KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.
Form N-CSRS
July 30, 2014

Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM N-CSR

CERTIFIED SHAREHOLDER REPORT OF REGISTERED

MANAGEMENT INVESTMENT COMPANIES

Investment Company Act file number 811-22467

Kayne Anderson Midstream/Energy Fund, Inc.

(Exact name of registrant as specified in charter)

811 Main Street, 14th Floor, Houston, Texas	77002
(Address of principal executive offices)	(Zip code)

David Shladovsky, Esq.

KA Fund Advisors, LLC, 811 Main Street, 14th Floor, Houston, Texas 77002

(Name and address of agent for service)

Registrant s telephone number, including area code: (713) 493-2020

Date of fiscal year end: November 30, 2014

Date of reporting period: May 31, 2014

Form N-CSR is to be used by management investment companies to file reports with the Commission not later than 10 days after the transmission to stockholders of any report that is required to be transmitted to stockholders under Rule 30e-1 under the Investment Company Act of 1940 (17 CFR 270.30e-1). The Commission may use the information provided on Form N-CSR in its regulatory, disclosure review, inspection, and policymaking roles.

A registrant is required to disclose the information specified by Form N-CSR, and the Commission will make this information public. A registrant is not required to respond to the collection of information contained in Form N-CSR unless the Form displays a currently valid Office of Management and Budget (OMB) control number. Please direct comments concerning the accuracy of the information collection burden estimate and any suggestions for reducing the burden to Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. The OMB has reviewed this collection of information under the clearance requirements of 44 U.S.C. § 3507.

Table of Contents

Item 1. Reports to Stockholders.

The report of Kayne Anderson Midstream/Energy Fund, Inc. (the   Registrant   ) to stockholders for the semi-annual period ended May 31, 2014 is attached below.

Table of Contents

Midstream/Energy Fund

KMF Semi-Annual Report

May 31, 2014

Table of Contents

CONTENTS

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS: This report of Kayne Anderson Midstream/Energy Fund, Inc. (the Fund) contains forward-looking statements as defined under the U.S. federal securities laws. Generally, the words believe, expect, intend, estimate, anticipate, project, will and similar expressions identify forward-looking statements, which generally are not hist in nature. Forward-looking statements are subject to certain risks and uncertainties that could cause actual results to materially differ from the Fund s historical experience and its present expectations or projections indicated in any forward-looking statement. These risks include, but are not limited to, changes in economic and political conditions; regulatory and legal changes; MLP industry risk; leverage risk; valuation risk; interest rate risk; tax risk; and other risks discussed in the Fund s filings with the Securities and Exchange Commission (SEC). You should not place undue reliance on forward-looking statements, which speak only as of the date they are made. The Fund undertakes no obligation to publicly update or revise any forward-looking statements made herein. There is no assurance that the Fund s investment objectives will be attained.

Table of Contents

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

MANAGEMENT DISCUSSION

(UNAUDITED)

Fund Overview

Kayne Anderson Midstream/Energy Fund, Inc. is a non-diversified, closed-end fund. We commenced operations on November 24, 2010. Our shares of common stock are listed on the New York Stock Exchange under the symbol KMF.

Our investment objective is to provide a high level of total return with an emphasis on making quarterly cash distributions to our stockholders. We seek to achieve that investment objective by investing at least 80% of our total assets in the securities of companies in the Midstream/Energy Sector, consisting of (a) Midstream MLPs, (b) Midstream Companies, (c) Other MLPs and (d) Other Energy Companies. We anticipate that the majority of our investments will consist of investments in Midstream MLPs and Midstream Companies. Please see the Glossary of Key Terms on page 38 for a description of these investment categories and for the meaning of capitalized terms not otherwise defined herein.

As of May 31, 2014, we had total assets of $1.3 billion, net assets applicable to our common stock of $893 million (net asset value of $40.78 per share), and 21.9 million shares of common stock outstanding. As of May 31, 2014, we held $1.2 billion in equity investments and $127 million in debt investments.

Recent Events

On July 25, 2014, we entered into a $50 million unsecured revolving credit agreement (Bank Facility). The Bank Facility has a five-year commitment, and borrowings under the Bank Facility will bear interest at a rate of 1-month LIBOR plus 1.30%. We pay a fee of 0.25% per annum on any unused amount of the Bank Facility.

Results of Operations For the Three Months Ended May 31, 2014

Investment Income. Investment income totaled $8.3 million for the quarter and consisted primarily of net dividends and distributions and interest income on our investments. We received $11.8 million of dividends and distributions, of which $6.0 million was treated as return of capital. Interest and other income was $2.5 million. We received $2.9 million of paid-in-kind dividends during the quarter, which are not included in investment income, but are reflected as an unrealized gain.

Operating Expenses. Operating expenses totaled $7.7 million, including $3.8 million of investment management fees, $2.6 million of interest expense (including non-cash amortization of debt issuance costs of $0.2 million), $0.4 million of other operating expenses and $1.0 million of preferred stock distributions.

Net Investment Income. Our net investment income totaled $0.6 million.

Net Realized Gains. We had net realized gains of $16.5 million, which includes $0.7 million of net realized gains from option activity and $0.4 million of net realized losses on interest rate swap contracts.

Net Change in Unrealized Gains. We had a net increase in unrealized gains of $63.9 million. The net increase consisted of $64.3 million of unrealized gains from investments and $0.4 million of net unrealized losses from option activity.

Net Increase in Net Assets Resulting from Operations. We had an increase in net assets resulting from operations of $81.0 million. This increase was comprised of net investment income of $0.6 million, net realized gains of $16.5 million and net increase in unrealized gains of $63.9 million, as noted above.

Distribution to Common Stockholders

We pay quarterly distributions to our common stockholders, funded generally by net distributable income (NDI) generated from our portfolio investments. NDI is the amount of income received by us from our

Table of Contents

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

MANAGEMENT DISCUSSION

(UNAUDITED)

portfolio investments less operating expenses, subject to certain adjustments as described below. NDI is not a financial measure under the accounting principles generally accepted in the United States of America (GAAP). Refer to the Reconciliation of NDI to GAAP section below for a reconciliation of this measure to our results reported under GAAP.

Income from portfolio investments includes (a) cash dividends and distributions, (b) paid-in-kind dividends received (*i.e.*, stock dividends), (c) interest income from debt securities and commitment fees from private investments in public equity (PIPE investments) and (d) net premiums received from the sale of covered calls.

Operating expenses include (a) investment management fees paid to our investment adviser, (b) other expenses (mostly comprised of fees paid to other service providers), (c) an accrual for estimated excise taxes and (d) interest expense and preferred stock distributions.

Net Distributable Income (NDI)

(amounts in millions, except for per share amounts)

		Three Months Ended May 31, 2014
Distributions and Other Income from Investments		
Dividends[1]	$	11.8
Paid-In-Kind Dividends and Distributions[1]		2.9
Interest and Other Income		2.5
Net Premiums Received from Call Options Written		2.4
Total Distributions and Other Income from Investments		19.6
Expenses		
Investment Management Fee		(3.8)
Other Expenses		(0.4)
Excise Taxes[2][3]		
Interest Expense		(2.4)
Preferred Stock Distributions		(1.0)
Net Distributable Income (NDI)	**$**	**12.0**
Weighted Shares Outstanding		22.1
NDI per Weighted Share Outstanding	**$**	**0.545**
Adjusted NDI per Weighted Share Outstanding[4]	**$**	**0.545**
Distributions paid per Common Share[5]	**$**	**0.480**

(1)

See Note 2 (Investment Income) to the Financial Statements for additional information regarding paid-in-kind and non-cash dividends and distributions.

(2) During the six months ended May 31, 2014, we paid $0.76 million of excise taxes related to undistributed income during 2013. At November 30, 2013, we accrued $0.75 million in excise taxes and increased this accrual by $0.01 million during first quarter of fiscal 2014 to true-up to the actual amount of taxes paid. As of May 31, 2014, for GAAP purposes, we did not accrue any excise taxes related to undistributed income for 2014 because the liability was not probable and estimable.

(3) Our Board of Directors currently intends to declare a special distribution prior to the end of calendar 2014 to eliminate our potential excise tax liability. The amount of the special distribution, if any, will depend on many factors, including the amount of our undistributed income at year end (if any), as well as our leverage

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

MANAGEMENT DISCUSSION

(UNAUDITED)

levels at such time. Based on the current intentions of our Board of Directors, we have assumed no excise tax expense for purposes of calculating NDI for fiscal 2014.

(4) There were no adjustments during the quarter.

(5) The distribution of $0.48 per share for the second quarter of fiscal 2014 was paid on July 18, 2014.

Payment of future distributions is subject to Board of Directors approval, as well as meeting the covenants of our debt agreements and terms of our preferred stock. In determining our quarterly distribution to common stockholders, our Board of Directors considers a number of factors that include, but are not limited to:

- NDI and Adjusted NDI generated in the current quarter;
- Expected NDI over the next twelve months; and
- Realized and unrealized gains generated by the portfolio.

On June 25, 2014, we declared a quarterly distribution of $0.48 per common share for the second quarter of fiscal 2014 (a total distribution of $10.5 million). The distribution represents an increase of 1.6% from the prior quarter s distribution and an increase of 5.5% from the distribution for the quarter ended May 31, 2013. The distribution was paid on July 18, 2014.

Reconciliation of NDI to GAAP

The difference between distributions and other income from investments in the NDI calculation and total investment income as reported in our Statement of Operations is reconciled as follows:

- GAAP recognizes that a significant portion of the cash distributions received from MLPs is characterized as a return of capital and therefore excluded from investment income, whereas the NDI calculation includes the return of capital portion of such distributions.
- NDI includes the value of paid-in-kind dividends and distributions whereas such amounts are not included as investment income for GAAP purposes, but rather are recorded as unrealized gains upon receipt.
- NDI includes commitment fees from PIPE investments, whereas such amounts are generally not included in investment income for GAAP purposes, but rather are recorded as a reduction to the cost of the investment.

Certain of our investments in debt securities were purchased at a discount or premium to the par value of such security. When making such investments, we consider the security s yield to maturity, which factors in the impact of such discount (or premium). Interest income reported under GAAP includes the non-cash accretion of the discount (or amortization of the premium) based on the effective interest method. When we calculate interest income for purposes of determining NDI, in order to better reflect the yield to maturity, the accretion of the discount (or amortization of the premium) is calculated on a straight-line basis to the earlier of the expected call date or the maturity date of the debt security.

We may sell covered call option contracts to generate income or to reduce our ownership of certain securities that we hold. In some cases, we are able to repurchase these call option contracts at a price less than the call premium that we received, thereby generating a profit. The premium we receive from selling call options, less (i) the amount that we pay to repurchase such call option contracts and (ii) the amount by which the market price of an underlying security is above the strike price at the time a new call option is written (if any), is included in NDI. For GAAP purposes, premiums received from call option contracts sold are not included in investment income. See Note 2 Significant Accounting Policies for a full discussion of the GAAP treatment of option contracts.

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

MANAGEMENT DISCUSSION

(UNAUDITED)

The treatment of expenses included in NDI also differs from what is reported in the Statement of Operations as follows:

- The non-cash amortization or write-offs of capitalized debt issuance costs and preferred stock offering costs related to our financings is included in interest expense and distributions on preferred stock for GAAP purposes, but is excluded from our calculation of NDI.

- NDI also includes recurring payments (or receipts) on interest rate swap contracts (excluding termination payments) whereas for GAAP purposes, these amounts are included in the realized gains/losses section of the Statement of Operations.

- Under GAAP, excise taxes are accrued when probable and estimable. For NDI, we have assumed that the annual excise tax expense will equal the amount paid for the prior year s undistributed income and have ratably allocated the expense over four quarters.

Liquidity and Capital Resources

Total leverage outstanding at May 31, 2014 of $390 million was comprised of $235 million of senior unsecured notes (Notes), $50 million outstanding under our unsecured revolving credit facility (the Credit Facility) and $105 million of mandatory redeemable preferred stock (MRP Shares). Total leverage represented 30% of total assets at May 31, 2014. As of July 24, 2014, we had $56 million borrowed under our Credit Facility, and we had $2.4 million of cash.

Our Credit Facility has a total commitment of $105 million and matures on November 21, 2016. The interest rate varies between LIBOR plus 1.50% and LIBOR plus 2.15%, depending on our asset coverage ratios. Outstanding loan balances accrue interest daily at a rate equal to one-month LIBOR plus 1.50% based on current asset coverage ratios. We pay a fee of 0.25% per annum on any unused amounts of the Credit Facility.

On July 25, 2014, we entered into a $50 million unsecured revolving credit agreement (Bank Facility). The Bank Facility has a five-year commitment, and borrowings under the Bank Facility will bear interest at a rate of 1-month LIBOR plus 1.30%. We pay a fee of 0.25% per annum on any unused amount of the Bank Facility.

On April 30, 2014, we completed a private placement of $30 million of Notes and $40 million of MRP Shares that mature in 2021. Net proceeds from the offerings were used to make new portfolio investments, to refinance existing indebtedness and for general corporate purposes. As a result, at May 31, 2014, we had $235 million of Notes outstanding which mature between 2016 and 2023, and we had $105 million of MRP Shares outstanding, which are subject to mandatory redemption in 2018, 2020 and 2021.

At May 31, 2014, our asset coverage ratios under the Investment Company Act of 1940, as amended (the 1940 Act), were 450% for debt and 329% for total leverage (debt plus preferred stock). Our long-term target asset coverage ratio with respect to our debt is 400%, but at times we may be above or below our target depending on market conditions.

As of May 31, 2014, our total leverage consisted of both fixed rate (87%) and floating rate (13%) obligations. At such date, the weighted average interest/dividend rate on our total leverage was 3.89%.

On April 15, 2014, we announced that our Board of Directors approved a program to purchase up to $20 million of our common stock. The repurchase program will continue until the earlier of (i) the repurchase of $20 million of common stock or (ii) September 30, 2014. We will authorize our agents to make purchases in the open market when shares are trading at a discount of at least 8% to our NAV per share and we have sufficient borrowing capacity relative to our target leverage ratios. As of July 24, 2014, the Fund had repurchased 382,961 shares of its common stock at an average price of $37.61 (total cost of $14.4 million), which represented an average discount to the Fund s NAV per share of approximately 9.3%.

Table of Contents

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

PORTFOLIO SUMMARY

(UNAUDITED)

Portfolio of Long-Term Investments by Category[(1)]

May 31, 2014 **November 30, 2013**

Top 10 Holdings by Issuer

Holding	Sector[(1)]	Percent of Long-Term Investments as of May 31, 2014	Percent of Long-Term Investments as of November 30, 2013
1. The Williams Companies, Inc.	Midstream Company	7.6%	7.7%
2. Kinder Morgan Management, LLC	Midstream MLP	6.7	7.5
3. ONEOK, Inc.	Midstream Company	5.9	6.9
4. Enbridge Energy Management, L.L.C.	Midstream MLP	5.9	5.8
5. Plains GP Holdings, L.P.	Midstream Company	4.3	3.7
6. Kinder Morgan, Inc.	Midstream Company	3.7	5.3
7. Golar LNG Partners LP	Midstream Company	3.1	3.1
8. Regency Energy Partners LP[(3)]	Midstream MLP	2.9	2.3
9. Enbridge, Inc.	Midstream Company	2.2	1.7
10. Crestwood Midstream Partners LP	Midstream MLP	2.0	2.4

(1) See Glossary of Key Terms for Definitions.

(2) Includes MLP affiliates.

(3) As of November 30, 2013, our investments in Regency Energy Partners LP (Regency) and PVR Partners, L.P. (PVR) represented 2.3% of total investments. On March 21, 2014, PVR completed its merger with Regency.

Table of Contents

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

SCHEDULE OF INVESTMENTS

MAY 31, 2014

(amounts in 000 s, except number of option contracts)

(UNAUDITED)

Description	No. of Shares/Units	Value
Long-Term Investments 144.1%		
Equity Investments[(1)] 129.9%		
United States 120.0%		
Midstream Company[(2)] 53.5%		
Capital Product Partners L.P.[(3)]	1,354	$ 14,515
Capital Products Partners L.P. Class B Units[(3)(4)(5)]	606	6,503
CenterPoint Energy, Inc.	599	14,436
Dynagas LNG Partners LP[(3)]	862	20,707
GasLog Partners LP[(3)(6)]	27	727
Golar LNG Partners LP[(3)]	1,202	39,619
Kinder Morgan, Inc.	1,436	47,952
KNOT Offshore Partners LP[(3)]	665	18,258
National Fuel Gas Company[(7)]	222	16,612
NiSource Inc.[(7)]	441	16,476
ONEOK, Inc.[(7)]	1,180	76,112
Plains GP Holdings, L.P.[(3)(8)]	248	6,856
Plains GP Holdings, L.P. Unregistered[(3)(4)(8)(9)]	1,836	48,103
SemGroup Corporation[(7)]	50	3,397
Spectra Energy Corp.[(7)]	524	21,260
Targa Resources Corp.[(7)]	36	4,111
Teekay Offshore Partners L.P.[(3)(7)]	483	17,245
Teekay Offshore Partners L.P. Series A Preferred Units[(3)]	300	7,671
The Williams Companies, Inc.[(7)]	2,083	97,810
		478,370
Midstream MLP[(2)(10)] 52.3%		
Access Midstream Partners, L.P.[(7)]	115	7,231
Arc Logistics Partners LP	82	1,937
Atlas Pipeline Partners, L.P.[(7)]	75	2,435
Buckeye Partners, L.P.[(7)]	268	21,062
Crestwood Midstream Partners LP	1,190	25,935
DCP Midstream Partners, LP[(7)]	356	19,112
El Paso Pipeline Partners, L.P.	146	5,013
Enable Midstream Partners, LP[(6)]	37	950
Enbridge Energy Management, L.L.C.[(7)(11)(12)]	2,535	75,622
Energy Transfer Partners, L.P.[(13)]	309	17,421
EnLink Midstream Partners, LP	498	15,167
Enterprise Products Partners L.P.[(7)(13)]	252	18,879
Exterran Partners, L.P.	297	8,301
Global Partners LP[(7)]	326	13,363
Holly Energy Partners, L.P.	87	3,082

Kinder Morgan Management, LLC[11][12]	1,193	85,984
MarkWest Energy Partners, L.P.[7][8]	399	24,695
Midcoast Energy Partners, L.P.	60	1,321
Niska Gas Storage Partners LLC	87	1,235
ONEOK Partners, L.P.	213	11,709
PBF Logistics LP[6]	37	982
Plains All American Pipeline, L.P.[8]	459	25,914
QEP Midstream Partners, LP	37	895
Regency Energy Partners LP	1,338	37,174
Sprague Resources LP	26	636
Summit Midstream Partners, LP[7]	119	5,352

See accompanying notes to financial statements.

6

Table of Contents

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

SCHEDULE OF INVESTMENTS

MAY 31, 2014

(amounts in 000 s, except number of option contracts)

(UNAUDITED)

Description	No. of Shares/Units	Value
Midstream MLP[2][10] (continued)		
Targa Resources Partners LP	89	$ 6,048
Western Gas Partners, LP[7]	88	6,299
Williams Partners L.P.	438	23,262
		467,016
Other Energy 11.9%		
CONSOL Energy Inc.[7]	220	9,722
Enduro Royalty Trust	320	4,041
Ensco plc	123	6,451
HollyFrontier Corporation[7]	125	6,161
Marathon Petroleum Corporation[7]	133	11,907
NRG Yield, Inc. Class A	28	1,299
Pacific Coast Oil Trust	376	5,005
PBF Energy Inc.	83	2,636
Phillips 66[7]	177	14,991
Seadrill Limited	246	9,359
Seadrill Partners LLC[3]	402	13,189
Tesoro Corporation[7]	79	4,451
The Southern Company	105	4,575
Transocean Ltd.	185	7,852
Valero Energy Corporation[7]	45	2,522
VOC Energy Trust	141	2,149
		106,310
Other 1.2%		
Seaspan Corporation 7.95% Series D Preferred Shares	200	5,154
Seaspan Corporation 8.25% Series E Preferred Shares	200	5,170
		10,324
Other MLP[10] 1.1%		
Alliance Holdings GP, L.P.	14	913
BreitBurn Energy Partners L.P.	119	2,558
Legacy Reserves LP	8	229
LRR Energy LP	22	375
Northern Tier Energy LP	54	1,509
Suncoke Energy Partners, L.P.	158	4,524

		10,108
Total United States (Cost — $761,351)		1,072,128
Canada — 9.9%		
Midstream Company[2] — 8.0%		
AltaGas Ltd.	348	15,472
Enbridge Inc.[13]	598	28,413
Gibson Energy Inc.[13]	145	4,186
Inter Pipeline Ltd.	199	5,840
Keyera Corp.	77	5,228
Pembina Pipeline Corporation	206	8,282
TransCanada Corporation	82	3,830
		71,251

See accompanying notes to financial statements.

Table of Contents

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

SCHEDULE OF INVESTMENTS

MAY 31, 2014

(amounts in 000 s, except number of option contracts)

(UNAUDITED)

Description	No. of Shares/Units	Value
Other Energy 1.9%		
ARC Resources Ltd.	159	$ 4,574
Baytex Energy Corp.	118	4,929
Bonavista Energy Corporation(13)	153	2,280
Crescent Point Energy Corp.(7)	123	5,026
		16,809
Total Canada (Cost $76,513)		88,060
Total Equity Investments (Cost $837,864)		1,160,188

Description	Interest Rate	Maturity Date	Principal Amount	Value
Debt Instruments 14.2%				
Upstream 12.8%				
BlackBrush Oil & Gas, L.P.	(14)	6/3/19	$ 8,623	8,666
Chief Oil & Gas LLC	(15)	5/15/21	4,000	4,013
CrownRock, L.P.	7.125%	4/15/21	2,500	2,637
Goodrich Petroleum Corporation	8.875	3/15/19	7,500	7,913
Halcón Resources Corporation	9.750	7/15/20	15,250	16,775
Jonah Energy LLC	(16)	5/29/21	3,000	3,030
Jones Energy, Inc.	6.750	4/1/22	1,500	1,586
Midstates Petroleum Company, Inc.	10.750	10/1/20	3,850	4,312
Midstates Petroleum Company, Inc.	9.250	6/1/21	7,800	8,424
Parsley Energy, Inc.	7.500	2/15/22	6,025	6,402
Penn Virginia Corporation	8.500	5/1/20	6,300	7,001
Resolute Energy Corporation	8.500	5/1/20	3,775	3,935
Rex Energy Corporation	8.875	12/1/20	9,700	10,816
RKI Exploration & Production, LLC	8.500	8/1/21	12,500	13,625
Sanchez Energy Corporation	7.750	6/15/21	7,750	8,331
Vantage Energy, LLC	(17)	12/31/18	6,485	6,534
				114,000
Other Energy 0.7%				
Arch Coal, Inc.	7.250	6/15/21	9,500	6,816
Midstream Company(2) 0.7%				
Kinder Morgan, Inc.	7.750	1/15/32	5,875	6,433

Total Debt Investments (Cost $121,638)	127,249
Total Long-Term Investments (Cost $959,502)	1,287,437

	Strike Price	Expiration Date	No. of Contracts	Value
Liabilities				
Call Option Contracts Written[18]				
United States				
Midstream Company				
National Fuel Gas Company	$ 75.00	6/20/14	500	(53)
NiSource Inc.	36.00	6/20/14	300	(43)
NiSource Inc.	37.00	6/20/14	300	(24)
NiSource Inc.	38.00	7/18/14	800	(48)
ONEOK, Inc.	62.50	6/20/14	350	(84)
ONEOK, Inc.	65.00	6/20/14	700	(47)
SemGroup Corporation	65.00	6/20/14	250	(80)

See accompanying notes to financial statements.

Table of Contents

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

SCHEDULE OF INVESTMENTS

MAY 31, 2014

(amounts in 000 s, except number of option contracts)

(UNAUDITED)

Description	Strike Price	Expiration Date	No. of Contracts	Value
Midstream Company (continued)				
SemGroup Corporation	$ 70.00	6/20/14	250	$ (14)
Spectra Energy Corp.	40.00	6/20/14	900	(83)
Spectra Energy Corp.	40.00	7/18/14	600	(69)
Targa Resources Corp.	115.00	7/18/14	350	(106)
Teekay Offshore Partners L.P.	35.00	6/20/14	190	(19)
The Williams Companies, Inc.	44.00	6/20/14	700	(204)
The Williams Companies, Inc.	45.00	6/20/14	700	(139)
				(1,013)
Midstream MLP				
Access Midstream Partners, L.P.	60.00	6/20/14	500	(159)
Atlas Pipeline Partners, L.P.	33.00	7/18/14	200	(13)
Buckeye Partners, L.P.	80.00	6/20/14	500	(23)
Buckeye Partners, L.P.	80.00	7/18/14	270	(26)
DCP Midstream Partners, LP	55.00	7/18/14	450	(17)
Enbridge Energy Management, L.L.C.	30.00	7/18/14	300	(14)
Enterprise Products Partners L.P.	75.00	6/20/14	500	(35)
Enterprise Products Partners L.P.	75.00	7/18/14	500	(40)
Global Partners LP	40.00	7/18/14	600	(89)
MarkWest Energy Partners, L.P.	65.00	6/20/14	450	(11)
MarkWest Energy Partners, L.P.	67.50	6/20/14	450	(6)
Summit Midstream Partners, LP	45.00	7/18/14	400	(66)
Western Gas Partners, LP	70.00	6/20/14	400	(92)
				(591)
Other Energy				
CONSOL Energy Inc.	45.00	6/20/14	200	(13)
CONSOL Energy Inc.	46.00	7/18/14	250	(20)
HollyFrontier Corporation	53.50	6/20/14	170	(1)
HollyFrontier Corporation	54.50	6/20/14	150	(1)
Marathon Petroleum Corporation	97.50	6/20/14	155	(3)
Marathon Petroleum Corporation	100.00	6/20/14	200	(3)
Marathon Petroleum Corporation	105.00	6/20/14	150	(1)
Marathon Petroleum Corporation	92.50	7/18/14	250	(52)
Marathon Petroleum Corporation	95.00	7/18/14	325	(41)
Marathon Petroleum Corporation	97.50	7/18/14	250	(20)
Phillips 66	85.00	6/20/14	400	(58)
Phillips 66	85.00	7/18/14	200	(46)
Phillips 66	87.50	6/20/14	530	(27)

Phillips 66	87.50	7/18/14	200	(24)
Phillips 66	90.00	6/20/14	120	(2)
Tesoro Corporation	55.00	6/20/14	250	(53)
Tesoro Corporation	60.00	6/20/14	250	(7)
Valero Energy Corporation	60.00	6/20/14	450	(11)
				(383)
Total United States (Premium Received $1,724)				(1,987)

See accompanying notes to financial statements.

Table of Contents

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

SCHEDULE OF INVESTMENTS

MAY 31, 2014

(amounts in 000 s, except number of option contracts)

(UNAUDITED)

Description	Strike Price	Expiration Date	No. of Contracts	Value
Canada				
Other Energy				
Crescent Point Energy Corp. (Premium Received $10)	$ 44.00	6/20/14	200	$ (8)
Total Call Option Contracts Written (Premiums Received $1,734)				(1,995)
Credit Facility				(50,000)
Notes				(235,000)
Mandatory Redeemable Preferred Stock at Liquidation Value				(105,000)
Other Liabilities				(14,410)
Total Liabilities				(406,405)
Other Assets				12,291
Total Liabilities in Excess of Other Assets				(394,114)
Net Assets Applicable to Common Stockholders				$ 893,323

(1) Unless otherwise noted, equity investments are common units/common shares.

(2) Refer to the Glossary of Key Terms (page 38) for the definition of Midstream Companies and Midstream MLPs.

(3) This company is structured like an MLP, but is not treated as a publicly-traded partnership for RIC qualification purposes.

(4) Fair valued security, restricted from public sale. See Notes 2, 3 and 7 in Notes to Financial Statements.

(5) Class B Units are convertible on a one-for-one basis into common units of Capital Product Partners L.P. (CPLP) and are senior to the common units in terms of liquidation preference and priority of distributions. The Class B Units pay quarterly cash distributions of $0.21375 per unit and are convertible at any time at the option of the holder. If CPLP increases the quarterly cash distribution per common unit, the distribution per Class B Unit will increase by an equal amount. If CPLP does not redeem the Class B Units by May 2022, then the distribution increases by 25% per quarter to a maximum of $0.33345 per unit. CPLP may require that the Class B Units convert into common units after May 2015 if the common unit price exceeds $11.70 per unit, and the Class B Units are callable after May 2017 at a price of $9.27 per unit and after May 2019 at $9.00 per unit.

(6) Security is not currently paying cash distributions but is expected to pay cash distributions within the next 12 months.

(7) Security or a portion thereof is segregated as collateral on option contracts written.

(8) The Fund believes that it is an affiliate of MarkWest Energy Partners, L.P., Plains All American Pipeline, L.P. and Plains GP Holdings, L.P. (Plains GP). See Note 5 Agreements and Affiliations.

(9) The Fund holds an interest in Plains AAP, L.P. (PAA GP), which controls the general partner of Plains All American, L.P. The Fund s ownership of PAA GP is exchangeable into shares of Plains GP (which trades on the NYSE under the ticker PAGP) on a one-for-one basis at the Fund s option. See Note 3 Fair Value.

(10) Unless otherwise noted, securities are treated as a publicly-traded partnership for regulated investment company (RIC) qualification purposes. To qualify as a RIC for tax purposes, the Fund may directly invest up to 25% of its total assets in equity and debt securities of entities treated as publicly-traded partnerships. The Fund had 24.3% of its total assets invested in publicly-traded partnerships at May 31, 2014. It is the Fund s intention to be treated as a RIC for tax purposes.

See accompanying notes to financial statements.

Table of Contents

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

SCHEDULE OF INVESTMENTS

MAY 31, 2014

(amounts in 000 s, except number of option contracts)

(UNAUDITED)

(11) Dividends are paid-in-kind.

(12) Security is not treated as a publicly-traded partnership for RIC qualification purposes.

(13) In lieu of cash distributions, the Fund has elected to receive distributions in additional units/stock through the issuer s dividend reinvestment program.

(14) Floating rate first lien secured term loan. Security pays interest at a rate of LIBOR + 650 basis points with a 1.25% LIBOR floor (7.75% as of May 31, 2014).

(15) Floating rate second lien secured term loan. Security pays interest at a rate of LIBOR + 650 basis points with a 1.00% LIBOR floor (7.50% as of May 31, 2014).

(16) Floating rate second lien secured term loan. Security pays interest at a rate of LIBOR + 650 basis points with a 1.00% LIBOR floor (7.50% as of May 31, 2014).

(17) Floating rate second lien secured term loan. Security pays interest at a rate of LIBOR + 750 basis points with a 1.00% LIBOR floor (8.50% as of May 31, 2014).

(18) Security is non-income producing.

See accompanying notes to financial statements.

Table of Contents

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

STATEMENT OF ASSETS AND LIABILITIES

MAY 31, 2014

(amounts in 000 s, except share and per share amounts)

(UNAUDITED)

ASSETS	
Investments, at fair value:	
Non-affiliated (Cost $911,113)	$ 1,181,869
Affiliated (Cost $48,389)	105,568
Total investments (Cost $959,502)	1,287,437
Cash	2,568
Deposits with brokers	229
Receivable for securities sold	683
Interest, dividends and distributions receivable	4,252
Deferred debt and preferred stock offering costs and other assets	4,559
Total Assets	1,299,728
LIABILITIES	
Payable for securities purchased	8,960
Investment management fee payable	1,325
Call option contracts written (Premiums received $1,734)	1,995
Accrued directors fees and expenses	50
Accrued expenses and other liabilities	4,075
Credit facility	50,000
Notes	235,000
Mandatory redeemable preferred stock, $25.00 liquidation value per share (4,200,000 shares issued and outstanding)	105,000
Total Liabilities	406,405
NET ASSETS APPLICABLE TO COMMON STOCKHOLDERS	$ 893,323
NET ASSETS APPLICABLE TO COMMON STOCKHOLDERS CONSIST OF	
Common stock, $0.001 par value (22,141,297 shares issued, 21,907,097 shares outstanding and 195,800,000 shares authorized)	$ 22
Paid-in capital	519,344
Accumulated net investment income less distributions not treated as tax return of capital	(30,353)
Accumulated net realized gains less distributions not treated as tax return of capital	76,639
Net unrealized gains	327,671
NET ASSETS APPLICABLE TO COMMON STOCKHOLDERS	$ 893,323
NET ASSET VALUE PER COMMON SHARE	$ 40.78

See accompanying notes to financial statements.

Table of Contents

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

STATEMENT OF OPERATIONS

(amounts in 000 s)

(UNAUDITED)

	For the Three Months Ended May 31, 2014	For the Six Months Ended May 31, 2014
INVESTMENT INCOME		
Income		
Dividends and distributions:		
Non-affiliated investments	$ 10,911	$ 20,645
Affiliated investments	872	1,669
Total dividends and distributions (after foreign taxes withheld of $94 and $170, respectively)	11,783	22,314
Return of capital	(6,022)	(11,694)
Net dividends and distributions	5,761	10,620
Interest and other income	2,551	5,145
Total Investment Income	8,312	15,765
Expenses		
Investment management fees	3,788	7,281
Professional fees	121	245
Administration fees	71	154
Directors fees and expenses	52	93
Insurance	38	76
Reports to stockholders	32	71
Custodian fees	19	35
Other expenses	62	114
Total Expenses before interest expense, preferred distributions and excise taxes	4,183	8,069
Interest expense and amortization of offering costs	2,576	5,038
Distributions on mandatory redeemable preferred stock and amortization of offering costs	986	1,821
Excise taxes		10
Total Expenses	7,745	14,938
Net Investment Income	567	827
REALIZED AND UNREALIZED GAINS (LOSSES)		
Net Realized Gains		
Investments non-affiliated	16,265	48,792
Foreign currency transactions	(22)	(15)
Options	688	1,542
Interest rate swap contracts	(431)	(431)
Net Realized Gains	16,500	49,888

Net Change in Unrealized Gains				
Investments non-affiliated		62,759		69,506
Investments affiliated		1,502		11,132
Foreign currency translations		16		6
Options		(364)		(74)
Net Change in Unrealized Gains		63,913		80,570
Net Realized and Unrealized Gains		80,413		130,458
NET INCREASE IN NET ASSETS APPLICABLE TO COMMON STOCKHOLDERS RESULTING FROM OPERATIONS	$	80,980	$	131,285

See accompanying notes to financial statements.

Table of Contents

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

STATEMENT OF CHANGES IN NET ASSETS APPLICABLE TO COMMON STOCKHOLDERS

(amounts in 000 s, except share amounts)

	For the Six Months Ended May 31, 2014 (Unaudited)	For the Fiscal Year Ended November 30, 2013
OPERATIONS		
Net investment income (loss)(1)	$ 827	$ (2,315)
Net realized gains	49,888	43,922
Net change in unrealized gains	80,570	146,243
Net Increase in Net Assets Resulting from Operations	131,285	187,850
DIVIDENDS AND DISTRIBUTIONS TO COMMON STOCKHOLDERS(1)		
Dividends	(20,712)(2)	(25,108)(3)
Distributions net long-term capital gains	(2)	(14,572)(3)
Dividends and Distributions to Common Stockholders	(20,712)	(39,680)
CAPITAL STOCK TRANSACTIONS		
Issuance of 97,252 and 148,803 shares of common stock from reinvestment of dividends and distributions, respectively	3,220	4,661
Common stock purchased under the share repurchase program (234,200 shares)	(8,527)	
Net Increase (Decrease) in Net Assets Applicable to Common Stockholders from Capital Stock Transactions	(5,307)	4,661
Total Increase in Net Assets Applicable to Common Stockholders	105,266	152,831
NET ASSETS APPLICABLE TO COMMON STOCKHOLDERS		
Beginning of period	788,057	635,226
End of period	$ 893,323	$ 788,057

(1) Distributions on the Fund s mandatory redeemable preferred stock (MRP Shares) are treated as an operating expense under GAAP and are included in the calculation of net investment loss. See Note 2 Significant Accounting Policies. The distributions in the amount of $1,750 paid to MRP shareholders during the six months ended May 31, 2014 are characterized as dividend income (a portion of which may be eligible to be treated as qualified dividend income) until after the end of the fiscal year when the Fund can determine its earnings and profits for the full year, which includes gains and losses on the sale of securities for the remainder of the fiscal year. The final tax character may differ substantially from this preliminary information. The tax character for each distribution paid during the year will be the same as the tax character of the total distributions paid during the full year. Distributions in the amount of $3,212 paid to MRP shareholders for the fiscal year ended November 30, 2013 were characterized as dividend income ($2,007) and as long-term capital gains ($1,205). A portion of the distributions characterized as dividend income was eligible to be treated as qualified dividend income. This characterization is based on the Fund s earnings and profits.

(2)

The distributions paid to common stockholders for the six months ended May 31, 2014 are characterized as dividend income (a portion of which may be eligible to be treated as qualified dividend income) until after the end of the fiscal year when the Fund can determine its earnings and profits for the full year, which includes gains and losses on the sale of securities for the remainder of the fiscal year. The final tax character may differ substantially from this preliminary information. The tax character for each distribution paid during the year will be the same as the tax character of the total distributions paid during the full year.

(3) Distributions paid to common stockholders for the fiscal year ended November 30, 2013 are characterized as either dividends (a portion was eligible to be treated as qualified dividend income) or distributions (long-term capital gains or return of capital). This characterization is based on the Fund s earnings and profits. The tax character for each distribution paid during the year was the same as the tax character of the total distributions paid during the full year.

See accompanying notes to financial statements.

14

Table of Contents

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

STATEMENT OF CASH FLOWS

FOR THE SIX MONTHS ENDED MAY 31, 2014

(amounts in 000 s)

(UNAUDITED)

CASH FLOWS FROM OPERATING ACTIVITIES	
Net increase in net assets resulting from operations	$ 131,285
Adjustments to reconcile net increase in net assets resulting from operations to net cash used in operating activities:	
Return of capital distributions	11,694
Net realized gains (excluding foreign currency transactions)	(49,903)
Net unrealized gains (excluding foreign currency translations)	(80,564)
Accretion of bond discounts, net	(11)
Purchase of long-term investments	(329,740)
Proceeds from sale of long-term investments	266,817
Decrease in deposits with brokers	289
Decrease in receivable for securities sold	3,784
Increase in interest, dividends and distributions receivable	(195)
Amortization of deferred debt offering costs	295
Amortization of mandatory redeemable preferred stock offering costs	71
Increase in other assets	(705)
Increase in payable for securities purchased	3,501
Increase in investment management fee payable	212
Decrease in call option contracts written	(16)
Decrease in accrued excise taxes	(750)
Increase in accrued expenses and other liabilities	726
Net Cash Used in Operating Activities	(43,210)
CASH FLOWS FROM FINANCING ACTIVITIES	
Proceeds from offering of notes	30,000
Proceeds from offering of mandatory redeemable preferred stock	40,000
Shares of common stock repurchased	(8,527)
Costs associated with offering of notes	(276)
Costs associated with offering of mandatory redeemable preferred stock	(585)
Cash distributions paid to common stockholders	(17,492)
Net Cash Provided by Financing Activities	43,120
NET DECREASE IN CASH	(90)
CASH BEGINNING OF PERIOD	2,658
CASH END OF PERIOD	$ 2,568

Supplemental disclosure of cash flow information:

Non-cash financing activities not included herein consisted of reinvestment of distributions of $3,220 pursuant to the Fund s dividend reinvestment plan.

During the six months ended May 31, 2014, interest paid was $4,623 and federal excise tax paid was $760.

During the six months ended May 31, 2014, the Fund received $6,789 of paid-in-kind and non-cash dividends and distributions. See Note 2 Significant Accounting Policies.

See accompanying notes to financial statements.

Table of Contents

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

FINANCIAL HIGHLIGHTS

(amounts in 000 s, except share and per share amounts)

	For the Six Months Ended May 31, 2014 (Unaudited)	For the Fiscal Year Ended November 30, 2013	2012	2011	For the Period November 24, 2010[1] through November 30, 2010
Per Share of Common Stock[2]					
Net asset value, beginning of period	$ 35.75	$ 29.01	$ 25.94	$ 23.80	$ 23.83[3]
Net investment income (loss)[4]	0.04	(0.06)	0.17	0.29	(0.02)
Net realized and unrealized gains (losses)	5.90	8.61	4.64	3.12	(0.01)
Total income (loss) from operations	5.94	8.55	4.81	3.41	(0.03)
Common dividends dividend income[5]	(0.94)	(1.15)	(1.30)	(1.20)	
Common distributions long-term capital gains[5]		(0.66)	(0.41)		
Common distributions return of capital[5]					
Total dividends and distributions common	(0.94)	(1.81)	(1.71)	(1.20)	
Effect of shares issued in reinvestment of distributions	(0.01)		(0.03)	(0.04)	
Effect of issuance of common stock				(0.03)	
Effect of common stock repurchased	0.04				
Net asset value, end of period	$ 40.78	$ 35.75	$ 29.01	$ 25.94	$ 23.80
Market value per share of common stock, end of period	$ 37.85	$ 32.71	$ 28.04	$ 22.46	$ 25.00
Total investment return based on common stock market value[6]	18.9%[7]	23.5%	33.3%	(5.5)%	0.0%[7]

See accompanying notes to financial statements.

16

Table of Contents

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

FINANCIAL HIGHLIGHTS

(amounts in 000 s, except share and per share amounts)

	For the Six Months Ended May 31, 2014 (Unaudited)	For the Fiscal Year Ended November 30, 2013	2012	2011	For the Period November 24, 2010[1] through November 30, 2010
Supplemental Data and Ratios[8]					
Net assets applicable to common stockholders, end of period	$ 893,323	$ 788,057	$ 635,226	$ 562,044	$ 452,283
Ratio of expenses to average net assets					
Management fees[9]	1.8%	1.8%	1.7%	1.6%	1.3%
Other expenses	0.2	0.2	0.3	0.3	0.3[10]
Subtotal	2.0	2.0	2.0	1.9	1.6
Interest expense and distributions on mandatory redeemable preferred stock[4]	1.6	1.8	1.8	1.3	
Management fee waiver				(0.3)	(0.3)
Excise taxes		0.1			
Total expenses	3.6%	3.9%	3.8%	2.9%	1.3%
Ratio of net investment income (loss) to average net assets[4]	0.2%	(0.2)%	0.6%	1.1%	(1.3)%[10]
Net increase (decrease) in net assets applicable to common stockholders resulting from operations to average net assets	15.8%[7]	25.9%	16.8%	13.4%	(0.1)%[7]
Portfolio turnover rate	22.7%[7]	49.1%	67.6%	74.1%	0.0%[7]
Average net assets	$ 829,346	$ 726,248	$ 620,902	$ 537,044	$ 452,775
Notes outstanding, end of period	235,000	205,000	165,000	115,000	
Credit facility outstanding, end of period	50,000	50,000	48,000	45,000	
Mandatory redeemable preferred stock, end of period	105,000	65,000	65,000	35,000	
Average shares of common stock outstanding	22,093,712	21,969,288	21,794,596	21,273,512	19,004,000
Asset coverage of total debt[11]	450.3%	434.5%	428.7%	473.2%	
Asset coverage of total leverage (debt and preferred stock)[12]	329.1%	346.3%	328.5%	388.2%	
Average amount of borrowings per share of common stock during the period[2]	$ 11.91	$ 10.51	$ 8.85	$ 6.50	

See accompanying notes to financial statements.

17

Table of Contents

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

FINANCIAL HIGHLIGHTS

(amounts in 000 s, except share and per share amounts)

(1) Commencement of operations.

(2) Based on average shares of common stock outstanding.

(3) Initial public offering price of $25.00 per share less underwriting discounts of $1.125 per share and offering costs of $0.05 per share.

(4) Distributions on the Fund s MRP Shares are treated as an operating expense under GAAP and are included in the calculation of net investment income (loss). See Note 2 Significant Accounting Policies.

(5) The actual characterization of the distributions made during the six months ended May 31, 2014 will not be determinable until after the end of the fiscal year when the Fund can determine its actual earnings and profits for the full year (including gains and losses on the sale of securities for the remainder of the fiscal year) and may differ substantially from this preliminary information. The information presented for each of the other periods is a characterization of the total distributions paid to the preferred stockholders and common stockholders as either a dividend (a portion was eligible to be treated as qualified dividend income) or a distribution (capital gains or return of capital) and is based on the Fund s earnings and profits.

(6) Total investment return is calculated assuming a purchase of common stock at the market price on the first day and a sale at the current market price on the last day of the period reported. The calculation also assumes reinvestment of distributions at actual prices pursuant to the Fund s dividend reinvestment plan.

(7) Not annualized.

(8) Unless otherwise noted, ratios are annualized.

(9) Ratio reflects total management fee before waiver.

(10) For purposes of annualizing other expenses of the Fund, professional fees and reports to stockholders are fees associated with the annual audit and annual report and therefore have not been annualized.

(11)

Calculated pursuant to section 18(a)(1)(A) of the 1940 Act. Represents the value of total assets less all liabilities not represented by senior unsecured notes (Notes) or any other senior securities representing indebtedness and MRP Shares divided by the aggregate amount of Notes and any other senior securities representing indebtedness. Under the 1940 Act, the Fund may not declare or make any distribution on its common stock nor can it incur additional indebtedness if at the time of such declaration or incurrence its asset coverage with respect to senior securities representing indebtedness would be less than 300%. For purposes of this test, the Credit Facility is considered a senior security representing indebtedness.

(12) Calculated pursuant to section 18(a)(2)(A) of the 1940 Act. Represents the value of total assets less all liabilities not represented by Notes, any other senior securities representing indebtedness and preferred stock divided by the aggregate amount of Notes, any other senior securities representing indebtedness and preferred stock. Under the 1940 Act, the Fund may not declare or make any distribution on its common stock nor can it issue additional preferred stock if at the time of such declaration or issuance, its asset coverage with respect to all senior securities would be less than 200%. In addition to the limitations under the 1940 Act, the Fund, under the terms of its MRP Shares, would not be able to declare or pay any distributions on its common stock if such declaration would cause its asset coverage with respect to all senior securities to be less than 225%. For purposes of these asset coverage ratio tests, the Credit Facility is considered a senior security representing indebtedness.

See accompanying notes to financial statements.

Table of Contents

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

NOTES TO FINANCIAL STATEMENTS

(amount in 000 s, except number of option contracts, share and per share)

(UNAUDITED)

1. Organization

Kayne Anderson Midstream/Energy Fund, Inc. (the Fund) was organized as a Maryland corporation on August 26, 2010 and commenced operations on November 24, 2010. The Fund is registered under the Investment Company Act of 1940, as amended (the 1940 Act), as a non-diversified, closed-end investment management company. The Fund s investment objective is to provide a high level of return with an emphasis on making quarterly cash distributions to its stockholders. The Fund seeks to achieve that investment objective by investing at least 80% of its total assets in the securities of companies in the Midstream/Energy Sector, consisting of (a) Midstream MLPs, (b) Midstream Companies, (c) Other MLPs and (d) Other Energy Companies. The Fund s shares of common stock are listed on the New York Stock Exchange, Inc. (NYSE) under the symbol KMF.

2. Significant Accounting Policies

A. *Use of Estimates* The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements and the reported amounts of revenue and expenses during the period. Actual results could differ materially from those estimates.

B. *Cash and Cash Equivalents* Cash and cash equivalents include short-term, liquid investments with an original maturity of three months or less and include money market fund accounts.

C. *Calculation of Net Asset Value* The Fund determines its net asset value no less frequently than as of the last day of each month based on the most recent close of regular session trading on the NYSE, and makes its net asset value available for publication monthly. Currently, the Fund calculates its net asset value on a weekly basis. Net asset value is computed by dividing the value of the Fund s assets (including accrued interest and distributions), less all of its liabilities (including accrued expenses, distributions payable and any indebtedness) and the liquidated value of any outstanding preferred stock, by the total number of common shares outstanding.

D. *Investment Valuation* Readily marketable portfolio securities listed on any exchange other than the NASDAQ Stock Market, Inc. (NASDAQ) are valued, except as indicated below, at the last sale price on the business day as of which such value is being determined. If there has been no sale on such day, the securities are valued at the mean of the most recent bid and ask prices on such day. Securities admitted to trade on the NASDAQ are valued at the NASDAQ official closing price. Portfolio securities traded on more than one securities exchange are valued at the last sale price on the business day as of which such value is being determined at the close of the exchange representing the principal market for such securities.

Equity securities traded in the over-the-counter market, but excluding securities admitted to trading on the NASDAQ, are valued at the closing bid prices. Debt securities that are considered bonds are valued by using the mean of the bid and ask prices provided by an independent pricing service. For debt securities that are considered bank loans, the fair market value is determined by using the mean of the bid and ask prices provided by the agent or syndicate bank or principal market maker. When price quotes are not available, fair market value will be based on prices of comparable securities. In certain cases, the Fund may not be able to purchase or sell debt securities at the quoted prices due to the lack of liquidity for these securities.

Exchange-traded options and futures contracts are valued at the last sales price at the close of trading in the market where such contracts are principally traded or, if there was no sale on the applicable exchange on such day, at the mean between the quoted bid and ask price as of the close of such exchange.

The Fund holds securities that are privately issued or otherwise restricted as to resale. For these securities, as well as any other portfolio security held by the Fund for which reliable market quotations are not readily available,

Table of Contents

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

NOTES TO FINANCIAL STATEMENTS

(amount in 000 s, except number of option contracts, share and per share)

(UNAUDITED)

valuations are determined in a manner that most accurately reflects fair value of the security on the valuation date. Unless otherwise determined by the Board of Directors, the following valuation process is used for such securities:

Investment Team Valuation. The applicable investments are valued by senior professionals of KA Fund Advisors, LLC (KAFA or the Adviser) who are responsible for the portfolio investments. The investments will be valued monthly, with new investments valued at the time such investment was made.

Investment Team Valuation Documentation. Preliminary valuation conclusions will be determined by senior management of KAFA. Such valuations and supporting documentation is submitted to the Valuation Committee (a committee of the Fund s Board of Directors) and the Board of Directors on a quarterly basis.

Valuation Committee. The Valuation Committee meets to consider the valuations submitted by KAFA at the end of each quarter. Between meetings of the Valuation Committee, a senior officer of KAFA is authorized to make valuation determinations. All valuation determinations of the Valuation Committee are subject to ratification by the Board of Directors at its next regular meeting.

Valuation Firm. Quarterly, a third-party valuation firm engaged by the Board of Directors reviews the valuation methodologies and calculations employed for these securities, unless the aggregate fair value of such security is less than 0.1% of total assets.

Board of Directors Determination. The Board of Directors meets quarterly to consider the valuations provided by KAFA and the Valuation Committee and ratify valuations for the applicable securities. The Board of Directors considers the report provided by the third-party valuation firm in reviewing and determining in good faith the fair value of the applicable portfolio securities.

As of May 31, 2014, the Fund held 6.1% of its net assets applicable to common stockholders (4.2% of total assets) in securities that were fair valued pursuant to the procedures adopted by the Board of Directors. The aggregate fair value of these securities at May 31, 2014 was $54,606. See Note 3 Fair Value and Note 7 Restricted Securities.

E. *Repurchase Agreements* From time to time, the Fund has agreed to purchase securities from financial institutions subject to the seller s agreement to repurchase them at an agreed-upon time and price (repurchase agreements). The financial institutions with whom the Fund enters into repurchase agreements are banks and broker/dealers which KAFA considers creditworthy. The seller under a repurchase agreement is required to maintain the value of the securities as collateral, subject to the agreement, at not less than the repurchase price plus accrued interest. KAFA monitors daily the mark-to-market of the value of the collateral, and, if necessary, requires the seller to maintain additional securities, so that the value of the collateral is not less than the repurchase price. Default by or bankruptcy of the seller would, however, expose the Fund to possible loss because of adverse market action or delays in connection with the disposition of the underlying securities. As of May 31, 2014, the Fund did not have any repurchase agreements.

F. *Short Sales* A short sale is a transaction in which the Fund sells securities it does not own (but has borrowed) in anticipation of or to hedge against a decline in the market price of the securities. To complete a short sale, the Fund may arrange through a broker to borrow the securities to be delivered to the buyer. The proceeds received by the Fund for the short sale are retained by the broker until the Fund replaces the borrowed securities. In borrowing the securities to be delivered to the buyer, the Fund becomes obligated to replace the securities borrowed at their market price at the time of replacement, whatever the price may be.

The Fund s short sales, if any, are fully collateralized. The Fund is required to maintain assets consisting of cash or liquid securities equal in amount to the liability created by the short sale. These assets are adjusted daily to reflect changes in the value of the securities sold short. The Fund is liable for any dividends or distributions paid on securities sold short.

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

NOTES TO FINANCIAL STATEMENTS

(amount in 000 s, except number of option contracts, share and per share)

(UNAUDITED)

The Fund may also sell short against the box (*i.e.*, the Fund enters into a short sale as described above while holding an offsetting long position in the security which it sold short). If the Fund enters into a short sale against the box, the Fund would segregate an equivalent amount of securities owned as collateral while the short sale is outstanding. During the three and six months ended May 31, 2014, the Fund did not engage in any short sales.

G. *Derivative Financial Instruments* The Fund may utilize derivative financial instruments in its operations.

Interest rate swap contracts. The Fund may use hedging techniques such as interest rate swaps to mitigate potential interest rate risk on a portion of the Fund s leverage. Such interest rate swaps would principally be used to protect the Fund against higher costs on its leverage resulting from increases in interest rates. The Fund does not hedge any interest rate risk associated with portfolio holdings. Interest rate transactions the Fund uses for hedging purposes expose it to certain risks that differ from the risks associated with its portfolio holdings. A decline in interest rates may result in a decline in the value of the swap contracts, which, everything else being held constant, would result in a decline in the net assets of the Fund. In addition, if the counterparty to an interest rate swap defaults, the Fund would not be able to use the anticipated net receipts under the interest rate swap to offset its cost of financial leverage.

Interest rate swap contracts are recorded at fair value with changes in value during the reporting period, and amounts accrued under the agreements, included as unrealized gains or losses in the Statement of Operations. Monthly cash settlements under the terms of the interest rate swap agreements or termination payments are recorded as realized gains or losses in the Statement of Operations. The Fund generally values its interest rate swap contracts based on dealer quotations, if available, or by discounting the future cash flows from the stated terms of the interest rate swap agreement by using interest rates currently available in the market. See Note 8 Derivative Financial Instruments.

Option contracts. The Fund is also exposed to financial market risks including changes in the valuations of its investment portfolio. The Fund may purchase or write (sell) call options. A call option on a security is a contract that gives the holder of the option, in return for a premium, the right to buy from the writer of the option the security underlying the option at a specified exercise price at any time during the term of the option.

The Fund would realize a gain on a purchased call option if, during the option period, the value of such securities exceeded the sum of the exercise price, the premium paid and transaction costs; otherwise the Fund would realize either no gain or a loss on the purchased call option. The Fund may also purchase put option contracts. If a purchased put option is exercised, the premium paid increases the cost basis of the securities sold by the Fund.

The Fund may also write (sell) call options with the purpose of generating realized gains or reducing its ownership of certain securities. If the Fund writes a call option on a security, the Fund has the obligation upon exercise of the option to deliver the underlying security upon payment of the exercise price. The Fund will only write call options on securities that the Fund holds in its portfolio (*i.e.*, covered calls).

When the Fund writes a call option, an amount equal to the premium received by the Fund is recorded as a liability and is subsequently adjusted to the current fair value of the option written. Premiums received from writing options that expire unexercised are treated by the Fund on the expiration date as realized gains from investments. If the Fund repurchases a written call option prior to its exercise, the difference between the premium received and the amount paid to repurchase the option is treated as a realized gain or loss. If a call option is exercised, the premium is added to the proceeds from the sale of the underlying security in determining whether the Fund has realized a gain or loss. The Fund, as the writer of an option, bears the market risk of an unfavorable change in the price of the security underlying the written option. See Note 8 Derivative Financial Instruments.

Table of Contents

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

NOTES TO FINANCIAL STATEMENTS

(amount in 000 s, except number of option contracts, share and per share)

(UNAUDITED)

H. *Security Transactions* Security transactions are accounted for on the date these securities are purchased or sold (trade date). Realized gains and losses are reported on an identified cost basis.

I. *Return of Capital Estimates* Dividends and distributions received from the Fund s investments are comprised of income and return of capital. The payments made by MLPs (and other entities treated as partnerships for federal income tax purposes) are categorized as distributions and payments made by corporations are categorized as dividends. At the time such dividends and distributions are received, the Fund estimates the amount of such payments that is considered investment income and the amount that is considered a return of capital. The Fund estimates that 90% of the MLP distributions received will be treated as a return of capital. Such estimates for MLPs and other investments are based on historical information available from each investment and other industry sources. These estimates may subsequently be revised based on information received from investments after their tax reporting periods are concluded.

The following table sets forth (i) the components of total dividends and distributions, (ii) the percentage of return of capital attributable to each category and (iii) the estimated total return of capital portion of the dividends and distributions received that are attributable to net realized gains (losses) and net change in unrealized gains (losses). The return of capital portion of the dividends and distributions received is a reduction to investment income, results in an equivalent reduction in the cost basis of the associated investments, and increases net realized gains (losses) and net change in unrealized gains (losses). In accordance with GAAP, the return of capital cost basis reductions for the Fund s MLP investments are limited to the total amount of the cash distributions received from such investments. For income tax purposes, the cost basis reductions for the Fund s MLP investments typically exceed cash distributions received from such investments due to allocated losses from these investments.

	For the Three Months Ended May 31, 2014	For the Six Months Ended May 31, 2014
Dividends from investments	$ 6,901	$ 12,798
Distributions from investments	4,976	9,686
Total dividends and distributions from investments (before foreign taxes withheld of $94 and $170, respectively)	$ 11,877	$ 22,484
Dividends % return of capital	23%	24%
Distributions % return of capital	89%	89%
Total dividends and distributions % return of capital	51%	52%
Return of capital attributable to net realized gains (losses)	$ 1,374	$ 2,014
Return of capital attributable to net change in unrealized gains (losses)	4,648	9,680
Total return of capital	$ 6,022	$ 11,694

J. *Investment Income* The Fund records dividends and distributions on the ex-dividend date. Interest income is recognized on the accrual basis, including amortization of premiums and accretion of discounts. When investing in securities with payment in-kind interest, the Fund will accrue interest income during the life of the security even though it will not be receiving cash as the interest is accrued. To the extent that interest income to be received is not expected to be realized, a reserve against income is established. During the three and six months ended May 31, 2014, the Fund did not have a reserve against interest income, since all interest income accrued is expected to be received.

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

NOTES TO FINANCIAL STATEMENTS

(amount in 000 s, except number of option contracts, share and per share)

(UNAUDITED)

Many of the debt securities that the Fund holds were purchased at a discount or premium to the par value of the security. The non-cash accretion of a discount to par value increases interest income while the non-cash amortization of a premium to par value decreases interest income. The accretion of a discount and amortization of a premium are based on the effective interest method. The amount of these non-cash adjustments can be found in the Fund s Statement of Cash Flows. The non-cash accretion of a discount increases the cost basis of the debt security, which results in an offsetting unrealized loss. The non-cash amortization of a premium decreases the cost basis of the debt security, which results in an offsetting unrealized gain. To the extent that par value is not expected to be realized, the Fund discontinues accruing the non-cash accretion of the discount to par value of the debt security.

The Fund receives paid-in-kind and non-cash dividends and distributions in the form of additional units or shares from the investments listed in the table below. For paid-in-kind dividends, the additional units are not reflected in investment income during the period received but are recorded as unrealized gains upon receipt. Non-cash distributions are reflected in investment income because the Fund has the option to receive its distribution in cash or in additional units of the security. During the three and six months ended May 31, 2014, the Fund received the following paid-in-kind and non-cash dividends and distributions.

	For the Three Months Ended May 31, 2014	For the Six Months Ended May 31, 2014
Paid-in-kind dividends		
Enbridge Energy Management, L.L.C.	$ 1,244	$ 2,463
Kinder Morgan Management, LLC	1,616	3,137
	2,860	5,600
Non-cash dividends and distributions		
Bonavista Energy Corporation	38	38
Enbridge, Inc.	148	148
Energy Transfer Partners, L.P.	284	545
Enterprise Products Partners L.P.	206	441
Gibson Energy Inc.	17	17
	693	1,189
Total paid-in-kind and non-cash dividends and distributions	$ 3,553	$ 6,789

K. *Distributions to Stockholders* Distributions to common stockholders are recorded on the ex-dividend date. Distributions to MRP shareholders are accrued on a daily basis as described in Note 12 Preferred Stock. As required by the Distinguishing Liabilities from Equity topic of the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC 480), the Fund includes the accrued distributions on its MRP Shares as an operating expense due to the fixed term of this obligation. For tax purposes the payments made to the holders of the Fund s MRP Shares are treated as dividends or distributions.

The distributions paid to preferred and common stockholders for the six months ended May 31, 2014 are characterized as dividend income until after the end of the fiscal year when the Fund can determine its actual earnings and profits for the full year (including gains and losses on the sale of securities for the remainder of the fiscal year). The final tax character may differ substantially from this preliminary information. The tax character for each distribution paid during the year will be the same as the tax character of the total distributions paid during the full year.

L. *Partnership Accounting Policy* The Fund records its pro-rata share of the income (loss) and capital gains (losses), to the extent of distributions it has received, allocated from the underlying partnerships and adjusts the cost basis of the underlying partnerships accordingly. These amounts are included in the Fund s Statement of Operations.

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

NOTES TO FINANCIAL STATEMENTS

(amount in 000 s, except number of option contracts, share and per share)

(UNAUDITED)

M. *Taxes* It is the Fund s intention to continue to be treated as and to qualify each year for special tax treatment afforded a regulated investment company (RIC) under Subchapter M of the Internal Revenue Code of 1986, as amended. As long as the Fund meets certain requirements that govern its source of income, diversification of assets and timely distribution of earnings to stockholders, the Fund will not be subject to U.S. federal income tax. See Note 6 Taxes.

All RICs are subject to a non-deductible 4% excise tax on income that is not distributed on a timely basis in accordance with the calendar year distribution requirements. To avoid the tax, the Fund must distribute during each calendar year an amount at least equal to the sum of (i) 98% of its ordinary income for the calendar year, (ii) 98.2% of its net capital gains for the one-year period ending on November 30, the last day of our taxable year, and (iii) undistributed amounts from previous years on which the Fund paid no U.S. federal income tax. A distribution will be treated as paid during the calendar year if it is paid during the calendar year or declared by the Fund in October, November or December of the year, payable to stockholders of record on a date during such a month and paid by the Fund during January of the following year. Any such distributions paid during January of the following year will be deemed to be received by stockholders on December 31 of the year the distributions are declared, rather than when the distributions are actually received.

There can be no assurance that sufficient amounts of the Fund s taxable income and capital gains will be distributed in future periods to avoid the imposition of the 4% excise tax. In that event, the Fund will be liable for the excise tax on the amount by which it does not meet the distribution requirement and will accrue an excise tax liability at the time that the liability is estimable and probable. In each of the past two years, the Board of Directors has determined not to make a special distribution of income in order to avoid the excise tax. The Fund s Board of Directors continues to review the merits of making a special distribution of undistributed income or paying the excise tax on such undistributed income. Currently, the Board of Directors intends to declare a special distribution prior to the end of calendar 2014 to eliminate the Fund s potential excise tax liability. The amount of the special distribution, if any, will depend on many factors, including the amount of the Fund s undistributed income at year end (if any) as well as the Fund s leverage levels relative to its stated target levels and financial covenants at such time. The Fund s Board of Directors may come to a different conclusion at the end of the year based on the facts and circumstances at such time. See Note 6 Taxes.

Dividend income received by the Fund from sources within Canada is subject to a 15% foreign withholding tax. For non-cash dividends from Bonavista Energy Corporation and Gibson Energy Inc. received during the three months ended May 31, 2014, there was no foreign withholding tax. Interest income on Canadian corporate obligations may be subject to a 10% withholding tax unless an exemption is met. The most common exemption available is for corporate bonds that have a tenor of at least 5 years, provided that not more than 25% of the principal is repayable in the first 5 years and provided that the borrower and lender are not associated. Further, interest is exempt if derived from debt obligations guaranteed by the Canadian government.

The Accounting for Uncertainty in Income Taxes Topic of the FASB Accounting Standards Codification (ASC 740) defines the threshold for recognizing the benefits of tax-return positions in the financial statements as more-likely-than-not to be sustained by the taxing authority and requires measurement of a tax position meeting the more-likely-than-not criterion, based on the largest benefit that is more than 50% likely to be realized.

The Fund s policy is to classify interest and penalties associated with underpayment of federal and state income taxes, if any, as income tax expense on its Statement of Operations. For the three and six months ended May 31, 2014, the Fund did not have any interest or penalties associated with the underpayment of any income taxes. All tax years since inception remain open and subject to examination by federal and state tax authorities.

N. *Foreign Currency Translations* The books and records of the Fund are maintained in U.S. dollars. Foreign currency amounts are translated into U.S. dollars on the following basis: (i) market value of investment

Table of Contents

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

NOTES TO FINANCIAL STATEMENTS

(amount in 000 s, except number of option contracts, share and per share)

(UNAUDITED)

securities, assets and liabilities at the rate of exchange as of the valuation date; and (ii) purchases and sales of investment securities, income and expenses at the relevant rates of exchange prevailing on the respective dates of such transactions.

The Fund does not isolate that portion of gains and losses on investments in equity and debt securities which is due to changes in the foreign exchange rates from that which is due to changes in market prices of equity and debt securities. Accordingly, realized and unrealized foreign currency gains and losses with respect to such securities are included in the reported net realized and unrealized gains and losses on investment transactions balances.

Net realized foreign exchange gains or losses represent gains and losses from transactions in foreign currencies and foreign currency contracts, foreign exchange gains or losses realized between the trade date and settlement date on security transactions, and the difference between the amounts of interest and dividends recorded on the Fund s books and the U.S. dollar equivalent of such amounts on the payment date.

Net unrealized foreign exchange gains or losses represent the difference between the cost of assets and liabilities (other than investments) recorded on the Fund s books from the value of the assets and liabilities (other than investments) on the valuation date.

O. *Indemnifications* Under the Fund s organizational documents, its officers and directors are indemnified against certain liabilities arising out of the performance of their duties to the Fund. In addition, in the normal course of business, the Fund enters into contracts that provide general indemnification to other parties. The Fund s maximum exposure under these arrangements is unknown, as this would involve future claims that may be made against the Fund that have not yet occurred, and may not occur. However, the Fund has not had prior claims or losses pursuant to these contracts and expects the risk of loss to be remote.

3. Fair Value

The Fair Value Measurement Topic of the FASB Accounting Standards Codification (ASC 820) defines fair value as the price at which an orderly transaction to sell an asset or to transfer a liability would take place between market participants under current market conditions at the measurement date. As required by ASC 820, the Fund has performed an analysis of all assets and liabilities measured at fair value to determine the significance and character of all inputs to their fair value determination. Inputs are the assumptions, along with considerations of risk, that a market participant would use to value an asset or a liability. In general, observable inputs are based on market data that is readily available, regularly distributed and verifiable that the Fund obtains from independent, third-party sources. Unobservable inputs are developed by the Fund based on its own assumptions of how market participants would value an asset or a liability.

Accounting Standards Update (ASU) No. 2011-04 Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs amends ASC 820. The amended guidance clarifies the wording used to describe many requirements in accounting literature for fair value measurement and disclosure to establish consistency between U.S. GAAP and International Financial Reporting Standards (IFRSs).

ASU No. 2011-04 requires the inclusion of additional disclosures on assumptions used by the Fund to determine fair value. Specifically, for assets measured at fair value using significant unobservable inputs (Level 3), ASU No. 2011-04 requires that the Fund (i) describe the valuation process, (ii) disclose quantitative information about unobservable inputs and (iii) provide a qualitative discussion about the sensitivity of the fair value measurement to changes in the unobservable inputs and inter-relationships between the inputs.

Table of Contents

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

NOTES TO FINANCIAL STATEMENTS

(amount in 000 s, except number of option contracts, share and per share)

(UNAUDITED)

The fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into the following three broad categories.

Level 1 Valuations based on quoted unadjusted prices for identical instruments in active markets traded on a national exchange to which the Fund has access at the date of measurement.

Level 2 Valuations based on quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets. Level 2 inputs are those in markets for which there are few transactions, the prices are not current, little public information exists or instances where prices vary substantially over time or among brokered market makers.

Level 3 Model derived valuations in which one or more significant inputs or significant value drivers are unobservable. Unobservable inputs are those inputs that reflect the Fund s own assumptions that market participants would use to price the asset or liability based on the best available information.

The following table presents the Fund s assets and liabilities measured at fair value on a recurring basis at May 31, 2014, and the Fund presents these assets and liabilities by security type and description on its Schedule of Investments or on its Statement of Assets and Liabilities. Note that the valuation levels below are not necessarily an indication of the risk or liquidity associated with the underlying investment.

	Total	Quoted Prices in Active Markets (Level 1)	Prices with Other Observable Inputs (Level 2)	Unobservable Inputs (Level 3)
Assets at Fair Value				
Equity investments	$ 1,160,188	$ 1,105,582	$	$ 54,606
Debt investments	127,249		127,249	
Total assets at fair value	$ 1,287,437	$ 1,105,582	$ 127,249	$ 54,606
Liabilities at Fair Value				
Call option contracts written	$ 1,995	$	$ 1,995	$

For the six months ended May 31, 2014, there were no transfers between Level 1 and Level 2.

As of May 31, 2014, the Fund had Notes outstanding with aggregate principal amount of $235,000 and 4,200,000 shares of MRP Shares outstanding with a total liquidation value of $105,000. The Notes and MRP Shares were issued in private placements to institutional investors and are not listed on any exchange or automated quotation system. See Note 11 Notes and Note 12 Preferred Stock. As a result, the Fund categorizes the Notes and MRP Shares as Level 3 and determines the fair value of these instruments based on estimated market yields and credit spreads for comparable instruments with similar maturity, terms and structure.

The Fund records these securities on its Statement of Assets and Liabilities at principal amount or liquidation value. As of May 31, 2014, the estimated fair values of these leverage instruments are as follows.

Security	**Principal Amount/ Liquidation Value**	**Fair Value**
Notes	$ 235,000	$ 244,600
MRP Shares	$ 105,000	$ 109,200

26

Table of Contents

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

NOTES TO FINANCIAL STATEMENTS

(amount in 000 s, except number of option contracts, share and per share)

(UNAUDITED)

The following tables present the Fund s assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three and six months ended May 31, 2014.

Three Months Ended May 31, 2014	**Equity Investments**
Balance February 28, 2014	$ 54,303
Purchases	
Issuances	
Transfers out to Level 1 and 2	
Realized gains (losses)	
Unrealized gains, net	303
Balance May 31, 2014	$ 54,606

Six Months Ended May 31, 2014	**Equity Investments**
Balance November 30, 2013	$ 45,096
Purchases	
Issuances	
Transfers out to Level 1 and 2	
Realized gains (losses)	
Unrealized gains, net	9,510
Balance May 31, 2014	$ 54,606

The $303 and $9,510 of unrealized gains presented in the tables above for the three and six months ended May 31, 2014 relate to investments that were still held at May 31, 2014, and the Fund includes these unrealized gains on the Statement of Operations Net Change in Unrealized Gains.

Valuation Techniques and Unobservable Inputs

Unless otherwise determined by the Board of Directors, the Fund values its private investments in public equity (PIPE) investments that are convertible into or otherwise will become publicly-tradeable (*e.g.,* through subsequent registration or expiration of a restriction on trading) based on the market value of the publicly-traded security less a discount. This discount is initially equal to the discount negotiated at the time the Fund agrees to a purchase price. To the extent that such securities are convertible or otherwise become publicly traded within a time frame that may be reasonably determined, this discount will be amortized on a straight line basis over such estimated time frame.

The Fund s investment in Plains AAP, L.P. (PAA GP), which controls the general partner of Plains All American, L.P., is valued as a PIPE investment. The Fund s ownership of PAA GP is exchangeable into shares of Plains GP Holdings, L.P. (Plains GP) on a one-for-one basis at the Fund s option. Plains GP completed its initial public offering in October 2013 and in connection with the offering, the Fund agreed to a 15-month lock-up on any Plains GP shares it receives in exchange for its ownership in PAA GP (lock-up expires in January 2015). During the 15-month lock-up period, the Fund is valuing its investment in PAA GP on an as exchanged basis based on the public market value of Plains GP less a discount because of the lack of liquidity.

One of the Fund s private investments is Class B Units of Capital Product Partners L.P. (CPLP). The Class B Units are convertible units (convertible on a one-for-one basis into common units) and are senior to CPLP s common units in terms of liquidation preference and priority of distributions. The Fund s Board of Directors has determined that it is appropriate to value the Class B Units using a convertible pricing model. This model takes into account the attributes of the Class B Units, including the preferred dividend, conversion ratio and call features to determine the estimated value of such units. In using this model, the Fund estimates (i) the

Table of Contents

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

NOTES TO FINANCIAL STATEMENTS

(amount in 000 s, except number of option contracts, share and per share)

(UNAUDITED)

credit spread for CPLP s Class B Units, which is based on credit spreads for companies in a similar line of business as CPLP and (ii) the expected volatility for CPLP s common units, which is based on CPLP s historical volatility. The Fund applies a discount to the value derived from the convertible pricing model to account for an expected discount in market prices for convertible securities relative to the values calculated using pricing models. To the extent this resulting price per Class B Unit is less than the public market price for CPLP s common units at such time, the public market price is used for the Class B Units.

Due to the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of the Fund s investments may fluctuate from period to period. Additionally, the fair value of the Fund s investments may differ from the values that would have been used had a ready market existed for such investments and may differ materially from the values that the Fund may ultimately realize.

The following table summarizes the significant unobservable inputs that the Fund used to value its portfolio investments categorized as Level 3 as of May 31, 2014:

Quantitative Table for Valuation Techniques

				Range		
Assets at Fair Value	**Fair Value**	**Valuation Technique**	**Unobservable Inputs**	**Low**	**High**	**Average**
Equity securities of public companies (PIPE) valued based on a discount to market value	$ 48,103	- Discount to publicly-traded securities	- Current discount	5.1%	5.1%	5.1%
Equity securities of public companies not valued based on a discount to market value	6,503	- Convertible pricing model	- Credit spread	6.3%	6.8%	6.5%
			- Volatility	25.0%	30.0%	27.5%
			- Discount for marketability	8.0%	8.0%	8.0%
Total	$ 54,606					

4. Concentration of Risk

The Fund s investments are concentrated in the Energy Sector. The focus of the Fund s portfolio within the Energy Sector may present more risks than if the Fund s portfolio were broadly diversified across numerous sectors of the economy. A downturn in the Energy Sector would have a larger impact on the Fund than on an investment company that does not concentrate in energy. The performance of securities in the Energy Sector may lag the performance of other industries or the broader market as a whole. Additionally, to the extent that the Fund invests a relatively high percentage of its assets in the securities of a limited number of issuers, the Fund may be more susceptible than a more widely diversified investment company to any single economic, political or regulatory occurrence. At May 31, 2014, the Fund had the following investment concentrations.

Category	**Percent of Long-Term Investments**
Securities of Energy Companies[(1)]	99.2%
Equity securities	90.1%
Debt securities	9.9%
MLP securities[(1)]	37.1%
Largest single issuer	7.6%
Restricted securities	8.5%

(1) Refer to the Glossary of Key Terms (page 38) for the definition of Energy Companies and MLPs.

Table of Contents

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

NOTES TO FINANCIAL STATEMENTS

(amount in 000 s, except number of option contracts, share and per share)

(UNAUDITED)

5. Agreements and Affiliations

A. *Administration Agreement* The Fund has an administration and accounting agreement with Ultimus Fund Solutions, LLC (Ultimus) that may be amended from time to time. Pursuant to the agreement, Ultimus will provide certain administrative and accounting services for the Fund. The agreement has an initial term of two years (expiring on November 14, 2015) and has automatic one-year renewals unless earlier terminated by either party as provided under the terms of the agreement.

B. *Investment Management Agreement* The Fund has entered into an investment management agreement with KAFA under which KAFA, subject to the overall supervision of the Fund s Board of Directors, manages the day-to-day operations of, and provides investment advisory services to, the Fund. For providing these services, KAFA receives an investment management fee from the Fund. On September 25, 2013, the Fund renewed its agreement with KAFA for a period of one year, which expires on October 19, 2014. The agreement may be renewed annually upon the approval of the Fund s Board of Directors (including a majority of the Fund s directors who are not interested persons of the Fund, as such term is defined in the 1940 Act). For the six months ended May 31, 2014, the Fund paid management fees at an annual rate of 1.25% of the average monthly total assets of the Fund.

For purposes of calculating the management fee, the average total assets for each monthly period are determined by averaging the total assets at the last business day of that month with the total assets at the last business day of the prior month. The total assets of the Fund shall be equal to its average monthly gross asset value (which includes assets attributable to the Fund s use of debt and preferred stock, minus the sum of the Fund s accrued and unpaid dividends and distributions on any outstanding common stock and accrued and unpaid dividends and distributions on any outstanding preferred stock and accrued liabilities (other than liabilities associated with borrowing or leverage by the Fund). Liabilities associated with borrowing or leverage include the principal amount of any debt issued by the Fund, the liquidation preference of any outstanding preferred stock, and other liabilities from other forms of borrowing or leverage such as short positions and put or call options held or written by the Fund.

C. *Portfolio Companies* From time to time, the Fund may control or may be an affiliate of one or more of its portfolio companies, as each of these terms is defined in the 1940 Act. In general, under the 1940 Act, the Fund would be presumed to control a portfolio company if the Fund and its affiliates owned 25% or more of its outstanding voting securities and would be an affiliate of a portfolio company if the Fund and its affiliates owned 5% or more of its outstanding voting securities. The 1940 Act contains prohibitions and restrictions relating to transactions between investment companies and their affiliates (including the Fund s investment adviser), principal underwriters and affiliates of those affiliates or underwriters.

The Fund believes that there are several factors that determine whether or not a security should be considered a voting security in complex structures such as limited partnerships of the kind in which the Fund invests. The Fund also notes that the Securities and Exchange Commission (the SEC) staff has issued guidance on the circumstances under which it would consider a limited partnership interest to constitute a voting security. Under most partnership agreements, the management of the partnership is vested in the general partner, and the limited partners, individually or collectively, have no rights to manage or influence management of the partnership through such activities as participating in the selection of the managers or the board of the limited partnership or the general partner. As a result, the Fund believes that many of the limited partnership interests in which it invests should not be considered voting securities. However, it is possible that the SEC staff may consider the limited partner interests the Fund holds in certain limited partnerships to be voting securities. If such a determination were made, the Fund may be regarded as a person affiliated with and controlling the issuer(s) of those securities for purposes of Section 17 of the 1940 Act.

In making such a determination as to whether to treat any class of limited partnership interests the Fund holds as a voting security, the Fund considers, among other factors, whether or not the holders of such limited partnership interests have the right to elect the board of directors of the limited partnership or the general partner.

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

NOTES TO FINANCIAL STATEMENTS

(amount in 000 s, except number of option contracts, share and per share)

(UNAUDITED)

If the holders of such limited partnership interests do not have the right to elect the board of directors, the Fund generally has not treated such security as a voting security. In other circumstances, based on the facts and circumstances of those partnership agreements, including the right to elect the directors of the general partner, the Fund has treated those securities as voting securities. If the Fund does not consider the security to be a voting security, it will not consider such partnership to be an affiliate unless the Fund and its affiliates own more than 25% of the outstanding securities of such partnership. Additionally, certain partnership agreements give common unitholders the right to elect the partnership s board of directors, but limit the amount of voting securities any limited partner can hold to no more than 4.9% of the partnership s outstanding voting securities (*i.e.*, any amounts held in excess of such limit by a limited partner do not have voting rights). In such instances, the Fund does not consider itself to be an affiliate if it owns more than 5% of such partnership s common units.

There is no assurance that the SEC staff will not consider that other limited partnership securities that the Fund owns and does not treat as voting securities are, in fact, voting securities for the purposes of Section 17 of the 1940 Act. If such determination were made, the Fund will be required to abide by the restrictions on control or affiliate transactions as proscribed in the 1940 Act. The Fund or any portfolio company that it controls, and its affiliates, may from time to time engage in certain of such joint transactions, purchases, sales and loans in reliance upon and in compliance with the conditions of certain exemptive rules promulgated by the SEC. The Fund cannot make assurances, however, that it would be able to satisfy the conditions of these rules with respect to any particular eligible transaction, or even if the Fund were allowed to engage in such a transaction, that the terms would be more or as favorable to the Fund or any company that it controls as those that could be obtained in arm s length transaction. As a result of these prohibitions, restrictions may be imposed on the size of positions that may be taken for the Fund or on the type of investments that it could make.

As of May 31, 2014, the Fund believes that MarkWest Energy Partners, L.P. meets the criteria described above and is therefore considered an affiliate of the Fund.

Plains GP Holdings, L.P., Plains AAP, L.P. and Plains All American Pipeline, L.P. Robert V. Sinnott is Chief Executive Officer of Kayne Anderson Capital Advisors, L.P. (KACALP), the managing member of KAFA. Mr. Sinnott also serves as a director of (i) PAA GP Holdings LLC, which is the general partner of Plains GP Holdings, L.P. (Plains GP) and (ii) Plains All American GP LLC (Plains All American GP), which controls the general partner of Plains All American Pipeline, L.P. (PAA). Members of senior management of KACALP and KAFA and various affiliated funds managed by KACALP, including the Fund, own shares of Plains GP as well as interests in Plains AAP, L.P. (PAA GP) (which are exchangeable into shares of Plains GP as described in Note 3 Fair Value). The Fund believes that it is an affiliate of Plains GP and PAA under the 1940 Act by virtue of (i) the Fund s and other affiliated Kayne Anderson funds ownership interest in Plains GP and PAA GP and (ii) Mr. Sinnott s participation on the boards of Plains GP and Plains All American GP.

6. Taxes

Income and capital gain distributions made by RICs often differ from GAAP basis net investment income (loss) and any net realized gains (losses). For the Fund, the principal reason for these differences is the return of capital treatment of dividends and distributions from MLPs and certain other of its investments. Net investment income and net realized gains for GAAP purposes may differ from taxable income for federal income tax purposes due to wash sales, disallowed partnership losses from MLPs and foreign currency transactions.

As of May 31, 2014, the principal temporary differences were (a) realized losses that were recognized for book purposes, but disallowed for tax purposes due to wash sale rules; (b) disallowed partnership losses related to the Fund s MLP investments; and (c) other basis adjustments in the Fund s MLPs and other investments. For purposes of characterizing the nature of the dividends/distributions to investors, the amounts in excess of the Fund s earnings and profits for federal income tax purposes are treated as a return of capital. Earnings and profits differ from taxable income due principally to adjustments related to the Fund s investments in MLPs.

Table of Contents

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

NOTES TO FINANCIAL STATEMENTS

(amount in 000 s, except number of option contracts, share and per share)

(UNAUDITED)

For the fiscal year ended November 30, 2013, the tax character of the total $39,680 distributions paid to common stockholders was $25,108 of dividend income and $14,572 of long-term capital gains, and the tax character of the total $3,212 distributions paid to MRP shareholders was $2,007 of dividend income and $1,205 of long-term capital gains.

The Fund is subject to a non-deductible 4% excise tax on income that is not distributed in accordance with the calendar year distribution requirements. See Note 2 Significant Accounting Policies. As of November 30, 2013, the Fund accrued $750 for excise taxes related to estimated undistributed income of $18,800 for the calendar year ended December 31, 2013. The Fund s Board of Directors elected not to distribute the Fund s undistributed income and incur this excise tax. During the six months ended May 31, 2014, the Fund paid $760 in estimated excise taxes attributable to the Fund s activities during calendar 2013. The incremental amount paid ($10) is reflected as an expense on the Fund s Statement of Operations. As of May 31, 2014, the Fund did not accrue any excise taxes related to undistributed income for 2014 because the liability was not probable and estimable.

The Fund s Board of Directors continues to review the merits of making a special distribution of undistributed income or paying the excise tax on such undistributed income. Currently, the Board of Directors intends to declare a special distribution prior to the end of calendar 2014 to eliminate the Fund s potential excise tax liability. The amount of the special distribution, if any, will depend on many factors, including the amount of the Fund s undistributed income at year end (if any) as well as the Fund s leverage levels relative to its stated target levels and financial covenants at such time. The Fund s Board of Directors may come to a different conclusion at the end of the year based on the facts and circumstances at such time.

Under the Regulated Investment Company Modernization Act of 2010, any net capital losses recognized after December 31, 2010 may be carried forward indefinitely, and their character is retained as short-term and/or long-term losses.

At May 31, 2014, the cost basis of investments for federal income tax purposes was $973,183, and the net cash received on option contracts written was $1,734. At May 31, 2014, gross unrealized appreciation and depreciation of investments and options for federal income tax purposes were as follows:

Gross unrealized appreciation of investments (including options)	$ 321,658
Gross unrealized depreciation of investments (including options)	(7,666)
Net unrealized appreciation of investments before foreign currency related translations	313,992
Unrealized depreciation on foreign currency related translations	(3)
Net unrealized appreciation of investments	$ 313,989

7. Restricted Securities

From time to time, certain of the Fund s investments may be restricted as to resale. For instance, private investments that are not registered under the Securities Act of 1933, as amended, cannot be offered for public sale in a non-exempt transaction without first being registered. In other cases, certain of the Fund s investments have restrictions such as lock-up agreements that preclude the Fund from offering these securities for public sale.

Table of Contents

KAYNE ANDERSON MIDSTREAM/ENERGY FUND, INC.

NOTES TO FINANCIAL STATEMENTS

(amount in 000 s, except number of option contracts, share and per share)

(UNAUDITED)

At May 31, 2014, the Fund held the following restricted investments:

Investment	Acquisition Date	Type of Restriction	Number of Units, Principal ($) (in 000s)	Cost Basis (GAAP)	Fair Value	Fair Value Per Unit	Percent of Net Assets	Percent of Total Assets
Level 2 Investments[1]								
Senior Notes and Secured Term Loans								
BlackBrush Oil & Gas, L.P.	[2]	[3]	$ 8,623	$ 8,587	$ 8,666	n/a	1.0%	0.7%
Chief Exploration & Development LLC	05/12/14	[3]	4,000	3,960	4,013	n/a	0.5	0.3
CrownRock, L.P.	[2]	[3]	2,500	2,500	2,637	n/a	0.3	0.2
Jonah Energy LLC	5/08/14	[3]	3,000	2,955	3,030	n/a	0.3	0.2
Jones Energy, Inc.	3/27/14	[4]	1,500	1,500	1,586	n/a	0.2	0.1
Parsley Energy, Inc.	[2]	[4]	6,025	6,147	6,402	n/a	0.7	0.5
RKI Exploration & Production, LLC	7/15/13	[3]	12,500	12,689	13,625	n/a	1.5	1.0
Sanchez Energy Corporation	[2]	[4]	7,750	7,750	8,331	n/a	0.9	0.7
Vantage Energy, LLC	12/19/13	[3]	6,485	6,434	6,534	n/a	0.7	0.5
Total				$ 52,522	$ 54,824		6.1%	4.2%
Level 3 Investments[5]								
Capital Products Partners L.P.								
Class B Units	[2]	[4]	606	$ 4,362	$ 6,503	$ 10.73	0.7%	0.5%
Plains GP Holdings, L.P.								
Common Units	[2]	[6]	1,836	6,755	48,103	26.20	5.4	3.7
Total				$ 11,117	$ 54,606		6.1%	4.2%

&nb60;2010 2009

Current assets:			
Cash and cash equivalents	$996,000	$747,300	$730,400
Investments	205,000	—	—
Accounts receivable, net	194,300	303,900	182,300
Inventories, net	876,700	1,052,500	1,042,700
	574,100	112,600	518,700

Prepaid expenses and other current assets			
Prepaid royalties	522,100	959,700	439,900
Due from employees	—	—	19,600
Total current assets	3,368,200	3,176,000	2,933,600
Property and equipment, net	91,000	71,800	40,500
Intangible asset, net	7,100	8,000	9,000
Prepaid facility costs	1,468,000	—	—
Total assets	$4,934,300	$3,255,800	$2,983,100
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current liabilities:			
Accounts payable	$491,400	$292,500	$159,700
Capital leases - current portion	13,800	6,500	—
Accrued expenses	1,332,500	470,000	592,300
Deferred revenues	303,400	164,600	190,800
Total current liabilities	2,141,100	933,600	942,800
Long-term liabilities:			
Capital leases - net of current	21,000	10,300	—
Commitments and contingencies (note 12)			
Shareholders' equity:			
Common stock, $.001 par value, 350,000,000 shares authorized; 308,736,705, 286,449,511, and 268,174,642 shares issued and outstanding at December 31, 2011, 2010, and 2009 respectively	308,800	286,500	268,200
	49,273,300	44,861,100	41,371,000

Additional paid-in capital			
Accumulated deficit	(46,809,900)	(42,835,700)	(39,528,900)
Stock subscription receivable	—	—	(70,000)
Total shareholders' equity	2,772,200	2,311,900	2,040,300
Total liabilities and shareholders' equity	$4,934,300	$3,255,800	$2,983,100

See accompanying notes to financial statements

Table of Contents

PAID, INC.
STATEMENTS OF OPERATIONS
FOR THE YEARS ENDED DECEMBER 31,

	2011	2010	2009
Revenues	$6,920,500	$7,194,700	$4,726,000
Cost of revenues	4,595,500	5,033,600	3,269,700
Gross profit	2,325,000	2,161,100	1,456,300
Operating expenses	6,313,100	5,467,400	5,018,600
Loss from operations	(3,988,100)	(3,306,300)	(3,562,300)
Other income (expense):			
Interest expense	(2,800)	(600)	(2,500)
Other income	16,700	100	80,500
Total other income (expense), net	13,900	(500)	78,000
Loss before income taxes	(3,974,200)	(3,306,800)	(3,484,300)
Provision for income taxes	—	—	—
Net loss	$(3,974,200)	$(3,306,800)	$(3,484,300)
Loss per share - basic	$(0.01)	$(0.01)	$(0.01)
Weighted average shares - basic and diluted	294,685,429	277,021,260	260,711,253

See accompanying notes to financial statements

-46-

Table of Contents

PAID, INC.
STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
FOR THE FOR THE YEARS ENDED DECEMBER 31, 2011, 2010, AND 2009

	Common stock		Additional Paid-in Capital	Accumulated Deficit	Stock Subscription Receivable	Total
	Shares	Amount				
Balance, December 31, 2008	251,369,046	$251,400	$36,392,500	$(36,044,600)	—	$599,300
Issuance of common stock pursuant to exercise of stock options granted to employees for services	1,098,272	1,100	280,900	—	—	282,000
Issuance of common stock pursuant to exercise of stock options granted to professionals and consultants	8,880,400	8,900	2,472,600	—	—	2,481,500
Gross compensation related to stock options granted to consultant for service	—	—	74,400	—	—	74,400
Proceeds from the assignment of call options	—	—	158,200	—	—	158,200
Issuance of common stock	4,826,924	4,800	1,341,400	—	—	1,346,200
Exercise of warrants	2,000,000	2,000	198,000	—	(120,000)	80,000
Services received in consideration of payment of stock subscription receivable	—	—	—	—	50,000	50,000
Share based compensation related to issuance of incentive stock options	—	—	453,000	—	—	453,000
Net loss	—	—	—	(3,484,300)	—	(3,484,300)
Balance, December 31, 2009	268,174,642	$268,200	$41,371,000	$(39,528,900)	$ (70,000)	$2,040,300
Issuance of common stock pursuant to exercise of stock options granted to employees for services	910,239	900	288,000	—	—	288,900
Issuance of common stock pursuant to exercise of stock options granted to professionals and consultants	7,986,582	8,000	2,375,000	—	—	2,383,000
Share based compensation related to issuance of incentive stock options	—	—	452,000	—	—	452,000
Services received in consideration of payment of stock subscription receivable	—	—	—	—	70,000	70,000
Options exercised	9,378,048	9,400	375,100	—	—	384,500
Net loss	—	—	—	(3,306,800)	—	(3,306,800)

Balance, December 31, 2010	286,449,511	$286,500	$44,861,100	$(42,835,700)	$ —	$2,311,900

-47-

Table of Contents

	Common stock		Additional Paid-in Capital	Accumulated Deficit	Stock Subscription Receivable	Total
	Shares	Amount				
Issuance of common stock pursuant to exercise of stock options granted to employees for services	2,280,344	2,300	524,300	—	—	526,600
Issuance of common stock pursuant to exercise of stock options granted to professionals and consultants	7,211,585	7,200	1,686,700	—	—	1,693,900
Issuance of restricted common stock for the prepayment of facility costs	6,082,985	6,100	1,271,300	—	—	1,277,400
Share based compensation related to issuance of incentive stock options	—	—	699,900	—	—	699,900
Options exercised	6,712,280	6,700	230,000	—	—	236,700
Net loss	—	—	—	(3,974,200)		(3,974,200)
Balance, December 31, 2011	308,736,705	$308,800	49,273,300	(46,809,900)	—	$2,772,200

See accompanying notes to financial statements

-48-

Table of Contents

PAID, INC.
STATEMENTS OF CASH FLOWS
FOR THE FOR THE YEARS ENDED DECEMBER 31,

	2011	2010	2009
Operating activities:			
Net loss	$(3,974,200)	$(3,306,800)	$(3,484,300)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:			
Depreciation and amortization	40,600	26,900	18,300
Unrealized gain on investments	(80,000)	—	—
Bad debts	23,300	22,500	—
Inventory reserve	125,000	—	112,500
Change in fair value of stock price guarantee	63,300	—	—
Payments received in common stock	(125,000)	—	—
Payment of stock option exercise received as compensation	235,800	384,500	—
Share based compensation	699,900	452,000	453,000
Fair value of stock options awarded to professionals and consultants in payment of fees for services provided	1,693,900	2,383,000	2,555,800
Fair value of stock options awarded to employees in payment of compensation	526,600	288,900	282,000
Services received in consideration of payment of stock subscription receivable	—	70,000	50,000
Changes in assets and liabilities:			
Accounts receivable	86,300	(144,200)	(199,500)
Inventories	50,800	(9,800)	(138,300)
Prepaid expense and other current assets	(209,700)	425,900	58,000
Prepaid royalties	437,600	(519,900)	(148,900)
Accounts payable	198,900	132,800	(239,700)
Accrued expenses	356,700	(122,400)	97,200
Deferred revenue	138,800	(26,100)	71,100
Net cash provided by (used in) operating activities	288,600	57,300	(512,800)
Investing activities:			
Property and equipment additions	(28,500)	(38,900)	(26,900)
Financing activities:			
Payments on capital lease	(12,400)	(1,500)	—
Proceeds from assignment of call option	—	—	158,200
Proceeds from sale of warrants	—	—	80,000
Proceeds from issuance of common stock	—	—	925,000
Proceeds from the exercise of stock options	1,000	—	—
Net cash provided by (used in) financing activities	(11,400)	(1,500)	1,163,200
Net increase in cash and cash equivalents	248,700	16,900	623,500
Cash and cash equivalents, beginning	747,300	730,400	106,900
Cash and cash equivalents, ending	$996,000	$747,300	$730,400

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION			
Cash paid during the period for:			
Income taxes	$—	$—	$—
Interest	$2,000	$600	$—
SUPPLEMENTAL DISCLOSURES OF NON-CASH INFORMATION			
Acquisition of property and equipment under capital lease	$30,400	$18,300	$—
Amounts due in connection with issuance of common stock	$—	$—	$421,200
Common stock issued in payment of future facility costs	$1,277,400	$—	$—

See accompanying notes to financial statements

-49-

Table of Contents

PAID, INC.
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2011, 2010, AND 2009
NOTE 1. ORGANIZATION
The Company's primary focus is to provide brand-related services to businesses, celebrity clients in the entertainment industry as well as charitable organizations. PAID's brand management, brand marketing, social media marketing, product design and merchandising, website design; development and hosting services are designed to grow each client's customer base in size, loyalty and revenue generation. We offer entertainers and business entities comprehensive web-presence and related services supporting and managing clients' official websites and fan-community services including e-commerce, VIP ticketing, live event fan experiences, user-generated content, client content publishing and distribution, fan forums, social network management, social media marketing, customer data capture, management and analysis.

NOTE 2. MANAGEMENT'S PLANS
The Company has continued to incur significant losses. For the years ended December 31, 2011, 2010, and 2009, the Company reported losses of $3,974,200, $3,306,800, and $3,484,300, respectively. The Company has an accumulated deficit of $46,809,900 at December 31, 2011.

Management believes that its efforts over the past two years has positioned the Company to take advantage of growth opportunities within the music and entertainment related industries. With the consolidation of facilities into our new Westborough location, management believes that the Company will be able to increase productivity and will be able to create efficiencies without having to incur additional overhead to support our client base. In addition, the Company expects to have a direct cash savings in 2012 of approximately $75,000 due to the Company's prior payment of rent in stock as outlined in Note 12. In 2011 the Company invested in infrastructure and new technologies, to enable us to process a higher volume of ecommerce activity, and be able to collect key data on buyers of our products and services. The Company has restructured personnel and has hired top talent to oversee business functions, such as fulfillment operations, client services, and business development. The Company will continue to develop key partnerships to aid in the acquisition of new clients and services.

Management believes that these changes will have a positive impact on revenues and gross profits for 2012, and with the recoupment of prepaid royalties and an increase in inventory turns, the Company should have sufficient resources to generate positive cash flow. In addition, the Company continues to increase its efforts to generate income from its patents.

NOTE 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICES
Presentation and Basis of Financial Statements
The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”).

Use of Estimates
In preparing financial statements in conformity with GAAP, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the balance sheets and reported amounts of revenue and expenses during the reporting periods. Material estimates that are particularly susceptible to significant change in the near term relate to inventories, deferred tax asset valuation, assumptions used in the determination of fair value of stock options and warrants using the Black-Scholes option-pricing model, and forfeiture rates related to unvested stock options. Although these estimates are based on management's knowledge of current events and actions, they may ultimately differ from actual results.

Cash and Cash Equivalents

The Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

Investments

As of December 31, 2011, the Company's investments consisted of trading securities that were stated at fair value, with gains or losses resulting from changes in fair value recognized in earnings as other (income) expense, net. Management determines the appropriate classification of its investments in debt and equity securities at the time of purchase and reevaluates such determinations at each balance sheet date. Marketable debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and are reported at fair value, with unrealized

Table of Contents

gains and losses recognized as earnings. Debt securities are classified as held for maturity when the Company has the positive intent and ability to hold the securities to maturity. Held to maturity securities are recorded as either short term or long term on the balance sheet based on contractual maturity dates and are stated at cost. Securities not classified as held to maturity or as trading, are classified as available-for-sale, and are carried at fair market value, with the unrealized gains and losses, net of tax, included in the determination of comprehensive income and reported in shareholders' equity.

Accounts Receivable

Accounts receivable are carried at original invoice amount less an estimate for doubtful receivables based on a review of all outstanding amounts on a monthly basis. Accounts receivable are presented net of an allowance for doubtful collections of $48,300, $25,000 and $2,500 at December 31, 2011, 2010, and 2009, respectively. In determining this allowance, objective evidence that a single receivable is uncollectible as well as a historical pattern of collections of accounts receivable that indicates the entire face amount of a portfolio of accounts receivable may not be collectible is considered at each balance sheet date. Accounts are written off when significantly past due after exhaustive efforts at collection.

Inventories

Inventories consist of merchandise for sale and are stated at the lower of average cost or market determined on a first-in, first-out (FIFO) method. When a purchase contains multiple copies of the same item, they are stated at average cost.

Management periodically reviews inventories on hand to ascertain if any is slow moving or obsolete. In connection with this review, at December 31, 2011, 2010, and 2009 the Company provided for reserves totaling $655,000, $609,000, and $587,000 respectively.

Prepaid Royalties

In accordance with GAAP, prepaid royalties, which consist of artist royalty advances are deferred when paid and expensed based on the completion of performances, shows or other activities. Certain stock advances contain guarantees related to the proceeds from the sale of the stock, and are accounted for at fair value on the date of issuance.

Property and Equipment

Property and equipment are stated at cost. Depreciation is computed using the straight-line method over the estimated useful lives of 3 to 5 years.

Intangible Assets

Intangible assets consist of patents which are being amortized on a straight-line basis over their estimated useful life of 17 years.

Asset Impairment

Long lived assets to be held and used are reviewed to determine whether any events or changes in circumstances indicate that their carrying amount not be recoverable. The Company bases its evaluation on indicators about the future economic benefits that the assets can be expected to provide including historical or future profitability measurements. Management reviews the estimated useful lives, as well as other external market conditions or factors that may be present. If such impairment indicators are present or other factors exist that indicate that the carrying amount of the asset may not be recoverable, the Company determines whether an impairment has occurred through the use of an undiscounted cash flow analysis of assets at the lowest level for which identifiable cash flows exist. If impairment is indicated, the Company recognizes a loss for the difference between the carrying amount and the estimated fair value of the asset. The fair value of the asset is measured using an estimated discounted cash flow analysis.

Table of Contents

Fair Value Measurement
Financial instruments and certain non-financial assets and liabilities are measured at their fair value as determined based on the assets highest and best use. GAAP has established a framework for measuring fair value that is based on a hierarchy which requires that the valuation technique used be based on the most objective inputs available for measuring a particular asset or liability. There are three broad levels in the fair value hierarchy which describe the degree of objectivity of the inputs used to determine fair value. The fair value hierarchy is set forth below:
Level 1 - inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
Level 2 - inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.
Level 3 - inputs to the valuation methodology are unobservable and significant to the fair value measurement. They are based on best information available in the absence of level 1 and 2 inputs.

The fair value of the Company's cash and cash equivalents, accounts receivable, investments, accounts payable, accrued expenses, and capital leases are approximately the same as their carrying amounts. In addition, the Company's derivative instruments, consisting of stock options, stock purchase warrants, and a stock price guarantee, are all valued using the Black-Scholes option pricing model.

Income Taxes
Income taxes are accounted for under the liability method. Under this method, deferred income taxes are provided for temporary differences between the financial reporting and the tax bases of assets and liabilities and are measured using enacted laws and rates that will be in effect when the differences are expected to reverse. A valuation allowance is provided when management believes it is more likely than not that some or all of the deferred tax assets will not be realized. GAAP requires that, in applying the liability method, the financial statement effects of an uncertain tax position be recognized based on the outcome that is more likely than not to occur. Under this criterion the most likely resolution of an uncertain tax position should be analyzed based on technical merits and on the outcome that would likely be sustained under examination. These requirements became effective for annual financial statements beginning after December 15, 2008 and the Company adopted them as of January 1, 2009. The Company has no uncertain tax positions as of December 31, 2011.

Revenue Recognition
The Company generates revenue principally from sales of fan experiences, fan club membership fees, sales of its purchased inventories, and from consulting services.

Fan experience sales generally include tickets and related experiences at concerts and other events conducted by performing artists. Revenues associated with these fan experiences are generally reported gross, rather than net, and are deferred until the related event has been concluded, at which time the revenues and related direct costs are recognized.

Fan club membership fees are recognized ratably over the term of the related membership, generally one year.

For sales of merchandise owned and warehoused by the Company, the Company is responsible for conducting the sale, billing the customer, shipping the merchandise to the customer, processing customer returns and collecting accounts receivable. The Company recognizes revenue upon verification of the credit card transaction and shipment of the merchandise, discharging all obligations of the Company with respect to the transaction.

Client services revenues include web development and design, creative services, film and video services, marketing services and general business consulting services. For contracts that are of a short duration and fixed price, revenue is recognized when there are no significant obligations and upon acceptance by the customer of the completed project. Revenues on longer-term fixed price contracts are recognized using the percent-of-completion method. Services that are preformed on a time and material basis are recognized as the related services are performed.

Cost of Revenues

Cost of revenues include event tickets, ticketing and venue fees, shipping and handling fees associated with e-commerce sales, merchandise and royalties paid to clients.

Table of Contents

Selling and Administration Expenses

Selling, general, and administrative expenses include indirect client related expenses, including credit card processing fees, payroll, travel, facility costs, and other general and administrative expenses.

Advertising Costs

Advertising costs, totaling $9,900, $12,800, and $33,700 in 2011, 2010, and 2009, respectively, are charged to expense when incurred.

Share-Based Compensation

Share-based compensation cost is measured at their fair value on the grant date, and is recognized as an expense over the employee's or non-employee's requisite service period (generally the vesting period of the equity grant).

Segment Reporting

The Company has determined that it has only one discreet operating segment consisting of activities and services surrounding the sale of fan experiences, fan club memberships, and merchandise associated with its relationships with performing artists and organizations.

Concentrations

The Company's financial instruments that are exposed to concentrations of credit risk consist primarily of cash and cash equivalents. The Company places its cash and cash equivalents with high credit quality institutions.

For the years ended December 31, 2011 and December 31, 2010 revenues from a limited number of clients accounted for approximately 54% and 75%, respectively, of total revenues. These revenues were generated from the sales of tour merchandise, VIP services, merchandising and fulfillment services, and client services. For the year ended December 31, 2009, one client Aerosmith, generated 67% of the Company's revenues primarily from the sales of VIP experiences

Earnings Per Common Share

Basic earnings per share represents income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by the Company relate to outstanding stock options and warrants. The number of common shares that would be included in the calculation of outstanding options and warrants is determined using the treasury stock method. The assumed conversion of outstanding dilutive stock options and warrants would increase the shares outstanding but would not require an adjustment of income as a result of the conversion. Stock options and warrants applicable to 17,183,284, 18,995,564, and 32,914,625 shares at December 31, 2011, 2010, and 2009, respectively, have been excluded from the computation of diluted earnings per share because they would reduce the reported loss per share and therefore have an anti-dilutive effect.

Reclassifications

Certain amounts in the 2010 and 2009 financial statements have been reclassified to conform to the 2011 presentation with no effect on previously reported net loss or accumulated deficit.

Table of Contents

NOTE 4. PROPERTY AND EQUIPMENT

At December 31, property and equipment consisted of the following:

	2011	2010	2009
Computer equipment and software	$226,900	$177,800	$126,100
Office furniture and equipment	19,200	9,300	3,800
Website development costs	314,200	314,200	314,200
	560,300	501,300	444,100
Accumulated depreciation	(469,300)	(429,500)	(403,600)
	$91,000	$71,800	$40,500

Depreciation expense of property and equipment for the years ended December 31, 2011, 2010, and 2009 amounted to $39,700, $25,900, and $17,400

NOTE 5. INTANGIBLE ASSETS

The Company has a patent for the real-time calculation of shipping costs for items purchased through online auctions using a zip code as a destination location indicator. It includes shipping charge calculations across multiple carriers and accounts for additional characteristics of the item being shipped, such as weight, special packaging or handling, and insurance costs.

On April 19, 2011, the Company was granted a patent for a technique for facilitating advanced, rapid, accurate estimation of shipping costs across multiple shipping carriers and shipping options between buyer and seller in an online auction.

At December 31, intangible assets consisted of the following:

	2011	2010	2009
Patents	$16,000	$16,000	$16,000
	16,000	16,000	16,000
Accumulated amortization	(8,900)	(8,000)	(7,000)
	$7,100	$8,000	$9,000

Amortization expense of intangible assets for the years ended December 31, 2011, 2010, and 2009 was approximately $900.

Estimated future annual amortization expense is approximately $900 for each year through 2019.

NOTE 6. ACCRUED EXPENSES

At December 31, accrued expenses consist of the following:

	2011	2010	2009
Payroll and related costs	$41,600	$48,300	$179,600
Professional and consulting fees	51,200	86,400	186,100
Royalties	587,300	266,100	184,500
Rent guarantee liability	505,900	—	—
Other	146,500	69,200	42,100
Total	$1,332,500	$470,000	$592,300

Table of Contents

NOTE 7. LONG-TERM LIABILITIES

Capital Lease Obligations

The Company is obligated under various capital leases for equipment, which expire at various dates through April 2015. As of December 31, 2011 the assets capitalized under these leases cost approximately $50,000, and have associated accumulated depreciation of approximately $13,800. As of December 31, 2010, the assets capitalized under these leases cost approximately $19,500, and have associated accumulated depreciation of approximately $1,600.

Minimum future lease payments under capital lease obligations as of December 31, 2011 are as follows:

Year Ended December 31,	
2012	$ 14,870
2013	12,160
2014	8,360
2015	2,780
Total future minimum lease payments	38,170
Less amount representing interest	3,370
Present value of net minimum lease payments	34,800
Less current portion	13,800
	$ 21,000

NOTE 8. INCOME TAXES

There was no provision for income taxes for the years ended December 31, 2011, 2010, and 2009 due to the Company's net operating losses and its valuation reserve against deferred income taxes.

The difference between the provision for income taxes using amounts computed by applying the statutory federal income tax rate of 34% and the Company's effective tax rate is due primarily to the net operating losses incurred by the Company and the valuation reserve against the Company's deferred tax asset.

The tax effects of significant temporary differences and carry forwards that give rise to deferred taxes are as follows:

	2011	2010	2010
Federal net operating loss carry forward	$ 12,536,000	$ 11,529,000	$ 10,568,000
State net operating loss carry forward	1,653,000	1,340,000	1,311,000
	14,189,000	12,869,000	11,879,000
Valuation allowance	(14,189,000)	(12,869,000)	(11,879,000)
Net deferred tax asset	$—	$—	$—

The valuation reserve applicable to net deferred tax assets at December 31, 2011, 2010, and 2009 is due to the likelihood that the potential future benefits from the deferred tax assets will not to be realized.

The Company has not been audited by the Internal Revenue Service ("IRS") or any states in connection with income taxes. The Company files income tax returns in the U.S. federal jurisdiction and Massachusetts. The periods from 2008-2011 remain open to examination by the IRS and state jurisdictions. The Company believes it is not subject to any tax risk beyond the preceding discussion. The Company's policy is to recognize interest and penalties accrued on any unrecognized tax benefits as a component of income tax expense.

At December 31, 2011 and 2010, the Company has federal and state net operating loss carry forwards of approximately $38,500,000 and $17,400,000, respectively, available to offset future taxable income. The state carry-forwards will expire intermittently through 2015, while the federal carry forwards will expire intermittently through 2030.

Table of Contents

NOTE 9. COMMON STOCK

Call Option Agreements

In connection with a May 9, 2005 settlement with Leslie Rotman regarding the value paid and the value received in a 2001 transaction the Company received a call option for 2,000,000 shares of the Company's common stock at $.001 per share. Leslie Rotman is the mother, of Gregory Rotman, President of the Company, and Richard Rotman, Vice President and Secretary of the Company. The option was assignable by the Company. During 2009 and prior years the Company assigned options to purchase 2,000,000 shares of common stock in exchange for $725,979. The proceeds from the assignments of these options were added to the paid in capital of the Company. At December 31, 2009 there were no remaining call options outstanding.

Warrants

During the year ended December 31, 2005, the Company entered into an Agreement and sold a warrant to purchase common stock ("Warrant") to an investor. The investor paid the Company $110,000 in deposits ("Deposits") for the right to acquire up to 2,000,000 shares of unregistered common stock. On June 28, 2009 the Warrant was exercised with a remaining $200,000 of consideration paid in the form of $80,000 of cash and an agreement for $120,000 for future consulting services valued at $120,000. At December 31, 2009 the unused portion of consulting services included in stock subscription receivable was $70,000. During the year ended December 31, 2010 the investor provided the balance of the consulting services.

During the second and third quarters of 2008, in connection with $1,100,000 of short term notes payable, the Company granted warrants for 1,100,000 shares of common stock exercisable at $.25 per share. All of these warrants expired during the second and third quarter of 2011.

Share-based Incentive Plans

During the years ended December 31, 2011, 2010, and 2009, the Company had three stock option plans that include both incentive and non-qualified options to be granted to certain eligible employees, non-employee directors, or consultants of the Company.

Issuance of Common Stock

During 2009 the Company had agreements with certain individual artists of a single band, the Company issued 4,826,924 shares of common stock and guaranteed the individual artists that those shares would sell for a minimum of $1,600,000. If the shares sold for less than the minimum agreed upon amount the artists would receive cash or additional shares to make up the difference. The shares and guaranteed amounts were based upon a minimum number of tour dates. A portion of the related tour was canceled after only approximately 35% of the dates were performed. Consequently, in 2009 the Company included approximately $565,000 related to the portion of the tour that was completed in the cost of revenues. The artists sold the related shares, and as a result of an unanticipated increase in the market value of the Company's stock, and the tour cancellation, received in excess of the guaranteed amounts. Consequently, the Company agreed to receive back $1,346,220 representing the amount of the original advance payment associated with the canceled portion of the tour totaling $346,876 plus $999,344 representing the amount in excess of the guaranteed payment for the tour dates performed. These transactions are reported in the 2009 statement of changes in stockholders' equity as issuance of common stock.

At December 31, 2009, there remained outstanding receivables related to this arrangement totaling approximately $421,200. In January 2010, $115,000 was collected and the balance totaling $306,200 was reclassified to prepaid royalties. As of December 31, 2011 those royalties were earned and fully recouped.

Table of Contents

Share-based Incentive Plans
Active Plans:
2011 Plan
On February 1, 2011, the Company adopted the 2011 Non-Qualified Stock Option Plan (the "2011 Plan"), to replace the 2001 Plan discussed below, and has filed Registration Statements on Form S-8 to register 30,000,000 shares of its common stock. Under the 2011 Plan, employees and consultants may elect to receive their gross compensation in the form of options, exercisable at $.001 per share, to acquire the number of shares of the Company's common stock equal to their gross compensation divided by the fair value of the stock on the date of grant. Information with respect to stock options granted under this plan during the year ended December 31, 2011 is as follows:

	Number of shares		Weighted average exercise price per share
Options outstanding at December 31, 2010	—		$—
Granted	12,027,653		0.037
Exercised	(9,027,653	)	0.001
Options outstanding at December 31, 2011	3,000,000		$0.145

A summary of the awards under this plan during the year ended December 31, 2011 is as follows:

	Number of shares 2011	Gross Compensation
Employee payroll	2,262,367	$522,400
Consulting and professional fees	6,154,472	1,440,800
Total	8,416,839	$1,963,200

At December 31, 2011 there were 19,047,447 shares reserved for issuance under this plan.

2002 Plan
The 2002 Stock Option Plan (“2002 Plan”) provides for the award of qualified and non-qualified options for up to 30,000,000 shares. The options granted have a ten-year contractual term and have a vesting schedule of either immediately, two years, or four years from the date of grant. Information with respect to stock options granted under this plan during the years ended December 31, 2011, 2010, and 2009 is as follows:

	Number of shares		Weighted average exercise price per share
Options outstanding at December 31, 2008	28,250,000		$1.080
Forfeited	(3,000,000	)	0.415
Options outstanding at December 31, 2009	25,250,000		$0.115
Granted	—		—
Exercised	(9,378,048	)	0.041
Options outstanding at December 31, 2010	15,871,952		$0.159
Granted	3,000,000		0.145
Exercised	(5,750,000	)	0.041
Options outstanding at December 31, 2011	13,121,952		$0.104

There are currently no shares reserved for issuance under this plan.

Table of Contents

Option Repricing

In November 2011 the Board of Directors approved a vote to reprice 5,000,000 employee stock options. The options were originally issued on January 2008, and had an original grant price $0.415. The grant price was lowered to $0.145, which reflects the market value of the stock as of the reprice date. The repriced options continue to vest according to the original grant date. The Company recorded an additional compensation charge of $148,415 at December 31, 2011, using the Black-Scholes option pricing model with the following weighted average assumptions:

Expected term (plain-vanilla)	3 years	
Expected volatility	104.12	%
Expected dividends	None	
Risk free interest rate	0.01	%

The intrinsic value of options exercised during the years ended December 31, 2011 and, 2010, was $1,066,963, and $4,743,392 in exchange for $236,712, and $384,500 of cash respectively. The intrinsic value of option exercised during the year ended December 31, 2009 was $2,387,424 in exchange for no cash, since they were all exercised under the 2001 Plan.

Fair value of issuances

The fair value of the Company's option grants under the 2011, 2002 and 2001 Plans was estimated at the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	2011		2010		2009	
Expected term (based upon historical experience)	<1 week		<1 week		<1 week	
Expected volatility	103.26	%	107.24	%	108.31	%
Expected dividends	None		None		None	
Risk free interest rate	0.02	%	0.13	%	3.40	%

The stock volatility for each grant is determined based on a review of the experience of the weighted average of historical daily price changes of the Company's common stock over the expected option term. The expected term was determined using the simplified method for estimating expected option life, which qualify as “plain-vanilla” options; and the risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant for periods corresponding with the expected life of the option.

The fair value of options granted under all plans in 2011 was $694,179 which, assuming no forfeiture rate, resulted in $97,618, in additional compensation expense being charged to operations during 2011. The Company used the Black-Scholes option pricing model with the following weighted average assumptions:

Expected term (plain-vanilla)	5.75 years	
Expected volatility	104.12	%
Expected dividends	None	
Risk free interest rate	0.01	%

All but 10,500,000 options outstanding at December 31, 2011 are fully vested and exercisable. Information pertaining to options outstanding at December 31, 2011 is as follows:

Table of Contents

Exercise Prices	Number of shares	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
0.001	1,061,332	6.73	$200,600
0.041	5,121,952	0.78	763,200
0.145	11,000,000	8.12	495,000
	17,183,284		

2001 Plan

The 2001 Non-Qualified Stock Option Plan (the "2001 Plan") expired on January 31, 2011. The Company adopted the 2001 Plan on February 1, 2001 and filed Registration Statements on Form S-8 to register 120,000,000 shares of its common stock. Under the 2001 Plan, employees and consultants could have elected to receive their gross compensation in the form of options, exercisable at $.001 per share, to acquire the number of shares of the Company's common stock equal to their gross compensation divided by the fair value of the stock on the date of grant. Information with respect to stock options granted under this plan during the years ended December 31, 2011, 2010, and 2009 is as follows:

	Number of shares	Weighted average exercise price per share
Options outstanding at December 31, 2008	1,527,625	$1.08
Granted	15,301,583	0.415
Exercised	(14,805,596)	0.001
Options outstanding at December 31, 2009	2,023,612	$0.001
Granted	8,896,821	0.001
Exercised	(8,896,821)	0.001
Options outstanding at December 31, 2010	2,023,612	$0.001
Granted	1,075,090	0.001
Exercised	(2,037,370)	0.001
Options outstanding at December 31, 2011	1,061,332	$0.001

A summary of the awards under this plan during the years ended December 31, 2011, 2010, and 2009 is as follows:

	Number of shares	Gross Compensation
	2011	
Employee payroll	17,977	$4,200
Consulting and professional fees	1,057,113	253,100
Total	1,075,090	$257,300
	2010	
Employee payroll	910,239	$288,900
Consulting and professional fees	7,986,582	2,383,000
Total	8,896,821	$2,671,900
	2009	
Employee payroll	1,098,272	$282,000
Consulting and professional fees	13,707,324	3,827,600
Total	14,805,596	$4,109,600

Table of Contents

There are currently no shares reserved for issuance under this plan.

Expired Plans

During July 1999, the Company's Board of Directors adopted the 1999 Plan (“1999 Plan”) which provided for the award of non-qualified options for up to 1,000,000 shares. The 1999 Plan expired in July 2009 as did all 37,000 options that were outstanding with an exercise price of $1.62 per share.

Also during July 1999, the Company's Board of Directors adopted, subject to stockholders' approval, the 1999 Omnibus Share Plan (the "Omnibus Plan") that provided for both incentive and non-qualified stock options, stock appreciation rights and other awards to directors, officers, and employees of the Company to purchase or receive up to 1,000,000 shares of the Company's stock. The Omnibus Plan also expired in July 2009. No options were ever granted under the Omnibus Plan.

NOTE 10. REVENUE SEGMENT

The segments of revenue for the years ended December 31, are as follows:

	Years ended December 31,		
	2011	2010	2009
Merchandising and fulfillment	$2,736,900	$2,173,400	$1,589,900
Client services	387,400	490,200	642,500
Touring	3,796,200	4,531,100	2,493,600
Total revenues	$6,920,500	$7,194,700	$4,726,000

NOTE 11. RELATED PARTY TRANSACTIONS

Steven Rotman is the father, and Leslie Rotman is the mother, of Gregory Rotman, President of the Company, and Richard Rotman, Vice President and Secretary of the Company. The Company entered into a number of transactions during 2009 with both Steven Rotman and Leslie Rotman. Management believes that these transactions are fair and reasonable to the Company and no less favorable than could have been obtained by an unaffiliated third party.

In December 2001, the Company engaged Steven Rotman to provide consulting services to the Company. He has not provided any consulting services to the Company since 2009, where he provided $60,000 of consulting fees which were paid to him in the form of options under the 2001 Plan.

The Company pays rent, as a tenant at will, to a company in which Steven Rotman is a shareholder. Monthly payments under this arrangement are approximately $2,500.

NOTE 12. COMMITMENTS AND CONTINGINCIES

Lease commitment

The Company leases an office facility in Boston, Massachusetts under a tenant at will agreement. In November 2011 the Landlord was notified under the provisions of the agreement that the Company will terminate the tenant at will agreement and will vacate the premises in January 2012. The tenant at will agreement requires monthly payments of approximately $5,800, plus increases in real estate taxes and operating expenses.

On January 21, 2012 the Company closed its Boston office and moved to its new facility in Westborough, Massachusetts. The Company plans on moving its fulfillment center located in Worcester, Massachusetts to the Westborough facility in the second quarter of 2012.

Rent expense incurred for each of the years ended December 31, 2011, 2010 and 2009 is $94,000.

Prepaid facility costs

Effective August 5, 2011, the Company had entered into a Lease with Flanders 155 LLC for premises located at 155 Flanders Road, Westborough, Massachusetts. Due to additional spacing needs, the Company and the Landlord terminated the lease and entered into a new lease on substantially the same terms for a different location owned by a sister affiliate of the Landlord, located at 40 Washington Street, Westborough, Massachusetts (the “Washington Street Location”). The lease is for

60

an initial five year term, with an option to renew for one additional five year term. Monthly rent is $13,855.77 for the initial five year term, plus applicable taxes and operating expenses, all of which has been paid in shares of restricted stock of the Company. Monthly rent under the new lease is slightly higher in cost, but due to increased square footage in the Washington Street Location, has a lower cost per square foot.

The original payment consisted of 6,082,985 shares of common stock, at a closing market price of $.21 per share, based on a closing price as of August 22, 2011, which will be applied to the new lease at the Washington Street Location. The payment was for rent over five years, projected taxes and operating expenses, and a security deposit, for a total payment in common stock of $1,277,400. The Company has guaranteed to the Landlord under the Lease that the shares will sell on the open market for at least the value of the rent and other costs for a period of three months after the initial six month restriction on transfer, if the shares are sold during that time, although the Landlord may choose to hold the shares and forego the guaranty.

Legal matters

In the normal course of business, the Company periodically becomes involved in litigation. As of December 31, 2011, in the opinion of management, the Company had no pending litigation that would have a material adverse effect on the Company's financial position, results of operations, or cash flows.

NOTE 13. PREPAID ROYALTIES

Prepaid royalties represent amounts paid in advance to certain clients and are recoupable against future royalties earned by the clients. Advances are issued in either cash or stock and advance amounts are calculated based on the clients' projected earning potential over a fixed period of time. Advances issued in stock are recorded at the fair value on the date of issue. The Company did not have any royalty payment guaranties outstanding at December 31, 2011.

NOTE 14. FAIR VALUE DISCLOSURE

The following table presents fair values for those assets and liabilities measured at fair value on a recurring basis and the level within the fair value hierarchy in which the measurements fall. No transfers among the levels within the fair value hierarchy occurred during the years ended December 31, 2011 or December 31, 2010.

	Fair Value Level	2011	2010
Investments	1	$205,000	—
Rent payment guarantee	2	$(505,900)	

The fair value of the Company's investments classified as trading securities is determined based on the closing market prices of the respective common stocks as of December 31, 2011.

NOTE 15. STOCK PRICE GUARANTEE

In 2011 the Company entered into a lease agreement for the Company's principal office and warehouse facility. The terms of the lease consisted of a payment of rent over five years plus projected operating expenses and a security deposit. The payment was made with 6,082,985 shares of common stock, at a closing price of $.21 per share, based on the closing price as of August 22, 2011. The Company has guaranteed the landlord that the shares will sell on the open market for at least $1,386,500, given the landlord sells the shares within a period of three months after the initial six month restriction on transfer has expired.

The fair value of the rent guarantee was calculated using the Black-Scholes Option Pricing Model with the following assumptions:

Term of guarantee	5 months
Historical volatility	83.73%

Expected dividend	None
Risk free interest rate	0.01%

The Company recorded $442,600 in additional pre-paid rent expense due to the fair value of the guarantee, and will be amortized over the life of the lease. The fair value adjustment of the offsetting derivative liability will be recorded in the

-61-

statement of operations as a component of other income.

Table of Contents

NOTE 16. RESULTS BY QUARTER (UNAUDITED)

The following table presents selected unaudited financial information for the twelve quarters in the period ended December 31, 2011. The results for any quarter are not necessarily indicative of future quarterly results and, accordingly, period-to-period comparisons should not be relied upon as an indication of future performance.

	FOR THE QUARTERS ENDED			
	3/31/2011	6/30/2011	9/30/2011	12/31/2011
Revenues	$711,300	$1,674,500	$1,620,400	$2,914,300
Gross Profit	211,000	591,600	609,900	912,400
Loss from Operations	(1,020,400)	(810,700)	(802,500)	(1,354,500)
Net Loss	$(1,020,900)	$(811,400)	$(803,300)	$(1,338,600)
Loss per share - basic	$—	$—	$—	$—
Weighted average shares - basic	287,979,151	289,464,362	295,014,276	306,111,060

	FOR THE QUARTERS ENDED			
	3/31/2010	6/30/2010	9/30/2010	12/31/2010
Revenues	$1,078,100	$1,194,500	$4,186,700	$735,400
Gross Profit	429,200	457,200	1,150,700	124,000
Loss from Operations	(783,100)	(805,100)	(344,000)	(1,374,100)
Net Loss	$(783,100)	$(805,100)	$(344,200)	$(1,374,400)
Loss per share - basic	$—	$—	$—	$—
Weighted average shares - basic	269,918,897	273,501,440	279,750,389	284,611,109

	FOR THE QUARTERS ENDED			
	3/31/2009	6/30/2009	9/30/2009	12/31/2009
Revenues	$326,900	$1,620,900	$2,116,500	$661,700
Gross Profit	159,500	528,200	1,300,700	(532,100)
Loss from Operations	(836,300)	(1,111,500)	209,100	(1,823,600)
Net Loss	$(838,800)	$(1,106,800)	$209,800	$(1,748,500)
Loss per share - basic	$—	$—	$—	$(0.01)
Weighted average shares - basic	252,826,173	257,294,430	257,294,430	267,380,185
Weighted average shares - diluted	N/A	N/A	286,541,637	N/A

Table of Contents

EXHIBIT INDEX

No.	Description of Exhibits
3.1	Certificate of Incorporation, as amended (incorporated by reference to Exhibit 3.1 to Form 8-K, filed on November 25, 2003)
3.2	Amended and Restated Bylaws (incorporated by reference to Exhibit 3.2 to Form 8-K, filed on December 8, 2004)
4.1	Specimen of certificate for Common Stock (incorporated by reference to Exhibit 4.1 to Form SB-2/A filed on December 1, 2000)
4.2	Agreement dated November 21, 2008, by and between the Company and Lewis Asset Management Equity Fund, LLP with respect to the purchase of 2,500,000 shares at $.20 per share (incorporated by reference to Exhibit 4.2 to Form 10-KSB filed on March 31, 2009)
4.3	Form of Warrant to Lewis Asset Management with respect to Promissory Note dated April 29, 2009 (incorporated by reference to Exhibit 4.2 to Form 10-Q filed on May 12, 2009)
10.1+	2001 Non-Qualified Stock Option Plan, as amended (incorporated by reference from Exhibit 99.1 to Form S-8 filed on September 5, 2003)
10.2+	2002 Non-Qualified Stock Option Plan (incorporated by reference from Exhibit 10.17 to Form 10-KSB filed on March 31, 2003)
10.3+	2011 Non-Qualified Stock Option Plan (incorporated by reference from Exhibit 99.1 to Form S-8 filed on February 2, 2011)
10.4	Promissory Note dated April 29, 2009 for up to $2,500,000 to Lewis Asset Management (incorporated by reference to Exhibit 10.2 to Form 10-Q filed on May 12, 2009)
10.5	Lease agreement, dated December 7, 2011 between Forty Washington, LLC and the Company (incorporated by reference to exhibit 10.1 to our Report on Form 8-K/A filed on December 13, 2011)
23*	Consent of Rosen Seymour Shapss Martin & Company LLP
31.1*	CEO Certification required under Section 302 of Sarbanes-Oxley Act of 2002
31.2*	CFO Certification required under Section 302 of Sarbanes-Oxley Act of 2002
32*	CEO and CFO Certification required under Section 906 of Sarbanes-Oxley Act of 2002

*filed herewith

+Indicates a management contract or any compensatory plan, contract or arrangement