

RITA MEDICAL SYSTEMS INC
Form 10-Q
May 10, 2005
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2005

OR

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

For the transition period from _____ to _____

Commission file number 000-30959

RITA MEDICAL SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

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Delaware
(State or other jurisdiction of
incorporation or organization)

94-3199149
(I.R.S. Employer
Identification No.)

46421 Landing Parkway
Fremont, CA 94538

(Address of principal executive offices, including zip code)

510-771-0400

(Registrant's telephone number, including area code)

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

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

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

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Table of Contents**PART 1. FINANCIAL INFORMATION****Item 1. Financial Statements****RITA MEDICAL SYSTEMS, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands, unaudited)**

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

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

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

Table of Contents**RITA MEDICAL SYSTEMS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(In thousands, except per share data, unaudited)

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

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

Table of Contents**RITA MEDICAL SYSTEMS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands, unaudited)**

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

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

Table of Contents**RITA MEDICAL SYSTEMS, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

1. Basis of presentation

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

2. Business Combination

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

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

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

3. Liquidity

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

4. Reclassifications

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

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

5. Net loss per share

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

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

6. Accounting for stock-based compensation

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

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

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

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

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

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

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

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

7. Inventories

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

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

8. Intangible assets and related amortization

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

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

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

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

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

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

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

9. Goodwill

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

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

10. Debt

The Company has the following debts:

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

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

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

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

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

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

11. Restructuring

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

12. Segment information

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

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

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

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

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

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

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13. Comprehensive income (loss)

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

14. Recent accounting pronouncements

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

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

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

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15. Commitments and contingencies

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

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

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

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

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

Overview

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Table of Contents**Critical Accounting Policies and Estimates**

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

Results of Operations

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

	<u>Q1 2005</u>	<u>Q4 2004</u>	<u>Q3 2004</u>	<u>Q2 2004</u>	<u>Q1 2004</u>
Domestic sales	86%	86%	86%	80%	79%
International sales	14%	14%	14%	20%	21%
Total sales	1006	45,000	-	45,006	
Common stock issued for cash at \$0.39 per share	168,503	169	65,819	-	65,988
Net loss from inception Jan 7, 1982 to Dec. 31, 1982	-	-	-	(39,597)	(39,597)
Balances at Dec. 31, 1982	174,503	175	110,819	(39,597)	71,397
Net loss for the year ended Dec. 31, 1983	-	-	-	(71,397)	(71,397)
Balances at Dec. 31, 1983	174,503	175	110,819	(110,994)	(0)
Common stock issued for cash at \$25.00 per share	57	0	1,425	-	1,425
Common stock issued for cash at \$25.00 per share	3	0	75	-	75
Common stock issued for cash at \$0.025 per share	1,580,000	1,580	38,373	-	39,953
Net loss - FYE 12/31/84	-	-	-	-	-
	1,754,563	1,755	150,692	(110,994)	41,453

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Balances at Dec. 31, 1984					
Cancellation of common stock	(1,296,132)	(1,297)			(1,297)
Net loss - FYE 12/31/85	-	-	-	-	-
Balances at Dec. 31, 1985	458,431	458	150,692	(110,994)	40,156
Net loss - FYE 12/31/86	-	-	-	-	-
Balances at Dec. 31, 1986	458,431	458	150,692	(110,994)	40,156
Net loss - FYE 12/31/87	-	-	-	-	-
Balances at Dec. 31, 1987	458,431	458	150,692	(110,994)	40,156
Net loss - FYE 12/31/88	-	-	-	-	-
Balances at Dec. 31, 1988	458,431	458	150,692	(110,994)	40,156
Net loss - FYE 12/31/89	-	-	-	-	-
Balances at Dec. 31, 1989	458,431	458	150,692	(110,994)	40,156
Net loss - FYE 12/31/90	-	-	-	-	-
Balances at Dec. 31, 1990	458,431	458	150,692	(110,994)	40,156
Net loss - FYE 12/31/91	-	-	-	-	-
Balances at Dec. 31, 1991	458,431	458	150,692	(110,994)	40,156
Net loss - FYE 12/31/92	-	-	-	-	-
Balances at Dec. 31, 1992	458,431	458	150,692	(110,994)	40,156
Net loss - FYE 12/31/93	-	-	-	-	-
Balances at Dec. 31, 1993	458,431	458	150,692	(110,994)	40,156
	(316,000)	(316)			(316)

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Cancellation of common stock					
Net loss - FYE 12/31/94	-	-	-	(6,656)	(6,656)
Balances at Dec. 31, 1994	142,431	142	150,692	(117,650)	33,184
Common stock issued for cash at \$0.001 per share	2,357,895	2,359	-	-	2,359
Net loss - FYE 12/31/95	-	-	-	(49,097)	(49,097)
Balances at Dec. 31, 1995	2,500,326	2,500	150,692	(166,747)	(13,555)
Common stock issued for cash at \$0.001 per share	120,000	120	-	-	120
Net loss - FYE 12/31/96	-	-	-	(1,681)	(1,681)
Balances at Dec. 31, 1996	2,620,326	2,620	150,692	(168,428)	(15,116)
Net loss - FYE 12/31/97	-	-	-	(3,517)	(3,517)
Balances at Dec. 31, 1997	2,620,326	2,620	150,692	(171,945)	(18,633)
Net loss - FYE 12/31/98	-	-	-	(2,479)	(2,479)
Balances at Dec. 31, 1998	2,620,326	2,620	150,692	(174,424)	(21,112)
Net loss - FYE 12/31/99	-	-	-	(6,307)	(6,307)
Balances at Dec. 31, 1999	2,620,326	2,620	150,692	(180,731)	(27,419)
Net loss - FYE 12/31/00	-	-	-	(9,011)	(9,011)
Balances at Dec. 31, 2000	2,620,326	2,620	150,692	(189,742)	(36,430)
Net loss - FYE 12/31/01	-	-	-	(19,461)	(19,461)
Balances at Dec. 31, 2001	2,620,326	2,620	150,692	(209,203)	(55,891)
Contributed capital for rent and other compensation	-	-	1,950	-	1,950

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Net loss - FYE 12/31/02	-	-	-	(13,960)	(13,960)
Balances at Dec. 31, 2002	2,620,326	2,620	152,642	(223,163)	(67,901)
Contributed capital for rent and officer compensation	-	-	488	-	488
Capital contributed by shareholders through forgiveness of accounts payable and interest		-	77,415	-	77,415
Common stock issued for services \$0.025 per share	13,389,932	13,390	321,358	-	334,748
Common stock issued for legal services at \$0.61 per sh.	100,000	100	60,900	-	61,000
Common stock issued for consulting services at \$0.47	10,000	10	4,690	-	4,700
Net loss - FYE 12/31/03	-	-	-	(592,962)	(592,962)
Balances at Dec. 31, 2003	16,120,258	16,120	617,493	(816,125)	(182,512)
Common stock issued for services at \$0.16 per share	1,000,000	1,000	159,000	-	160,000
Common stock issued for services at \$0.17 per share	1,800,000	1,800	304,200	-	306,000
Common stock issued for services at \$0.165 per share	800,000	800	131,200	-	132,000
Common stock issued for services at \$0.215 per share	30,000	30	6,420	-	6,450
Common stock issued for debt at \$0.45 per share	150,000	150	67,350	-	67,500
Common stock issued for services at \$0.40 per share	300,000	300	119,700	-	120,000
Common stock issued for services at \$0.34 per share	700,000	700	237,300	-	238,000
Common stock issued for services at \$0.41	300,000	300	122,700	-	123,000

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per share					
Common stock issued for services at \$0.27 per share	300,000	300	80,700	-	81,000
Common stock issued for services at \$0.22 per share	600,000	600	131,400	-	132,000
Net loss - FYE 12/31/04				(1,606,057)	(1,606,057)
Balances at Dec. 31, 2004	22,100,258	22,100	1,977,463	(2,422,182)	(422,619)
Contributed capital for general and administrative expenses			138,701		138,701
Common stock issued for services at \$0.03 per share	19,860,000	19,860	575,940		595,800
Net loss for the year ended December 31, 2005				(1,323,775)	(1,323,775)
Balances at December 31, 2005	41,960,258	41,960	2,692,104	(3,745,957)	(1,011,893)
Common stock issued for services at \$0.09 per share	17,583,334	17,584	459,916		477,500
Common stock issued for debt at \$0.06 per share	5,000,000	5,000	295,000		300,000
Common stock issued for services at \$0.03 per share	2,500,000	2,500	72,500		75,000
Common stock issued for services at \$0.05 per share	500,000	500	24,500		25,000
Net loss for the six months ended June 30, 2006				(1,156,852)	(1,156,852)
Balances at June 30, 2006	67,543,592 \$	67,544 \$	3,544,020	(\$4,902,809)	(\$1,291,245)

The accompanying notes are an integral part of these

consolidated financial
statements

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

	For the		For the		From
	Three Months Ended		Six Months Ended		Inception
	June 30,	June 30,	June 30,	June 30,	on
	2006	2005	2006	2005	Jan. 7, 1982 Through Jun. 30, 2006
CASH FLOWS FROM OPERATING ACTIVITIES:					
Net Loss	\$ (380,974)	\$ (349,804)	\$ (1,156,852)	\$ (349,804)	\$ (4,827,809)
Adjustments to reconcile net loss to net cash used by operating activities:					
Depreciation	599	229	599	229	1,797
Loss on extinguishment of debt					48,363
Issuance of common stock for services	400,000		877,500		2,976,343
Increase in Short Term Receivables	88,300		(122,684)		
Decrease (Increase) in Prepaid Expenses		247		247	
Increase in Deposits		(2,020)		(2,020)	
Increase in Prepaid Subscriptions	153,500		50,000		203,500
Increase (Decrease) in accounts payable	(330,970)	312,900	(330,970)	312,900	
Increase (Decrease) in accounts payable -related		24,252			
Increase (Decrease) in accrued liabilities			4,590		16,006
Increase in Accrued Payroll and Payroll Taxes	(300,000)		450,970	24,252	690,970
Increase in Deposits			153,500		
Increase in Short Term Receivables	(210,984)				(210,984)
Repayment of long term debt	(146,431)				(13,569)
Increase in Accrued Liabilities - Related	690,970		(2,500)	481	121,000
Non-cash contributed capital					(524)
Net Cash provided by (used by)					
Operating Activities	\$ (35,990)	\$ (14,196)	\$ (75,847)	\$ (13,715)	\$ (994,907)
CASH FLOWS FROM INVESTING ACTIVITIES					
Purchase of Fixed Assets		(14,941)		(14,941)	(2,294)
Purchase of Marketable Securities		(88,300)		(88,300)	
Investment in Joint Venture	(50,000)		(50,000)		(50,000)
Net Cash (used by) Investing Activities	\$ (50,000)	\$ (103,241)	\$ (50,000)	\$ (103,241)	\$ (52,294)
CASH FLOWS FROM FINANCING ACTIVITIES					

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Proceeds of Note Payable			3,027		114,664
Proceeds from Loans		160,000		160,000	
Proceeds of Loan from Officer	58,310		116,664		200,031
Proceeds (Repayment) of Note Payable-Related Party	(2,500)	481			169,679
Contributed capital for rent and officers' compensation					2,438
Issuance of Common Stock for Cash					41,960
Proceeds from the sale of Common Stock					300,231
Contributed Capital by shareholders				-	216,116
Net Cash provided by Financing Activities	\$ 55,810	\$ 160,481	\$ 119,691	\$ 160,000	\$ 1,045,119

NET INCREASE IN CASH	(30,180)	43,044	(6,156)	43,044	(2,082)
CASH AT BEGINNING OF PERIOD	28,098	-	4,074	-	-
CASH AT END OF PERIOD	\$ (2,082)	\$ 43,044	\$ (2,082)	\$ 43,044	\$ (2,082)

CASH PAID FOR:

Interest	\$ -	\$ -	\$ -	\$ -	\$ -
Income Taxes	\$ -	\$ -	\$ -	\$ -	\$ -

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION

Proceeds from the sale of Common Stock	\$ -	\$ -	\$ -	\$ -	\$ 342,191
Contributed Capital by shareholders		\$ -	\$ -	\$ 138,701	\$ 216,116
Stock issued for services	\$ 400,000	\$ -	\$ 877,500	\$ -	\$ 2,930,418
Contributed capital for rent, officer compensation	\$ -	\$ -	\$ -	\$ -	\$ 2,438
Other contributed capital	\$ -	\$ -	\$ -	\$ -	\$ 45,401

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 - BASIS OF PRESENTATION

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

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

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

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

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Going Concern

The Company’s financial statements are prepared using accounting principles generally accepted in the United States of America applicable to a going concern which contemplates the realization of assets and liquidation of liabilities in the normal course of business. The Company has not yet established an ongoing source of revenues sufficient to cover its operating costs and to allow it to continue as a going concern. In addition, the Company has a working capital deficit of \$701,574 and a stockholders’ deficit of \$1,291,245 at June 30, 2006. The ability of the Company to continue as a going concern is dependent on the Company obtaining adequate capital to fund operating losses until it becomes profitable. If the Company is unable to obtain adequate capital, it could be forced to cease development of operations.

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

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

Development-Stage Company

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

Use of Estimates

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

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Loss Per Share

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

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

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

Equipment and Fixtures

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

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

Recent Accounting Pronouncements

In March 2004, the Emerging Issues Task Force (“EITF”) reached a consensus on Issue No. 03-1, “The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments.” The EITF reached a consensus about the criteria that should be used to determine when an investment is considered impaired, whether that impairment is other-than-temporary, and the measurement of an impairment loss and how that criteria should be applied to investments accounted for under SFAS No. 115, “ACCOUNTING IN CERTAIN INVESTMENTS IN DEBT AND EQUITY SECURITIES.” EITF 03-01 also included accounting considerations subsequent to the recognition of other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. Additionally, EITF 03-01 includes new disclosure requirements for

investments that are deemed to be temporarily impaired. In September 2004, the Financial Accounting Standards Board (FASB) delayed the accounting provisions of EITF 03-01; however, the disclosure requirements remain effective for annual reports ending after June 15, 2004. The Company will evaluate the impact of EITF 03-01 once final guidance is issued.

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

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment". Statement 123(R) will provide investors and other users of financial statements with more complete and neutral financial information by requiring that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the fair value of the equity or liability instruments issued. Statement 123(R) covers a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. Statement 123(R) replaces FASB Statement No. 123, Accounting for Stock-Based Compensation, and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees. Statement 123, as originally issued in 1995, established as preferable a fair-value-based method of accounting for share-based payment transactions with employees. However, that Statement permitted entities the option of continuing to apply the guidance in Opinion 25, as long as the footnotes to financial statements disclosed what net income would have been had the preferable fair-value-based method been used. Public entities (other than those filing as small business issuers) will be required to apply Statement 123(R) as of the first interim or annual reporting period that begins after June 15, 2005. The Company adopted Statement 123(R) in December of 2005.

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

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

Stock Based Compensation

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

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

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

NOTE 3 - RELATED PARTY TRANSACTIONS

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

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

NOTE 4 - COMMITMENTS AND CONTINGENCIES

Employment Agreement

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

Share Exchange Agreement

On March 8, 2005, the Company entered into a Share Exchange Agreement with Union Media News (“Union”), a Nevada corporation whereby the Company exchanged 20% of the outstanding shares of its wholly-owned subsidiary Victory Communication Services, Inc. for 100% of the outstanding shares of Union. After the close of the agreement,

Union would become a wholly-owned subsidiary of the Company. The agreement calls for Union and the Company to cooperate in various joint ventures. If any joint ventures are launched, the agreement requires Union to pay the Company the greater of (i) fifteen-percent (15%) of Union's net revenues or (ii) ten thousand dollars (\$10,000) per month beginning the third month after the formation of any joint ventures. The agreement also requires the Company to assist in obtaining \$300,000 in financing for Union within sixty days of the closing. In the event that the Company is unable to obtain the necessary financing the agreement is cancelled. At the date of this report, the agreement had not been closed nor any financing obtained for Union.

Note Receivable

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

NOTE 5 - COMMON STOCK TRANSACTIONS

Common Stock Transactions During the year ended December 31, 2004

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

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

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

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

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

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

Common Stock Transactions During the Year Ended December 31, 2005

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

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

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

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

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

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

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

Additional Common Stock

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

NOTE 6 - LITIGATION

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

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

NOTE 7 - RESTATEMENT

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

- (1) The error affected only the reporting of the three month period ended June 30, 2005. An adjustment of the cumulative effect on prior periods was not necessary.
- (2) The error does no affect net income. An offsetting adjustment to components of equity and net assets is not required.
- (3) Adjustment of financial statements of prior periods was not required.

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

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

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

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

Our Business

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

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

Current Business of the Company

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

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

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

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

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

1. A percentage of the Company's ownership interest may be sold off until we own a percentage of the prospect with no out-of-pocket expenses required from us; or
2. We may seek to raise between \$1 million and \$4 million to finance each respected prospect in its entirety.

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

Plan of Operation

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

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

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

Results of Operations for Period Ended June 30, 2006

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

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

Liquidity and Capital Resources

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

Item 3. Controls and Procedures

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

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

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

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

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

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

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

Item 3. Defaults Upon Senior Securities

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

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

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

Item 5. Other Information.

None

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Item 6. Exhibits and Reports on Form 8-K

(a) Index to Exhibits

Exhibit No. Description of Exhibit

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

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

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

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SIGNATURE

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

Victory Energy Corporation

Date: August 17, 2006

By: /s/ Jon Fullenkamp

Principal Executive Officer
Principal Financial Officer
Principal Accounting Officer and Director

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