-term distribution rights would be unable to deliver approximately 13,000 music recordings under contract and that an additional 10,000 music recordings previously delivered would not be able to be posted for sale due to various reasons. These factors reduced the contract from a total of 75,000 music recordings to approximately 52,000 music recordings that we expect to be able to make available for sale. We are typically not required to pay additional consideration for deliveries in excess of contract amounts and are not required to make cash payments for the content that was not delivered, or is defective or otherwise non-usable. However, our expected revenue growth rate is negatively impacted when we do not receive all the content we have contracted for. If there are long delays in the time it takes for the owners to deliver to us the music and video content in physical format or complete data format and the related complete descriptive information, it will delay our ability to begin the process of converting the content into the digital formats required by digital entertainment services. It could also cause inefficiencies in the utilization of our operations personnel who process these recordings. Any delay in making our music and video content available for purchase at the digital entertainment services will delay our revenue growth, and inefficiencies caused by such delays could cause a reduction in our cash flow in the interim.

***Any extended delay by digital entertainment services in processing and making our music and video content available to consumers causes a delay in our ability to earn revenue from such content.***

Following receipt of music and video content from the owners, we convert them into the specific digital formats required by digital entertainment services. We then deliver the music and video content in digital format, together with their associated descriptive information and artwork, to the digital entertainment services to be made available to consumers in the specific territories where we have acquired the digital rights. The digital entertainment services must then review our music and video content, descriptive information and artwork to ensure that they are in the proper format for their store or service. The content is only made available to consumers once the digital retailer or service has completed its review, encrypted the content with the particular retailer's digital rights management protection and other retailer or service-specific coding, and posted the digital files on the retailer's or services' computer servers. We are subject to the digital entertainment services' internal processing timing and priorities. Our agreements with the digital entertainment services do not provide for a fixed processing time. Our experience has been that the review and posting process takes several weeks to several months. Any extended delay in making our music and video content available to consumers causes a delay in when we can begin to earn revenue and return on investment from our content.

***Piracy is likely to continue to negatively impact our potential revenue.***

Our revenue comes from the sale of our digital content over the Internet and wireless and cable and mobile networks, which is subject to unauthorized consumer copying and widespread dissemination on the Internet without an economic return to us. Global piracy is a significant threat to the entertainment industry generally and to us. Unauthorized copies and piracy have contributed to the decrease in the volume of legitimate sales of music and video content and have put pressure on the price of legitimate sales.

***We may need to raise additional capital to accomplish our objectives of acquiring additional digital rights to music and video content, and if we are unable to raise such money as needed our growth would be limited.***

We may use our common stock in addition to our cash for the consideration for future acquisitions of digital rights to additional music and video content. If our common stock does not maintain a sufficient market value or content owners are unwilling to accept common stock as part of the consideration for the sale of the digital rights to their music and video content or their businesses or as consideration for licensed rights to their music and video content, we may be required to utilize more of our cash resources, if available. Although we currently anticipate that the proceeds from our February 2006 initial public offering of common stock will be sufficient to meet our cash needs for 2007, we may require additional financing in the future. If we do not have sufficient cash resources, our ability to acquire additional rights to music and video content could be limited unless we are able to obtain additional capital through future debt or equity financings. Our ability to obtain financing will depend, among other things, on our development efforts, business plans, operating performance and condition of the capital markets at the time we seek financing. Additional financing may not be available to us on favorable terms when required, or at all. Using cash to finance acquisitions could substantially limit our financial flexibility and using debt could result in financial covenants that limit our operations and financial flexibility. If we raise additional funds through the issuance of equity, equity-linked or debt securities, those securities may have rights, preferences or privileges senior to the rights of our common stock, and our stockholders may experience dilution.

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***We may acquire record labels or other companies that own master rights to music or video content, and if we are unable to successfully acquire or integrate these companies, we may not be able to acquire additional content or grow our revenue.***

We may attempt to acquire record labels or other companies that own master rights to music or video content for purposes of acquiring their digital rights. If we are not able to successfully acquire such companies, we may not be able to acquire additional content or grow our revenue. In the event we are able to acquire other companies, we may be subject to a number of risks related to the integration and management of such companies, including failure to obtain valid consents to assignment of contracts, including contracts granting rights to music content, failure of the business of the acquired company to achieve expected results, diversion of management's attention, and failure to retain key personnel of the acquired company. In addition, if we undertake an acquisition of a company that owns digital and other rights to music and video content, we may attempt to operate the non-digital businesses or sell the non-digital rights to another person or entity, and we may not be able to do so in a manner or on terms favorable to us.

***We are substantially dependent on a limited number of digital entertainment services, in particular Apple iTunes Store, for the sale of our content.***

We derive our revenue from a small number of leading digital entertainment services that make our content available to consumers. We generally deliver our music and video content to these digital entertainment services in priority of their significance to us. We received 56% and 89% for the three months ended June 30, 2007 and 2006 and 63% and 89% for the six months ended June 30, 2007 and 2006 of our total revenue from Apple iTunes, respectively. Our agreements with Apple iTunes have terms of three years ending in April 2010 and DRA's agreements with Apple iTunes expire in December 2008. If we are not able to continue to renew our relationships with Apple iTunes and other digital entertainment services that make our music and video content available to consumers on similar economic terms, our ability to generate revenue will be significantly reduced.

***Our accounts receivable are concentrated with a limited number of digital entertainment services, particularly Apple iTunes, which subjects us to substantial payment risk.***

We rely on reports from digital entertainment services detailing download and other activity to determine our revenue, and such reports are typically provided to us within 30 to 45 days following the end of the reporting period. We receive payment at approximately the same time as we receive these detailed revenue reports. Our accounts receivable therefore consists of approximately one month's revenue (or one quarter in the case of certain digital entertainment services that report quarterly). As of June 30, 2007, accounts receivable from Apple iTunes Store represented 40% of our total accounts receivable, compared to 74% of our total accounts receivable as of June 30, 2006. The concentration of our accounts receivable among a small number of digital entertainment services is likely to continue and we expect our accounts receivable to become larger as we grow. While we have never had a bad debt loss since inception, if any of these digital entertainment services are unable to pay us as due each month (or quarter, as the case may be), it could disrupt our business and cause us to report a bad debt loss.

***If we are not able to scale our reporting and payment processes, we may experience delays providing reports to the content owners and paying required royalties that could have a negative effect on our brand identity.***

We receive regular sales reports from digital entertainment services that contain sales information for our music and video content. Based on these reports, we provide summary reports to the content owners. When we acquire the perpetual digital rights to music content and in certain of our distribution agreements, we may assume the obligations of the content owner to pay any required royalty payments to the artists according to the terms of the existing agreements. In addition, we may be required to pay statutory publishing royalties on behalf of the content owner according to the terms of our agreements. As we acquire digital rights to additional music and video content, we may experience difficulties in preparing and distributing sales reports for the content owners or processing and paying artist and publishing royalties in a timely fashion. If we are not able to successfully expand our processing capability or introduce technology to allow us to determine and pay royalty amounts due and automate these tasks, we may experience delays as we increase the volume of our music and video content, which could have a negative effect on our relationships with content owners and brand identity.

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***The loss of one or more of our key personnel, or our failure to attract, assimilate and retain other highly qualified personnel in the future, could cause a disruption in our relationships with the digital entertainment services and content owners.***

We depend on the continued services and performance of our key personnel. Although we have employment agreements with our executive officers, they may decide to terminate their employment or otherwise cease to be employed by us. We do not have key person life insurance for any of our personnel. In the past year, four of our founding officers have left our Company. As we grow, our business will be dependent on our ability to recruit, employ and retain additional management and other skilled personnel. The loss of the services of any of our key personnel or the failure to attract other key personnel could disrupt and limit our ability to grow our business.

***We face a potential loss of music content if it is determined that recording artists have a right to recapture rights in their content under the U.S. Copyright Act.***

The U.S. Copyright Act provides authors and their heirs a right to terminate licenses or assignments of rights in their copyrighted works that were not works made for hire. If any of our music content were determined not to be works made for hire, then the recording artists or their heirs could have the right to terminate the rights we hold. These residual author rights generally survive for five years after the end of the 35-year period from the date of a post-1977 license or assignment, and in the case of a pre-1978 grant in a pre-1978 recording, five years after the end of the 56-year period from the date of creation or January 1, 1978, whichever is later. Any termination of our rights to our music content could have a material reduction in our revenue.

***If the Internet and portable digital music and video players and mobile phones cease to be the medium accepted by the mass market for digital music and video content, our business could be affected adversely.***

Our success depends to a substantial extent on the willingness of consumers to increase their use of digital entertainment services as a method of purchasing music and video content or viewing ad-supported content. The use of the Internet and wireless, cable and mobile networks to select and download purchased music and video content is growing rapidly but is still evolving, and offering ad-supported video content is in its infancy. It is uncertain whether these markets will achieve and sustain high levels of demand and market acceptance. If the use of the Internet and wireless, cable and mobile networks to select and purchase music and video content or view ad-supported content does not gain in popularity and market acceptance, our business could be adversely affected. Much of our revenue is currently tied to the popularity of portable digital music players like the iPod by Apple Inc. and other digital music listening and video viewing devices. If the market penetration by these devices does not continue, the number of consumers purchasing digital music and video content may decrease or not grow, which could result in a reduction in our revenue.

***Provisions in our charter documents and under Delaware law could discourage a takeover that stockholders may consider favorable.***

Our charter documents may discourage, delay or prevent a merger or acquisition that a stockholder may consider favorable because they:

authorize our board of directors, without stockholder approval, to issue up to 1,000,000 shares of undesignated preferred stock; and

establish advance notice requirements for proposing matters to be approved by stockholders at stockholder meetings.

As a Delaware corporation, we are also subject to the Delaware anti-takeover provisions contained in Section 203 of the Delaware General Corporation Law. Under Delaware law, a corporation may not engage in a business combination with any holder of 15% or more of its capital stock unless the holder has held the stock for three years or, among other things, the board of directors has approved the transaction. Our board of directors could rely on this provision to prevent or delay an acquisition of us.

***Our stock price is subject to fluctuation and could decline.***

The price at which our common stock has traded since our initial public offering in February 2006 has fluctuated significantly. The price is likely to continue to fluctuate significantly due to the following factors, some of which are beyond our control:

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imbalances between the market supply and demand for shares of our stock due to the limited number of shares available in the public float;

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variations between our actual operating results and the expectations of securities analysts, investors and the financial community;

announcements of developments affecting our business, systems or expansion plans by us or others; and

conditions and trends in online commerce industries, particularly in the digital entertainment services.

As a result of these and other factors, investors in our common stock may not be able to resell their shares at or above their purchase price.

In addition, sales of substantial amounts of our common stock by our existing stockholders in the public market following the expiration during 2007 of lock-up agreements entered into in connection with our initial public offering completed in February 2006 and compliance with Rule 144 holding periods may adversely affect the future market price of our common stock. Shares issued upon the exercise of outstanding options granted to our employees and directors also may be sold in the public market. Such sales could create the perception to the public of difficulties or problems with our business. As a result, these sales might make it more difficult for us to sell securities in the future at a time and price that we deem necessary or appropriate.

In the past, securities class action litigation often has been instituted against companies following periods of volatility in the market price of their securities. We maintain Directors and Officers liability insurance for this type of litigation. However if such litigation is directed at us, it could result in substantial costs, including the deductible amount under our insurance policy and other indirect costs and a diversion of management's attention and resources.

***We do not intend to pay dividends.***

We have never declared or paid any cash dividends on our capital stock and do not intend to pay dividends in the foreseeable future. We intend to invest our future earnings, if any, to fund our growth. We cannot assure you that you will receive a return on your investment when you sell your shares or that you will not lose the entire amount of your investment.

***Our internal controls over financial reporting may not be adequate and our independent auditors may not be able to certify as to their adequacy, which could have a significant and adverse effect on our business and reputation.***

We are in the process of documenting and evaluating our internal controls over financial reporting in order to allow management to report on such controls, as required by Section 404 of the Sarbanes-Oxley Act of 2002 for the year ended December 31, 2007. Section 404 requires a reporting company to, among other things, annually review and disclose its internal controls over financial reporting, and evaluate and disclose changes in its internal controls over financial reporting quarterly. We are currently performing the systems and process documentation, evaluation and testing required (and any necessary remediation) in an effort to comply with the management certification requirements of Section 404. In the course of our ongoing evaluation, we may identify areas of our internal controls requiring improvement, and plan to design enhanced processes and controls to address issues that might be identified through this review. As a result, we expect to incur additional expenses and diversion of management's time. We cannot be certain as to the timing of completion of our documentation, evaluation, testing and remediation actions or the impact of the same on our operations and may not be able to ensure that the process is effective or that the internal controls are or will be effective in a timely manner. If we are not able to implement the requirements of Section 404 in a timely manner or with adequate compliance, we may not be able to certify as to the effectiveness of our internal control over financial reporting and we may be subject to sanctions or investigation by regulatory authorities, such as the Securities and Exchange Commission. As a result, there could be an adverse reaction in the financial markets due to a loss of confidence in the reliability of our financial statements. In addition, we may be required to incur costs in improving our internal control system and the hiring of additional personnel. Any such conditions could adversely affect our results.

**Table of Contents****Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS****Use of Proceeds**

Through June 30, 2007, we have used a portion of the \$33.2 million in net cash proceeds from our initial public offering in February 2006, including \$3,981,000 to acquire digital rights and master recordings; \$9,629,000 to advance royalty payments for catalogs to be distributed under long-term license agreements; \$1,028,000 for capital expenditures for processing and encoding equipment and upgrades to our royalty payment system; and for general corporate purposes, including funding working capital requirements. We also used \$3,467,000, net of cash received, in partial consideration for the acquisition of Digital Rights Agency, LLC in September 2006. We had approximately \$14 million in cash and cash equivalents as of June 30, 2007 that is designated primarily for the acquisition of digital music and video content and for general corporate purposes.

**Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

The 2007 Annual Meeting of Stockholders of Digital Music Group, Inc. was held on June 5, 2007. The following matters were voted on at the meeting: (i) the election of eight directors and (ii) the ratification of the appointment of Perry-Smith LLP to serve as the independent registered public accountants for the year ending December 31, 2007.

- (i) The following nominated directors were elected and the votes cast for or withheld with respect to the election of each director was as follows:

| Name               | Number of Votes |          |
|--------------------|-----------------|----------|
|                    | Cast For        | Withheld |
| David Altschul     | 4,598,888       | 342,615  |
| Roger Biscay       | 4,598,888       | 342,615  |
| Peter Csathy       | 4,598,888       | 342,615  |
| Terry Hatchett     | 4,598,888       | 342,615  |
| John Kilcullen     | 4,598,888       | 342,615  |
| Mitchell Koulouris | 4,596,738       | 344,765  |
| Tuhin Roy          | 4,596,738       | 344,765  |
| Clayton Trier      | 4,598,888       | 342,615  |

- (ii) The votes cast for, against or abstaining with respect to the ratification of the appointment of Perry-Smith LLP as independent registered public accountants of Digital Music Group, Inc. for the fiscal year ending December 31, 2007 were as follows:

| For       | Against | Abstain | Broker Non-Vote |
|-----------|---------|---------|-----------------|
| 4,928,834 | 162     | 12,507  | 0               |



**Table of Contents****Item 6. EXHIBITS**

| <b>Exhibit</b> |  | <b>Incorporated By Reference</b> |                 |                |                       | <b>Filed<br/>Herewith</b> |
|----------------|--|----------------------------------|-----------------|----------------|-----------------------|---------------------------|
| <b>Number</b>  | <b>Exhibit Description</b>   | <b>Form</b>                      | <b>File No.</b> | <b>Exhibit</b> | <b>Filing Date</b>    |                           |
| 2.1            | Agreement and Plan of Merger as of July 10, 2007   | 8-K                              | 000-51761       | 2.1            | July 16, 2007         |                           |
| 3.1            | Amended and Restated Certificate of Incorporation.   | S-1                              | 333-128687      | 3.2            | February 1,<br>2006   |                           |
| 3.2            | Amended and Restated Bylaws.   | 8-K                              | 000-51761       | 3.1            | July 16, 2007         |                           |
| 4.1            | Form of Registrant's Common Stock Certificate.   | S-1                              | 333-128687      | 4.1            | February 1,<br>2006   |                           |
| 4.2            | Form of Warrant to Purchase Registrant's common stock.   | 8-K                              | 000-51761       | 4.1            | February 10,<br>2006  |                           |
| 4.3            | Warrant to Purchase Common Stock dated as of September 8, 2006 by and between Digital Music Group, Inc. and Tuhin Roy.   | 8-K                              | 000-51761       | 4.1            | September 11,<br>2006 |                           |
| 10.1           | Form of Indemnification Agreement by and between Registrant and each of its directors and officers.  | S-1                              | 333-128687      | 10.1           | February 1,<br>2006   |                           |
| 10.2           | Amended and Restated 2005 Stock Plan.  | S-1                              | 333-128687      | 10.2           | February 1,<br>2006   |                           |
| 10.3           | Second Amended and Restated Stockholders Agreement dated September 8, 2005 by and among Digital Musicworks International, Inc. (now Registrant) and certain of its stockholders. | S-1                              | 333-128687      | 10.3           | February 1,<br>2006   |                           |
| 10.4           | Office Lease Agreement dated March 20, 2006 between Registrant and CA-Gateway Oakes Limited Partnership.   | 10-Q                             | 000-51761       | 10.4           | May 15,<br>2006       |                           |
| 10.5           | Office Lease Agreement dated July 16, 2006, between Digital Rights Agency, LLC and Hamms Building Associates, assumed by the Registrant.   | 10-Q                             | 000-51761       | 10.33          | November 14,<br>2006  |                           |
| 10.6           | Non-Competition and Non-Solicitation Agreement dated September 12, 2005 between Registrant and Mitchell Koulouris.   | S-1                              | 333-128687      | 10.10          | February 1,<br>2006   |                           |
| 10.7           | Non-Competition and Non-Solicitation Agreement dated September 12, 2005 between Registrant and Anders Brown.   | S-1                              | 333-128687      | 10.11          | February 1,<br>2006   |                           |
| 10.8           | Non-Competition and Non-Solicitation Agreement dated September 12, 2005 between Registrant and Peter Koulouris.  | S-1                              | 333-128687      | 10.12          | February 1,<br>2006   |                           |
| 10.9           | Non-Competition and Non-Solicitation Agreement dated September 22, 2005 between Registrant and Richard Rees.   | S-1                              | 333-128687      | 10.13          | February 1,<br>2006   |                           |
| 10.10          | Non-Competition and Non-Solicitation Agreement dated September 8, 2006 between Registrant and Tuhin Roy.   | 10-Q                             | 000-51761       | 10.30          | November 14,<br>2006  |                           |

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|        |  |      |            |       |                   |
|--------|--|------|------------|-------|-------------------|
| 10.11  | Employment Agreement dated September 13, 2005 with Mitchell Koulouris, President and Chief Executive Officer and Director of Registrant, as amended by Amendment No. 1 to Employment Agreement dated September 10, 2006. | S-1  | 333-128687 | 10.14 | February 1, 2006  |
| 10.12  | Employment Agreement dated September 13, 2005 with Anders Brown, Chief Operating Officer of Registrant, as amended by Amendment No. 1 to Employment Agreement dated September 10, 2006.                                  | S-1  | 333-128687 | 10.15 | February 1, 2006  |
| 10.13  | Employment Agreement dated March 22, 2006 with Karen Davis, Chief Financial Officer and Corporate Secretary of Registrant, as amended by Amendment No. 1 to Employment Agreement dated September 10, 2006.               | 10-Q | 000-51761  | 10.18 | May 15, 2006      |
| 10.14  | Employment Agreement dated September 8, 2006 with Tuhin Roy, Chief Strategy Officer of Registrant.   | 10-Q | 000-51761  | 10.29 | November 14, 2006 |
| 10.15  | Management Incentive Bonus Plan for the Year Ended December 31, 2006.  | 10-Q | 000-51761  | 10.19 | August 14, 2006   |
| 10.16  | Notice of Termination dated July 10, 2007 of Mitchell Koulouris  | 8-K  | 000-51761  | 10.1  | July 16, 2007     |
| 10.17* | Digital Music Download Sales Agreement dated March 30, 2004 between Apple Computer, Inc. and Digital Musicworks International, Inc. (now Registrant).  | S-1  | 333-128687 | 10.22 | February 1, 2006  |
| 10.18* | Digital Music Download Sales Agreement dated March 2, 2004 between Apple Computer, Inc. and Rio Bravo Entertainment LLC dba Psychobaby, assumed by Registrant.   | S-1  | 333-128687 | 10.23 | February 1, 2006  |
| 10.19* | Digital Music Download Sales Agreement effective as of April 2, 2007, between Apple Inc. and Registrant.   | 10-K | 000-51761  | 10.24 | March 30, 2007    |
| 10.20* | Digital Music Download Sales Agreement dated April 2, 2007 between iTunes S.a.r.l. and Registrant.   | 10-K | 000-51761  | 10.25 | March 30, 2007    |
| 10.21* | Deal Memorandum dated February 7, 2005 between Carinco AG and Digital Musicworks International, Inc. (now Registrant).   | S-1  | 333-128687 | 10.19 | February 1, 2006  |
| 10.22* | Digital Rights Purchase Agreement dated August 26, 2005 between CASCADE GmbH and Digital Musicworks International, Inc. (now Registrant).  | S-1  | 333-128687 | 10.20 | February 1, 2006  |
| 10.23* | Deal Memorandum dated June 15, 2005 between San Juan Music Group and Digital Musicworks International, Inc. (now Registrant).  | S-1  | 333-128687 | 10.21 | February 1, 2006  |

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|        |   |      |            |       |                    |   |
|--------|---|------|------------|-------|--------------------|---|
| 10.24* | Digital Distribution Agreement dated as of October 1, 2005 between Fulfill aka Artful Records and Rio Bravo Entertainment, LLC dba Psychobaby, assumed by Registrant.   | S-1  | 333-128687 | 10.24 | February 1, 2006   |   |
| 10.25* | Portal Agreement dated September 9, 2004 between Green Linnet Records Inc. and Rio Bravo Entertainment, LLC dba Psychobaby, assumed by Registrant.  | S-1  | 333-128687 | 10.25 | February 1, 2006   |   |
| 10.26* | Distribution Agreement dated September 29, 2005 between LICENSEMUSIC.COM ApS and Digital Musicworks International, Inc. (now Registrant), as amended by Amendment No. 1 dated January 29, 2006.   | S-1  | 333-128687 | 10.27 | February 1, 2006   |   |
| 10.27* | Digital Distribution Agreement dated September 12, 2006 between TufAmerica, Inc. (d/b/a/ Tuff City and Night Train Music Group) and the Registrant.   | 10-Q | 000-51761  | 10.32 | November 14, 2006  |   |
| 10.28  | Agreement and Plan of Merger dated as of September 8, 2006, by and among Digital Music Group, Inc., Longtail Acquisition Corp., Digital Rights Agency LLC, Tuhin Roy and Rapfogel Partners Ltd.   | 8-K  | 000-51761  | 2.1   | September 11, 2006 |   |
| 10.29  | Lock Up Agreement dated September 8, 2006 between Registrant and Tuhin Roy.   | 10-Q | 000-51761  | 10.31 | November 14, 2006  |   |
| 10.30  | Amendment dated June 21, 2007 by and between Digital Music Group, Inc. and Tuhin Roy, to the Agreement and Plan of Merger dated as of September 8, 2006, by and among Digital Music Group, Inc., Longtail Acquisition Corp., Digital Rights Agency LLC, Tuhin Roy and Rapfogel Partners Ltd | 8-K  | 000-51761  | 2.1   | June 26, 2007      |   |
| 10.31  | Unaudited Condensed Consolidated Statement of Operations for the 12 Months Ended February 28, 2007 of Digital Music Group, Inc  | 8-K  | 000-51761  | 99.1  | June 26, 2007      |   |
| 31.1   | Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.   |      |            |       |                    | X |
| 32.1   | Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.   |      |            |       |                    | X |

\* Confidential treatment granted for certain confidential portions of this exhibit. These confidential portions have been omitted from this exhibit and filed separately with the Commission.

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**SIGNATURES**

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

DIGITAL MUSIC GROUP, INC.

By: /s/ Karen B. Davis  
Karen B. Davis

Chief Financial Officer

Date: August ,14 2007

**Table of Contents****EXHIBIT INDEX**

| Exhibit |  | Incorporated By Reference |            |         |                       | Filed<br>Herewith |
|---------|--|---------------------------|------------|---------|-----------------------|-------------------|
| Number  | Exhibit Description  | Form                      | File No.   | Exhibit | Filing Date           |                   |
| 2.1     | Agreement and Plan of Merger as of July 10, 2007   | 8-K                       | 000-51761  | 2.1     | July 16, 2007         |                   |
| 3.1     | Amended and Restated Certificate of Incorporation.   | S-1                       | 333-128687 | 3.2     | February 1,<br>2006   |                   |
| 3.2     | Amended and Restated Bylaws.   | 8-K                       | 000-51761  | 3.1     | July 16, 2007         |                   |
| 4.1     | Form of Registrant's Common Stock Certificate.   | S-1                       | 333-128687 | 4.1     | February 1,<br>2006   |                   |
| 4.2     | Form of Warrant to Purchase Registrant's common stock.   | 8-K                       | 000-51761  | 4.1     | February 10,<br>2006  |                   |
| 4.3     | Warrant to Purchase Common Stock dated as of September 8, 2006 by and between Digital Music Group, Inc. and Tuhin Roy.   | 8-K                       | 000-51761  | 4.1     | September 11,<br>2006 |                   |
| 10.1    | Form of Indemnification Agreement by and between Registrant and each of its directors and officers.  | S-1                       | 333-128687 | 10.1    | February 1,<br>2006   |                   |
| 10.2    | Amended and Restated 2005 Stock Plan.  | S-1                       | 333-128687 | 10.2    | February 1,<br>2006   |                   |
| 10.3    | Second Amended and Restated Stockholders Agreement dated September 8, 2005 by and among Digital Musicworks International, Inc. (now Registrant) and certain of its stockholders.   | S-1                       | 333-128687 | 10.3    | February 1,<br>2006   |                   |
| 10.4    | Office Lease Agreement dated March 20, 2006 between Registrant and CA-Gateway Oakes Limited Partnership.   | 10-Q                      | 000-51761  | 10.4    | May 15,<br>2006       |                   |
| 10.5    | Office Lease Agreement dated July 16, 2006, between Digital Rights Agency, LLC and Hamms Building Associates, assumed by the Registrant.   | 10-Q                      | 000-51761  | 10.33   | November 14,<br>2006  |                   |
| 10.6    | Non-Competition and Non-Solicitation Agreement dated September 12, 2005 between Registrant and Mitchell Koulouris.   | S-1                       | 333-128687 | 10.10   | February 1,<br>2006   |                   |
| 10.7    | Non-Competition and Non-Solicitation Agreement dated September 12, 2005 between Registrant and Anders Brown.   | S-1                       | 333-128687 | 10.11   | February 1,<br>2006   |                   |
| 10.8    | Non-Competition and Non-Solicitation Agreement dated September 12, 2005 between Registrant and Peter Koulouris.  | S-1                       | 333-128687 | 10.12   | February 1,<br>2006   |                   |
| 10.9    | Non-Competition and Non-Solicitation Agreement dated September 22, 2005 between Registrant and Richard Rees.   | S-1                       | 333-128687 | 10.13   | February 1,<br>2006   |                   |
| 10.10   | Non-Competition and Non-Solicitation Agreement dated September 8, 2006 between Registrant and Tuhin Roy.   | 10-Q                      | 000-51761  | 10.30   | November 14,<br>2006  |                   |
| 10.11   | Employment Agreement dated September 13, 2005 with Mitchell Koulouris, President and Chief Executive Officer and Director of Registrant, as amended by Amendment No. 1 to Employment Agreement dated September 10, 2006. | S-1                       | 333-128687 | 10.14   | February 1,<br>2006   |                   |

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|--------|--|------|------------|-------|-------------------|
| 10.12  | Employment Agreement dated September 13, 2005 with Anders Brown, Chief Operating Officer of Registrant, as amended by Amendment No. 1 to Employment Agreement dated September 10, 2006.                    | S-1  | 333-128687 | 10.15 | February 1, 2006  |
| 10.13  | Employment Agreement dated March 22, 2006 with Karen Davis, Chief Financial Officer and Corporate Secretary of Registrant, as amended by Amendment No. 1 to Employment Agreement dated September 10, 2006. | 10-Q | 000-51761  | 10.18 | May 15, 2006      |
| 10.14  | Employment Agreement dated September 8, 2006 with Tuhin Roy, Chief Strategy Officer of Registrant.   | 10-Q | 000-51761  | 10.29 | November 14, 2006 |
| 10.15  | Management Incentive Bonus Plan for the Year Ended December 31, 2006.  | 10-Q | 000-51761  | 10.19 | August 14, 2006   |
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