

YOUTHSTREAM MEDIA NETWORKS INC  
Form 10QSB  
September 15, 2006

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549**

**FORM 10-QSB**

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**QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

**For the Quarterly Period Ended June 30, 2006**

o

**TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission file number: 0-27556**

**YOUTHSTREAM MEDIA NETWORKS, INC.**  
(Exact name of small business issuer as specified in its charter)

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

**13-4082185**  
(I.R.S. Employer  
Identification Number)

**244 Madison Avenue, PMB #358, New  
York, New York**  
(Address of principal executive offices)

**10016**  
(Zip Code)

**(212) 883-0083**  
(Issuer's telephone number, including area code)

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

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

As of August 31, 2006, the issuer had 39,242,251 shares of common stock, \$0.01 par value, issued and outstanding.

Transitional Small Business Disclosure Format. Yes o No x

Documents incorporated by reference: None.

**YOUTHSTREAM MEDIA NETWORKS, INC. AND SUBSIDIARIES**

**EXPLANATORY NOTES**

The statements included in this Quarterly Report on Form 10-QSB for the quarterly period ended June 30, 2006 (the "Report") regarding future financial performance and results and other statements that are not historical facts constitute forward-looking statements. The words "believes," "intends," "expects," "anticipates," "projects," "estimates," "predicts," and similar expressions are also intended to identify forward-looking statements. These forward-looking statements are based on current expectations and are subject to risks and uncertainties. In connection with the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995, the Company cautions the reader that actual results or events could differ materially from those set forth or implied by such forward-looking statements and related assumptions due to certain important factors, including, without limitation, the following: (i) cyclical changes in market supply and demand for steel, (ii) general economic conditions affecting steel consumption, (iii) U.S. or foreign trade policy affecting the price of imported steel, (iv) governmental monetary or fiscal policy in the U.S. and other major international economies, (v) increased price competition brought about by excess domestic and global steelmaking capacity and imports of low priced steel, (vi) continued consolidation in the domestic and global steel industry, resulting in larger producers with much greater market power to affect price and/or supply, (vii) changes in the availability or cost of steel scrap, which has risen dramatically over the past few years, (viii) periodic fluctuations in the availability and cost of electricity, natural gas or other utilities, (ix) the occurrence of unanticipated equipment failures and plant outages or the occurrences of extraordinary operating expenses, (x) competitive actions by the Company's domestic and foreign competitors, (xi) margin squeeze or compression resulting from the Company's inability to pass through to its customers, price increases or surcharges, the increased cost of raw materials and supplies, (xii) loss of business from one or more major customers or end-users, (xiii) labor unrest, work stoppages and/or strikes involving the Company's workforce, those of its important suppliers or customers, or those affecting the steel industry in general, (xiv) the effect of the elements upon the Company's production or upon the production or needs of its important suppliers or customers, (xv) the impact of, or changes in, environmental laws or in the application of other legal or regulatory requirements upon the Company's production processes or costs of production or upon those of its suppliers or customers, including actions by government agencies, such as the U.S. Environmental Protection Agency or the Kentucky Department for Environmental Protection, (xvi) private or governmental liability claims or litigation, or the impact of any adverse outcome of any litigation on the adequacy of the Company's reserves, the availability or adequacy of its insurance coverage, its financial well-being or its business and assets, (xvii) changes in interest rates or other borrowing costs, or the effect of existing loan covenants or restrictions upon the cost or availability of credit to fund operations or take advantage of other business opportunities, (xviii) changes in the Company's business strategies or development plans which it may adopt or which may be brought about in response to actions by its suppliers or customers, and any difficulty or inability to successfully consummate or implement as planned any planned or potential projects, acquisitions, joint ventures or strategic alliances; and (xix) the impact of regulatory or other governmental permits or approvals, litigation, construction delays, cost overruns, technology risk or operational complications upon the Company's ability to complete, start-up or continue to profitably operate a project or a new business, or to complete, integrate and operate any potential acquisitions as anticipated. The Company is also subject to general business risks, including management's success in continuing to settle the Company's outstanding obligations from its prior business activities, results of tax audits, adverse state, federal or foreign legislation and regulation, changes in general economic factors, the Company's ability to retain and attract key employees, acts of war or global terrorism, and unexpected natural disasters. Any forward-looking statements included in this Report are made as of the date hereof, based on information available to the Company as of the date hereof, and, subject to applicable law, the Company assumes no obligation to update any forward-looking statements.

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**YOUTHSTREAM MEDIA NETWORKS, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

|                                                                                                                             | <b>June 30, 2006</b><br><b>(Unaudited)</b> | <b>September 30,</b><br><b>2005</b> |
|-----------------------------------------------------------------------------------------------------------------------------|--------------------------------------------|-------------------------------------|
| <b>ASSETS</b>                                                                                                               |                                            |                                     |
| Current assets:                                                                                                             |                                            |                                     |
| Cash and cash equivalents                                                                                                   | \$ 933,747                                 | \$ 998,835                          |
| Accounts receivable, less allowance for doubtful accounts of \$932,019 at June 30, 2006 and \$747,399 at September 30, 2005 | 12,277,210                                 | 14,668,539                          |
| Inventories                                                                                                                 | 19,242,246                                 | 17,880,805                          |
| Prepaid expenses and other current assets                                                                                   | 1,103,507                                  | 2,167,382                           |
| Total current assets                                                                                                        | 33,556,710                                 | 35,715,561                          |
| Property, plant and equipment                                                                                               | 6,630,012                                  | 6,630,012                           |
| Less accumulated depreciation and amortization                                                                              | (1,609,892)                                | (1,062,267)                         |
| Property, plant and equipment, net                                                                                          | 5,020,120                                  | 5,567,745                           |
| Other assets:                                                                                                               |                                            |                                     |
| Deferred loan costs, net of amortization of \$690,130 at June 30, 2006 and \$438,913 at September 30, 2005                  | 246,695                                    | 422,913                             |
| Deposits                                                                                                                    | 215,435                                    | 216,035                             |
| Total other assets                                                                                                          | 462,130                                    | 638,948                             |
| Total assets                                                                                                                | \$ 39,038,960                              | \$ 41,922,254                       |

(continued)

**YOUTHSTREAM MEDIA NETWORKS, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS (continued)**

|                                                                                                                                                                                                                                                                                                                                                                                                                | <b>June 30, 2006</b> | <b>September 30,</b> |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------|----------------------|
|                                                                                                                                                                                                                                                                                                                                                                                                                | <b>(Unaudited)</b>   | <b>2005</b>          |
| <b>LIABILITIES AND STOCKHOLDERS' DEFICIENCY</b>                                                                                                                                                                                                                                                                                                                                                                |                      |                      |
| Current liabilities:                                                                                                                                                                                                                                                                                                                                                                                           |                      |                      |
| Accounts payable                                                                                                                                                                                                                                                                                                                                                                                               | \$ 8,883,565         | \$ 9,008,612         |
| Accrued expenses                                                                                                                                                                                                                                                                                                                                                                                               | 3,380,003            | 2,048,481            |
| Accrued interest payable:                                                                                                                                                                                                                                                                                                                                                                                      |                      |                      |
| 12% subordinated promissory notes payable to related parties                                                                                                                                                                                                                                                                                                                                                   | 209,425              | 1,085,753            |
| 8% subordinated promissory notes payable to related parties                                                                                                                                                                                                                                                                                                                                                    | 1,149,862            | ---                  |
| Notes payable to directors                                                                                                                                                                                                                                                                                                                                                                                     | ---                  | 50,000               |
| Secured line of credit                                                                                                                                                                                                                                                                                                                                                                                         | 9,890,679            | 19,009,379           |
| 12% subordinated promissory notes payable to related parties                                                                                                                                                                                                                                                                                                                                                   | 7,000,000            | ---                  |
| 8% subordinated promissory notes payable to related parties                                                                                                                                                                                                                                                                                                                                                    | 3,159,416            | ---                  |
| Current portion of 8% subordinated promissory notes payable to related parties                                                                                                                                                                                                                                                                                                                                 | 1,849,300            | ---                  |
| Current portion of equipment contract payable                                                                                                                                                                                                                                                                                                                                                                  | 82,652               | 77,091               |
| Current portion of capital lease obligation                                                                                                                                                                                                                                                                                                                                                                    | 416,291              | 372,256              |
| Liabilities related to discontinued operations                                                                                                                                                                                                                                                                                                                                                                 | 2,984,660            | 2,984,660            |
| Total current liabilities                                                                                                                                                                                                                                                                                                                                                                                      | 39,005,853           | 34,636,232           |
| Non-current liabilities:                                                                                                                                                                                                                                                                                                                                                                                       |                      |                      |
| Accrued interest payable:                                                                                                                                                                                                                                                                                                                                                                                      |                      |                      |
| 4% note payable to investor                                                                                                                                                                                                                                                                                                                                                                                    | 137,419              | 107,419              |
| 8% subordinated promissory notes payable to related parties                                                                                                                                                                                                                                                                                                                                                    | ---                  | 1,852,384            |
| 4% note payable to related party, plus cumulative interest of \$952,775                                                                                                                                                                                                                                                                                                                                        | 3,952,775            | 3,952,775            |
| 4% note payable to investor, net of unamortized discount                                                                                                                                                                                                                                                                                                                                                       | 967,082              | 964,194              |
| 8% subordinated secured promissory notes payable to related parties, less current portion                                                                                                                                                                                                                                                                                                                      | 37,643,700           | 39,493,000           |
| 12% subordinated promissory notes payable to related parties                                                                                                                                                                                                                                                                                                                                                   | ---                  | 7,000,000            |
| Equipment contract payable, less current portion                                                                                                                                                                                                                                                                                                                                                               | 109,977              | 172,714              |
| Capital lease obligation, less current portion                                                                                                                                                                                                                                                                                                                                                                 | 994,102              | 1,312,064            |
| Deferred rent                                                                                                                                                                                                                                                                                                                                                                                                  | 117,188              | 144,360              |
| Preferred stock of subsidiary subject to mandatory redemption; issued and outstanding at June 30, 2006 - 25,000 shares, and at September 30, 2005 - 24,733 shares of Series A 13% cumulative, non-convertible, redeemable preferred stock, mandatory redemption and liquidation value of \$1,000.00 per share, plus cumulative dividends of \$4,336,301 at June 30, 2006 and \$1,885,129 at September 30, 2005 | 29,336,301           | 26,618,129           |
| Preferred stock subject to mandatory redemption; issued and outstanding at June 30, 2006 and September 30, 2005 - 1,000,000 shares of Series A 4% cumulative, non-convertible, redeemable preferred stock, mandatory redemption and liquidation value of \$4.00 per share, plus cumulative                                                                                                                     | 5,269,333            | 5,269,333            |

dividends of \$1,269,333

|                                     |                    |                    |
|-------------------------------------|--------------------|--------------------|
| Minority interest - related parties | ---                | ---                |
| <b>Total liabilities</b>            | <b>117,533,730</b> | <b>121,522,604</b> |

### Commitments and contingencies

### Stockholders' deficiency:

|                                                                                                                                                                                                                                                                          |                      |                      |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------|----------------------|
| Preferred stock, \$0.01 par value; authorized - 5,000,000 shares; issued and outstanding at June 30, 2006 and September 30, 2005 - 1,000,000 shares of Series A preferred stock (classified in long-term liabilities as preferred stock subject to mandatory redemption) | ---                  | ---                  |
| Common stock, \$0.01 par value; authorized - 100,000,000 shares; issued - 39,849,751 shares; outstanding -39,242,251 shares at June 30, 2006 and September 30, 2005                                                                                                      | 398,486              | 398,486              |
| Additional paid-in capital                                                                                                                                                                                                                                               | 267,835,888          | 268,096,138          |
| Accumulated deficit                                                                                                                                                                                                                                                      | (345,899,568)        | (347,265,398)        |
| Treasury stock - 607,500 shares, at cost                                                                                                                                                                                                                                 | (829,576)            | (829,576)            |
| <b>Total stockholders' deficiency</b>                                                                                                                                                                                                                                    | <b>(78,494,770)</b>  | <b>(79,600,350)</b>  |
| <b>Total liabilities and stockholders' deficiency</b>                                                                                                                                                                                                                    | <b>\$ 39,038,960</b> | <b>\$ 41,922,254</b> |

See accompanying notes to condensed consolidated financial statements.

**YOUTHSTREAM MEDIA NETWORKS, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)**

|                                                                | <b>Three Months Ended<br/>June 30,</b> |                       | <b>Nine Months Ended<br/>June 30,</b> |                       |
|----------------------------------------------------------------|----------------------------------------|-----------------------|---------------------------------------|-----------------------|
|                                                                | <b>2006</b>                            | <b>2005</b>           | <b>2006</b>                           | <b>2005</b>           |
| NET SALES                                                      | \$ 34,284,157                          | \$ 29,127,566         | \$ 104,287,949                        | \$ 38,261,343         |
| <b>COSTS AND EXPENSES</b>                                      |                                        |                       |                                       |                       |
| Cost of sales                                                  | 29,407,919                             | 27,194,477            | 89,887,425                            | 35,666,705            |
| Selling                                                        | 389,025                                | 300,486               | 1,184,781                             | 412,544               |
| General and administrative                                     | 1,559,607                              | 994,051               | 4,557,136                             | 1,593,208             |
|                                                                | 31,356,551                             | 28,489,014            | 95,629,342                            | 37,672,457            |
| Income from operations                                         | 2,927,606                              | 638,552               | 8,658,607                             | 588,886               |
| <b>OTHER INCOME (EXPENSE)</b>                                  |                                        |                       |                                       |                       |
| Interest income                                                | 119                                    | 9,944                 | 321                                   | 35,478                |
| Interest expense:                                              |                                        |                       |                                       |                       |
| 13% Series A Preferred Stock                                   | (810,274)                              | (801,621)             | (2,451,172)                           | (1,074,700)           |
| Notes payable to related parties                               | (1,060,135)                            | (997,121)             | (3,085,168)                           | (1,336,799)           |
| Other                                                          | (454,385)                              | (573,146)             | (1,570,806)                           | (797,455)             |
| Transaction costs related to KES acquisition                   | ---                                    | (280,773)             | ---                                   | (1,073,727)           |
| Other income (expense), net                                    | 2,249                                  | 4,216                 | 88,048                                | (26,489)              |
| Other income (expense), net                                    | (2,322,426)                            | (2,638,501)           | (7,018,777)                           | (4,273,692)           |
| <b>INCOME (LOSS) BEFORE INCOME TAXES AND MINORITY INTEREST</b> | <b>605,180</b>                         | <b>(1,999,949)</b>    | <b>1,639,830</b>                      | <b>(3,684,806)</b>    |
| Income taxes                                                   | 146,000                                | ---                   | 274,000                               | ---                   |
| <b>INCOME (LOSS) BEFORE MINORITY INTEREST</b>                  | <b>459,180</b>                         | <b>(1,999,949)</b>    | <b>1,365,830</b>                      | <b>(3,684,806)</b>    |
| <b>MINORITY INTEREST - related parties</b>                     | <b>---</b>                             | <b>162,820</b>        | <b>---</b>                            | <b>430,931</b>        |
| <b>NET INCOME (LOSS)</b>                                       | <b>\$ 459,180</b>                      | <b>\$ (1,837,129)</b> | <b>\$ 1,365,830</b>                   | <b>\$ (3,253,875)</b> |
| <b>NET INCOME (LOSS) PER COMMON SHARE -</b>                    |                                        |                       |                                       |                       |
| Basic                                                          | \$ 0.01                                | \$ (0.05)             | \$ 0.03                               | \$ (0.08)             |
| Diluted                                                        | \$ 0.01                                | \$ (0.05)             | \$ 0.03                               | \$ (0.08)             |
| <b>WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING -</b>  |                                        |                       |                                       |                       |
| Basic                                                          | 39,242,251                             | 39,242,251            | 39,242,251                            | 39,242,251            |
| Diluted                                                        | 39,971,097                             | 39,242,251            | 40,067,251                            | 39,242,251            |

See accompanying notes to condensed consolidated financial statements.

**YOUTHSTREAM MEDIA NETWORKS, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' DEFICIENCY (UNAUDITED)**  
**NINE MONTHS ENDED JUNE 30, 2006**

|                                                                | <b>Common Stock</b> |               | <b>Additional</b> |                  | <b>Accumulated</b> |  | <b>Treasury</b> |              |
|----------------------------------------------------------------|---------------------|---------------|-------------------|------------------|--------------------|--|-----------------|--------------|
|                                                                | <b>Shares</b>       | <b>Amount</b> | <b>Paid-in</b>    | <b>Capital</b>   | <b>Deficit</b>     |  | <b>Stock</b>    | <b>Total</b> |
| Balances at October 1, 2005                                    | 39,849,751          | \$ 398,486    | \$ 268,096,138    | \$ (347,265,398) | \$ (829,576)       |  |                 | (79,600,350) |
| Fair value of stock options                                    | --                  | --            | 6,750             | --               | --                 |  | --              | 6,750        |
| Deemed distribution to sellers of KES Acquisition Company, LLC | --                  | --            | (267,000)         | --               | --                 |  | --              | (267,000)    |
| Net income                                                     |                     | --            | --                | --               | 1,365,830          |  | --              | 1,365,830    |
| Balances at June 30, 2006                                      | 39,849,751          | \$ 398,486    | \$ 267,835,888    | \$ (345,899,568) | \$ (829,576)       |  |                 | (78,494,770) |

See accompanying notes to condensed consolidated financial statements.

**YOUTHSTREAM MEDIA NETWORKS, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)**

|                                                                                                    | Nine Months Ended<br>June 30, |                    |
|----------------------------------------------------------------------------------------------------|-------------------------------|--------------------|
|                                                                                                    | 2006                          | 2005               |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                                        |                               |                    |
| Net income (loss)                                                                                  | \$ 1,365,830                  | \$ (3,253,875)     |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: |                               |                    |
| Net change in liabilities related to discontinued operations                                       | ---                           | (27,727)           |
| Depreciation and amortization                                                                      | 547,625                       | 245,452            |
| Stock-based compensation                                                                           | 6,750                         | ---                |
| Amortization of original issue discount on subordinated notes payable                              | 2,888                         | 1,951              |
| Amortization of deferred loan costs                                                                | 251,218                       | 152,456            |
| Write-off of fixed assets                                                                          | ---                           | 20,430             |
| Write-off of KES acquisition costs                                                                 | ---                           | 362,846            |
| Minority interest - related parties                                                                | ---                           | (430,931)          |
| Changes in operating assets and liabilities:                                                       |                               |                    |
| (Increase) decrease in -                                                                           |                               |                    |
| Accounts receivable, net                                                                           | 2,391,329                     | (2,202,051)        |
| Inventories                                                                                        | (1,361,441)                   | 3,294,122          |
| Accrued interest receivable                                                                        | ---                           | (31,259)           |
| Prepaid expenses                                                                                   | 1,063,875                     | (258,264)          |
| Deposits                                                                                           | 600                           | ---                |
| Increase (decrease) in -                                                                           |                               |                    |
| Accounts payable                                                                                   | (125,047)                     | (2,326,412)        |
| Accrued interest and dividends payable                                                             | 4,061,738                     | 2,411,499          |
| Accrued expenses                                                                                   | 1,331,522                     | (575,794)          |
| Deferred rent                                                                                      | (27,172)                      | (12,030)           |
| <b>NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES</b>                                         | <b>9,509,715</b>              | <b>(2,629,587)</b> |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                                        |                               |                    |
| Principal and interest payments on BTW note receivable                                             | ---                           | 247,227            |
| <b>NET CASH PROVIDED BY INVESTING ACTIVITIES</b>                                                   | <b>---</b>                    | <b>247,227</b>     |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                                        |                               |                    |
| Net borrowings (repayments) under secured line of credit                                           | (9,193,700)                   | 1,410,683          |
| Repayment of notes payable to directors                                                            | (50,000)                      | ---                |
| Principal payments on equipment contract payable and capital lease obligation                      | (331,103)                     | (131,440)          |
| <b>NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES</b>                                         | <b>(9,574,803)</b>            | <b>1,279,243</b>   |
| <b>NET CASH USED IN OPERATING, INVESTING AND FINANCING ACTIVITIES</b>                              | <b>(65,088)</b>               | <b>(1,103,117)</b> |
| <b>CASH ACQUIRED IN CONNECTION WITH KES ACQUISITION</b>                                            | <b>---</b>                    | <b>913,194</b>     |
| <b>CASH AND CASH EQUIVALENTS</b>                                                                   |                               |                    |

|                                |            |            |
|--------------------------------|------------|------------|
| Net decrease                   | (65,088)   | (189,923)  |
| Balance at beginning of period | 998,835    | 674,880    |
| Balance at end of period       | \$ 933,747 | \$ 484,957 |

## SUPPLEMENTAL CASH FLOW INFORMATION

## Cash paid for -

|              |              |            |
|--------------|--------------|------------|
| Interest     | \$ 3,045,408 | \$ 777,455 |
| Income taxes | \$ ---       | \$ ---     |

## NON-CASH INVESTING AND FINANCING ACTIVITIES

|                                                                                                 |              |               |
|-------------------------------------------------------------------------------------------------|--------------|---------------|
| Deemed distribution to sellers of KES Acquisition Company, LLC                                  | \$ 267,000   | \$ ---        |
| 8% promissory notes payable to related parties issued in payment of accrued interest            | \$ 3,159,416 | \$ ---        |
| Preferred stock issued in connection with acquisition of KES Acquisition Company, LLC           | \$ ---       | \$ 24,733,000 |
| Notes payable issued in connection with acquisition of KES Acquisition Company, LLC             | \$ ---       | \$ 39,493,000 |
| Non-cash assets acquired in connection with acquisition of KES Acquisition Company, LLC         | \$ ---       | \$ 37,019,827 |
| Liabilities assumed in connection with acquisition of KES Acquisition Company, LLC              | \$ ---       | \$ 36,255,513 |
| Deemed distribution to sellers of KES Acquisition Company, LLC in excess of predecessor's basis | \$ ---       | \$ 63,104,423 |
| Loan fees capitalized and added to note principal                                               | \$ 75,000    | \$ 125,000    |

See accompanying notes to condensed consolidated financial statements.

**YOUTHSTREAM MEDIA NETWORKS, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**  
**THREE MONTHS AND NINE MONTHS ENDED JUNE 30, 2006 AND 2005**

**1. Organization and Basis of Presentation**

**Basis of Presentation**

The accompanying consolidated financial statements include the accounts of YouthStream Media Networks, Inc. ("YouthStream"), and its direct and indirect wholly and majority-owned subsidiaries: Network Event Theater, Inc. ("NET"), American Passage Media, Inc. ("American Passage"), Beyond the Wall, Inc. ("Beyond the Wall" or "BTW"), and W3T.com, Inc. ("Teen.com") (all inactive); and, commencing March 1, 2005, YouthStream Acquisition Corp. ("Acquisition Corp."), Atacama KES Holding Corporation ("Atacama KES") and KES Acquisition Company, LLC ("KES Acquisition") (see Note 2) (collectively, the "Company").

The consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America. All intercompany items and transactions have been eliminated in consolidation.

Commencing March 1, 2005, the Company has included the operations of a steel mini-mill located in Ashland, Kentucky in its consolidated financial statements (see Note 2), which represents the only business segment in which the Company currently operates.

The accompanying condensed consolidated financial statements are unaudited, but in the opinion of management of the Company, contain all adjustments, which include normal recurring accruals, necessary to present fairly the financial position at June 30, 2006, the results of operations for the three months and nine months ended June 30, 2006 and 2005, and the cash flows for the nine months ended June 30, 2006 and 2005. The balance sheet as of September 30, 2005 is derived from the Company's audited financial statements included in the Company's Annual Report on Form 10-KSB for the fiscal year ended September 30, 2005.

Certain information and footnote disclosures normally included in financial statements that have been prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission, although management of the Company believes that the disclosures contained in these financial statements are adequate to make the information presented therein not misleading. For further information, refer to the financial statements and the notes thereto included in the Company's Annual Report on Form 10-KSB for the fiscal year ended September 30, 2005, as filed with the Securities and Exchange Commission.

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

The results of operations for the three months and nine months ended June 30, 2006 are not necessarily indicative of the results of operations to be expected for the full fiscal year ending September 30, 2006.

**Going Concern**

The Company has incurred recurring operating losses since its inception. The Company incurred a net loss of \$3,430,562 and a negative cash flow from operating activities of \$4,300,395 for the year ended September 30, 2005,

and had an accumulated deficit of \$347,265,398 and a stockholders' deficiency of \$79,600,350 at September 30, 2005. As of September 30, 2005, the Company had insufficient capital to fund all of its obligations on a consolidated basis. These factors raise substantial doubt about the Company's ability to continue as a going concern. The consolidated financial statements do not include any adjustments to reflect the possible future effect of the recoverability and classification of assets or the amounts and classifications of liabilities that may result from the outcome of this uncertainty.

On March 9, 2005, the Company completed the acquisition of a steel mini-mill located in Ashland, Kentucky (see Note 2). The Company utilized substantially all of its available cash resources to fund such acquisition and will require additional operating capital to fund corporate general and administrative expenses, which the Company expects to obtain primarily through periodic tax sharing payments from Acquisition Corp. and Atacama KES (see Note 2). In addition, the steel mini-mill restarted operations in late January 2004 after being acquired by the previous owners, and until recently has incurred losses. For the year ended September 30, 2005, operating income was \$2,691,955 (which included the operations of the steel mini-mill for the seven month period March through September 2005), exclusive of interest expense. For the three months and nine months ended June 30, 2006, operating income was \$2,927,606 and \$8,658,607, respectively, exclusive of interest expense. The steel mini-mill relies on cash flows from operations to support a secured line of credit with General Electric Capital Corporation to fund its separate operations. As a result of improved operating performance of the steel mini-mill beginning in late 2005, the Company has been able to increase borrowing availability under this line of credit.

Based on its current level of operations, the Company believes that its current cash resources provided by operations and the secured line of credit will be adequate to fund its operations through September 30, 2006. However, to the extent the Company's estimates are inaccurate or its assumptions are incorrect, the Company may not have sufficient cash resources to fund its operations. In such event, the Company may have to consider a formal or informal restructuring or reorganization, including a sale or other disposition of its assets.

The Company's management may also consider various strategic alternatives in the future, including the acquisition of new business opportunities, which may be from related or unrelated parties. However, there can be no assurances that such efforts will ultimately be successful. The Company may finance any acquisitions through a combination of debt and/or equity securities.

#### Stock-Based Compensation

Through December 31, 2005, the Company accounted for stock-based employee compensation in accordance with the provisions of Accounting Principles Board ("APB") Opinion No. 25 and FASB Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation", and complied with the disclosure requirements of SFAS No. 123 (as modified by SFAS No. 48), "Accounting for Stock-Based Compensation". Under APB No. 25, compensation expense was recorded based on the difference, if any, between the fair value of the Company's stock and the exercise price on the measurement date. The Company accounted for stock issued to non-employees in accordance with SFAS No. 123, which required entities to recognize as expense over the service period the fair value of all stock-based awards on the date of grant and EITF No. 96-18, "Accounting for Equity Investments that are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services", which addressed the measurement date and recognition approach for such transactions.

The Company recognized compensation expense related to variable awards in accordance with FASB Interpretation No. 28, "Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans". For fixed awards, the Company recognized expense over the vesting period or the period of service.

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123R"), a revision to SFAS No. 123, "Accounting for Stock-Based Compensation". SFAS No. 123R superseded APB Opinion No. 25, "Accounting for Stock Issued to Employees", and amended SFAS No. 95, "Statement of Cash Flows". SFAS No. 123R requires that the Company measure the cost of employee services received in exchange for equity awards based on the grant date fair value of the awards. The cost will be recognized as compensation expense over the vesting period of the awards.

Under this method, the Company began recognizing compensation cost for equity-based compensation for all new or modified grants after the date of adoption. The pro forma disclosures previously permitted under SFAS No. 123 are no longer an alternative to financial statement recognition. In addition, the Company will recognize the unvested portion

of the grant date fair value of awards issued prior to adoption based on the fair values previously calculated for disclosure purposes over the remaining vesting period of the outstanding options and warrants.

Accordingly, the Company recognizes compensation cost for equity-based compensation for all new or modified grants issued after December 31, 2005.

In addition, commencing January 1, 2006, the Company is required to recognize the unvested portion of the grant date fair value of awards issued prior to the adoption of SFAS No. 123R based on the fair values previously calculated for disclosure purposes over the remaining vesting period of the outstanding stock options and warrants. The Company had one partially vested stock option outstanding at December 31, 2005 (see Note 6). This option fully vested during the six months ended June 30, 2006 and compensation cost of \$6,750 was recognized during the period. On June 26, 2006, the Company issued an option to purchase 200,000 shares of common stock to a new director, exercisable through June 26, 2013 at \$0.12 per share, which was the fair market value on the date of issuance. The fair value of the option, calculated pursuant to the Black-Scholes option-pricing model, was \$24,000 (\$0.12 per share). The option vests over a 12-month period in equal monthly installments beginning July 1, 2006 (see Note 6).

Although the expense for stock options that may be vested or granted in future periods cannot be determined at this time due to the uncertainty of the vesting or timing of future grants, the Company's future stock price, and the related fair value calculation, the adoption of SFAS No. 123R could have a material effect on the Company's future financial statements.

Pro forma information regarding net loss per share is required by SFAS No. 123 as if the Company had accounted for its employee stock options under the fair value method of such statement. The fair value of these options was estimated on the grant date using the Black-Scholes option-pricing model.

For purposes of pro forma disclosures, the estimated fair value of the options is amortized to operations over the vesting period of the options or the expected period of benefit. The Company's unaudited pro forma information is summarized as follows:

|                                                                                                       | Nine Months<br>Ended June 30,<br>2006 | Three Months<br>Ended June 30,<br>2005 | Nine Months<br>Ended June 30,<br>2005 |
|-------------------------------------------------------------------------------------------------------|---------------------------------------|----------------------------------------|---------------------------------------|
| Net income (loss) - as reported                                                                       | \$ 1,365,830                          | \$ (1,837,129)                         | \$ (3,253,875)                        |
| Less: Total stock-based compensation expense<br>determined under the fair value method for all awards | (13,500)                              | (13,500)                               | (20,250)                              |
| Net income (loss) - pro forma                                                                         | \$ 1,352,330                          | \$ (1,850,629)                         | \$ (3,274,125)                        |
| Net income (loss) per share - basic:                                                                  |                                       |                                        |                                       |
| As reported                                                                                           | \$ 0.03                               | \$ (0.05)                              | \$ (0.08)                             |
| Pro forma                                                                                             | \$ 0.03                               | \$ (0.05)                              | \$ (0.08)                             |
| Net income (loss) per share - diluted:                                                                |                                       |                                        |                                       |
| As reported                                                                                           | \$ 0.03                               | \$ (0.05)                              | \$ (0.08)                             |
| Pro forma                                                                                             | \$ 0.03                               | \$ (0.05)                              | \$ (0.08)                             |

## Earnings Per Share

The Company calculates net income (loss) per share as required by SFAS No. 128, "Earnings per Share". Basic earnings (loss) per share excludes any dilution for common stock equivalents and is computed by dividing net income (loss) by the weighted average number of common shares outstanding during the relevant period. Diluted earnings per share reflects the potential dilution that could occur if options or other securities or contracts entitling the holder to acquire shares of common stock were exercised or converted, resulting in the issuance of additional shares of common stock that would then share in earnings. However, diluted loss per share does not consider such dilution as its effect would be anti-dilutive.

At June 30, 2006 and 2005, potentially dilutive securities entitling the holder thereof to acquire shares of common stock are summarized as follows:

|                                | 2006      | 2005      |
|--------------------------------|-----------|-----------|
| Stock options                  | 1,605,404 | 1,405,404 |
| Common stock purchase warrants | 1,000,000 | 1,000,000 |

## Concentrations

The Company's cash balances exceeded federally-insured levels at June 30, 2006 and September 30, 2005. The Company minimizes its credit risk by investing its cash and cash equivalents with major banks and financial institutions located in the United States, as a result of which the Company believes that it had nominal risk with respect to its concentration of balances in cash and cash equivalents at such date.

During the three months ended June 30, 2006, the Company had two suppliers that accounted for approximately 53% of raw materials purchases, one supplier providing approximately 30% and the other supplier providing approximately 23%, of which \$2,624,138 was included in accounts payable at June 30, 2006. During the three months ended June 30, 2006, the Company had two customers that accounted for approximately 21% of net sales, one customer providing approximately 11% and the other customer providing approximately 10%, of which \$2,933,411 was included in accounts receivable at June 30, 2006.

During the nine months ended June 30, 2006, the Company had two suppliers that accounted for approximately 54% of raw materials purchases, one supplier providing approximately 35% and the other supplier providing approximately 19%, of which \$2,624,138 was included in accounts payable at June 30, 2006. During the nine months ended June 30, 2006, the Company had one customer that accounted for approximately 11% of net sales, of which \$2,724,484 was included in accounts receivable at June 30, 2006.

## Discontinued Operations

As of June 30, 2006 and September 30, 2005, the Company has accrued liabilities \$2,984,660 remaining from its discontinued businesses. The accrued liabilities consist primarily of severance, lease payments and other costs related to the operations of the discontinued businesses.

## Recent Accounting Pronouncements and Developments

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections" ("SFAS No. 154"). SFAS No. 154 is a replacement of APB Opinion No. 20, "Accounting Changes" and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements - (an Amendment of APB Opinion No. 28)" and provides guidance on the accounting for and reporting of accounting changes and error corrections. SFAS No. 154 establishes retrospective

application as the required method for reporting a change in accounting principle, and provides guidance for determining whether retrospective application of a change in accounting principle is impracticable and for reporting a change when retrospective application is impracticable. Retrospective application is the application of a different accounting principle to a prior accounting period as if that principle had always been used or as the adjustment of previously issued financial statements to reflect a change in the reporting entity. SFAS No. 154 also addresses the reporting of the correction of an error by restating previously issued financial statements. SFAS No. 154 is effective for accounting changes and error corrections occurring in fiscal years beginning after December 15, 2005. The adoption of SFAS No. 154 is not expected to have any impact on the Company's financial statement presentation or disclosures.

In June 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109 ("FIN 48"). FIN 48 provides criteria for the recognition, measurement, presentation and disclosure of uncertain tax positions that has an effect on a company's financial statements accounted for in accordance with SFAS No. 109, "Accounting for Income Taxes", as a result of positions taken or expected to be taken in a company's tax return. A tax benefit from an uncertain position may be recognized only if it is "more likely than not" that the position is sustainable based on its technical merits. The provisions of FIN 48 are effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the potential effect that the adoption of FIN 48 will have on the Company's financial statement presentation and disclosures.

On September 22, 2005, the Securities and Exchange Commission ("SEC") issued rules to delay by one year the required reporting by management on internal controls over financial reporting for non-accelerated filers. The new SEC rule extends the compliance date for such registrants to fiscal years ending on or after July 15, 2007. Accordingly, the Company qualifies for the deferral to comply with the internal control reporting requirements until its fiscal year ending September 30, 2007. On August 9, 2006, the SEC issued two releases that when adopted are designed to grant smaller public companies further relief from compliance with Section 404 of the Sarbanes-Oxley Act of 2002.

## **2. Acquisition of Steel Mini-Mill**

In September 2003, YouthStream invested \$125,000 to acquire a 1.00% membership interest in KES Holdings, LLC, a Delaware limited liability company ("KES Holdings"), which was formed to acquire certain assets of Kentucky Electric Steel, Inc., a Delaware corporation ("KES"), consisting of a steel mini-mill located in Ashland, Kentucky (the "Mill"). On September 2, 2003, KES Holdings, through its subsidiary, KES Acquisition Company, LLC, a Delaware limited liability company ("KES Acquisition"), completed the acquisition of the Mill pursuant to Section 363 of the United States Bankruptcy Code for cash consideration of \$2,650,000, which was funded through the capital contributions of the members of KES Holdings. Members' capital contributions were also used for start-up costs, working capital purposes and payment of deferred maintenance of the Mill. KES had ceased production on or about December 16, 2002 and filed a voluntary petition for relief under Chapter 11 of the United States Bankruptcy Code on February 5, 2003.

The Mill had been in operation for approximately forty years and was refurbished by KES Acquisition subsequent to its acquisition. The refurbished Mill has been generating revenues since late January 2004. The current production capacity of the Mill for finished products, based on the current operating structure and man-hours worked, is approximately 200,000 short-tons per year, and the Mill is currently operating at approximately 99% of such annualized capacity. Management is focusing on developing the business and improving operating efficiencies.

The Mill produces bar flats that are produced to a variety of specifications and fall primarily into two general quality levels - merchant bar quality steel bar flats ("MBQ Bar Flats") for generic types of applications, and special bar quality steel bar flats ("SBQ Bar Flats"), where more precise customer specifications require the use of alloys, customized equipment and special production procedures to insure that the finished product meets critical end-use performance characteristics.

The Mill manufactures over 2,600 different Bar Flat items which are sold to volume niche markets, including original equipment manufacturers ("OEMs"), cold drawn bar converters, steel service centers and the leaf-spring suspension market for light- and heavy-duty trucks, mini-vans and utility vehicles. The Mill was specifically designed to manufacture wider and thicker bar flats up to three inches in thickness and twelve inches in width that are required by these markets. In addition, the Mill employs a variety of specially designed equipment which is necessary to manufacture SBQ Bar Flats to the specifications of the Mill's customers.



On March 9, 2005, YouthStream completed the acquisition of KES Acquisition (the "Acquisition"), which was deemed effective March 1, 2005. Pursuant to definitive agreements executed with KES Holdings and Atacama Capital Holdings, Ltd., a British Virgin Islands company ("Atacama", and together with KES Holdings, collectively, the "Sellers"), YouthStream, through its newly-formed subsidiary, YouthStream Acquisition Corp., a Delaware corporation ("Acquisition Corp."), acquired 100% of the membership interests of KES Acquisition by acquiring (i) a 37.45% membership interest from KES Holdings and (ii) all of the capital stock of Atacama KES Holding Corporation, a wholly-owned subsidiary of Atacama ("Atacama KES"), the owner of the remaining 62.55% membership interest in KES Acquisition. As consideration for the Acquisition, Acquisition Corp. issued to the Sellers (i) \$40,000,000 in promissory notes (the "Notes"), (ii) 25,000 shares of 13% Series A Non-Convertible Preferred Stock with an aggregate liquidation value of \$25,000,000 (the "13% Series A Preferred Stock") and (iii) 100% of its authorized shares of Series B Non-Voting Common Stock. With respect to the \$65,000,000 of purchase consideration, \$19,000,000 of the Notes and \$10,000,000 of the 13% Series A Preferred Stock were issued to KES Holdings, and \$21,000,000 of the Notes and \$15,000,000 of the 13% Series A Preferred Stock were issued to Atacama. YouthStream also contributed an aggregate of \$500,000 of cash to Acquisition Corp. as consideration for the issuance by Acquisition Corp. of 100% of its Series A Voting Common Stock. In addition, YouthStream will periodically be required to purchase shares of Series B Preferred Stock of Acquisition Corp. in amounts equal to distributions it receives on its KES Holdings membership interest.

As a result of these transactions, YouthStream owns 80.01% of the common stock, and 100% of the voting stock, of Acquisition Corp. The remaining 19.99% common stock interest in Acquisition Corp. is owned 62.55% by Atacama and 37.45% by KES Holdings. YouthStream currently has a 2.67% equity interest in KES Holdings (this percentage has increased from 1.00% as a result of the redemption of another member's interest), as a result of which the Company has eliminated its \$507,000 equity interest in the Notes and \$267,000 equity interest in the 13% Series A Preferred Stock in the consolidated balance sheet at September 30, 2005, and its \$507,000 equity interest in the Notes and \$0 equity interest in the 13% Series A Preferred Stock in the consolidated balance sheet at March 31, 2006 (see Note 6). YouthStream has consolidated the operations of the Mill through its ownership of KES Acquisition commencing March 1, 2005. As a result of the Acquisition, the Company's financial statements for periods ending after March 1, 2005 are materially different from and are not comparable to its financial statements prior to that date.

Subsequent to the Acquisition, the management of the Mill continued unchanged. The Acquisition did not result in any change in the Mill's business operations or financial condition, and, other than as set forth herein, the working capital, operating cash flow, debt service obligations and credit profile of the Mill were not affected in any way by the Acquisition.

As described herein, the Notes and 13% Series A Preferred Stock were issued by Acquisition Corp., the parent company of KES Acquisition. KES Acquisition is a separate legal entity that owns and operates the Mill. The Notes are legal obligations solely of Acquisition Corp., and are not obligations of KES Acquisition, nor are they secured by the assets or cash flows of the Mill. In the future, Acquisition Corp. may grant liens to secure repayment of the Notes, upon the consent of any senior lender to KES Acquisition at that time. In addition, the Notes are non-recourse to the assets of YouthStream, except for the shares of capital stock of Acquisition Corp. that have been pledged by YouthStream to the holders of the Notes. Pursuant to the terms of the transaction documentation in connection with the Acquisition and the loan facility with General Electric Capital Corporation ("GECC"), YouthStream and Acquisition Corp. are currently limited in their ability to receive cash distributions from KES Acquisition, but are permitted to receive tax sharing payments as described below. Any change in control of Acquisition Corp. in the future as a result of the holders of the Notes exercising their legal rights would not reasonably be expected to have a material impact on the operations or financial position of the Mill.

The Notes are structurally subordinate in right and payment of up to \$40,000,000 of senior debt, including existing debt obligations in favor of GECC. Scheduled principal payments commence in (i) February 2007 with respect to the \$19,000,000 principal amount of Notes issued in favor of KES Holdings and (ii) February 2011 with respect to the \$21,000,000 principal amount of Notes issued in favor of Atacama. In addition, the Notes require additional quarterly

principal payments out of "free cash", as that term is defined in the Note Purchase Agreement. The Notes bear interest at the rate of 8% per annum, payable annually during the first two years of the Note, as provided for in a letter agreement dated as of July 14, 2005 and effective as of February 28, 2005 by and among Acquisition Corp. and the Note holders, and quarterly thereafter. The obligations of Acquisition Corp. under the Notes are secured by a limited guaranty by YouthStream, which guaranty is secured by and limited in recourse solely to a pledge by YouthStream of all of its interest in Acquisition Corp. As of September 30, 2005, the balance outstanding on the Notes was \$39,493,000, and related accrued interest payable was \$1,852,384. As of June 30, 2006, the balance outstanding on the notes was \$39,493,000 (of which \$1,849,300 was classified as a current liability) and the related accrued interest payable was \$1,064,688 (which was classified as a current liability).

Future scheduled principal payments on the Notes are summarized as follows:

| <u>Years Ending September 30,</u> | <b>KES Holdings -<br/>\$19,000,000 Note</b> | <b>Atacama -<br/>\$21,000,000 Note</b> |
|-----------------------------------|---------------------------------------------|----------------------------------------|
| 2006                              | \$ ---                                      | \$ ---                                 |
| 2007                              | 1,900,000                                   | ---                                    |
| 2008                              | 950,000                                     | ---                                    |
| 2009                              | 950,000                                     | ---                                    |
| 2010                              | 950,000                                     | ---                                    |
| 2011                              | 2,850,000                                   | 4,200,000                              |
| 2012                              | 2,850,000                                   | 4,200,000                              |
| 2013                              | 2,850,000                                   | 4,200,000                              |
| 2014                              | ---                                         | 1,264,000                              |
| 2015                              | 5,700,000                                   | 7,136,000                              |
| <b>Total</b>                      | <b>\$ 19,000,000</b>                        | <b>\$ 21,000,000</b>                   |

Pursuant to a further letter agreement dated April 11, 2006 and effective as of February 27, 2006 by and among Acquisition Corp. and the Note holders, the interest payment of \$3,200,000 due on February 27, 2006 was paid by the delivery of short-term notes due February 27, 2007 in the principal amount of \$3,200,000, with interest at 8% per annum. The balance outstanding on the notes, net of eliminations, was \$3,159,416 at June 30, 2006. Accrued interest payable was \$85,174 at June 30, 2006.

For the nine months ending September 30, 2005, Acquisition Corp., KES Acquisition and Atacama KES were collectively required to have, on a consolidated basis, in excess of \$4,000,000 of earnings before interest, taxes, depreciation and amortization, calculated in accordance with generally accepted accounting principles ("EBITDA"). For each of the fiscal years ending on and after September 30, 2006, Acquisition Corp., KES Acquisition and Atacama KES are collectively required to have, on a consolidated basis, in excess of \$7,200,000 of EBITDA. At March 31 of each fiscal year following the fiscal year ending September 30, 2005 in which the obligations under the Notes remain outstanding, Acquisition Corp., KES Acquisition and Atacama KES are collectively required to have, on a consolidated basis, in excess of \$3,000,000 of EBITDA for the six months then ended. Effective September 23, 2005, the holders of the Notes executed an agreement to amend the Notes to eliminate the requirement that Acquisition Corp., KES Acquisition and Atacama KES collectively have, on a consolidated basis, in excess of \$4,000,000 of EBITDA for the nine months ending September 30, 2005. The Company was in compliance with this minimum EBITDA requirement for the nine months ended June 30, 2006.

The holders of each share of 13% Series A Preferred Stock are entitled to receive a cumulative dividend at an annual rate of 13% of the sum of \$1,000 and all accrued but unpaid dividends. The 13% Series A Preferred Stock contains a liquidation preference equal to \$1,000 per share, plus accrued but unpaid dividends, and is redeemable out of, and to the extent of, legally available funds, at a redemption price equal to the sum of \$1,000 and all accrued but unpaid dividends on the earlier to occur of (i) any liquidation of Acquisition Corp., (ii) the occurrence of an event of default under the Note Purchase Agreement pursuant to which the Notes were issued or (iii) the first anniversary of

Acquisition Corp.'s full and complete repayment of the Notes. As of September 30, 2005, the balance outstanding on the 13% Series A Preferred Stock was \$24,733,000, and related accrued dividends payable were \$1,885,129. As of June 30, 2006, the balance outstanding on the 13% Series A Preferred Stock was \$25,000,000 and related accrued dividends payable were \$4,336,301.

Since the acquisition of the Mill by the Sellers, the Mill has been operating under a Management Services Agreement with Pinnacle Steel, LLC (the "Pinnacle Agreement"), which agreement remained in effect following the closing. The principals of Pinnacle Steel LLC that manage the Mill have significant experience and expertise in the steel industry. The Pinnacle Agreement will remain in effect through October 31, 2009, subject to earlier termination or extension based on the financial performance of the Mill. Pinnacle is entitled to a monthly management fee and a management incentive fee as provided in the Pinnacle Agreement.

Subsequent to the acquisition of the Mill by the Sellers, KES Acquisition issued an aggregate of \$7,000,000 of subordinated promissory notes to the Sellers and certain of their respective affiliates (the "Subordinated Promissory Notes"). The proceeds from the Subordinated Promissory Notes were used to accelerate the development and expansion of the Mill's operations. The Subordinated Promissory Notes bear interest at the rate of 12% per annum, with interest payable monthly, subject to compliance with various agreements and covenants, are secured by a subordinated security interest in all of the assets of KES Acquisition, and are subject to an Intercreditor and Subordination Agreement dated March 24, 2004 with GECC. When originally issued, principal and interest were due and payable upon the earlier to occur of (i) an event of default under the Loan and Security Agreement with GECC or (ii) each note's respective due date, which ranged from March 31, 2005 to December 31, 2005. As of September 30, 2005, the due dates of the notes had all been extended to December 31, 2006, if not repaid earlier. At September 30, 2005, accrued interest payable with respect to the Subordinated Promissory Notes was \$1,085,753. At June 30, 2006, accrued interest payable with respect to the Subordinated Promissory Notes was \$209,425.

Related parties with respect to this transaction are summarized as follows: Robert Scott Fritz, a director of YouthStream, is an investor in KES Holdings. Hal G. Byer, another director of YouthStream, is an employee of affiliates of Libra/KES Investment I, LLC ("Libra/KES"), the Manager of KES Holdings, and has an economic interest in KES Holdings through his relationship with Libra Securities, LLC ("Libra Securities"). Jess M. Ravich, a director of YouthStream effective as of June 26, 2006, is a principal of Libra/KES. In addition, affiliates of Mr. Ravich, including a trust for the benefit of Mr. Ravich and certain of his family members (the "Ravich Trust") are investors in KES Holdings. Mr. Ravich, either directly or through the Ravich Trust, holds 1,860,000 shares of YouthStream's common stock, warrants to purchase 500,000 shares of YouthStream's common stock exercisable through August 31, 2008, 1,000,000 shares of YouthStream's redeemable preferred stock and an option to purchase 200,000 shares of YouthStream's common stock exercisable through June 26, 2013, which was issued to Mr. Ravich under YouthStream's 2000 Stock Option Incentive Plan in connection with his election to the Board of Directors. Through his positions at Libra/KES, Mr. Ravich managed the business of KES Acquisition through February 28, 2005. Subordinated Promissory Notes with a principal amount of \$1,650,000 and \$450,000 are payable to the Ravich Trust and Libra Securities Holdings, LLC, the parent of Libra Securities, respectively. Mr. Fritz and Mr. Byer have each previously acquired an option from the Ravich Trust for \$2,500 (\$0.04 per share) to purchase 62,500 shares of YouthStream's redeemable preferred stock issued to the Ravich Trust in January 2003, exercisable at \$0.36 per share until December 31, 2006 or earlier upon the occurrence of certain events.

The Acquisition was accounted for as a purchase in accordance with SFAS No. 141, "Business Combinations", and in accordance with Emerging Issues Task Force ("EITF") No. 88-16, "Basis in Leveraged Buyout Transactions". As a result of the substantial and continuing relationships between YouthStream and the Sellers, and the provisions of EITF 88-16 that are required to be considered when determining the extent of fair value/predecessor basis to be used in recording the transaction, the Acquisition has been recorded at predecessor basis. Since the debt and equity held by the Sellers represented almost the entire amount of capital at risk both before and after the Acquisition, the application of the "monetary test" specified in Section 3 of EITF 88-16, which limits the portion of the purchase consideration that can be valued at fair value to the percentage of the total consideration that is monetary, was utilized by the Company

in determining to record the transaction at predecessor basis. The excess of the purchase price over predecessor basis of the net assets acquired has been reflected as a deemed distribution of \$63,104,423 to the Sellers at the date of acquisition in the consolidated financial statements.

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For taxable periods beginning after February 28, 2005, Acquisition Corp. and Atacama KES are included in the consolidated federal income tax return filed by YouthStream as the common parent. Acquisition Corp. and Atacama KES have entered into a Tax Sharing Agreement with YouthStream, pursuant to which they have agreed to pay YouthStream an amount equal to 50% of their respective "separate company tax liability", subject to compliance with the GECC secured line of credit. The term "separate company tax liability" is defined as the amount, if any, of the federal income tax liability (including, without limitation, liability for any penalty, fine, additions to tax, interest, minimum tax and other items applicable to such subsidiary in connection with the determination of the subsidiary's tax liability), which such subsidiary would have incurred if its federal income tax liability for the periods during which it is includible in a consolidated federal income tax return with YouthStream were determined generally in the same manner in which its separate return liability would have been calculated under Section 1552(a)(2) of the Internal Revenue Code of 1986, as amended. YouthStream has approximately \$255,000,000 of federal net operating loss carryovers currently available to offset the consolidated federal taxable income of the affiliated group in the future.

The total purchase price of \$65,000,000, as well as the terms and conditions of the Notes and 13% Series A Preferred Stock issued to the Sellers, was determined to be at fair value based on reports prepared by an independent valuation firm.

The following is a summary of the assets acquired and liabilities assumed at predecessor basis at February 28, 2005.

|                                                  |                     |
|--------------------------------------------------|---------------------|
| <b>Assets Acquired:</b>                          |                     |
| Cash                                             | \$ 913,194          |
| Accounts receivable                              | 10,781,836          |
| Allowance for doubtful accounts                  | (328,351)           |
| Inventories                                      | 18,762,218          |
| Prepaid expenses and other current assets        | 904,271             |
| Property, plant and equipment                    | 6,630,012           |
| Accumulated depreciation and amortization        | (639,254)           |
| Due from YouthStream Acquisition Corp.           | 187,702             |
| Other non-current assets                         | 721,393             |
| <b>Total assets acquired</b>                     | <b>37,933,021</b>   |
| <b>Liabilities Assumed:</b>                      |                     |
| Accounts payable                                 | 9,566,327           |
| Accrued expenses                                 | 1,267,016           |
| Accrued interest payable                         | 593,260             |
| Deferred rent                                    | 165,413             |
| Subordinated promissory notes payable            | 7,000,000           |
| Line of credit                                   | 15,495,095          |
| Equipment contract payable                       | 291,223             |
| Capital lease obligation                         | 1,877,179           |
| <b>Total liabilities assumed</b>                 | <b>36,255,513</b>   |
| <b>Net assets acquired</b>                       | <b>1,677,508</b>    |
| <b>Adjustment to recognize minority interest</b> | <b>(331,981)</b>    |
|                                                  | <b>\$ 1,345,527</b> |

|                                                                                                        |    |              |
|--------------------------------------------------------------------------------------------------------|----|--------------|
| Total purchase consideration, net of intercompany eliminations of 2.67% interest held by KES Holdings: |    |              |
| 8% Subordinated secured promissory notes payable                                                       | \$ | 39,493,000   |
| 13% Series A preferred stock                                                                           |    | 24,733,000   |
| Net purchase consideration                                                                             |    | 64,226,000   |
| Minority interests in equity                                                                           |    | 223,950      |
| Adjustment to record deemed distribution to Sellers                                                    |    | (63,104,423) |
|                                                                                                        | \$ | 1,345,527    |

The amount due from Acquisition Corp. of \$187,702 represents costs incurred by KES Acquisition with respect to the Acquisition, which were included in the \$1,171,406 of transaction costs related to the Acquisition charged to operations during the year ended September 30, 2005.

As of September 30, 2004, the Company had incurred \$175,144 of costs with respect to the Acquisition, which were presented as deferred costs in the Company's consolidated balance sheet at such date. These costs were included in the \$1,171,406 of transaction costs related to the Acquisition charged to operations during the year ended September 30, 2005.

Minority interest - related parties was \$430,931 on February 28, 2005. For the year ended September 30, 2005, the net loss of Acquisition Corp. (an 80.01% consolidated subsidiary) allocable to the 19.99% minority shareholders was \$681,698, but the reduction to minority interest - related parties was limited to the balance at February 28, 2005 of \$430,931. Accordingly, the remainder of the net loss of Acquisition Corp. allocable to the 19.99% minority shareholders for the year ended September 30, 2005 of \$250,767 was included in the Company's consolidated statement of operations for the year ended September 30, 2005, and will be recovered to the extent that Acquisition Corp. generates net income in future periods. For the three months and nine months ended June 30, 2006, net income allocable to the 19.99% minority shareholders was \$26,210 and \$56,439, respectively.

The following pro forma operating data shown below presents the results of operations for the three months and nine months ended June 30, 2005, as if the Acquisition had occurred on the last day of the immediately preceding fiscal period. Accordingly, transaction costs related to the Acquisition are not included in the net loss from continuing operations shown below. The pro forma results are not necessarily indicative of the financial results that might have occurred had the Acquisition actually taken place on the respective dates, or of future results of operations. Pro forma information for the three months and nine months ended June 30, 2005 is summarized as follows:

|                                             | <b>Three<br/>Months<br/>Ended<br/>June 30,<br/>2005</b> | <b>Nine<br/>Months<br/>Ended<br/>June 30,<br/>2005</b> |
|---------------------------------------------|---------------------------------------------------------|--------------------------------------------------------|
| Net sales                                   | \$ 29,127,566                                           | \$ 82,865,839                                          |
| Cost of sales                               | 27,194,477                                              | 77,993,132                                             |
| Gross margin                                | 1,933,089                                               | 4,872,707                                              |
| Operating income                            | 638,552                                                 | 1,066,767                                              |
| Interest expense                            | (2,371,888)                                             | (7,075,831)                                            |
| Minority interest                           | 218,439                                                 | 218,439                                                |
| Net loss from continuing operations         | \$ (1,500,737)                                          | \$ (5,693,104)                                         |
| Basic and diluted net loss per common share | \$ (0.04)                                               | \$ (0.15)                                              |
| Weighted average common shares outstanding  | 39,242,251                                              | 39,242,251                                             |

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Almost all of the Company's net assets are owned by KES Acquisition, a consolidated subsidiary. As a result of various contractual restrictions contained in various financing agreements (as previously described) and documents relating to the Acquisition, there are limits on the Company's ability to transfer assets from KES Acquisition to Youthstream, whether in the form of loans and advances, cash dividends, tax-sharing payments, or otherwise, without notice to and/or consent of one or more third parties.

A summary of the Company's restricted and unrestricted assets, liabilities and equity at June 30, 2006 (unaudited) and at September 30, 2005 is presented below.

| <u>June 30, 2006</u>                    | <b>Unrestricted</b> | <b>Restricted</b>    | <b>As Reported</b>   |
|-----------------------------------------|---------------------|----------------------|----------------------|
| Current assets                          | \$ 878,875          | \$ 32,677,835        | \$ 33,556,710        |
| Property, plant and equipment, net      | -                   | 5,020,120            | 5,020,120            |
| Other assets                            | -                   | 462,130              | 462,130              |
| <b>Total assets</b>                     | <b>\$ 878,875</b>   | <b>\$ 38,160,085</b> | <b>\$ 39,038,960</b> |
| Current liabilities                     | \$ 10,182,245       | \$ 28,823,608        | \$ 39,005,853        |
| Non-current liabilities                 | 77,306,610          | 1,221,267            | 78,527,877           |
| Equity:                                 |                     |                      |                      |
| Retained earnings (accumulated deficit) | (352,337,270)       | 6,437,702            | (345,899,568)        |
| Other                                   | 265,727,290         | 1,677,508            | 267,404,798          |
| <b>Total liabilities and equity</b>     | <b>\$ 878,875</b>   | <b>\$ 38,160,085</b> | <b>\$ 39,038,960</b> |
| <u>September 30, 2005</u>               | <b>Unrestricted</b> | <b>Restricted</b>    | <b>As Reported</b>   |
| Current assets                          | \$ 261,740          | \$ 35,453,821        | \$ 35,715,561        |
| Property, plant and equipment, net      | -                   | 5,567,745            | 5,567,745            |
| Other assets                            | -                   | 638,948              | 638,948              |
| <b>Total assets</b>                     | <b>\$ 261,740</b>   | <b>\$ 41,660,514</b> | <b>\$ 41,922,254</b> |
| Current liabilities                     | \$ 4,224,995        | \$ 30,411,237        | \$ 34,636,232        |
| Non-current liabilities                 | 78,257,234          | 8,629,138            | 86,886,372           |
| Equity:                                 |                     |                      |                      |
| Retained earnings (accumulated deficit) | (348,435,183)       | 1,169,785            | (347,265,398)        |
| Other                                   | 266,214,694         | 1,450,354            | 267,665,048          |
| <b>Total liabilities and equity</b>     | <b>\$ 261,740</b>   | <b>\$ 41,660,514</b> | <b>\$ 41,922,254</b> |

**3. Inventories**

Inventories are comprised of the following at June 30, 2006 and September 30, 2005:

|                         | <b>June 30,<br/>2006<br/>(Unaudited)</b> | <b>September 30,<br/>2005</b> |
|-------------------------|------------------------------------------|-------------------------------|
| Raw materials and scrap | \$ 3,669,997                             | \$ 2,954,405                  |
| Semi-finished goods     | 6,251,028                                | 6,556,006                     |
| Finished goods          | 9,321,221                                | 8,370,394                     |
| Total                   | \$ 19,242,246                            | \$ 17,880,805                 |

Inventories are comprised of raw materials (consisting of billets and scrap metal), semi-finished goods and finished goods. Inventory costs include material, labor and manufacturing overhead. Inventories are valued at the lower of average cost or market. The average cost of the billets and scrap metal is adjusted periodically to reflect current changes in cost inputs.

**4. Notes Payable and Long-Term Debt****Notes Payable to Related Parties**

During September 2005, the Company borrowed \$50,000 from certain directors under short-term unsecured notes due December 31, 2005, with interest at 4% per annum, to fund corporate general and administrative expenses. The notes were subject to mandatory prepayment based on any proceeds received by the Company from, among other sources, the note that the Company received in February 2004 from the sale of the assets and operations of its subsidiary, Beyond the Wall, Inc., and any tax sharing payments received under the Tax Sharing Agreement with Acquisition Corp. and Atacama KES (see Note 2). On September 30, 2005, the Company received a cash payment of \$258,922 as settlement in full of the outstanding note receivable from the sale of the assets and operations of Beyond the Wall, Inc., and repaid the notes payable to directors in October 2005.

**Subordinated Secured Promissory Notes Payable to Related Parties**

Subordinated secured promissory notes payable consist of seven notes payable aggregating \$7,000,000 issued by KES Acquisition to three related parties. The proceeds from these notes were used to accelerate the development and expansion of the steel mini-mill's operations prior to its acquisition by the Company. The notes bear interest at 12% per annum, with interest payable monthly, subject to compliance with various agreements and covenants, are secured by a subordinated security interest in all of the assets of KES Acquisition, and are subject to an Intercreditor and Subordination Agreement dated March 24, 2004 with GECC. When originally issued, principal and interest were due and payable upon the earlier to occur of (i) an event of default under the Loan and Security Agreement with GECC or (ii) each note's respective due date, which ranged from March 31, 2005 to December 31, 2005. As of September 30, 2005, the due dates of the notes had all been extended to December 31, 2006, if not repaid earlier. At June 30, 2006 and September 30, 2005, accrued interest payable with respect to the subordinated secured promissory notes payable was \$209,425 and \$1,085,753, respectively.

At June 30, 2006, KES Acquisition was in compliance with all terms and covenants relating to its subordinated secured promissory notes payable.

On August 29, 2006, the subordinated secured promissory notes were amended and restated to extend their maturity date to March 31, 2010, with all other terms and conditions described above remaining substantially the same.

On August 31, 2006, the Company made a principal payment on the subordinated secured promissory notes of \$4,000,000.

## **Secured Line of Credit**

Effective March 24, 2004, KES Acquisition entered into a loan and security agreement, as amended, with GECC. Under the terms of the agreement, KES Acquisition has the ability to borrow up to \$23,000,000, subject to limitations under the lender's borrowing base formula and compliance with a minimum fixed charge coverage ratio. Interest is payable monthly in arrears on the outstanding principal balance at the index rate (defined as the thirty-day dealer commercial paper rate) plus 3.5% per annum. The line of credit originally matured on March 24, 2007, however, was extended to March 24, 2010 on August 27, 2006 (see below), and is secured by all of the assets of KES Acquisition and a pledge of (i) the membership interests of KES Acquisition owned by Acquisition Corp. and (ii) the capital stock of Atacama KES owned by Acquisition Corp. As of June 30, 2006 and September 30, 2005, the balance outstanding on the line of credit was \$9,890,679 and \$19,009,379, respectively, which has been presented as a current liability in the consolidated balance sheet at such date due to the collateral securing such line of credit consisting primarily of current assets and the continuing uncertainty with respect to the Company's ability to maintain compliance under the terms and conditions of the line of credit.

At March 31, 2005, KES Acquisition was not in compliance with the fixed charge coverage ratio based on its consolidated financial statements as originally filed, in part relating to changes to its accounting procedures as a result of the review of its financial statements conducted in conjunction with its acquisition by YouthStream (see Note 2), and subsequently received a waiver of default from the lender. At June 30, 2005, KES Acquisition was in compliance with the fixed charge coverage ratio based on its consolidated financial statements as originally filed. However, KES Acquisition was not in compliance with the fixed charge coverage ratio at June 30, 2005 based on its revised consolidated financial statements, as a result of a determination by management to re-characterize a lease for certain equipment used by KES Acquisition as a capital lease rather than an operating lease. In addition, KES Acquisition was not in compliance with its obligation to deliver audited financial statements in the form and time period as set forth in the loan agreement. On June 26, 2006, the Company received a waiver of default from the lender with respect to the fixed charge coverage ratio for the restated March 31, 2005 and June 30, 2005 interim financial statements, as well as with respect to the form and timeliness of the September 30, 2005 annual audited financial statements being provided to GECC.

At June 30, 2006, March 31, 2006, December 31, 2005 and September 30, 2005, KES Acquisition was in compliance with the fixed charge coverage ratio based on its consolidated financial statements.

In the event that KES Acquisition is not in compliance with the fixed charge coverage ratio in any future period, the Company intends to seek a further waiver of any default from the lender, and if no such waiver is received, the lender would have the right to accelerate the maturity of the line of credit at that time.

On August 29, 2006, the loan and security agreement with GECC was amended and restated to extend its maturity date to March 24, 2010, and to allow the payment of principal on the Company's subordinated secured promissory notes, subject to compliance with various agreements and covenants, with all other terms and conditions described above remaining substantially the same.

## **5. Commitments and Contingencies**

### **Legal Proceedings**

The Company and/or its subsidiary that owned its former operating business, Beyond the Wall, Inc., have periodically been defendants in various lawsuits and claims from various trade creditors and former landlords. Based on the Company's contract relating to the sale of the Beyond the Wall, Inc. assets, certain of these claims are the responsibility of the buyer of the Beyond the Wall, Inc. business. The Company evaluates its response in each situation based on the particular facts and circumstances of a claim. Accordingly, the ultimate outcome of these

matters cannot be determined at this time and may ultimately result in judgments and liens against the Company or its assets. The Company has made sufficient accruals for the exposure related to such matters that have been deemed probable and reasonably estimable at June 30, 2006 and September 30, 2005.

KES Acquisition was named in a wrongful death lawsuit before the Circuit Court of Cabell County, West Virginia (the "Court"), which was filed in December 2004. The action was brought by Stephanie Harshbarger, individually and as Administratrix of the Estate of Chad Harshbarger against Aero-Fab, Inc. and KES Acquisition. Mr. Harshbarger was an employee of Aero-Fab, Inc., an unaffiliated contractor, who died while working at the Mill in April 2004. KES Acquisition was defended by its insurance carrier in this action. On July 3, 2006, the Court dismissed KES Acquisition from the lawsuit, ruling that KES Acquisition was not within the Court's jurisdiction. Notwithstanding such Court ruling, the plaintiff may appeal the ruling, or file an action against KES Acquisition in the State of Kentucky, neither of which has occurred to date. The Company does not believe that the resolution of this litigation will have a material adverse effect on its financial condition or results of operations.

## Operating Commitments

The Mill has been operating under a the Pinnacle Agreement effective through October 31, 2009 that provides for Pinnacle Steel, LLC to provide, at its expense, employees to serve as the General Manager of the Mill and provide oversight and general management of the operations of the Mill, for which the management company receives an annual fee of \$700,000, payable monthly, and bonus payments based on 16.6% of defined earnings before interest, taxes, depreciation and amortization ("EBITDA") in excess of \$6,000,000 for the fiscal years ending September 30, 2006 and thereafter. Management bonus charged to operations was \$437,000 and \$1,101,000 for the three months and nine months ended June 30, 2006, respectively.

The Company has various short-term commitments for the purchase of materials, supplies and energy arising in the ordinary course of business which aggregated approximately \$7,900,000 and \$7,962,000 at June 30, 2006 and September 30, 2005, respectively.

## 6. Common and Preferred Stock

On December 22, 2005, 10,000 shares of 13% Series A Preferred Stock with a face amount of \$10,000,000 that were originally issued by Acquisition Corp. to KES Holdings in February 2005 (see Note 2) were transferred to two independent charities. Since the Company owned a 2.67% interest in KES Holdings, the pro rata portion of the face amount of such 13% Series A Preferred Stock and the related accrued dividends had previously been eliminated in consolidation. However, as a result of the transfer of such preferred shares to the two charities in December 2005, the Company recorded the previously eliminated portion of the face amount of the 13% Series A Preferred Stock (\$267,000) as a deemed distribution to the Sellers of KES Acquisition, consistent with the accounting for the Acquisition as described at Note 2, and the previously eliminated portion of the preferred stock dividends (\$28,243) through December 22, 2005, as interest expense.

On February 15, 2005, the Company issued an option to purchase 200,000 shares of common stock to a new director, exercisable through February 15, 2012 at \$0.30 per share, which was the fair market value on the date of issuance. The fair value of the option, calculated pursuant to the Black-Scholes option-pricing model, was \$54,000 (\$0.27 per share). The option vests over a 12-month period in equal monthly installments beginning March 1, 2005.

On June 26, 2006, the Company issued an option to purchase 200,000 shares of common stock to a new director, exercisable through June 26, 2013 at \$0.12 per share, which was the fair market value on the date of issuance. The fair value of the option, calculated pursuant to the Black-Scholes option-pricing model, was \$24,000 (\$0.12 per share). The option vests over a 12-month period in equal monthly installments beginning July 1, 2006.

## 7. Income Taxes

Income tax expense was \$146,000 and \$274,000 for the three months and nine months ended June 30, 2006, respectively, consisting of a provision for state income taxes. No federal income tax provision was provided for the three months and nine months ended June 30, 2006 as a result of the utilization of the Company's net operating loss carryforwards as described below. No federal or state income tax provision was provided for the three months and nine months ended June 30, 2005 due to the Company reporting a pre-tax operating loss for such periods.

At September 30, 2005, the Company had net operating loss carryforwards for federal income tax purposes of approximately \$291,060,000 that expire from 2012 through 2025. The use of approximately \$36,000,000 of this net operating loss in future years may be restricted under Section 382 of the Internal Revenue Code.



In assessing the potential realization of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will be realized. The ultimate realization of deferred tax assets is dependent upon the Company attaining future taxable income during the periods in which those temporary differences become deductible. As of September 30, 2005, management was unable to determine if it was more likely than not that the deferred tax assets would be realized. Accordingly, due to the uncertainty surrounding the realization of the benefits of the Company's tax attributes (primarily net operating loss carryforwards), as of September 30, 2005, the Company recorded a 100% valuation allowance against its net deferred tax assets for financial reporting purposes.

The Company is subject to periodic audits by federal, state and local tax authorities for various tax liabilities incurred in prior periods from the parent entity and its subsidiaries, including previously discontinued businesses. The amount of any tax assessments and penalties may be material and may negatively impact the Company's operations. Given the uncertainty in the amount and the difficulty in estimating the probability of the assessments arising from future tax audits, the Company has not made any accruals for such tax contingencies.

For taxable periods beginning after February 28, 2005, Acquisition Corp. and Atacama KES (see Note 2) are included in the consolidated federal income tax return filed by YouthStream as the common parent. Acquisition Corp. and Atacama KES have entered into a Tax Sharing Agreement with YouthStream, pursuant to which they have agreed to pay YouthStream an amount equal to 50% of their respective "separate company tax liability", subject to compliance with the GECC secured line of credit. The term "separate company tax liability" is defined as the amount, if any, of the federal income tax liability (including, without limitation, liability for any penalty, fine, additions to tax, interest, minimum tax and other items applicable to such subsidiary in connection with the determination of the subsidiary's tax liability), which such subsidiary would have incurred if its federal income tax liability for the periods during which it is includible in a consolidated federal income tax return with YouthStream were determined generally in the same manner in which its separate return liability would have been calculated under Section 1552(a)(2) of the Internal Revenue Code of 1986, as amended. YouthStream has approximately \$255,000,000 of federal net operating loss carryovers currently available to offset the consolidated federal taxable income of the affiliated group in the future.

## **8. Subsequent Events**

### **Investment in Planet Hollywood (Alabama), LLC**

In August 2006, YouthStream invested \$75,000 to acquire an 8.82% membership interest in Planet Hollywood (Alabama), LLC, a Florida limited liability company, to pursue a licensing and merchandising arrangement with Planet Hollywood International, Inc., or one or more of its subsidiaries ("PHI"). Planet Hollywood (Alabama), LLC was formed by PHI on June 22, 2005 and assigned certain rights held by PHI in connection with PHI's role in the development of a charitable bingo facility, restaurant and entertainment venue in Shorter, Alabama with Lucky Palace, LLC ("Lucky"), a subsidiary of Lucky Palace, Inc. Libra Securities Holdings, LLC ("Libra Holdings") is also involved in this business enterprise.

Related parties with respect to this transaction are summarized as follows: Robert Scott Fritz, a director of YouthStream, is expected to be an investor in Lucky. Hal G. Byer, another director of YouthStream, is an employee of affiliates of Libra Holdings, and has an economic interest in Lucky. Jess M. Ravich, a director of YouthStream, is a principal of Libra Securities, a subsidiary of Libra Holdings. In addition, affiliates of Mr. Ravich, including a trust for the benefit of Mr. Ravich and certain of his family members (the "Ravich Trust") are investors in Planet Hollywood (Alabama), LLC and are expected to be investors in Lucky. Mr. Ravich, either directly or through the Ravich Trust, holds 1,860,000 shares of YouthStream's common stock, warrants to purchase 500,000 shares of YouthStream's common stock exercisable through August 31, 2008, 1,000,000 shares of YouthStream's redeemable preferred stock and an option to purchase 200,000 shares of YouthStream's common stock exercisable through June 26, 2013, which was issued to Mr. Ravich under YouthStream's 2000 Stock Option Incentive Plan. Subordinated Promissory Notes with a principal amount of \$1,650,000 and \$450,000 are payable to the Ravich Trust and Libra Holdings, respectively.

Mr. Fritz and Mr. Byer have each previously acquired an option from the Ravich Trust for \$2,500 (\$0.04 per share) to purchase 62,500 shares of YouthStream's redeemable preferred stock issued to the Ravich Trust in January 2003, exercisable at \$0.36 per share until December 31, 2006 or earlier upon the occurrence of certain events (see Note 2).

### **Renegotiated Debt Agreements**

On August 29, 2006, the loan and security agreement with GECC was amended and restated to extend its maturity date to March 24, 2010, and to allow the payment of principal on the Company's subordinated secured promissory notes, subject to compliance with various agreements and covenants, with all other terms and conditions described above remaining substantially the same (See Note 4).

On August 29, 2006, the subordinated secured promissory notes were amended and restated to extend their maturity date to March 31, 2010, with all other terms and conditions described above remaining substantially the same (See Note 4).

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

### General Overview

Commencing March 1, 2005, the Company has included the operations of a steel mini-mill located in Ashland, Kentucky, which represents the only business segment in which the Company currently operates, in its consolidated financial statements. The Company completed the acquisition of this steel mini-mill on March 9, 2005 (see "Acquisition of Steel Mini-Mill" below).

During September 2005, the Company borrowed \$50,000 from certain directors under short-term unsecured notes due December 31, 2005, with interest at 4% per annum, to fund corporate general and administrative expenses. The notes were subject to mandatory prepayment based on any proceeds received by the Company from, among other sources, the note that the Company received in February 2004 from the sale of the assets and operations of its subsidiary, Beyond the Wall, Inc., and any tax sharing payments received under the Tax Sharing Agreement with Acquisition Corp. and Atacama KES (see "Acquisition of Steel Mini-Mill" below). On September 30, 2005, the Company received a cash payment of \$258,922 as settlement in full of the outstanding note receivable from the sale of the assets and operations of Beyond the Wall, Inc., and repaid the notes payable to directors in October 2005.

### Acquisition of Steel Mini-Mill

In September 2003, YouthStream invested \$125,000 to acquire a 1.00% membership interest in KES Holdings, LLC, a Delaware limited liability company ("KES Holdings"), which was formed to acquire certain assets of Kentucky Electric Steel, Inc., a Delaware corporation ("KES"), consisting of a steel mini-mill located in Ashland, Kentucky (the "Mill"). On September 2, 2003, KES Holdings, through its subsidiary, KES Acquisition Company, LLC, a Delaware limited liability company ("KES Acquisition"), completed the acquisition of the Mill pursuant to Section 363 of the United States Bankruptcy Code for cash consideration of \$2,650,000, which was funded through the capital contributions of the members of KES Holdings. Members' capital contributions were also used for start-up costs, working capital purposes and payment of deferred maintenance of the Mill. KES had ceased production on or about December 16, 2002 and filed a voluntary petition for relief under Chapter 11 of the United States Bankruptcy Code on February 5, 2003.

The Mill had been in operation for approximately forty years and was refurbished by KES Acquisition subsequent to its acquisition. The refurbished Mill has been generating revenues since late January 2004. The current production capacity of the Mill for finished products, based on the current operating structure and man-hours worked, is approximately 200,000 short-tons per year, and the Mill is currently operating at approximately 99% of such annualized capacity. Management is focusing on developing the business and improving operating efficiencies.

The Mill produces bar flats that are produced to a variety of specifications and fall primarily into two general quality levels - merchant bar quality steel bar flats ("MBQ Bar Flats") for generic types of applications, and special bar quality steel bar flats ("SBQ Bar Flats"), where more precise customer specifications require the use of alloys, customized equipment and special production procedures to insure that the finished product meets critical end-use performance characteristics.

The Mill manufactures over 2,600 different Bar Flat items which are sold to volume niche markets, including original equipment manufacturers ("OEMs"), cold drawn bar converters, steel service centers and the leaf-spring suspension market for light- and heavy-duty trucks, mini-vans and utility vehicles. The Mill was specifically designed to manufacture wider and thicker bar flats up to three inches in thickness and twelve inches in width that are required by these markets. In addition, the Mill employs a variety of specially designed equipment which is necessary to manufacture SBQ Bar Flats to the specifications of the Mill's customers.

On March 9, 2005, YouthStream completed the acquisition of KES Acquisition (the "Acquisition"), which was deemed effective March 1, 2005. Pursuant to definitive agreements executed with KES Holdings and Atacama Capital Holdings, Ltd., a British Virgin Islands company ("Atacama", and together with KES Holdings, collectively, the "Sellers"), YouthStream, through its newly-formed subsidiary, YouthStream Acquisition Corp., a Delaware corporation ("Acquisition Corp."), acquired 100% of the membership interests of KES Acquisition by acquiring (i) a 37.45% membership interest from KES Holdings and (ii) all of the capital stock of Atacama KES Holding Corporation, a wholly-owned subsidiary of Atacama ("Atacama KES"), the owner of the remaining 62.55% membership interest in KES Acquisition. As consideration for the Acquisition, Acquisition Corp. issued to the Sellers (i) \$40,000,000 in promissory notes (the "Notes"), (ii) 25,000 shares of 13% Series A Non-Convertible Preferred Stock with an aggregate liquidation value of \$25,000,000 (the "13% Series A Preferred Stock") and (iii) 100% of its authorized shares of Series B Non-Voting Common Stock. With respect to the \$65,000,000 of purchase consideration, \$19,000,000 of the Notes and \$10,000,000 of the 13% Series A Preferred Stock were issued to KES Holdings, and \$21,000,000 of the Notes and \$15,000,000 of the 13% Series A Preferred Stock were issued to Atacama. YouthStream also contributed an aggregate of \$500,000 of cash to Acquisition Corp. as consideration for the issuance by Acquisition Corp. of 100% of its Series A Voting Common Stock. In addition, YouthStream will periodically be required to purchase shares of Series B Preferred Stock of Acquisition Corp. in amounts equal to distributions it receives on its KES Holdings membership interest.

As a result of these transactions, YouthStream owns 80.01% of the common stock, and 100% of the voting stock, of Acquisition Corp. The remaining 19.99% common stock interest in Acquisition Corp. is owned 62.55% by Atacama and 37.45% by KES Holdings. YouthStream currently has a 2.67% equity interest in KES Holdings (this percentage has increased from 1.00% as a result of the redemption of another member's interest), as a result of which the Company has eliminated its \$507,000 equity interest in the Notes and \$267,000 equity interest in the 13% Series A Preferred Stock in the consolidated balance sheet at September 30, 2005, and its \$507,000 equity interest in the Notes and \$0 equity interest in the 13% Series A Preferred Stock in the consolidated balance sheet at March 31, 2006. YouthStream has consolidated the operations of the Mill through its ownership of KES Acquisition commencing March 1, 2005. As a result of the Acquisition, the Company's financial statements for periods ending after March 1, 2005 are materially different from and are not comparable to its financial statements prior to that date.

Subsequent to the Acquisition, the management of the Mill continued unchanged. The Acquisition did not result in any change in the Mill's business operations or financial condition, and, other than as set forth herein, the working capital, operating cash flow, debt service obligations and credit profile of the Mill were not affected in any way by the Acquisition.

As described herein, the Notes and 13% Series A Preferred Stock were issued by Acquisition Corp., the parent company of KES Acquisition. KES Acquisition is a separate legal entity that owns and operates the Mill. The Notes are legal obligations solely of Acquisition Corp., and are not obligations of KES Acquisition, nor are they secured by the assets or cash flows of the Mill. In the future, Acquisition Corp. may grant liens to secure repayment of the Notes, upon the consent of any senior lender to KES Acquisition at that time. In addition, the Notes are non-recourse to the assets of YouthStream, except for the shares of capital stock of Acquisition Corp. that have been pledged by YouthStream to the holders of the Notes. Pursuant to the terms of the transaction documentation in connection with the Acquisition and the loan facility with General Electric Capital Corporation ("GECC"), YouthStream and Acquisition Corp. are currently limited in their ability to receive cash distributions from KES Acquisition, but are permitted to receive tax sharing payments as described below. Any change in control of Acquisition Corp. in the future as a result of the holders of the Notes exercising their legal rights would not reasonably be expected to have a material impact on the operations or financial position of the Mill.

The Notes are structurally subordinate in right and payment of up to \$40,000,000 of senior debt, including existing debt obligations in favor of GECC. Scheduled principal payments commence in (i) February 2007 with respect to the \$19,000,000 principal amount of Notes issued in favor of KES Holdings and (ii) February 2011 with respect to the \$21,000,000 principal amount of Notes issued in favor of Atacama. In addition, the Notes require additional quarterly principal payments out of "free cash", as that term is defined in the Note Purchase Agreement. The Notes bear interest at the rate of 8% per annum, payable annually during the first two years of the Note, as provided for in a letter agreement dated as of July 14, 2005 and effective as of February 28, 2005 by and among Acquisition Corp. and the Note holders, and quarterly thereafter. The obligations of Acquisition Corp. under the Notes are secured by a limited guaranty by YouthStream, which guaranty is secured by and limited in recourse solely to a pledge by YouthStream of all of its interest in Acquisition Corp. As of September 30, 2005, the balance outstanding on the Notes was \$39,493,000, and related accrued interest payable was \$1,852,384. As of June 30, 2006, the balance outstanding on the notes was \$39,493,000 (of which \$1,849,300 was classified as a current liability) and the related accrued interest payable was \$1,149,862 (which was classified as a current liability).

Future scheduled principal payments on the Notes are summarized as follows:

| <u>Years Ending September 30,</u> | <b>KES Holdings -<br/>\$19,000,000 Note</b> | <b>Atacama -<br/>\$21,000,000 Note</b> |
|-----------------------------------|---------------------------------------------|----------------------------------------|
| 2006                              | \$ ---                                      | \$ ---                                 |
| 2007                              | 1,900,000                                   | ---                                    |
| 2008                              | 950,000                                     | ---                                    |
| 2009                              | 950,000                                     | ---                                    |
| 2010                              | 950,000                                     | ---                                    |
| 2011                              | 2,850,000                                   | 4,200,000                              |
| 2012                              | 2,850,000                                   | 4,200,000                              |
| 2013                              | 2,850,000                                   | 4,200,000                              |
| 2014                              | ---                                         | 1,264,000                              |
| 2015                              | 5,700,000                                   | 7,136,000                              |
| <b>Total</b>                      | <b>\$ 19,000,000</b>                        | <b>\$ 21,000,000</b>                   |

Pursuant to a further letter agreement dated April 11, 2006 and effective as of February 27, 2006 by and among Acquisition Corp. and the Note holders, the interest payment of \$3,200,000 due on February 27, 2006 was paid by the delivery of short-term notes due February 27, 2007 in the principal amount of \$3,200,000, with interest at 8% per annum. The balance outstanding on the notes, net of eliminations, was \$3,159,416 at June 30, 2006. Accrued interest payable was \$85,174 at June 30, 2006.

Pursuant to the Notes, for the nine months ending September 30, 2005, Acquisition Corp., KES Acquisition and Atacama KES were collectively required to have, on a consolidated basis, in excess of \$4,000,000 of earnings before interest, taxes, depreciation and amortization, calculated in accordance with generally accepted accounting principles ("EBITDA"). For each of the fiscal years ending on and after September 30, 2006, Acquisition Corp., KES Acquisition and Atacama KES are collectively required to have, on a consolidated basis, in excess of \$7,200,000 of EBITDA. At March 31 of each fiscal year following the fiscal year ending September 30, 2005 in which the obligations under the Notes remain outstanding, Acquisition Corp., KES Acquisition and Atacama KES are collectively required to have, on a consolidated basis, in excess of \$3,000,000 of EBITDA for the six months then ended. Effective September 23, 2005, the holders of the Notes executed an agreement to amend the Notes to eliminate the requirement that Acquisition Corp., KES Acquisition and Atacama KES collectively have, on a consolidated basis, in excess of \$4,000,000 of EBITDA for the nine months ending September 30, 2005. The Company was in compliance with this minimum EBITDA requirement for the nine months ended June 30, 2006.

The holders of each share of 13% Series A Preferred Stock are entitled to receive a cumulative dividend at an annual rate of 13% of the sum of \$1,000 and all accrued but unpaid dividends. The 13% Series A Preferred Stock contains a liquidation preference equal to \$1,000 per share, plus accrued but unpaid dividends, and is redeemable out of, and to the extent of, legally available funds, at a redemption price equal to the sum of \$1,000 and all accrued but unpaid dividends on the earlier to occur of (i) any liquidation of Acquisition Corp., (ii) the occurrence of an event of default under the Note Purchase Agreement pursuant to which the Notes were issued or (iii) the first anniversary of Acquisition Corp.'s full and complete repayment of the Notes. As of September 30, 2005, the balance outstanding on the 13% Series A Preferred Stock was \$24,733,000, and related accrued dividends payable were \$1,885,129. As of June 30, 2006, the balance outstanding on the 13% Series A Preferred Stock was \$25,000,000 and related accrued dividends payable were \$4,336,301.

Since the acquisition of the Mill by the Sellers, the Mill has been operating under a Management Services Agreement with Pinnacle Steel, LLC (the "Pinnacle Agreement"), which agreement remained in effect following the closing. The principals of Pinnacle Steel, LLC that manage the Mill have significant experience and expertise in the steel industry.

The Pinnacle Agreement will remain in effect through October 31, 2009, subject to earlier termination or extension based on the financial performance of the Mill. Pinnacle is entitled to a monthly management fee and a management incentive fee as provided in the Pinnacle Agreement.

Subsequent to the acquisition of the Mill by the Sellers, KES Acquisition issued an aggregate of \$7,000,000 of subordinated promissory notes to the Sellers and certain of their respective affiliates (the "Subordinated Promissory Notes"). The proceeds from the Subordinated Promissory Notes were used to accelerate the development and expansion of the Mill's operations. The Subordinated Promissory Notes bear interest at the rate of 12% per annum, with interest payable monthly, subject to compliance with various agreements and covenants, are secured by a subordinated security interest in all of the assets of KES Acquisition, and are subject to an Intercreditor and Subordination Agreement dated March 24, 2004 with GECC. When originally issued, principal and interest were due and payable upon the earlier to occur of (i) an event of default under the Loan and Security Agreement with GECC or (ii) each note's respective due date, which ranged from March 31, 2005 to December 31, 2005. As of September 30, 2005, the due dates of the notes had all been extended to December 31, 2006, if not repaid earlier. At September 30, 2005, accrued interest payable with respect to the Subordinated Promissory Notes was \$1,085,753. At June 30, 2006, accrued interest payable with respect to the Subordinated Promissory Notes was \$209,425.

Related parties with respect to this transaction are summarized as follows: Robert Scott Fritz, a director of YouthStream, is an investor in KES Holdings. Hal G. Byer, another director of YouthStream, is an employee of affiliates of Libra/KES Investment I, LLC ("Libra/KES"), the Manager of KES Holdings, and has an economic interest in KES Holdings through his relationship with Libra Securities, LLC ("Libra Securities"). Jess M. Ravich, a director of YouthStream effective as of June 26, 2006, is a principal of Libra/KES. In addition, affiliates of Mr. Ravich, including a trust for the benefit of Mr. Ravich and certain of his family members (the "Ravich Trust") are investors in KES Holdings. Mr. Ravich, either directly or through the Ravich Trust, holds 1,860,000 shares of YouthStream's common stock, warrants to purchase 500,000 shares of YouthStream's common stock exercisable through August 31, 2008, 1,000,000 shares of YouthStream's redeemable preferred stock and an option to purchase 200,000 shares of YouthStream's common stock exercisable through June 26, 2013, which was issued to Mr. Ravich under YouthStream's 2000 Stock Option Incentive Plan in connection with his election to the Board of Directors. Through his positions at Libra/KES, Mr. Ravich managed the business of KES Acquisition through February 28, 2005. Subordinated Promissory Notes with a principal amount of \$1,650,000 and \$450,000 are payable to the Ravich Trust and Libra Securities Holdings, LLC, the parent of Libra Securities, respectively. Mr. Fritz and Mr. Byer have each previously acquired an option from the Ravich Trust for \$2,500 (\$0.04 per share) to purchase 62,500 shares of YouthStream's redeemable preferred stock issued to the Ravich Trust in January 2003, exercisable at \$0.36 per share until December 31, 2006 or earlier upon the occurrence of certain events.

The Acquisition was accounted for as a purchase in accordance with SFAS No. 141, "Business Combinations", and in accordance with Emerging Issues Task Force (EITF) No. 88-16, "Basis in Leveraged Buyout Transactions". As a result of the substantial and continuing relationships between YouthStream and the Sellers, and the provisions of EITF 88-16 that are required to be considered when determining the extent of fair value/predecessor basis to be used in recording the transaction, the Acquisition has been recorded at predecessor basis. Since the debt and equity held by the Sellers represented almost the entire amount of capital at risk both before and after the Acquisition, the application of the "monetary test" specified in Section 3 of EITF 88-16, which limits the portion of the purchase consideration that can be valued at fair value to the percentage of the total consideration that is monetary, was utilized by the Company in determining to record the transaction at predecessor basis. The excess of the purchase price over predecessor basis of the net assets acquired has been reflected as a deemed distribution of \$63,104,423 to the Sellers at the date of acquisition in the consolidated financial statements.

For taxable periods beginning after February 28, 2005, Acquisition Corp. and Atacama KES are included in the consolidated federal income tax return filed by YouthStream as the common parent. Acquisition Corp. and Atacama KES have entered into a Tax Sharing Agreement with YouthStream, pursuant to which they have agreed to pay YouthStream an amount equal to 50% of their respective "separate company tax liability", subject to compliance with the GECC secured line of credit. The term "separate company tax liability" is defined as the amount, if any, of the federal income tax liability (including, without limitation, liability for any penalty, fine, additions to tax, interest, minimum tax and other items applicable to such subsidiary in connection with the determination of the subsidiary's tax liability), which such subsidiary would have incurred if its federal income tax liability for the periods during which it

is includible in a consolidated federal income tax return with YouthStream were determined generally in the same manner in which its separate return liability would have been calculated under Section 1552(a)(2) of the Internal Revenue Code of 1986, as amended. YouthStream has approximately \$255,000,000 of federal net operating loss carryovers currently available to offset the consolidated federal taxable income of the affiliated group in the future.

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The total purchase price of \$65,000,000, as well as the terms and conditions of the Notes and 13% Series A Preferred Stock issued to the Sellers, was determined to be at fair value based on reports prepared by an independent valuation firm.

The following is a summary of the assets acquired and liabilities assumed at predecessor basis at February 28, 2005.

|                                                                                                               |               |
|---------------------------------------------------------------------------------------------------------------|---------------|
| <b>Assets Acquired:</b>                                                                                       |               |
| Cash                                                                                                          | \$ 913,194    |
| Accounts receivable                                                                                           | 10,781,836    |
| Allowance for doubtful accounts                                                                               | (328,351)     |
| Inventories                                                                                                   | 18,762,218    |
| Prepaid expenses and other current assets                                                                     | 904,271       |
| Property, plant and equipment                                                                                 | 6,630,012     |
| Accumulated depreciation and amortization                                                                     | (639,254)     |
| Due from YouthStream Acquisition Corp.                                                                        | 187,702       |
| Other non-current assets                                                                                      | 721,393       |
| Total assets acquired                                                                                         | 37,933,021    |
| <b>Liabilities Assumed:</b>                                                                                   |               |
| Accounts payable                                                                                              | 9,566,327     |
| Accrued expenses                                                                                              | 1,267,016     |
| Accrued interest payable                                                                                      | 593,260       |
| Deferred rent                                                                                                 | 165,413       |
| Subordinated promissory notes payable                                                                         | 7,000,000     |
| Line of credit                                                                                                | 15,495,095    |
| Equipment contract payable                                                                                    | 291,223       |
| Capital lease obligation                                                                                      | 1,877,179     |
| Total liabilities assumed                                                                                     | 36,255,513    |
| Net assets acquired                                                                                           | 1,677,508     |
| Adjustment to recognize minority interest                                                                     | (331,981)     |
|                                                                                                               | \$ 1,345,527  |
| <b>Total purchase consideration, net of intercompany eliminations of 2.67% interest held by KES Holdings:</b> |               |
| 8% Subordinated secured promissory notes payable                                                              | \$ 39,493,000 |
| 13% Series A preferred stock                                                                                  | 24,733,000    |
| Net purchase consideration                                                                                    | 64,226,000    |
| Minority interests in equity                                                                                  | 223,950       |
| Adjustment to record deemed distribution to Sellers                                                           | (63,104,423)  |
|                                                                                                               | \$ 1,345,527  |



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The amount due from YouthStream Acquisition Corp. of \$187,702 represents costs incurred by KES Acquisition with respect to the Acquisition, which were included in the \$1,171,406 of transaction costs related to the Acquisition charged to operations during the year ended September 30, 2005.

As of September 30, 2004, the Company had incurred \$175,144 of costs with respect to the Acquisition, which were presented as deferred costs in the Company's consolidated balance sheet at such date. These costs were included in the \$1,171,406 of transaction costs related to the Acquisition charged to operations during the year ended September 30, 2005.

Minority interest - related parties was \$430,931 on February 28, 2005. For the year ended September 30, 2005, the net loss of Acquisition Corp. (an 80.01% consolidated subsidiary) allocable to the 19.99% minority shareholders was \$681,698, but the reduction to minority interest - related parties was limited to the balance at February 28, 2005 of \$430,931. Accordingly, the remainder of the net loss of Acquisition Corp. allocable to the 19.99% minority shareholders for the year ended September 30, 2005 of \$250,767 was included in the Company's consolidated statement of operations for the year ended September 30, 2005, and will be recovered to the extent that Acquisition Corp. generates net income in future periods. For the three months and nine months ended June 30, 2006, net income allocable to the 19.99% minority shareholders was \$26,210 and \$56,439, respectively.

### Pro Forma Information

The following pro forma operating data shown below presents the results of operations for the three months and nine months ended June 30, 2005, as if the Acquisition had occurred on the last day of the immediately preceding fiscal period. Accordingly, transaction costs related to the Acquisition are not included in the net loss from continuing operations shown below. The pro forma results are not necessarily indicative of the financial results that might have occurred had the Acquisition actually taken place on the respective dates, or of future results of operations. Pro forma information for the three months and nine months ended June 30, 2005 is summarized as follows:

|                                             | <b>Three<br/>Months<br/>Ended<br/>June 30,<br/>2005</b> | <b>Nine<br/>Months<br/>Ended<br/>June 30,<br/>2005</b> |
|---------------------------------------------|---------------------------------------------------------|--------------------------------------------------------|
| Net sales                                   | \$ 29,127,566                                           | \$ 82,865,839                                          |
| Cost of sales                               | 27,194,499                                              | 77,993,132                                             |
| Gross margin                                | 1,933,089                                               | 4,872,707                                              |
| Operating income                            | 638,552                                                 | 1,066,767                                              |
| Interest expense                            | (2,371,888)                                             | (7,075,831)                                            |
| Minority interest                           | 218,439                                                 | 218,439                                                |
| Net loss from continuing operations         | \$ (1,500,737)                                          | \$ (5,693,104)                                         |
| Basic and diluted net loss per common share | \$ (0.04)                                               | \$ (0.15)                                              |
| Weighted average common shares outstanding  | 39,242,251                                              | 39,242,251                                             |

### Critical Accounting Policies and Estimates

The Company prepared its financial statements in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. Management

periodically evaluates the estimates and judgments made. Management bases its estimates and judgments on historical experience and on various factors that are believed to be reasonable under the circumstances. Actual results may differ from these estimates as a result of different assumptions or conditions.

The following critical accounting policies affect the more significant judgments and estimates used in the preparation of the Company's financial statements.

#### Revenue Recognition

The Company recognizes revenue when there is persuasive evidence that an arrangement exists, delivery of the product has occurred and title has passed, the selling price is both fixed and determinable, and collectibility is reasonably assured, all of which generally occur either upon shipment of the Company's product or delivery of the product to the destination specified by the customer.

#### Accounts Receivable

The Company grants credit to its customers generally in the form of short-term trade accounts receivable. Management evaluates the credit risk of its customers utilizing historical data and estimates of future performance. Accounts receivable are stated at the amount management expects to collect from outstanding balances. When appropriate, management provides for probable uncollectible amounts through a provision for doubtful accounts and an adjustment to a valuation allowance. Management reviews and adjusts this allowance periodically based on the aging of accounts receivable balances, historical write-off experience, customer concentrations, customer creditworthiness, and current industry and economic trends. Balances that are still outstanding after management has used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to accounts receivable.

#### Inventories

Inventories are comprised of raw materials (consisting of billets and scrap metal), semi-finished goods and finished goods. Inventory costs include material, labor and manufacturing overhead. Inventories are valued at the lower of average cost or market. The average cost of the billets and scrap metal is adjusted quarterly.

#### Impairment of Assets

Long-lived assets are evaluated for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets". An asset is considered impaired if its carrying amount exceeds the future net cash flow the asset is expected to generate. If an asset is considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds its fair market value. The recoverability of long-lived assets is assessed by determining whether the unamortized balances can be recovered through undiscounted future net cash flows of the related assets. The amount of impairment, if any, is measured based on projected discounted future net cash flows using a discount rate reflecting the Company's average cost of capital.

#### Income Taxes

The Company accounts for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes". Under this method, deferred income taxes are provided for differences between the carrying amounts of the Company's assets and liabilities for financial reporting purposes and the amounts used for income tax purposes using expected tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. KES Acquisition Company is a limited liability company and as such does not provide for federal and state income taxes. Rather, its income is taxed to its members.

The Company records a valuation allowance to reduce its deferred tax assets to the amount that is more likely than not to be realized. In the event the Company was to determine that it would be able to realize its deferred tax assets in the future in excess of its recorded amount, an adjustment to the deferred tax assets would be credited to operations in the

period such determination was made. Likewise, should the Company determine that it would not be able to realize all or part of its deferred tax assets in the future, an adjustment to the deferred tax assets would be charged to operations in the period such determination was made.

## **Recent Accounting Pronouncements and Developments**

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections" ("SFAS No. 154"). SFAS No. 154 is a replacement of APB Opinion No. 20, "Accounting Changes" and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements - (an Amendment of APB Opinion No. 28)" and provides guidance on the accounting for and reporting of accounting changes and error corrections. SFAS No. 154 establishes retrospective application as the required method for reporting a change in accounting principle, and provides guidance for determining whether retrospective application of a change in accounting principle is impracticable and for reporting a change when retrospective application is impracticable. Retrospective application is the application of a different accounting principle to a prior accounting period as if that principle had always been used or as the adjustment of previously issued financial statements to reflect a change in the reporting entity. SFAS No. 154 also addresses the reporting of the correction of an error by restating previously issued financial statements. SFAS No. 154 is effective for accounting changes and error corrections occurring in fiscal years beginning after December 15, 2005. The adoption of SFAS No. 154 is not expected to have any impact on the Company's financial statement presentation or disclosures.

In June 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109 ("FIN 48"). FIN 48 provides criteria for the recognition, measurement, presentation and disclosure of uncertain tax positions that has an effect on a company's financial statements accounted for in accordance with SFAS No. 109, "Accounting for Income Taxes", as a result of positions taken or expected to be taken in a company's tax return. A tax benefit from an uncertain position may be recognized only if it is "more likely than not" that the position is sustainable based on its technical merits. The provisions of FIN 48 are effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the potential effect that the adoption of FIN 48 will have on the Company's financial statement presentation and disclosures.

On September 22, 2005, the Securities and Exchange Commission ("SEC") issued rules to delay by one year the required reporting by management on internal controls over financial reporting for non-accelerated filers. The new SEC rule extends the compliance date for such registrants to fiscal years ending on or after July 15, 2007. Accordingly, the Company qualifies for the deferral to comply with the internal control reporting requirements until its fiscal year ending September 30, 2007. On August 9, 2006, the SEC issued two releases that when adopted are designed to grant smaller public companies further relief from compliance with Section 404 of the Sarbanes-Oxley Act of 2002.

## **Results of Operations**

Effective February 25, 2004, the Company's wholly-owned subsidiary, Beyond the Wall, Inc. ("BTW"), sold substantially all of its assets and operations to a group unaffiliated with the Company (which included certain former management of BTW). Effective February 28, 2005, the Company acquired the Mill, and the operations of the Mill have been consolidated commencing March 1, 2005. Accordingly, for the period from March 2004 through February 2005, the Company did not have any revenue-generating operations.

For the nine months ended June 30, 2005, the Company's results of operations only include the operations of the Mill for the four months March through June 2005.

As a result of the acquisition of the Mill, the Company's financial statements for periods ending after March 1, 2005 are materially different from and are not comparable to its financial statements prior to that date.

## **Three Months Ended June 30, 2006 and 2005**

**Net Sales.** Net sales were \$34,284,157 for the three months ended June 30, 2006, an average of \$11,428,052 per month, as compared to net sales of \$29,127,566 for the three months ended June 30, 2005, an average of \$9,709,189

per month. The increase in net sales in 2006 as compared to 2005 reflects a general improvement in the steel industry as well as the Company's decision to focus on selling higher margin products.

**Cost of Sales.** Cost of sales was \$29,407,919 for the three months ended June 30, 2006, resulting in gross profit of \$4,876,238 and a gross profit margin of 14.2%. Cost of sales was \$27,194,477 for the three months ended June 30, 2005, resulting in a gross profit of \$1,933,089 and a gross profit margin of 6.6%. The increase in gross profit margin in 2006 as compared to 2005 reflects the Company's decision to focus on selling higher margin products.

**Selling Expenses.** For the three months ended June 30, 2006, selling expenses were \$389,025 or 1.1% of sales, as compared to selling expenses of \$300,486 or 1.0% of sales for the three months ended June 30, 2005. Selling expenses consist primarily of sales commissions and personnel-related costs.

**General and Administrative Expenses.** For the three months ended June 30, 2006, general and administrative expenses were \$1,559,607 or 4.5% of sales, as compared to general and administrative expenses of \$994,051 or 3.4% of sales for the three months ended June 30, 2005. General and administrative expenses consist primarily of management and office compensation and related costs, legal and accounting fees, and insurance costs at both corporate facilities and the Mill.

**Income from Operations.** Income from operations was \$2,927,606 for the three months ended June 30, 2006, as compared to income from operations of \$638,552 for the three months ended June 30, 2005.

**Interest Income.** Interest income was \$119 for the three months ended June 30, 2006, as compared to \$9,944 for the three months ended June 30, 2005.

**Interest Expense.** For the three months ended June 30, 2006, interest expense was \$2,324,794, which included interest expense related to the 8% notes payable of \$850,711 and the 13% Series A Preferred Stock of \$810,274 issued in conjunction with the acquisition of the Mill, the 12% notes payable of \$209,325 and the 4% notes payable of \$11,040.

For the three months ended June 30, 2005, interest expense was \$2,371,888, which included interest expense related to the 8% notes payable of \$787,696 and the 13% Series A Preferred Stock of \$801,621 issued in conjunction with the acquisition of the Mill, the 12% notes payable of \$209,425 and the 4% notes payable of \$10,416.

**Transaction Costs Related to KES Acquisition.** The Company incurred \$280,773 of costs with respect to the acquisition of the Mill, which were charged to operations during the three months ended June 30, 2005.

**Other Income (Expense).** For the three months ended June 30, 2006, other income was \$2,249, as compared to other income of \$4,216 for the three months ended June 30, 2005.

**Income (Loss) before Income Taxes and Minority Interest.** Income before income taxes and minority interest was \$605,180 for the three months ended June 30, 2006, as compared to a loss before income taxes and minority interest of \$(1,999,949) for the three months ended June 30, 2005.

**Income Taxes.** Income tax expense was \$146,000 for the three months ended June 30, 2006, consisting of a provision for state income taxes. No federal income tax provision was provided for the three months ended June 30, 2006 as a result of the utilization of the Company's net operating loss carryforwards. No federal or state income tax provision was provided for the three months ended June 30, 2005 due to the Company reporting a pre-tax operating loss for such period.

**Income (Loss) before Minority Interest.** Income before minority interest was \$459,180 for the three months ended June 30, 2006, as compared to a loss before minority interest of \$(1,999,949) for the three months ended June 30, 2005.

Minority Interest - Related Parties. Minority interest - related parties was \$0 for the three months ended June 30, 2006 and \$162,820 for the three months ended June 30, 2005. Minority interest - related parties was \$430,931 on February 28, 2005. For the year ended September 30, 2005, the net loss of Acquisition Corp. (an 80.01% consolidated subsidiary) allocable to the 19.99% minority shareholders was \$681,698, but the reduction to minority interest - related parties was limited to the balance at February 28, 2005 of \$430,931. Accordingly, the remainder of the net loss of Acquisition Corp. allocable to the 19.99% minority shareholders for the year ended September 30, 2005 of \$250,767 was included in the Company's consolidated statement of operations for the year ended September 30, 2005, and will be recovered to the extent that Acquisition Corp. generates net income in future periods. For the three months ended June 30, 2006, net income allocable to the 19.99% minority shareholders was \$26,210.

Net Income (Loss). Net income was \$459,180 for the three months ended June 30, 2006, as compared to a net loss of \$(1,837,129) for the three months ended June 30, 2005.

### **Nine Months Ended June 30, 2006 and 2005**

Net Sales. Net sales were \$104,287,949 for the nine months ended June 30, 2006, an average of \$11,587,550 per month, as compared to net sales of \$38,261,343 for the nine months ended June 30, 2005. If the Company had owned the Mill for the nine months ended June 30, 2005, pro forma net sales would have been \$82,865,839, an average of \$9,207,315 per month. The increase in net sales in 2006 as compared to 2005 reflects a general improvement in the steel industry as well as the Company's decision to focus on selling higher margin products.

Cost of Sales. Cost of sales was \$89,887,425 for the nine months ended June 30, 2006, resulting in gross profit of \$14,400,524 and a gross profit margin of 13.8%. Cost of sales was \$35,666,705 for the nine months ended June 30, 2005, resulting in a gross profit of \$2,594,638 and a gross profit margin of 6.8%. If the Company had owned the Mill for the nine months ended June 30, 2005, pro forma gross profit would have been \$4,872,707 and the gross profit margin would have been 5.9%. The increase in gross profit margin in 2006 as compared to 2005 reflects the Company's decision to focus on selling higher margin products.

Selling Expenses. For the nine months ended June 30, 2006, selling expenses were \$1,184,781 or 1.1% of sales, as compared to selling expenses of \$412,544 or 1.1% of sales for the nine months ended June 30, 2005. Selling expenses consist primarily of sales commissions and personnel-related costs.

General and Administrative Expenses. For the nine months ended June 30, 2006, general and administrative expenses were \$4,557,136 or 4.4% of sales, as compared to general and administrative expenses of \$1,593,208 or 4.2% of sales for the nine months ended June 30, 2005. General and administrative expenses consist primarily of management and office compensation and related costs, legal and accounting fees, and insurance costs at both corporate and the Mill.

Income from Operations. Income from operations was \$8,658,607 for the nine months ended June 30, 2006, as compared to income from operations of \$588,886 for the nine months ended June 30, 2005.

Interest Income. Interest income was \$321 for the nine months ended June 30, 2006, as compared to \$35,478 for the nine months ended June 30, 2005.

Interest Expense. For the nine months ended June 30, 2006, interest expense was \$7,107,146, which included interest expense related to the 8% notes payable of \$2,456,894 and the 13% Series A Preferred Stock of \$2,451,172 issued in conjunction with the acquisition of the Mill, the 12% notes payable of \$628,174 and the 4% notes payable of \$32,888.

For the nine months ended June 30, 2005, interest expense was \$3,208,954, which included interest expense related to the 8% notes payable of \$1,056,032 and the 13% Series A Preferred Stock of \$1,074,700 issued in conjunction with the acquisition of the Mill, the 12% notes payable of \$280,767 and the 4% notes payable of \$31,952.

Transaction Costs Related to KES Acquisition. The Company incurred \$1,073,727 of costs with respect to the acquisition of the Mill, which were charged to operations during the nine months ended June 30, 2005. Included in such costs was \$187,702 of transaction costs incurred by KES Acquisition.

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Other Income (Expense). For the nine months ended June 30, 2006, other income was \$88,048, as compared to other expense of \$(29,489) for the nine months ended June 30, 2005.

Income (Loss) before Income Taxes and Minority Interest. Income before income taxes and minority interest was \$1,639,830 for the nine months ended June 30, 2006, as compared to a loss before income taxes and minority interest of \$(3,684,806) for the nine months ended June 30, 2005.

Income Taxes. Income tax expense was \$274,000 for the nine months ended June 30, 2006, consisting of a provision for state income taxes. No federal income tax provision was provided for the nine months ended June 30, 2006 as a result of the utilization of the Company's net operating loss carryforwards. No federal or state income tax provision was provided for the nine months ended June 30, 2005 due to the Company reporting a pre-tax operating loss for such period.

Income (Loss) before Minority Interest. Income before minority interest was \$1,365,830 for the nine months ended June 30, 2006, as compared to a loss before minority interest of \$(3,684,806) for the nine months ended June 30, 2005.

Minority Interest - Related Parties. Minority interest - related parties was \$0 for the nine months ended June 30, 2006 and \$430,931 for the nine months ended June 30, 2005. Minority interest - related parties was \$430,931 on February 28, 2005. For the year ended September 30, 2005, the net loss of Acquisition Corp. (an 80.01% consolidated subsidiary) allocable to the 19.99% minority shareholders was \$681,698, but the reduction to minority interest - related parties was limited to the balance at February 28, 2005 of \$430,931. Accordingly, the remainder of the net loss of Acquisition Corp. allocable to the 19.99% minority shareholders for the year ended September 30, 2005 of \$250,767 was included in the Company's consolidated statement of operations for the year ended September 30, 2005, and will be recovered to the extent that Acquisition Corp. generates net income in future periods. For the nine months ended June 30, 2006, net income allocable to the 19.99% minority shareholders was \$56,439.

Net Income (Loss). Net income was \$1,365,830 for the nine months ended June 30, 2006, as compared to a net loss of \$(3,253,875) for the nine months ended June 30, 2005.

### **Liquidity and Capital Resources - June 30, 2006**

#### **Overview**

On March 9, 2005, YouthStream completed the acquisition of the Mill. In connection with the Company's acquisition and consolidation of the Mill, the Company also acquired \$913,194 of cash. The Company used substantially all of its available cash resources to fund the acquisition of the Mill, including its contribution of an aggregate of \$500,000 of cash to Acquisition Corp. and the payment of the costs related to the transaction. Accordingly, the Company will require additional operating capital to fund corporate general and administrative expenses, which the Company expects to obtain primarily through periodic tax sharing payments from Acquisition Corp. and Atacama KES. The Mill relies on cash flows from operations to support a secured line of credit with GECC to fund its separate operations. As a result of improved operating performance of the Mill beginning in late 2005, the Company has been able to increase borrowing availability under this line of credit.

As of June 30, 2006 and September 30, 2005, the balance outstanding on the line of credit was \$9,890,679 and \$19,009,379, respectively, which has been presented as a current liability in the consolidated balance sheet at such date due to the collateral securing such line of credit consisting primarily of current assets and the continuing uncertainty with respect to the Company's ability to maintain compliance under the terms and conditions of the line of credit.

At March 31, 2005, KES Acquisition was not in compliance with the fixed charge coverage ratio based on its consolidated financial statements as originally filed, in part relating to changes to its accounting procedures as a result of the review of its financial statements conducted in conjunction with its acquisition by YouthStream, and subsequently received a waiver of default from the lender. At June 30, 2005, KES Acquisition was in compliance with the fixed charge coverage ratio based on its consolidated financial statements as originally filed. However, KES Acquisition was not in compliance with the fixed charge coverage ratio at June 30, 2005 based on its revised consolidated financial statements, as a result of a determination by management to re-characterize a lease for certain equipment used by KES Acquisition as a capital lease rather than an operating lease. In addition, KES Acquisition was not in compliance with its obligation to deliver audited financial statements in the form and time period as set forth in the loan agreement. On June 26, 2006, the Company received a waiver of default from the lender with respect to the fixed charge coverage ratio for the restated March 31, 2005 and June 30, 2005 interim financial statements, as well as with respect to the form and timeliness of the September 30, 2005 annual audited financial statements being provided to GECC.

At June 30, 2006, March 31, 2006, December 31, 2005 and September 30, 2005, KES Acquisition was in compliance with the fixed charge coverage ratio based on its consolidated financial statements.

In the event that KES Acquisition is not in compliance with the fixed charge coverage ratio in any future period, the Company intends to seek a further waiver of any default from the lender, and if no such waiver is received, the lender would have the right to accelerate the maturity of the line of credit at that time.

To the extent that the Mill generates taxable income in the future, the Tax Sharing Agreement with Acquisition Corp. and Atacama KES will generate cash payments to YouthStream equal to 50% of their respective "separate company tax liability", subject to compliance with the GECC secured line of credit. The tax sharing payment due to YouthStream for the three months ended September 30, 2005 was \$334,826, which was received in December 2005. The tax sharing payment due to YouthStream for the three months ended December 31, 2005 was \$382,290, which was received in February 2006. The tax sharing payment due to YouthStream for the three months ended March 31, 2006 was \$387,607, which was received, net of certain intercompany offsets, in July 2006. The tax sharing payment due to YouthStream for the three months ended June 30, 2006 was \$500,027, which was received, net of certain offsets, in August 2006. YouthStream has approximately \$255,000,000 of federal net operating loss carryovers currently available to offset any federal income tax liability of Acquisition Corp and Atacama KES in subsequent periods. YouthStream expects that its federal net operating loss carryovers will be sufficient to absorb most of any future federal income tax liability of Acquisition Corp. and Atacama KES.

The Mill restarted operations in January 2004 after being acquired by the previous owners, and has incurred losses until recently. The long-term economic viability of the Mill and its ability to fund its operations and debt service requirements, including maintaining compliance with various debt covenants and servicing the interest and principal obligations on the Notes and the dividends and redemption features on the 13% Series A Preferred Stock issued in connection with the acquisition of the Mill, is dependent on various internal and external factors, including the Mill's ability to operate on a sustained basis at 80% or more of its annual capacity of 200,000 tons per year, as currently configured. To the extent that the Mill is not able to maintain this operating threshold, the ability of the Mill to generate sufficient cash flows to fund its operations and debt service requirements and maintain compliance with various debt covenants may be impaired. In such event, the Company may have to consider a formal or informal restructuring or reorganization, including a sale or other disposition of its assets.

### **Going Concern**

The Company has incurred recurring operating losses since its inception. The Company incurred a net loss of \$3,430,562 and a negative cash flow from operating activities of \$4,300,395 for the year ended September 30, 2005, and had an accumulated deficit of \$347,265,398 and a stockholders' deficiency of \$79,600,350 at September 30, 2005. As of September 30, 2005, the Company had insufficient capital to fund all of its obligations on a consolidated basis. These factors raise substantial doubt about the Company's ability to continue as a going concern. The consolidated financial statements do not include any adjustments to reflect the possible future effect of the recoverability and classification of assets or the amounts and classifications of liabilities that may result from the outcome of this uncertainty.

On March 9, 2005, the Company completed the acquisition of a steel mini-mill located in Ashland, Kentucky. The Company utilized substantially all of its available cash resources to fund such acquisition and will require additional operating capital to fund corporate general and administrative expenses, which the Company expects to obtain primarily through periodic tax sharing payments from Acquisition Corp. and Atacama KES. In addition, the steel mini-mill restarted operations in late January 2004 after being acquired by the previous owners, and until recently has incurred losses. For the year ended September 30, 2005, operating income was \$2,691,955 (which included the operations of the steel mini-mill for the seven month period March through September 2005), exclusive of interest expense. For the three months and nine months ended June 30, 2006, operating income was \$2,927,606 and \$8,658,607, respectively, exclusive of interest expense. The steel mini-mill relies on cash flows from operations to

support a secured line of credit with GECC to fund its separate operations. As a result of improved operating performance of the steel mini-mill beginning in late 2005, the Company has been able to increase borrowing availability under this line of credit.

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Based on its current level of operations, the Company believes that its current cash resources provided by operations and the secured line of credit will be adequate to fund its operations through September 30, 2006. However, to the extent the Company's estimates are inaccurate or its assumptions are incorrect, the Company may not have sufficient cash resources to fund its operations. In such event, the Company may have to consider a formal or informal restructuring or reorganization, including a sale or other disposition of its assets.

The Company's management may also consider various strategic alternatives in the future, including the acquisition of new business opportunities, which may be from related or unrelated parties. However, there can be no assurances that such efforts will ultimately be successful. The Company may finance any acquisitions through a combination of debt and/or equity securities.

**Operating Activities.** During the nine months ended June 30, 2006, the Company generated \$9,509,715 of cash from operating activities. During the nine months ended June 30, 2005, the Company used \$2,629,587 of cash in operating activities, both to fund the corporate overhead of YouthStream and to fund the operations of the Mill for the four month period March through June 2005.

**Investing Activities.** During the nine months ended June 30, 2005, net cash provided by investing activities was \$247,227, which consisted of principal and interest payments on the Beyond the Wall note receivable that the Company received in the February 2004 sale of the assets and operations of Beyond the Wall. During the nine months ended June 30, 2006, the Company did not have any investing activities.

**Financing Activities.** During the nine months ended June 30, 2006, net cash utilized in financing activities was \$9,574,803, consisting of \$9,193,700 to reduce borrowings under the secured line of credit with GECC, the repayment of \$50,000 of short-term notes payable to certain directors, and payments on an equipment contract payable and capital lease obligation of \$331,103. During the nine months ended June 30, 2005, net cash generated by financing activities was \$1,279,243, consisting of \$1,410,683 of borrowings under the secured line of credit with GECC, reduced by payments on an equipment contract payable and capital lease obligation of \$131,440.

### Summary of Restricted and Unrestricted Assets, Liabilities and Equity

Almost all of the Company's net assets are owned by KES Acquisition, a consolidated subsidiary. As a result of various contractual restrictions contained in various financing agreements (as previously described) and documents relating to the Acquisition, there are limits on the Company's ability to transfer assets from KES Acquisition to Youthstream, whether in the form of loans and advances, cash dividends, tax-sharing payments, or otherwise, without notice to and/or consent of one or more third parties.

A summary of the Company's restricted and unrestricted assets, liabilities and equity at June 30, 2006 (unaudited) and at September 30, 2005 is presented below.

| <u>June 30, 2006</u>               | <b>Unrestricted</b> | <b>Restricted</b>    | <b>As Reported</b>   |
|------------------------------------|---------------------|----------------------|----------------------|
| Current assets                     | \$ 878,875          | \$ 32,677,835        | \$ 33,556,710        |
| Property, plant and equipment, net | -                   | 5,020,120            | 5,020,120            |
| Other assets                       | -                   | 462,130              | 462,130              |
| <b>Total assets</b>                | <b>\$ 878,875</b>   | <b>\$ 38,160,085</b> | <b>\$ 39,038,960</b> |
|                                    |                     |                      |                      |
| Current liabilities                | \$ 10,182,245       | \$ 28,823,608        | \$ 39,005,853        |
| Non-current liabilities            | 77,306,610          | 1,221,267            | 78,527,877           |
| Equity:                            |                     |                      |                      |

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|                                         |               |               |               |
|-----------------------------------------|---------------|---------------|---------------|
| Retained earnings (accumulated deficit) | (352,337,270) | 6,437,702     | (345,899,568) |
| Other                                   | 265,727,290   | 1,677,508     | 267,404,798   |
| Total liabilities and equity            | \$ 878,875    | \$ 38,160,085 | \$ 39,038,960 |

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| <u>September 30, 2005</u>               | <b>Unrestricted</b> | <b>Restricted</b>    | <b>As Reported</b>   |
|-----------------------------------------|---------------------|----------------------|----------------------|
| Current assets                          | \$ 261,740          | \$ 35,453,821        | \$ 35,715,561        |
| Property, plant and equipment, net      | -                   | 5,567,745            | 5,567,745            |
| Other assets                            | -                   | 638,948              | 638,948              |
| <b>Total assets</b>                     | <b>\$ 261,740</b>   | <b>\$ 41,660,514</b> | <b>\$ 41,922,254</b> |
| Current liabilities                     | \$ 4,224,995        | \$ 30,411,237        | \$ 34,636,232        |
| Non-current liabilities                 | 78,257,234          | 8,629,138            | 86,886,372           |
| Equity:                                 |                     |                      |                      |
| Retained earnings (accumulated deficit) | (348,435,183)       | 1,169,785            | (347,265,398)        |
| Other                                   | 266,214,694         | 1,450,354            | 267,665,048          |
| <b>Total liabilities and equity</b>     | <b>\$ 261,740</b>   | <b>\$ 41,660,514</b> | <b>\$ 41,922,254</b> |

### Principal Commitments

At June 30, 2006, the Company's principal commitments consisted of the following obligations:

#### Payments Due by 12 Month Periods Ending June 30, (in thousands)

| Contractual cash obligations                                                                            | <b>Total</b>      | <b>2007</b>      | <b>2008</b>     | <b>2009</b>     | <b>2010</b>     | <b>2011</b>      | <b>There-after</b> |
|---------------------------------------------------------------------------------------------------------|-------------------|------------------|-----------------|-----------------|-----------------|------------------|--------------------|
| 4% notes payable                                                                                        | \$ 4,917          | \$ ---           | \$ ---          | \$ ---          | \$ ---          | \$ 4,917         | \$ ---             |
| 12% subordinated promissory notes payable                                                               | 7,000             | 7,000            | ---             | ---             | ---             | ---              | ---                |
| 8% subordinated secured promissory notes payable                                                        | 39,493            | 1,849            | 925             | 925             | 925             | 6,974            | 27,895             |
| 8% subordinated secured promissory notes payable - interest                                             | 3,159             | 3,159            | ---             | ---             | ---             | ---              | ---                |
| Secured line of credit                                                                                  | 9,891             | 9,891            | ---             | ---             | ---             | ---              | ---                |
| Operating leases                                                                                        | 1,274             | 416              | 390             | 390             | 78              | ---              | ---                |
| Capital lease obligation                                                                                | 1,410             | 416              | 483             | 511             | ---             | ---              | ---                |
| Equipment contact payable                                                                               | 193               | 83               | 110             | ---             | ---             | ---              | ---                |
| Management services agreement                                                                           | 2,333             | 700              | 700             | 700             | 233             | ---              | ---                |
| 4% Series A Preferred Stock subject to mandatory redemption                                             | 5,269             | ---              | ---             | ---             | ---             | 5,269            | ---                |
| 13% Series A Preferred Stock of subsidiary subject to mandatory redemption, excluding accrued dividends | 26,618            | ---              | ---             | ---             | ---             | ---              | 26,618             |
| <b>Total contractual cash obligations</b>                                                               | <b>\$ 101,557</b> | <b>\$ 23,514</b> | <b>\$ 2,608</b> | <b>\$ 2,526</b> | <b>\$ 1,236</b> | <b>\$ 17,160</b> | <b>\$ 54,513</b>   |

At June 30, 2006 and September 30, 2005, the Company did not have any material commitments for capital expenditures.

At June 30, 2006 and September 30, 2005, the Company has various short-term commitments for the purchase of materials, supplies and energy arising in the ordinary course of business which aggregated approximately \$7,900,000 and \$7,962,000, respectively.

**Off-Balance Sheet Arrangements**

The Company does not have any transactions, obligations or relationships that could be considered off-balance sheet arrangements at June 30, 2006 or September 30, 2005.

### ITEM 3. CONTROLS AND PROCEDURES

#### (a) Evaluation of Disclosure Controls and Procedures

The certifications of the principal executive officer and the principal financial officer (or persons performing similar functions) required by Rules 13a-14 and 15d-14 of the Securities Exchange Act of 1934, as amended are filed as exhibits to this report. This section of the report contains the information concerning the evaluation of the Company's disclosure controls and procedures (as defined in Securities Exchange Act Rules 13a-15(e) and 15d-15(e)) and changes to internal controls over financial reporting (as defined in Securities Exchange Act Rules 13a-15(f) and 15d-15(f)) referred to in the certifications and this information should be read in conjunction with the certifications for a more complete understanding of the topics presented herein.

Disclosure controls and procedures are designed to ensure that information required to be disclosed in the reports filed or submitted by the Company under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported, within the time periods specified in the rules and forms of the Securities and Exchange Commission. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in the reports filed under the Securities Exchange Act of 1934 is accumulated and communicated to management, including its principal executive and financial officers, as appropriate, to allow timely decisions regarding required disclosure.

The Company carried out an evaluation, under the supervision and with the participation of its management, including its principal executive and financial officers, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the period covered by this report. Based upon and as of the date of that evaluation, the Company's principal executive and financial officers concluded that there were material weaknesses in the internal controls at the Company's steel mini-mill acquired effective February 28, 2005, the financial statements of which are included in the consolidated financial statements of the Company from that date forward. In addition, as a result of this evaluation, the Company's consolidated financial reporting and disclosure controls were also determined to have material weaknesses.

Specifically, the steel mini-mill lacks adequate accounting systems and controls and procedures to process information for inclusion in the Company's reports filed with the Securities and Exchange Commission. Furthermore, the steel mini-mill also lacks adequate accounting personnel in general and adequately trained accounting personnel in particular in order to be able to process and generate the required financial information to be included in the Company's consolidated financial statements on a timely basis. The Company is addressing these issues by reviewing and revising its internal accounting policies and procedures. The Company also intends to increase the resources and personnel allocated to the steel mini-mill's accounting department. The Company expects that the resolution of these issues will take several months.

#### (b) Changes in Internal Controls

There were no changes in the Company's internal controls or in other factors that could have significantly affected those controls during the fiscal quarter ended June 30, 2006.

## **PART II. OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

The Company and/or its subsidiary that owned its former operating business, Beyond the Wall, have periodically been defendants in various lawsuits and claims from various trade creditors and former landlords. Based on the Company's contract relating to the sale of the Beyond the Wall assets, certain of these claims are the responsibility of the buyer of the Beyond the Wall business. The Company evaluates its response in each situation based on the particular facts and circumstances of a claim. Accordingly, the ultimate outcome of these matters cannot be determined at this time and may ultimately result in judgments and liens against the Company or its assets. The Company has made sufficient accruals for the exposure related to such matters that have been deemed probable and reasonably estimable at June 30, 2006 and September 30, 2005.

KES Acquisition was named in a wrongful death lawsuit before the Circuit Court of Cabell County, West Virginia (the "Court"), which was filed in December 2004. The action was brought by Stephanie Harshbarger, individually and as Administratrix of the Estate of Chad Harshbarger against Aero-Fab, Inc. and KES Acquisition. Mr. Harshbarger was an employee of Aero-Fab, Inc., an unaffiliated contractor, who died while working at the Mill in April 2004. KES Acquisition was defended by its insurance carrier in this action. On July 3, 2006, the Court dismissed KES Acquisition from the lawsuit, ruling that KES Acquisition was not within the Court's jurisdiction. Notwithstanding such Court ruling, the plaintiff may appeal the ruling, or file an action against KES Acquisition in the State of Kentucky, neither of which has occurred to date. The Company does not believe that the resolution of this litigation will have a material adverse effect on its financial condition or results of operations.

### **ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

Not applicable.

### **ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

Not applicable.

### **ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

Not applicable.

### **ITEM 5. OTHER INFORMATION**

Not applicable.

### **ITEM 6. EXHIBITS**

A list of exhibits required to be filed as part of this report is set forth in the Index to Exhibits, which immediately precedes such exhibits, and is incorporated herein by reference.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) the Securities Exchange Act of 1934, the registrant has caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

YOUTHSTREAM MEDIA NETWORKS, INC.  
(Registrant)

DATE: September 13, 2006

By: /s/ JOHN SCHEEL  
John Scheel  
Chief Executive Officer

DATE: September 13, 2006

By: /s/ DONALD A.  
REISENBERG  
Donald A. Reisenberg  
Chief Financial Officer

**EXHIBIT INDEX**

- |      |                                                                                                                                                                                                                                   |
|------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 3.1  | Certificate of Incorporation (incorporated by reference to Exhibit 3.1 to the Company's Registration Statement on Form SB-2, Registration No. 33-80935, filed on March 6, 1996).                                                  |
| 3.2  | Certificate of Amendment of Certificate of Incorporation (incorporated by reference to Exhibit 3.2 to the Company's Registration Statement on Form SB-2, Registration No. 33-80935, filed on March 6, 1996).                      |
| 3.3  | Certificate of Amendment of Certificate of Incorporation (incorporated by reference to Exhibit 3.3 to the Company's Form 10-KSB for the fiscal year ended June 30, 1998, filed May 27, 1998).                                     |
| 3.4  | Certificate of Designation for Preferred Stock of YouthStream Media Networks, Inc. (incorporated by reference to Exhibit 99.3 to the Company's Form 8K filed February 7, 2003).                                                   |
| 3.5  | Certificate of Correction to the Certificate of Designation of Series A Preferred Stock of YouthStream Media Networks, Inc. (incorporated by reference to Exhibit 3.5 to the Company's Amended Form 10-K/A, filed March 5, 2004). |
| 3.6  | Bylaws (incorporated by reference to Exhibit 4.2 to YouthStream's Registration Statement on Form S-8, Registration No. 333-32022, filed on March 9, 2000).                                                                        |
| 3.7  | Amendment to Bylaws (incorporated by reference to Exhibit 3.8 to the Company's Form 10-Q for the quarter ended June 30, 2004, filed August 13, 2004).                                                                             |
| 31.1 | Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.                                                                                                                           |
| 31.2 | Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.                                                                                                                           |
| 32.1 | Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.                                                                                                                                                          |