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MEDIABAY INC
Form 10-Q
August 15, 2005

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2005

OR

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

For the transition period from _____ to _____

Commission file number 1-13469

MediaBay, Inc.

(Exact name of Registrant as Specified in its Charter)

Florida

65-0429858

(State or other jurisdiction of
incorporation or organization)

(I.R.S. Employment
Identification No.)

2 Ridgedale Avenue, Cedar Knolls, New Jersey

07927

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code:

(973) 539-9528

Indicate by checkmark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirement for the past 90 days.

Yes No

Indicate by check mark whether the Registrant is an accelerated filer as defined in Rule 12b-2 of the Securities Exchange Act of 1934. Yes No

Indicate the number of shares outstanding of each of the Registrant's classes of common equity, as of the latest practical date. As of August 11, 2005, there were 62,535,702 shares of the Registrant's Common Stock outstanding.

MEDIABAY, INC.
Quarter ended June 30, 2005
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PART I: FINANCIAL INFORMATION

ITEM 1: FINANCIAL STATEMENTS

MEDIABAY, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(DOLLARS IN THOUSANDS)

ASSETS

Current Assets:

Cash and cash equivalents.....	\$
Accounts receivable, net of allowances for sales returns and doubtful accounts of \$1,980 and \$2,708 at June 30, 2005 and December 31, 2004, respectively.....	
Inventory.....	
Prepaid expenses and other current assets.....	

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Royalty advances.....
 Total current assets.....
 Fixed assets, net.....
 Other intangibles.....
 Goodwill.....

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:
 Accounts payable and accrued expenses.....
 Accounts payable, related party.....
 Short-term debt, net of original issue discount of \$53 at June 30, 2005 and December 31, 2004.....
 Preferred dividends payable.....
 Current portion of long-term debt.....
 Total current liabilities.....
 Long-term debt, net of original issue discount of \$140 and \$908 at June 30, 2005 and December 31, 2004.....
 Related party long-term debt including accrued interest.....
 Total liabilities.....

Commitments and Contingencies

Preferred stock, no par value, authorized 5,000,000 shares; no shares of Series A outstanding at June 30, 2005 and 25,000 shares of Series A outstanding at December 31, 2004; 200 shares of Series B issued and outstanding at June 30, 2005 and December 31, 2004; no shares of Series C issued and outstanding at June 30, 2005 and 43,527 shares of Series C issued and outstanding at December 31, 2004; and 34,720 shares of Series D issued and outstanding at June 30, 2005 and no shares of Series D issued and outstanding at December 31, 2004.....
 Common stock, no par value, authorized 300,000,000; issued and outstanding 37,576,353 as of June 30, 2005 and 150,000,000 shares; issued and outstanding 24,843,980 at December 31, 2004.....
 Contributed capital.....
 Accumulated deficit.....
 Total stockholders' equity (deficit).....

See accompanying notes to condensed consolidated financial statements.

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	THREE MONTHS ENDED JUNE 30,		SIX
	2005	2004	2005
Sales, net of returns, discounts and allowances of \$615 and \$1,430 and \$1,387 and \$5,043 for the three and six months ended June 30, 2005 and 2004, respectively	\$ 2,272	\$ 4,801	\$ 5,6
Cost of sales	1,302	2,228	3,0
Cost of sales - strategic charges	305	--	3
Gross profit	665	2,573	2,2
Expenses:			
Advertising and promotion	401	1,268	7
General and administrative	2,013	1,515	3,5
Termination charges	697	--	6
Depreciation and amortization	17	41	
Operating loss	(2,463)	(251)	(2,8
Interest (income)	(62)	--	(
Interest expense	16	6,745	6
Loss on early extinguishment of debt	--	--	5
Loss before income taxes	(2,417)	(6,996)	(4,0
Income tax expense	--	--	
Net loss	(2,417)	(6,996)	(4,0
Dividends on preferred stock	533	115	7
Deemed dividend on beneficial conversion of Series D Preferred Stock	--	--	17,4
Net loss applicable to common shares	\$ (2,950)	\$ (7,111)	\$ (22,1
Basic and diluted loss applicable to common shares per common share:	\$ (.08)	\$ (.40)	\$ (.

See accompanying notes to condensed consolidated financial statements.

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MEDIABAY, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(DOLLARS IN THOUSANDS)

Cash flows used in operating activities:	
Net loss applicable to common shares	\$ (2
Adjustments to reconcile net loss to net cash provided by operating activities:	

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Deemed dividend on beneficial conversion of Series D Preferred Stock	1
Loss on extinguishment of debt	
Non-current accrued interest and dividends payable	
Amortization of deferred financing costs and original issue discount	
Depreciation and amortization	
Payment of accrued dividends through issuance of common stock	
Amortization of deferred member acquisition costs	
Non-cash beneficial conversion charge included in interest expense	
Expense of inducement to convert	
Non-cash stock compensation	
Changes in asset and liability accounts, net of asset acquisition:	
Decrease in accounts receivable, net	
Decrease (increase) in inventory	
Increase in prepaid expenses	
Decrease (increase) in royalty advances	
Increase in deferred member acquisition costs	
Increase (decrease) in accounts payable, accrued expenses and preferred dividends payable	
Net cash used in operating activities	(
Cash flows used in investing activities:	
Acquisition of fixed assets, including website development costs	
Net cash used in investing activities	
Cash flows from financing activities:	
Net proceeds from issuance of preferred stock	3
Proceeds from issuance of long-term debt	
Proceeds from exercise of stock options	
Payment of long-term debt	(1
Redemption of Series A and Series C Preferred Stock	(
Increase in deferred financing costs	
Net cash provided by financing activities	1
Net increase in cash and cash equivalents	1
Cash and cash equivalents at beginning of period	
Cash and cash equivalents at end of period	\$ 1

See accompanying notes to condensed consolidated financial statements.

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MEDIABAY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(DOLLARS IN THOUSANDS, EXCEPT PER SHARE DATA)
(UNAUDITED)

(1) ORGANIZATION

MediaBay, Inc. ("MediaBay" or "the Company") is a Florida corporation formed on August 16, 1993. The Company is a media, marketing and publishing company specializing in spoken audio entertainment. Today, the Company is a leading reseller of audiobooks on CD and cassettes from the nation's largest publishing houses via the Audio Book Club, a mail order and Internet based

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business. MediaBay is also a licensee and marketer of programs from the golden age of radio. These titles are sold in physical formats through a catalog focused on collectors, a mail order based continuity program, retail outlets and an on-line download subscription service. The Company's strategy consist of pursuing download opportunities through both an exclusive distribution agreement with Microsoft and the opportunity to offer its content to other websites; creating affinity opportunities which provide lower customer acquisition costs and higher profit potential; and exploiting its existing content and businesses.

(2) SIGNIFICANT ACCOUNTING POLICIES

BASIS OF PRESENTATION

The interim unaudited condensed consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements contained in its Annual Report on Form 10-K. The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from these estimates. On an ongoing basis management reviews its estimates based on current available information. Changes in facts and circumstances may result in revised estimates. In the opinion of management, the interim unaudited financial statements include all material adjustments, all of which are of a normal recurring nature, necessary to present fairly the Company's financial position, results of operations and cash flows for the periods presented. The results for any interim period are not necessarily indicative of results for the entire year or any other interim period.

PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany accounts have been eliminated.

CASH AND CASH EQUIVALENTS

Securities with maturities of three months or less when purchased are considered to be cash equivalents.

FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying amount of cash, accounts receivable, accounts payable and accrued expenses approximates fair value due to the short maturity of those instruments.

The fair value of long-term debt is estimated based on the interest rates currently available for borrowings with similar terms and maturities. The carrying value of the Company's long-term debt approximates fair value.

INVENTORY

Inventory, consisting primarily of audiocassettes and compact discs held for resale, is valued at the lower of cost (weighted average cost method) or market.

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PREPAID EXPENSES

Prepaid expenses consist principally of deposits and other amounts being expensed over the period of benefit. All current prepaid expenses will be expensed over a period no greater than twelve months from the date of the Balance Sheet.

DEFERRED MEMBER ACQUISITION COSTS

Promotional costs directed at current members are expensed on the date the promotional materials are mailed. The cost of any premiums, gifts or the discounted audiobooks in the promotional offer to new members is expensed as incurred. The Company accounts for direct response advertising for the acquisition of new members in accordance with AICPA Statement of Position 93-7, "Reporting on Advertising Costs" ("SOP 93-7"). SOP 93-7 states that the cost of direct response advertising (a) whose primary purpose is to elicit sales to customers who could be shown to have responded specifically to the advertising and (b) that results in probable future benefits should be reported as assets net of accumulated amortization.

SOP 93-7 requires that the realizability of the amounts of direct-response advertising reported as assets should be evaluated at each balance sheet date by comparing the carrying amounts of the assets to their probable remaining future net revenues. At June 30, 2005, we had no direct-response advertising reported as assets, since we have determined that probable future benefits from any direct advertising we have incurred would not exceed the amounts expended.

FIXED ASSETS, NET

Fixed assets, consisting primarily of furniture, leasehold improvements, computer equipment, and third-party web site development costs, are recorded at cost. Depreciation and amortization, which includes the amortization of equipment under capital leases, is provided by the straight-line method over the estimated useful life of three years (the lease term) for computer equipment and five years (the lease term) for sound equipment under capital leases, five years for equipment, seven years for furniture and fixtures, five years for leasehold improvements, and three years from the date the assets are put into service for Internet web site development costs. Ongoing maintenance and other recurring charges are expensed as incurred.

OTHER INTANGIBLES, NET

Intangible assets, principally consisting of purchased intellectual property, which is reviewed for impairment on each reporting date, and non-compete agreements, which are being amortized over their contractual term.

GOODWILL

Goodwill represents the excess of the purchase price over the fair value of net assets acquired in business combinations accounted for using the purchase method of accounting. In accordance with Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets", the Company ceased amortization of goodwill as of January 1, 2002. Goodwill is tested for impairment annually or when certain triggering events require such tests and are written down, with a resulting charge to operations, only in the period in which the recorded value of goodwill is more than its fair value.

REVENUE RECOGNITION

During the six months ended June 30, 2005 and June 30, 2004, the Company derived its principal revenue through sales of audiobooks, classic radio shows and other spoken word audio products directly to consumers principally through

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direct mail and the Internet. The Company also sold classic radio shows to retailers either directly or through distributors. The Company derived additional revenue through rental of its proprietary database of names and addresses to non-competing third parties through list rental brokers. The Company also derived a small amount of revenue from advertisers included in its nationally syndicated classic radio shows. The Company recognizes sales to consumers, retailers and distributors upon shipment of merchandise. List rental revenue is recognized on notification by the list brokers of rental by a third party when the lists are rented. The Company recognizes advertising revenue upon notification of the airing of the advertisement by the media buying company representing the Company or directly from the broadcaster. Allowances for future returns are based upon historical experience and evaluation of current trends.

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Downloadable content revenue from the sale of individual content titles is recognized in the period when the content is downloaded and the customer's credit card is processed. Downloadable content revenue from the sale of downloadable content subscriptions is recognized pro rata over the term of the subscription period.

SHIPPING AND HANDLING REVENUE AND COSTS

Amounts paid to the Company for shipping and handling by customers is included in sales. Amounts the Company incurs for shipping and handling costs are included in cost of sales. The Company recognizes shipping and handling revenue upon shipment of merchandise. Shipping and handling expenses are recognized on a monthly basis from invoices from the third party fulfillment houses, which provide the services.

COST OF SALES

Cost of sales includes the following:

- o Product costs (including free audiobooks in the initial enrollment offer to prospective members)
- o Royalties to publishers and rightsholders
- o Fulfillment costs, including shipping and handling
- o Customer service
- o Direct response billing, collection and accounts receivable management

COOPERATIVE ADVERTISING AND RELATED SELLING EXPENSES

In accordance with EITF No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)", the Company classifies the cost of sales incentives as a reduction of net sales.

BAD DEBT EXPENSE

The Company records an estimate of its anticipated bad debt expense based on historical experience.

GENERAL AND ADMINISTRATIVE COSTS

General and administrative costs include the following:

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- o Bad debt expense
- o Payroll and related items
- o Commissions
- o Insurance
- o Office expenses
- o Telephone and postage
- o Public and investor relations
- o Dues and subscriptions
- o Rent and utilities
- o Travel and entertainment
- o Bank charges
- o Professional fees, principally legal and auditing fees
- o Consulting

STOCK-BASED COMPENSATION

The Company accounts for employee stock options in accordance with Accounting Principles Board Opinion No. 25 ("APB 25"), "Accounting for Stock Issued to Employees." In October 1995, SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123") was issued. SFAS 123, which prescribes the recognition of compensation expense based on the fair value of options on the grant date, allows companies to continue applying APB 25 if certain pro forma disclosures are made assuming a hypothetical fair value method application. In December 2004, the FASB issued SFAS No. 123(R), "Share-Based Payment," which is a revision of SFAS No. 123, "Accounting for Stock-Based Compensation". SFAS 123(R) requires that the compensation cost relating to share-based payment

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transactions be recognized in financial statements. The compensation cost will be measured based on the fair value of the equity or liability instruments issued. The Statement is effective as of the beginning of the first annual period beginning after June 15, 2005. Had compensation expense for the Company's stock options been recognized on the fair value on the grant date under SFAS 123, the Company's net loss and net loss per share for the three months ended March 31, 2005 and 2004 would have been as follows:

	THREE MONTHS ENDED JUNE 30,		
	2005	2004	2004
Net loss applicable to common shares, as reported	\$ 2,950	\$ 7,111	\$ 2
Add: Stock-based employee compensation expense included in			

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reported net loss applicable to common shares, net of related tax effects	--		
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(720)	(660)	
Pro forma net loss applicable to common shares	\$ 3,670	\$ 7,771	\$ 2
Net loss per share			
Basic and diluted - as reported	\$ (.08)	\$ (.40)	\$
Basic and diluted - pro forma	\$ (.10)	\$ (.44)	\$

No dividend yield and the following assumptions were used in the pro forma calculation of compensation expense:

DATE	NO. OF SHARES	EXERCISE PRICE	ASSUMED VOLATILITY	RISK-FREE INTEREST RATE	FAIR VALUE PER SHARE
FIRST SIX MONTHS 2004	3,300,000	\$.98	97%	4.00%	\$.59
FIRST SIX MONTHS 2005	4,810,000	\$.59	41%	3.35%	\$.16

INCOME TAXES

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amount of existing assets and liabilities and their respective tax basis and operating loss and tax credit carryforwards. A valuation allowance is provided when it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the period that includes the enactment date.

ROYALTIES

The Company is liable for royalties to licensors based upon revenue earned from the respective licensed product. The Company pays certain publishers and other rightsholders advances for rights to products. Royalties earned on the sale of the products are payable only in excess of the amount of the advance. Advances, which have not been recovered through earned royalties, are recorded as an asset. Advances not expected to be recovered through royalties on sales are charged to royalty expense.

USE OF ESTIMATES

The preparation of financial statements in accordance with accounting

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principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from these estimates. On an ongoing basis, management reviews its estimates based on current available information. Changes in facts and circumstances may result in revised estimate.

RECLASSIFICATIONS

Certain amounts relating to 2004 have been reclassified to conform to the current presentation.

(3) GOODWILL AND OTHER INTANGIBLES

Goodwill and indefinite-lived intangible assets are tested for impairment annually or when certain triggering events require such tests and are written down, with a resulting charge to operations, only in the period in which the recorded value of goodwill and indefinite-lived intangible assets is more than their fair value.

The Company amortizes other intangible assets over their estimated useful lives. Amortization expense for other intangible assets was \$4 and \$20 for the six months ended June 30, 2005 and 2004, respectively. The Company estimates intangible amortization expenses of \$8 in 2005:

The following table presents details of Other Intangibles at June 30, 2005 and December 31, 2004:

	JUNE 30, 2005			DECEMBER 31, 2004		
	COST	ACCUMULATED AMORTIZATION	NET	COST	ACCUMULATED AMORTIZATION	NET
Mailing Agreements	\$ 592	\$ 592	\$ --	\$ 592	\$ 592	\$ --
Customer Lists	4,380	4,380	--	4,380	4,380	--
Non-Compete Agreements	313	292	21	313	288	25
Other	25	--	25	25	--	25
	-----	-----	-----	-----	-----	-----
Total Other Intangibles	\$5,310	\$ 5,264	\$ 46	\$ 5,310	\$ 5,260	\$ 50
	=====	=====	=====	=====	=====	=====

Goodwill of \$9,658 as of June 30, 2005 and December 31, 2004 is attributable to the Company's Radio Spirits business. The Company conducted its annual impairment test for 2004 in January 2005, utilizing the services of an independent appraiser, and its annual impairment tests for 2003 in October 2003, neither of which resulted in an impairment loss. Any future impairment losses incurred will be reported in operating results.

(4) DEBT

	AS OF
JUNE 30,	DECEMBER 31,
2005	2004
-----	-----

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Credit agreement, senior secured debt, net of original issue discount	\$	--	\$	8,661
Premier debt, net of original issue discount		652		670
Related party notes and related accrued interest, net of original issue discount		--		7,750
		-----		-----
Total debt		652		17,081
Less: current portion		(31)		(229)
		-----		-----
Long-term debt	\$	621	\$	16,852
		=====		=====

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MARCH PAYMENT AND CONVERSION OF DEBT

On March 23, 2005, the Company completed the March Financing described below.

Concurrently with the March Financing, the Company repaid from the net proceeds all of the principal and accrued and unpaid interest due on the Company's outstanding senior notes issued on April 28, 2004, in the aggregate amount of approximately \$9,400. The Company reported a charge in the first quarter of 2005 of \$579 to reflect the write-off of unamortized financing charges related to the repayment of this debt.

Also in connection with the March Financing, the Company entered into an agreement (the "Herrick Agreement") with the Herrick Entities, described below (the "Herrick Agreement"). Pursuant to the Herrick Agreement, concurrently with the Financing, among other actions, all \$5,784 principal amount of the convertible notes of the Company owned by the Herrick Entities were converted into an aggregate of approximately 10.3 million shares of Common Stock, at their stated conversion rate of \$0.56 per share.

The Company also paid to Norton Herrick and Huntingdon all accrued and unpaid interest dividends due to them in the amount \$2,271.

(5) STOCKHOLDERS' EQUITY AND STOCK OPTIONS AND WARRANTS

The following table presents information regarding the Company's outstanding preferred stock at June 30, 2005 and December 31, 2004:

		AS OF	
		JUNE 30,	DE
		2005	
		-----	-----
Series A Convertible Preferred Stock	\$	--	\$
Series B Convertible Preferred Stock		20	
Series C Convertible Preferred Stock		--	
Series D Convertible Preferred Stock, total outstanding at June 30, 2005 \$34,720, net of cash fees and expenses of \$3,359; value ascribed to investors' and advisors' warrants of \$12,416			
		18,945	
		-----	-----

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Total Preferred Stock	\$ 18,965	\$
	=====	==

MARCH 2005 SALE OF SERIES D CONVERTIBLE PREFERRED STOCK AND WARRANTS

On March 21, 2005, the Company agreed to issue an aggregate of (a) 35,900 shares (the "Offering Shares") of its Series D Convertible Preferred Stock (the "Series D Preferred") convertible into 65,272,273 shares of the Company's common stock, (b) 32,636,364 five-year common stock purchase warrants (the "Offering Warrants"), valued at \$10,852 using an accepted valuation method and (c) preferred warrants (the "Over-Allotment Warrants" and, together with the Offering Shares and the Offering Warrants, the "Offering Securities") exercisable for a limited time, for additional proceeds to the Company of \$8,975, to purchase (1) up to 8,975 additional shares of Series D Preferred (the "Additional Shares" and, together with the Offering Shares, the "Preferred Shares") and (2) up to 8,159,091 additional warrants identical to the Offering Warrants (the "Additional Warrants" and, together with the Offering Warrants, the "Warrants"), to accredited investors (the "Investors") for an aggregate purchase price of \$35,900 (the "Financing").

Immediately prior to the Financing, holders of a majority of the Company's voting securities approved by written consent (the "Shareholder Consent") (a) an amendment to the Articles of Incorporation of the Company, increasing the number of authorized shares of the common stock of the Company ("Common Stock") from 150,000,000 to 300,000,000, (b) a change of control which may occur as a result of the Financing, and (c) the Company's issuance, in connection with the transactions contemplated by the Financing documents, of Common Stock in excess of 19.99% of the number of shares of Common Stock outstanding immediately prior to the Financing.

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While such actions were approved by a majority of the shareholders prior to the Financing, the Company was not permitted to effect them until it satisfied certain information requirements to the shareholders of the Company not party to the Shareholder Consent. As a result, the Shareholder Consent did not become effective until May 3, 2005.

The Preferred Shares have a face value of \$1,000 per share ("Stated Value") and are convertible at any time at the option of the holder into shares ("Conversion Shares") of common stock at the rate of \$0.55 per Conversion Share, subject to certain anti-dilution adjustments, including for issuances of Common Stock for consideration below the conversion price. The Preferred Shares are also mandatorily convertible at the option of the Company, subject to its satisfaction of certain conditions, commencing June 10, 2005, which is 30 days after May 11, 2005, the effective date of the registration statement registering the shares underlying the Series D Preferred Stock. Under certain circumstances under the control of the Company, the holders will also have the right to require the Company to redeem their Preferred Shares at their Stated Value. Cumulative dividends will accrue on the Preferred Shares on an annualized basis in an amount equal to 6% of their Stated Value until they are converted or redeemed and will be payable quarterly in arrears, beginning April 1, 2005, in cash or, at the Company's option, subject to its satisfaction of certain conditions, in shares of Common Stock ("Dividend Shares") valued at 93% of the average of the daily volume weighted average per-share price of the Common Stock for the five trading days prior to the applicable payment date. The Preferred Shares are non-voting. Subject to certain exceptions for accounts receivable and equipment and capital lease financings, the Company may not incur additional

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indebtedness for borrowed money or issue additional securities that are senior to or pari passu to the Preferred Shares without the prior written consent of holders of at least 2/3rds of the Preferred Shares then outstanding.

Each Warrant is exercisable to purchase one share of Common Stock (collectively, the "Warrant Shares"), at an exercise price of \$0.56 per share for a period of five years commencing September 23, 2005, subject to certain anti-dilution adjustments, including for issuances of Common Stock for consideration below the exercise price. In addition, once exercisable, the Warrants permit cashless exercises during any period when the Warrant Shares are not covered by an effective resale registration statement.

The Over-Allotment Warrants are exercisable until August 9, 2005 for the purchase of Additional Shares and Additional Warrants, at an exercise price equal to the Stated Value of the Additional Shares purchased, with the purchase of each Additional Share including an Additional Warrant exercisable for a number of Warrant Shares equal to 50% of the Conversion Shares underlying such Additional Share.

As part of the Financing, the Forest Hill Select Fund L.P. and related entities (the "Forest Hill Entities") exchanged 1.8 million shares of Common Stock and 400,000 common stock warrants previously purchased by them from the Company in October 2004 for \$900 of the Offering Securities. The Forest Hill Entities also purchased \$1,000 of the Offering Securities. The Company included an additional 119,048 shares of Common Stock, as well as 50,000 shares of Common Stock underlying certain additional warrants, already beneficially owned and retained by Forest Hill Capital, for resale in the registration statement declared effective May 11, 2005.

In connection with the Financing, the Company also entered into an agreement with Norton Herrick and certain of his affiliates (the "Herrick Entities") pursuant to which, concurrently with the Financing:

- o all \$5,784 principal amount of the convertible notes of the Company owned by the Herrick Entities (the "Herrick Notes") and 10,684 of their shares of the Series A Convertible Preferred Stock of the Company ("Series A Preferred") were converted into an aggregate of approximately 12.2 million shares of Common Stock (the "Herrick Shares"), at their stated conversion rate of \$0.56 per share;
- o the Company agreed to redeem the remaining 14,316 shares of Series A Preferred held by the Herrick Entities and all 43,527 of their shares of the Series C Convertible Preferred Stock of the Company (collectively, the "Redemption Securities") for \$5,784, the aggregate stated capital of such shares, on the earlier of the effective date of the Shareholder Consent (May 3, 2005);

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- o the Herrick Entities waived certain of their registration rights and the Company agreed to include the Herrick Shares for resale in the registration statement declared effective May 11, 2005 so long as such Herrick Shares are owned by the Herrick Entities and not otherwise transferred, including, but not limited to, in the Herrick Financing (as defined below); and
- o the Herrick Entities consented to the terms of the Financing and the agreements entered into in connection with the Financing, as the Company was required to obtain such consents pursuant to the terms of the Herrick Notes, the Series A Preferred and the Series C

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Preferred.

- o Herrick and Huntingdon also entered into a voting agreement and proxy with the Company pursuant to which they agreed not to take any action to contradict or negate the Shareholder Consent.
- o the Company entered into a registration rights agreement dated the date hereof with Herrick and Huntingdon in which the parties are granted "piggy-back" registration rights and, with respect to the shares of Common Stock issuable to Herrick and Huntingdon upon conversion of the Herrick Notes and Series A Preferred Stock, Herrick and Huntingdon are granted the same automatic registration rights as the Investors under the Registration Rights Agreement.
- o the Company also entered into another registration rights agreement dated March 23, 2005, with Herrick and Huntingdon in which the parties are granted "piggy-back" registration rights and, with respect to the shares of our common stock issuable to Herrick and Huntingdon upon exercise of the warrants held by Herrick and Huntingdon.

The Company received \$35,000 of gross proceeds (not including the securities exchanged by the Forest Hill Entities for \$900 of the purchase price) in the Financing. Merriman Curhan Ford & Co. ("Merriman") acted as a financial advisor with respect to certain of the investors in the Financing for which it received compensation from the Company of \$2,625 plus a five-year warrant (the "Merriman Warrant") to purchase 7,159,091 shares of Common Stock at an exercise price of \$0.69 per share commencing upon May 3, 2005, the effective date of the Shareholder Consent. Merriman also received a structuring fee from the Company with respect to the Financing in the amount of \$175. In addition, the Company issued to Satellite Strategic Finance Associates, LLC and Satellite Strategic Finance Partners, Ltd., investors in the Financing, warrants to purchase an aggregate of 250,000 shares of Common Stock (identical to the Warrants), and reimbursed them \$55 for expenses, for consulting services rendered by it in connection with the Financing. The Company incurred cash fees and expenses including fees paid to advisors of \$3,472. Warrants issued to advisors were valued at \$1,986 using an accepted valuation method.

The Preferred Shares are convertible at any time at the option of the holder into shares ("Conversion Shares") of common stock at the rate of \$0.55 per Conversion Share and each Warrant is exercisable to purchase one share of Common Stock (collectively, the "Warrant Shares"), at an exercise price of \$0.56 per share. The market price for the Company's common stock at March 21, 2005 was \$.69. The Company recorded as dividends an amount of \$17,423 to reflect the value of the deemed dividend for beneficial conversion feature of Series D Preferred Stock.

As of June 30, 2005, 1,180 shares of Series D Preferred Stock plus accrued dividends and warrants thereon were converted into 2,170,202 shares of common stock.

STOCK OPTIONS AND WARRANTS

From January 1, 2005 to June 30, 2005, the Company issued options to purchase 4,810,000 shares of its common stock to employees, officers, directors and consultants under its stock incentive plans. From January 1, 2005 to June 30, 2005, options to purchase 373,680 shares of its common stock were either cancelled or expired. The Company issued non-plan warrants to purchase 40,045,455 shares of its common stock in connection with the Financing described above. During the six months ended June 30, 2005, the Company cancelled non-plan warrants to purchase 460,000 shares of its common stock.

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(6) COST OF GOODS SOLD - STRATEGIC CHARGES

In the second quarter of 2005, the Company changed its negative option book club and converted to a business selling audiobooks and other audio entertainment without a negative option requirement. The Company has moved its warehouse and fulfillment operations to a facility which also provides products and accordingly the Company has changed from licensing and manufacturing many of its audiobook titles to buying on a wholesale basis and accordingly has recorded a \$305 write-down of royalty advances to what the Company believes is net realizable value at June 30, 2005.

(7) SUPPLEMENTAL CASH FLOW INFORMATION

No cash has been expended for income taxes for the six months ended June 30, 2005 and 2004. Cash paid for interest expense was \$2,015 and \$536 for the six months ended June 30, 2005 and 2004, respectively.

The Company had the following non-cash activities for the six months ended June 30, 2005:

	2005
Conversions of subordinated notes into common stock.....	5,784
Conversion of preferred shares into common stock.....	1,707
Conversion of common shares and warrants into preferred stock and warrants sold in the Financing.....	900
Issuance of warrants in connection with the Financing.....	12,838

(8) NET LOSS PER SHARE OF COMMON STOCK

Basic (loss) earnings per share was computed using the weighted average number of common shares outstanding for the three and six months ended June 30, 2005 of 35,902,638 and 30,503,964, respectively and for the three and six months ended June 30, 2004 of 17,692,451 and 15,376,207.

For the three months ended June 30, 2005 common equivalent shares which were not included in the computation of diluted loss per share because they would have been anti-dilutive were 878,118 common equivalent shares, as calculated under the treasury stock method and 68,068,560 common equivalent shares relating to convertible subordinated debt and convertible preferred stock calculated under the "if-converted method". Dividends on the convertible preferred stock added back to net income applicable to common stockholders would have been \$533 for the three months ended June 30, 2005.

For the six months ended June 30, 2005 common equivalent shares which were not included in the computation of diluted loss per share because they would have been anti-dilutive were 7,796,398 common equivalent shares, as calculated under the treasury stock method and 45,526,821 common equivalent shares relating to convertible subordinated debt and convertible preferred stock calculated under the "if-converted method". Interest expense and dividends on the convertible subordinated debt and convertible preferred stock added back to net income applicable to common stockholders would have been \$893 for the six months ended June 30, 2005.

For the three months ended June 30, 2004 common equivalent shares which were not included in the computation of diluted loss per share because they would have been anti-dilutive were 2,219 common equivalent shares, as calculated

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under the treasury stock method and 21,342,910 common equivalent shares relating to convertible subordinated debt and convertible preferred stock calculated under the "if-converted method". Interest expense and dividends on the convertible subordinated debt and convertible preferred stock added back to net income applicable to common stockholders would have been \$378 for the three months ended June 30, 2004.

For the six months ended June 30, 2004 common equivalent shares which were not included in the computation of diluted loss per share because they would have been anti-dilutive were 654,573 common equivalent shares, as calculated under the treasury stock method and 21,240,421 common equivalent shares relating to convertible subordinated debt and convertible preferred stock calculated under the "if-converted method". Interest expense and dividends on the convertible subordinated debt and convertible preferred stock added back to net income applicable to common stockholders would have been \$786 for the six months ended June 30, 2004.

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(9) SEGMENT REPORTING

For 2005 and 2004, the Company has divided its operations into four reportable segments: Corporate; Audio Book Club ("ABC") a business selling audiobooks via direct mail and on the Internet; Radio Spirits ("RSI") which produces, sells, licenses and syndicates old-time radio programs and MediaBay.com a media portal offering spoken word audio content in secure digital download formats. Segment operating income is total segment revenue reduced by operating expenses identifiable with that business segment. Corporate includes general corporate administrative costs, professional fees, interest expenses and amortization of acquisition related costs. The Company evaluates performance and allocates resources among its three operating segments based on operating income and opportunities for growth. Inter-segment sales are recorded at prevailing sales prices.

SEGMENT REPORTING THREE MONTHS ENDED JUNE 30, 2005

	Corporate -----	ABC -----	RSI -----	Mbay.com -----	I -----
Sales, net of returns, discounts and allowances	\$ --	\$ 1,322	\$ 906	\$ 44	
Operating (loss) profit before depreciation and amortization	(1,672)	(367)	(261)	(150)	
Depreciation and amortization	2	10	5	--	
Interest (income)	(62)	(62)			
Interest expense	16	--	--	--	
Dividends on preferred stock	533	--	--	--	
Net income (loss) applicable to common shares	(2,161)	(377)	(266)	(150)	
Total assets	--	14,690	13,133	9	
Acquisition of fixed assets	--	404	--	--	

THREE MONTHS ENDED JUNE 30, 2004

	Corporate -----	ABC -----	RSI -----	Mbay.com -----	I -----
Sales, net of returns, discounts and allowances	\$ --	\$ 3,339	\$ 1,421	\$ 54	

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Operating (loss) profit before depreciation and amortization	(334)	(60)	280	(96)
Depreciation and amortization	6	26	9	--
Interest expense	6,744	--	1	--
Dividends on preferred stock	115	--	--	--
Net income (loss) applicable to common shares	(7,199)	(86)	270	(96)
Total assets	--	22,859	13,799	3
Acquisition of fixed assets	--	20	--	--

SIX MONTHS ENDED JUNE 30, 2005

	Corporate	ABC	RSI	Mbay.com	I
	-----	-----	-----	-----	-----
Sales, net of returns, discounts and allowances	\$ --	\$ 3,562	\$ 1,972	\$ 91	
Operating (loss) profit before depreciation and amortization	(2,208)	(170)	(207)	(274)	
Depreciation and amortization	4	25	14	--	
Interest (income)	(75)	--	--	--	
Interest expense	626	--	--	--	
Loss on early retirement of debt	579	--	--	--	
Dividends on preferred stock	738	--	--	--	
Deemed dividend on beneficial conversion of Series D Preferred Stock	17,423	--	--	--	
Net income (loss) applicable to common shares	(21,503)	(195)	(221)	(274)	
Total assets	--	14,690	13,133	9	
Acquisition of fixed assets	--	580	--	--	

SIX MONTHS ENDED JUNE 30, 2004

	Corporate	ABC	RSI	Mbay.com	I
	-----	-----	-----	-----	-----
Sales, net of returns, discounts and allowances	\$ --	\$ 7,065	\$ 3,361	\$ 106	
Operating (loss) profit before depreciation and amortization	(842)	(126)	771	(216)	
Depreciation and amortization	19	50	19	--	
Interest expense	7,596	--	3	--	
Dividends on preferred stock	179	--	--	--	
Net income (loss) applicable to common shares	(8,636)	(176)	749	(216)	
Total assets	--	22,859	13,799	3	
Acquisition of fixed assets	--	58	9	--	

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(10) RECENT ACCOUNTING PRONOUNCEMENTS

CONSOLIDATION OF VARIABLE INTEREST ENTITIES

In March 2005, the FASB issued Staff Position (FSP) No. FIN 46(R)-5, Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities. This FSP clarifies that when applying the variable interest consolidation model, a reporting enterprise should consider whether it holds an implicit variable interest in a variable interest entity (VIE) or potential VIE when specific conditions exist. FSP No. FIN 46(R)-5 is effective as of April 1, 2005. The Company does not anticipate an impact from the adoption of this statement.

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SHARE-BASED PAYMENT

In December 2004, the FASB issued SFAS No. 123(R), "Share-Based Payment," which is a revision of SFAS No. 123, "Accounting for Stock-Based Compensation". SFAS 123(R) requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. The compensation cost will be measured based on the fair value of the equity or liability instruments issued. The Statement is effective as of the beginning of the first annual period beginning after June 15, 2005. Beginning in January 2006, the value of all options granted by the Company will be recorded as compensation expense and will be reported as general and administrative expense. Currently, the value of options granted to officers and directors at or above market at the date of the grant are not recorded as expenses by the Company. We do not yet know the impact that any future share-based payment transactions will have on our financial position or results of operations.

INVENTORY COSTS

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs." SFAS 151 amends ARB No. 43, "Inventory Pricing", to clarify the accounting for certain costs as period expense. The Statement is effective for fiscal years beginning after June 15, 2005; however, early adoption of this Statement is permitted. The Company does not anticipate an impact from the adoption of this statement.

ACCOUNTING CHANGES AND ERROR CORRECTIONS

In May 2005, the FASB issued SFAS No. 154 "Accounting Changes and Error Corrections--A Replacement of APB Opinion No. 20 and FASB Statement No. 3". This Statement requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. This Statement does not change the guidance for reporting the correction of an error in previously issued financial statements or a change in accounting estimate. The provisions of this Statement shall be effective for accounting changes and correction of errors made in fiscal years beginning after December 15, 2005. The Company is not able to assess at this time the future impact of this Statement on its consolidated financial position or results of operations.

(11) RELATED PARTY TRANSACTIONS

In addition to the transactions described above with the Herrick Entities and the Forest Hill entities, as of June 30, 2005, the Company owed to Norton Herrick, and his affiliates \$31 for reimbursement of certain expenses and services incurred in prior years. From January 1, 2005 through June 30, 2005, the Company paid Herrick a total of \$284, and has agreed to pay Herrick the remaining \$31 on August 1, 2005.

(12) SUBSEQUENT EVENTS

STOCK OPTIONS

From July 1, 2005 to August 11, 2005 options to purchase 60,000 shares of MediaBay common stock were cancelled or expired.

From July 1, 2005 to August 11, 2005, 13,657 shares of Series D Preferred Stock and related dividends were converted into 24,959,349 shares of MediaBay

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common stock under the terms of the Series D Preferred Stock.

On August 9, 2005, the period to exercise warrants to purchase additional shares of the Series D Preferred Stock granted to the investors in the March sale of Series D Convertible Preferred Stock was extended to November 9, 2005.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Certain statements in this Form 10-Q constitute "forward-looking" statements within the meaning of the Private Securities Litigation Reform Act of 1995. All statements other than statements of historical facts included in this Report, including, without limitation, statements regarding our future financial position, business strategy, budgets, projected costs and plans and objectives of our management for future operations are forward-looking statements. In addition, forward-looking statements generally can be identified by the use of forward-looking terminology such as "may," "will," "expect," "intend," "estimate," "anticipate," "believe," or "continue" or the negative thereof or variations thereon or similar terminology. Although we believe that the expectations reflected in such forward-looking statements are reasonable, we cannot assure you that such expectations will prove to be correct. These forward looking statements involve certain known and unknown risks, uncertainties and other factors which may cause our actual results, performance or achievements to be materially different from any results, performances or achievements expressed or implied by such forward-looking statements. Important factors that could cause actual results to differ materially from our expectations, include, without limitation, our ability to implement and the success of our new strategy and transition our business and the risks related thereto: our history of losses and declining revenues; our ability to license and sell new spoken word content, anticipate and respond to changing customer preferences, license and produce desirable content, protect our databases and other intellectual property from unauthorized access, and collect receivables; dependence on third-party providers, suppliers and distribution channels; competition; the costs and success of our marketing strategies, product returns, attrition; and risks relating to our capital structure. Undue reference should not be placed on these forward-looking statements, which speak only as of the date hereof. We undertake no obligation to update any forward-looking statements.

INTRODUCTION

We are a digital media and publishing company specializing in spoken audio entertainment. We have over 75,000 hours of audio content, which we distribute via mail order, our websites, some of the nation's largest retailers, and a la carte, digital downloads and subscription services.

Today we have two principal content libraries: (1) Audiobooks: which we license from the nation's largest publishing houses to sell on CD and cassette through the Audio Book Club and which we intend to distribute via digital downloads on third-party websites and a digital download service that is under development; and (2) An archive of the history of American radio which we produce and sell on CD and cassettes through our catalog, a mail order based continuity program, retail outlets, and our on-line download subscription service and third-party websites, of which one is currently operational. We broadcast our radio programs through a syndicated radio show on over 200 commercial radio stations across the United States, as well as our 24-hour Radio Classics channels on Sirius and XM Satellite Radio.

We are transitioning our business from selling hard goods primarily via mail order to digital distribution via wireless and Internet downloads. Our distribution strategy is two pronged: (1) to wholesale our audio content to the leading music services and broadband companies on a white label basis, both domestically and internationally; and (2) to operate our own downloadable

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content stores and subscription services which are intended to be branded via partnerships with celebrities and corporate affiliates, each chosen specifically to reach the targeted demographics known to be interested in its content. We intend to use various means to market our downloadable content stores, including

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working with manufacturers of digital music players, smart phones, and PDA's to include samples of our audio content for consumers to preview when they purchase these new devices, with the hope that that these samples will attract consumers to our content stores.

We recently executed distribution agreements with Microsoft's MSN Music to provide our spoken word content to the MSN audience, which has 350 million unique monthly visitors. We have also executed a distribution agreement with Loudeye Corp., a worldwide leader in business-to-business digital media solutions, to act as our digital sales agent in distributing our catalog to potentially 70 music services which that company hosts and sources content for. Today, some of our largest digital content partners include Simon & Schuster, Random House, Harper Collins, Penguin Group (USA) Audio, Hay House, Sound Room Publishers, Oasis, Time Warner Audio, Brilliance Audio, Zondervan, BBC, Blackstone, and CBS Radio.

MARCH 2005 EQUITY FINANCING

On March 23, 2005, pursuant to an agreement executed on March 21, 2005, we received an infusion of gross cash proceeds of \$35 million in private equity financing from several institutional investors. We retired all of our borrowings and increased our cash reserves. Because of this financing, we believe that we have sufficient cash to implement our new strategy, including required marketing expenditures, for at least twelve months.

The Preferred Shares are convertible at any time at the option of the holder into shares ("Conversion Shares") of common stock at the rate of \$0.55 per Conversion Share and each Warrant is exercisable to purchase one share of Common Stock (collectively, the "Warrant Shares"), at an exercise price of \$0.56 per share. The market price for our common stock at March 21, 2005 was \$.69. We recorded as a non-cash deemed dividend an amount of \$17,423 to reflect the value of the beneficial conversion feature of the Series D Preferred Stock and increased contributed capital by \$17,423. The recording of the deemed dividend had no effect on our cash or net equity.

STRATEGY

In response to the music industry's recent success in creating a market for legal digital downloads using digital rights management solutions that are intended to prevent piracy of copyrighted content, we intend to become a leading distributor for downloadable, spoken word audio entertainment. We intend to build this new distribution channel by utilizing our nearly twelve years of experience operating the Audio Book Club and our old-time radio business. During those twelve years, we have serviced approximately 2.9 million customer accounts and plan to leverage this list of audio buyers to attract new digital shoppers.

We intend to use the Windows Media Digital Rights Management (DRM) system, and other easy to use, rights management technologies that may evolve over time. Beginning this past Christmas season, 70 new digital devices that support the Microsoft "PlaysforSure(TM)" digital rights management and device platform became available for sale by many of the leading device manufacturers. Examples of companies offering a "PlaysforSure(TM)" device include Hewlett Packard, Dell, Creative, Rio, i-River and Samsung. Many of these devices have large file

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storage capacities and make, what we believe, could be a perfect match for our content, which is typically one half hour in length for our classic radio shows, to an average of 6 to 10 hours for an audiobook.

In addition, the rapid evolution of cell and smart phones with hard drives and media players presents a large potential user base of digital devices for our content, as more than 500 million new handsets are sold each year in the market place. These portable devices, coupled with the ubiquitous installed base of personal computers with CD burners and USB port memory discs are making digital audio content portable and more accessible to users.

We believe the proliferation of broadband Internet service, the Microsoft digital rights management solution, and an expanding user base of portable devices have created an inflection point where downloads are a better way to distribute audio than traditional CDs and tapes via a retail store or by mail order. Broadband Internet and ubiquitous wireless networks means companies like MediaBay can deliver audio files quickly and affordably. Downloads provide

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consumers a more convenient way to purchase audio in real time and provides incredible opportunity for broad choice since there are no inventory requirements. This distribution is better for the environment and most importantly, provides real savings for the consumer.

We have determined that future investment in our mail order, hard goods based, Audio Book Club would not provide the returns adequate to justify future expenditures. Accordingly, in 2004, we discontinued marketing to attract new Audio Book Club members. In the second quarter of 2005, the Company changed its negative option book club and converted to a business selling audiobooks and other audio entertainment without a negative option requirement. The Company has moved its warehouse and fulfillment operations to a facility which also provides products and accordingly the Company has changed from licensing and manufacturing many of its audiobook titles to buying on a wholesale basis and accordingly has recorded a \$305 write-down of royalty advances to what the Company believes is net realizable value at June 30, 2005.

Online Agreement with Microsoft

The first step in executing our new strategy is our agreements with Microsoft. These agreements provide for us to distribute spoken word audio content, including audiobooks from the largest publishers and our old-time radio programs, through an exclusive distribution relationship with the new MSN Music Service. Today, MSN has an audience of 350 million unique monthly visitors. Microsoft has announced that the new music service will have the largest selection of songs and audio content of any service and will be compatible with the most number of digital devices, leveraging its industry leading windows media player and windows digital rights management platform.

Online Agreement with Loudeye

We have also announced a multi-year agreement with Loudeye Corp., a worldwide leader in business-to-business digital media solutions. Loudeye is working with us to provide a solution for powering digital distribution of a wide range of audiobooks. Under the agreement, we hope to make available our audiobook content catalog to Loudeye for both domestic and international distribution, subject to obtaining appropriate international rights, to new and existing Loudeye partners. Loudeye and its OD2 services have relationships with more than 70 web storefronts and music services throughout the United States, Europe and Australia.

RealNetworks Agreement

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We also entered into a distribution agreement with RealNetworks, Inc. ("Real") to provide spoken-word and audio entertainment content to Real's subscriber base. Pursuant to the agreement, we intend to provide our content library on an "a la carte" basis through Real's Music Store or to the approximately 1.0 million subscribers of the Rhapsody music service. In addition, our users should be able to transfer their spoken word libraries onto hundreds of portable devices supported by Real.

Larry King Opportunity

Celebrity Interactive LLC, Larry King and MediaBay have signed an endorsement and promotion agreement; however, on July 29, 2005, we tabled this project due to developments beyond our control.

Open Standard Platform Technology

We have chosen to leverage the proliferation of the Windows Media DRM platform as the de facto rights management standard for content owners to protect their intellectual property on the Internet. According to a report from the International Federation of the Phonographic Industry (IFPI) trade group, the number of online music stores quadrupled to more than 230 in 2004. In the United States, the overwhelming majority of these stores have adopted the Windows Media DRM as their solution to protect content owners intellectual property and to transfer files to digital hand held devices. This trend is certain to improve consumer choice as it allows consumers to shop in a broad range of stores, but maintain the flexibility to switch devices over time as functionality improves without having to worry about media format conversion issues that closed proprietary systems, such as Apple i-Tunes, create. On-line music stores in the United States that use the Window's DRM system include such companies as RealNetworks, MSN Music, Wal-Mart, Napster, Music Maker, Yahoo's Music Match, Buy.com, Music Now, and VirginDigital. The competing storefronts, which use proprietary DRM technologies or closed systems, are Sony, Apple and Audible.

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CRITICAL ACCOUNTING POLICIES

Our discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities. On an on-going basis we evaluate our estimates including those related to product returns, bad debts, the carrying value and net realizable value of inventories, the recoverability of advances to publishers and other rightsholders, the future revenue associated with deferred advertising and promotion costs, investments, fixed assets, the valuation allowance provided to reduce our deferred tax assets and valuation of goodwill and other intangibles.

The Securities and Exchange Commission ("SEC") defines "critical accounting policies" as those that require application of management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain and may change in subsequent periods.

Our significant accounting policies are described in Note 2 to the Notes to Consolidated Financial Statements. Not all of these significant accounting policies require management to make difficult, subjective or complex judgments or estimates. However the following policies are considered to be critical within the SEC definition:

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Revenue Recognition

We derive our principal revenue through sales of audiobooks, classic radio shows and other spoken word audio products directly to consumers principally through direct mail. We also sell classic radio shows to retailers either directly or through distributors. We derive additional revenue through rental of our proprietary database of names and addresses to non-competing third parties through list rental brokers. We also derive a small amount of revenue from advertisers included in our nationally syndicated classic radio shows. We recognize sales to consumers, retailers and distributors upon shipment of merchandise. List rental revenue is recognized on notification by the list brokers of rental by a third party when the lists are rented. We recognize advertising revenue upon notification of the airing of the advertisement by the media buying company representing us. Allowances for future returns are based upon historical experience and evaluation of current trends.

We record reductions to our revenue for future returns and record an estimate of future bad debts arising from current sales in general and administrative expenses. These allowances are based upon historical experience and evaluation of current trends. If members and customers return products to us in the future at higher rates than in the past or than we currently anticipate, our net sales would be reduced and our operating results would be adversely affected. In November 2001, the Emerging Issues Task Force ("EITF") issued EITF No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)", which addresses the income statement classification of certain credits, allowances, adjustments, and payments given to customers for the services or benefits provided. We adopted EITF No. 01-9 effective January 1, 2002, and, as such, have classified the cost of these sales incentives as a reduction of sales.

Downloadable content revenue from the sale of individual content titles is recognized in the period when the content is downloaded and the customer's credit card is processed. Content revenue from the sale of content subscriptions is recognized pro rata over the term of the subscription period. Rebates and refunds are recorded as a reduction of revenue in the period in which the rebate or refund is paid in accordance with Emerging Issues Task Force Issue No. 01-9, Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products).

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Accounts Receivable Valuation

We record an estimate of our anticipated bad debt expense and return rates based on our historical experience. If the financial condition of our customers, including either individual consumers or retail chains, were to deteriorate, or if the payment or buying behavior were to change, resulting in either their inability or refusal to make payment to us, additional allowances would be required.

Income Taxes

The ultimate realization of deferred tax assets is dependent on the generation of future taxable income during the periods in which temporary timing differences become deductible. We determine the utilization of deferred tax assets in the future based on current year projections by management.

Based on a change in our strategy, which we believe will result in lower sales and losses in the near term, but ultimately will be more profitable, we have determined that it is "not more likely than not" that we will, in the foreseeable future, be able to realize all or part of our net deferred tax asset. We have accordingly made an adjustment to the deferred tax asset

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recording an increase to the valuation allowance, resulting in a deferred tax expense charged against income in the fourth quarter of 2004, the period when such determination was made.

Deferred Member Acquisition Costs

Promotional costs directed at current members are expensed on the date the promotional materials are mailed. The cost of any premiums, gifts or the discounted audiobooks in the promotional offer to new members is expensed as incurred. The Company accounts for direct response advertising for the acquisition of new members in accordance with AICPA Statement of Position 93-7, "Reporting on Advertising Costs" ("SOP 93-7"). SOP 93-7 states that the cost of direct response advertising (a) whose primary purpose is to elicit sales to customers who could be shown to have responded specifically to the advertising and (b) that results in probable future benefits should be reported as assets net of accumulated amortization.

SOP 93-7 requires that the realizability of the amounts of direct-response advertising reported as assets should be evaluated at each balance sheet date by comparing the carrying amounts of the assets to their probable remaining future net revenues. At June 30, 2005, we had no direct-response advertising reported as assets, since we have determined that probable future benefits from any direct advertising we have incurred would not exceed the amounts expended. We do not expect to capitalize any marketing costs until we have determined probable future benefits based on buying patterns of future customers.

Goodwill

Goodwill represents the excess of the purchase price over the fair value of net assets acquired in business combinations accounted for using the purchase method of accounting. In July 2001, the Financial Accounting Standards Board issued SFAS No. 142, "Goodwill and Other Intangible Assets". SFAS No. 142 requires that an intangible asset that is acquired shall be initially recognized and measured based on its fair value. The statement also provides that goodwill should not be amortized, but shall be tested for impairment annually, or more frequently if circumstances indicate potential impairment, through a comparison of fair value to its carrying amount. At December 31, 2004, we had \$9.7 million of goodwill, all of which relates to our Radio Spirits operations. We completed our annual impairment test as of January 2005, utilizing the services of an independent third-party appraiser, which did not result in an impairment loss. However, if conditions or circumstances were to change resulting in a deterioration of our Radio Spirits business, a future impairment of goodwill could be necessary.

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RESULTS OF OPERATIONS

The following table sets forth, for the periods indicated, historical operating data as a percentage of net sales.

	THREE MONTHS ENDED JUNE 30,		SIX MONTHS ENDED JUNE 30,	
	----- 2005 -----	2004 -----	----- 2005 -----	2004 -----
Sales	100.0%	100.0%	100.0%	100%
Cost of sales	57.3	46.4	55.1	45.8
Cost of sales - strategic charges	13.4		--	5.4
	-----	-----	-----	-----

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Gross profit	29.3	53.6	39.5	54.2
Advertising and promotion	17.6	26.4	14.0	25.1
General and administrative expense	88.6	31.5	63.8	33.1
Termination charges	30.7		--	12.4
Depreciation and amortization expense	0.7	0.9	0.8	0.8
Interest (income)	(2.7)		--	(1.3)
Interest expense	0.7	140.5	11.1	72.5
Loss on early extinguishment of debt	--	--	10.3	--
Income tax expense (benefit)	--	--	--	--
	-----	-----	-----	-----
Net (loss)	(106.4)	(145.7)	(71.5)	(77.3)
Dividends on preferred stock	23.5	(2.4)	13.1	(1.7)
Deemed dividends on beneficial conversion of preferred stock	--	--	309.7	--
	=====	=====	=====	=====
Net (loss) applicable to common shares				
	(129.8)%	(148.1)%	(394.4)%	(79.0)%
	=====	=====	=====	=====

RESULTS OF OPERATIONS

Three months ended June 30, 2005 compared to three months ended June 30, 2004:

NET SALES

(In thousands)	CHANGE FROM			
	2004	2005	2004 TO 2005	% CHANGE
	-----	-----	-----	-----
AUDIO BOOK CLUB	\$3,339	\$1,322	\$ (2,017)	(60.4)%
	-----	-----	-----	-----
RADIO SPIRITS				
Catalog	687	532	(155)	(22.6)%
Wholesale	413	228	(185)	(44.9)%
Continuity	308	146	(162)	(52.5)%
	-----	-----	-----	-----
	1,408	906	(502)	(35.7)%
	-----	-----	-----	-----
MEDIABAY.COM	54	44	(10)	(18.5)%
	-----	-----	-----	-----
	\$4,801	\$2,272	\$ (2,529)	(52.7)%
	=====	=====	=====	=====

Audio Book Club sales decreased principally due to a decrease in club membership as a result of substantially discontinuing our advertising expenditures for new members.

In the second quarter of 2005, we changed our negative option book club and converted to a business selling audiobooks and other audio entertainment without a negative option requirement. As a result of this change, we anticipate lower returns from our customers in future periods.

The decrease in Radio Spirits catalog sales is principally attributable to fewer customers, as we have not incurred marketing expenditures, to attract new customers and greater discounting in our catalogs. Wholesale sales of old-time radio products decreased principally due to reduced sales to our major customers. Sales of our World's Greatest Old-Time Radio continuity program decreased principally due to the lack of advertising expenditures for new customers.

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COST OF SALES

(In thousands)	2004		2005	
	\$	AS A % OF NET SALES	\$	AS A % OF NET SALES
AUDIO BOOK CLUB	\$ 1,569	47.0%	769	58.2%
RADIO SPIRITS				
Catalog	293	42.6%	262	49.2%
Wholesale	258	62.5%	206	90.6%
Continuity	108	35.0%	65	44.4%
Total Radio Spirits	659	46.8%	533	58.8%
MEDIABAY.COM	--	--	--	--
COST OF SALES	2,228	46.4%	1,302	57.3%
COST OF SALES - STRATEGIC CHARGE	--	--	305	13.4%
	\$ 2,228	46.4%	1,607	70.7%

The principal reason for the decline in cost of sales at Audio Book Club was a reduction in sales of 60.4% as described above. Cost of sales as a percentage of sales at Audio Book Club for the three months ended June 30, 2005 was 58.2%, compared to 47.0% for the same period in 2004. The increase in cost of sales as a percentage of sales is principally due to an increase in product costs as a percentage of sales since a smaller active membership required us to purchase finished goods from publishers rather than the licensing and manufacturing of product due to lower sales and our inability to meet manufacturing minimums and recoup advances to publishers, higher sales of unabridged and CD titles with higher costs and higher manufacturing costs due to lower volumes and to a lesser extent an increase in fulfillment costs as a percentage of sales since the fixed portion of our third party fulfillment costs is allocated to a smaller active membership.

Cost of catalog sales increased as a percentage of sales to 49.2% for the three months ended June 30, 2005 as compared to 42.6% for the three months ended June 30, 2004 principally due to sales of lower priced items with lower margins, increased discounting in the catalogs to sell older inventory and higher royalty costs as a percentage of the lower sales volume due to the fixed portion of royalty advances. The cost of wholesale sales as percentage of sales increased to 90.6% for the three months ended June 30, 2005 as compared to 62.5% for the three months ended June 30, 2004 principally due to a greater portion of fixed costs (allocated obsolescence and product development costs, the fixed cost of warehousing and fulfillment and royalty advances) in relation to the lower sales volume. The cost of World's Greatest Old-Time Radio continuity sales as a percentage of sales increased to 44.4% from 35.0% principally due to the fixed cost associated with warehousing and fulfillment in relation to the lower sales volume as we have not marketed for new customers.

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In the second quarter of 2005, we moved our warehouse and fulfillment operations to a facility which also provides products and accordingly we have changed from licensing and manufacturing many of its audiobook titles to buying on a wholesale basis and accordingly we recorded a \$305 write-down of royalty advances to what we believe is net realizable value at June 30, 2005. Under our new buying arrangement we are buying products at a fixed percentage off of manufacturer's suggested retail price. In addition we will be incurring certain fixed fulfillment charges. The cost of the new arrangement will be dependent on future sales volume.

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ADVERTISING AND PROMOTION

	2004	2005	FROM 2004 TO 2005 CHANGE	% CHANGE
	-----	-----	-----	-----
(In thousands)				
AUDIO BOOK CLUB				
New Member	\$ 32	--	(32)	100.0%
Current Member	330	51	(279)	(84.5)%
	-----	-----	-----	-----
Total Audio Book Club	362	51	(311)	(52.3)%
	-----	-----	-----	-----
RADIO SPIRITS				
Catalog	180	197	17	9.4%
Wholesale	8	27	19	237.5%
Continuity	--	--	--	--
	-----	-----	-----	-----
Total Radio Spirits	188	224	36	19.1%
	-----	-----	-----	-----
NEW PROJECTS	5	122	117	2340.0%
	-----	-----	-----	-----
TOTAL SPENDING	555	397	(158)	(28.5)%
	-----	-----	-----	-----
AMOUNT CAPITALIZED	(27)	--	27	(100.0)%
AMOUNT AMORTIZED	740	4	(736)	(99.4)%
	-----	-----	-----	-----
ADVERTISING AND PROMOTION EXPENSE	\$ 1,268	401	(867)	(68.4)%
	=====	=====	=====	=====

Advertising and promotion expenses decreased \$867,000 to \$401,000 for the three months ended June 30, 2005 as compared to \$1.3 million in the prior comparable period, principally due to lower amortization of deferred member acquisition costs. In the fourth quarter of 2004, based on the change in our strategy, described above, we determined that the future net revenue from our Audio Book Club would not support the carrying amount of the direct-response advertising reported as assets relating to the Audio Book Club. Accordingly, we wrote-off the carrying amount of the asset in the fourth quarter for 2004 resulting in an increase in advertising expense in 2004 and lower expense in 2005. The decrease in spending was due to the lack of new member marketing for Audio Book Club new members due to our change in strategy as described above and decreased advertising to existing members due to the reduction in Audio Book Club membership because of member attrition with no marketing to replace leaving members. During the three months ended June 30, 2005 we incurred \$122,000 related to new projects, principally marketing tests related to the download business.

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GENERAL AND ADMINISTRATIVE

(In thousands)	2004		2005		FROM 2004 TO 2005	
	\$	As a % of Net Sales	\$	As a % of Net Sales	Change	% Change
AUDIO BOOK CLUB	\$798	23.9%	441	33.4%	(357)	(44.7)%
RADIO SPIRITS	232	16.5%	354	39.1%	122	52.6%
MEDIABAY.COM	151	279.6%	193	438.6%	42	27.8%
CORPORATE	334		1,025		691	206.9%
	\$1,515	31.6%	2,013	88.6%	498	32.9%

The increase in general and administrative expenses of \$498,000 for the three months ended June 30, 2005 as compared to the three months ended June 30, 2004 is principally due to increases in payroll and related costs, public and investor relations (including directors fees) and travel and entertainment, partially offset by a decline in bad debt expense at Audio Book Club. The

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principal reason for the decline in bad debt expense at Audio Book Club was lower bad debts from remaining core Audio Book Club members who historically have been very good paying customers. The increase in payroll was mainly attributable to various bonuses paid in the second quarter of 2005 and the hiring, retention and promotion of key employees. The increase in investor and public relations costs was attributable to fees paid to directors in the second quarter of 2005, as well as an increase in public relations activity related to the download strategy. The increase in travel and entertainment relates mainly to business development travel in the implementation of the new strategy.

TERMINATION COSTS

(000's)

	2004	2005
TERMINATION COSTS	\$ --	\$ 697

In the second quarter of 2005, the employment of one senior executive who had an employment agreement was terminated and the employment of several employees, one of which had an employment agreement, was also terminated. We agreed to make aggregate settlement payments totaling \$697,000 payable through March 2006.

DEPRECIATION AND AMORTIZATION

2004

2005

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(In thousands)		
DEPRECIATION		
AUDIO BOOK CLUB	\$ 26	10
RADIO SPIRITS	9	5
TOTAL DEPRECIATION	35	15
AMORTIZATION		
CORPORATE	6	2
TOTAL DEPRECIATION AND AMORTIZATION	\$ 41	17

The decrease in depreciation and amortization expenses for the three months ended June 30, 2005 as compared to the three months ended June 30, 2004 is principally attributable to reductions in the amortization of intangibles, which had been fully amortized or written off during the year ended December 31, 2004 and certain equipment, which was fully depreciated in 2004.

INTEREST EXPENSE

	2004	2005	CHANGE
(IN THOUSANDS)			
TOTAL INTEREST PAID, NET	\$ 260	1	(259)
ACCRUED INTEREST PAID THIS PERIOD	--	--	--
CURRENT INTEREST PAID	260	1	(259)
INTEREST ACCRUED	--	--	--
INTEREST INCLUDED IN DEBT	206	--	(206)
AMORTIZATION OF DEFERRED FINANCING COSTS AND ORIGINAL ISSUE DISCOUNT	365	15	(350)
LOSS ON EARLY EXTINGUISHMENT OF DEBT	1,533	--	(1533)
BENEFICIAL CONVERSION EXPENSES OF JANUARY 2004 NOTES	3,991	--	(3,991)
EXPENSE OF INDUCEMENT TO CONVERT, RELATED PARTY DEBT	390	--	(390)
TOTAL INTEREST EXPENSE	\$6,745	16	(6,729)

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The decrease in interest expenses is principally due to the conversion of debt into preferred stock and common stock in 2004 and the payment of the senior debt facility and related party debt in connection with the March Financing described below.

PREFERRED STOCK DIVIDENDS

	2004	2005
\$ (000'S)		
DIVIDENDS ACCRUED ON SERIES A PREFERRED STOCK	\$ 57	--
DIVIDENDS ACCRUED ON SERIES B PREFERRED STOCK	8	--
DIVIDENDS ACCRUED ON SERIES C PREFERRED STOCK	51	--
DIVIDENDS ACCRUED ON SERIES D PREFERRED STOCK	--	533
TOTAL DIVIDENDS DEEMED OR ACCRUED ON PREFERRED STOCK	\$ 115	533

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The increase in the accrual of preferred stock dividends for the three months ended June 30, 2005 as compared to the three months ended June 30, 2004 is due to the accrual of dividends for the Series D Preferred Stock issued in March 2005, as described in the Liquidity and Capital Resources section below.

During the second quarter of 2005, 1,180 shares of Series D Preferred Stock were converted into 2,170,202 shares of common stock and between July 1, 2005 and August 11, 2005, an additional 13,657 shares of Series D Preferred Stock and related dividends were converted into 24,959,349 shares of common stock. These conversions and future conversions, if any, will reduce the preferred stock dividend in future periods.

LOSS APPLICABLE TO COMMON STOCKHOLDERS

	2004	2005	FROM 2004 TO 2005 CHANGE	% CHANGE
	----	----	-----	-----
(IN THOUSANDS)				
LOSS APPLICABLE TO COMMON STOCKHOLDERS	\$ 7,111	\$ 2,950	4,161	(58.5)%
	=====	=====	=====	=====

Principally due to lower interest expense partially offset by lower gross profit due to decreased sales, the strategic charge, termination costs and higher preferred dividends during the three months ended June 30, 2005, our net loss applicable to common shares for the three months ended June 30, 2005 decreased \$4.1 million to \$3.0 million, or \$0.08 per diluted share, as compared to a net loss applicable to common shares for the three months ended June 30, 2004 of \$7.1 million, or \$.40 per diluted share of common stock, for the three months ended June 30, 2004.

Six months ended June 30, 2005 compared to six months ended June 30, 2004:

NET SALES

	2004	2005	CHANGE FROM 2004 TO 2005	% CHANGE
(\$000'S)	----	----	-----	-----
AUDIO BOOK CLUB	\$ 7,065	\$ 3,562	\$ (3,503)	(49.6)%

RADIO SPIRITS				
Catalog	1,610	1,219	(391)	(24.3)%
Wholesale	982	439	(543)	(55.3)%
Continuity	721	314	(407)	(56.5)%
	3,314	1,972	(1,342)	(40.5)%

MEDIABAY.COM	106	91	(15)	(14.3)%
	\$ 10,485	\$ 5,625	\$ (4,860)	(46.4)%
	=====	=====	=====	=====

Audio Book Club sales decreased principally due to a decrease in club membership as a result of discontinuing our advertising expenditures for new members.

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In the second quarter of 2005, we changed our negative option book club and converted to a business selling audiobooks and other audio entertainment without a negative option requirement. As a result of this change, we anticipate lower returns from our customers in future periods.

The decrease in Radio Spirits catalog sales is principally attributable to fewer customers, as we have not incurred marketing expenditures to attract new members, and greater discounting in our catalogs. Wholesale sales of old-time radio products decreased principally due to reduced sales to our major customers. Sales of our World's Greatest Old-Time Radio continuity program decreased principally due to the lack of advertising expenditures for new customers.

COST OF SALES (In thousands)	2004		2005	
	\$	AS A % OF NET SALES	\$	AS A % OF NET SALES
AUDIO BOOK CLUB	\$ 3,224	45.6%	\$ 2,030	57.0%
RADIO SPIRITS				
Catalog	680	42.2%	556	45.6%
Wholesale	606	61.6%	380	86.6%
Continuity	287	39.9%	132	42.2%
Total Radio Spirits	1,573	47.5%	1,068	54.2%
MEDIABAY.COM	1	0.4%	--	--
COST OF SALES	4,798		3,098	55.1%
COST OF SALES - STRATEGIC CHARGES	--	--	305	5.4%
	\$ 4,798	45.8%	\$ 3,398	60.5%

The principal reason for the decline in cost of sales at Audio Book Club was a reduction in sales of 49.6% as described above. Cost of sales as a percentage of sales at Audio Book Club for the six months ended June 30, 2005 was 57.0%, compared to 45.6% for the same period in 2004. The increase in cost of sales as a percentage of sales is principally due to an increase in product costs as a percentage of sales since a smaller active membership required us to purchase finished goods from publishers rather than the licensing and manufacturing of product due to lower sales and our inability to meet manufacturing minimums and recoup advances to publishers, higher sales of unabridged and CD titles with higher costs and higher manufacturing costs due to lower volumes and to a lesser extent an increase in fulfillment costs as a percentage of sales since the fixed portion of our third party fulfillment costs is allocated to a smaller active membership.

Cost of catalog sales increased as a percentage of sales to 45.6% for the six months ended June 30, 2005 as compared to 42.2% for the six months ended

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June 30, 2004 principally due to sales of lower cost items with lower margins, increased discounting in the catalogs to sell older inventory and higher royalty costs as a percentage of the lower sales volume due to the fixed portion of royalty advances. The cost of wholesale sales as percentage of sales increased to 86.6% for the six months ended June 30, 2005 as compared to 61.6% for the six months ended June 30, 2004 principally due to a greater portion of fixed costs (allocated obsolescence and product development costs, the fixed cost of warehousing and fulfillment and royalty advances) in relation to the lower sales volume. The cost of World's Greatest Old-Time Radio continuity sales as a percentage of sales increased to 42.2% from 39.9% principally due to the fixed cost associated with warehousing and fulfillment in relation to the lower sales volume as we have not marketed for new customers.

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In the second quarter of 2005, we changed our negative option book club and converted to a business selling audiobooks and other audio entertainment without a negative option requirement. We have moved our warehouse and fulfillment operations to a facility which also provides products and accordingly we have changed from licensing and manufacturing many of its audiobook titles to buying on a wholesale basis and accordingly we recorded a \$305 write-down of royalty advances to what we believe is net realizable value at June 30, 2005. Under our new buying arrangement we are buying products at a fixed percentage off of manufacturer's suggested retail price. In addition we will be incurring certain fixed fulfillment charges. The cost of the new arrangement will be dependent on future sales volume.

ADVERTISING AND PROMOTION

(In thousands)

	FROM 2004 TO 2005			
	2004	2005	CHANGE	% CHANGE
AUDIO BOOK CLUB				
New Member	\$ 274	\$ --	\$ (274)	100.0%
Current Member	632	234	(398)	(63.0)%
Total Audio Book Club	906	234	(672)	(74.2)%
RADIO SPIRITS				
Catalog	341	380	39	11.4%
Wholesale	11	27	16	145.5%
Continuity	6	--	(6)	100.0%
Total Radio Spirits	358	407	49	13.7%
NEW PROJECTS	14	132	118	842.9%
TOTAL SPENDING	1,278	773	(505)	(39.5)%
AMOUNT CAPITALIZED	(245)	--	245	(100.0)%
AMOUNT AMORTIZED	1,595	14	(1,581)	(99.2)%
ADVERTISING AND PROMOTION EXPENSE	\$ 2,627	787	\$ (1,840)	(70.1)%

Advertising and promotion expenses decreased \$1.8 million to \$787,000 for the six months ended June 30, 2005 as compared to \$2.6 million in the prior comparable period, principally due to lower amortization of deferred member

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acquisition costs. In the fourth quarter of 2004, based on the change in our strategy, described above, we determined that the future net revenue from our Audio Book Club would not support the carrying amount of the direct-response advertising reported as assets relating to the Audio Book Club. Accordingly, we wrote-off the carrying amount of the asset in the fourth quarter for 2004 resulting in an increase in advertising expense in 2004 and lower expense in 2005. The decrease in spending was due to the lack of new member marketing for Audio Book Club new members due to our change in strategy as described above and decreased advertising to existing members due to the reduction in Audio Book Club membership because of member attrition with no marketing to replace leaving members. During the three months ended June 30, 2005 we incurred \$132,000 related to new projects, principally marketing tests related to the download business.

GENERAL AND ADMINISTRATIVE

(In thousands)	2004		2005		F
	\$	As a % Of Net Sales	\$	As a % Of Net Sales	
AUDIO BOOK CLUB	\$ 1,825	25.8%	\$ 1,030	28.9%	
RADIO SPIRITS	483	14.6%	631	32.0%	
MEDIABAY.COM	322	303.8%	366	402.2%	
CORPORATE	842		1,561		
	\$ 3,473	33.1%	\$ 3,588	63.8%	

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The increase in general and administrative expenses of \$115,000 for the six months ended June 30, 2005 as compared to the six months ended June 30, 2004 is principally due to increases in payroll and related costs, public and investor relations (including directors fees), travel and entertainment and legal and accounting fees, partially offset by lower bad debt expense. The principal reason for the decline in bad debt expense at Audio Book Club was lower bad debts from remaining core Audio Book Club members who historically have been good paying customers. The increase in payroll was mainly attributable to various bonuses paid in the second quarter of 2005 and the hiring, retention and promotion of key employees. The increase in investor and public relations costs was attributable to fees paid to directors in the second quarter of 2005, as well as an increase in public relations activity related to the download strategy. The increase in travel and entertainment relates mainly to business development travel in the implementation of the new strategy. The increase in legal fees is related to the implementation of the new download strategy and the increase in accounting fees is related to complying with the new requirements of Sarbanes-Oxley.

TERMINATION COSTS

(In thousands)	2004	2005
----------------	------	------

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TERMINATION COSTS	\$	--	\$	697
	=====		=====	

In the second quarter of 2005, the employment of one senior executive who had an employment agreement was terminated and the employment of several employees, one of which had an employment agreement, was also terminated. We agreed to make aggregate settlement payments totaling \$697,000 payable through March 2006.

DEPRECIATION AND AMORTIZATION

	2004	2005
	-----	-----
(In thousands)		
DEPRECIATION		
AUDIO BOOK CLUB	\$ 50	25
RADIO SPIRITS	18	14
	-----	-----
TOTAL DEPRECIATION	68	39
AMORTIZATION		
CORPORATE	19	4
	-----	-----
TOTAL DEPRECIATION AND AMORTIZATION	\$ 88	43
	=====	=====

The decrease in depreciation and amortization expenses for the six months ended June 30, 2005 as compared to the six months ended June 30, 2004 is principally attributable to reductions in the amortization of intangibles, which had been fully amortized or written off during the year ended December 31, 2004 and certain equipment, which was fully depreciated in 2004.

INTEREST EXPENSE

	2004	2005	CHANGE
	-----	-----	-----
(IN THOUSANDS)			
TOTAL INTEREST PAID	\$ 533	2,009	1,476
ACCRUED INTEREST PAID THIS PERIOD	74	1,599	1,525
	-----	-----	-----
CURRENT INTEREST PAID	459	410	(49)
INTEREST INCLUDED IN DEBT	436	81	(355)
AMORTIZATION OF DEFERRED FINANCING COSTS AND ORIGINAL ISSUE DISCOUNT	790	60	(730)
LOSS ON EARLY EXTINGUISHMENT OF DEBT	1,533	579	(954)
BENEFICIAL CONVERSION EXPENSES OF JANUARY 2004 NOTES	3,991	--	(3,991)
EXPENSE OF INDUCEMENT TO CONVERT, RELATED PARTY DEBT	390		(390)
	-----	-----	-----
TOTAL INTEREST EXPENSE	\$ 7,599	1,130	(6,469)
	=====	=====	=====

The decrease in interest expenses is principally due to the conversion of debt into preferred stock and common stock in 2004 and the payment of the senior debt facility and related party debt in connection with the March Financing described below.

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PREFERRED STOCK DIVIDENDS

	2004	2005
IN THOUSANDS		
DIVIDENDS ACCRUED ON SERIES A PREFERRED STOCK	\$ 114	51
DIVIDENDS ACCRUED ON SERIES B PREFERRED STOCK	15	1
DIVIDENDS ACCRUED ON SERIES C PREFERRED STOCK	50	100
DIVIDENDS ACCRUED ON SERIES D PREFERRED STOCK	--	586
DEEMED DIVIDEND FOR BENEFICIAL CONVERSION FEATURE OF SERIES D PREFERRED STOCK	--	17,423
TOTAL DIVIDENDS DEEMED OR ACCRUED ON PREFERRED STOCK	\$ 179	18,161
	=====	=====

The Series D Preferred Shares are convertible at any time at the option of the holder into shares of our common stock at the rate of \$0.55 per share and each warrant is exercisable to purchase one share of our common stock at an exercise price of \$0.56 per share. The market price for our common stock at March 21, 2005 was \$.69. We recorded as a non-cash deemed dividend an amount of \$17,423 to reflect the value of the beneficial conversion feature of the Series D Preferred Stock and increased contributed capital by \$17,423. The recording of the dividend had no effect on our cash or net equity.

The increase in the accrual of preferred stock dividends for the six months ended June 30, 2005 as compared to the six months ended June 30, 2004 is due to the accrual of dividends for the Series D Preferred Stock issued in March 2005, as described in the Liquidity and Capital Resources section below.

During the second quarter of 2005, 1,180 shares of Series D Preferred Stock were converted into common stock and between July 1, 2005 and August 11, 2005 an additional 13,657 shares of Series D Preferred Stock were converted into common stock. These conversions and future conversions, if any, will reduce the preferred stock dividend in future periods.

LOSS APPLICABLE TO COMMON STOCKHOLDERS

	2004	2005	FROM 2004 TO 2005	
	-----	-----	CHANGE	% CHANGE
(IN THOUSANDS)				
LOSS APPLICABLE TO COMMON STOCKHOLDERS	\$ 8,279	22,184	13,905	168.0%
	=====	=====	=====	=====

Primarily due to the deemed dividend for beneficial conversion of Series D Preferred Stock of \$17,423, lower sales and a loss on early extinguishment of debt of \$579 the strategic charge, termination costs and higher preferred dividends, partially offset by lower advertising expenses as described above, our net loss applicable to common shares for the six months ended June 30, 2005 increased \$14.0 million to \$22.2 million, or \$0.73 per diluted share, as compared to a net loss applicable to common shares for the six months ended June 30, 2004 of \$8.3 million, or \$.54 per diluted share of common stock, for the six months ended June 30, 2004.

LIQUIDITY AND CAPITAL RESOURCES

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As of June 30, 2005, we had cash on hand of \$14.3 million, which is substantially greater than the \$3.1 million cash on hand at June 30, 2004, as a result of the March 2005 financing described below. We believe that we have sufficient cash to operate the business for a minimum of twelve months.

March 2005 Equity Financing

On March 23, 2005, pursuant to an agreement executed on March 21, 2005, we issued an aggregate of (a) 35,900 shares (the "Offering Shares") of our Series D Convertible Preferred Stock (the "Series D Preferred") convertible into 65,272,273 of our common stock, (b) 32,636,364 five-year common stock purchase warrants (the "Offering Warrants") and (c) preferred warrants (the "Over-Allotment Warrants" and, together with the Offering Shares and the Offering Warrants, the "Offering Securities") exercisable for a limited time, for additional proceeds to us of \$8.975 million, to purchase (1) up to 8,975 additional shares of Series D Preferred (the "Additional Shares" and, together with the Offering Shares, the "Preferred Shares") and (2) up to 8,159,091 additional warrants identical to the Offering Warrants (the "Additional Warrants" and, together with the Offering Warrants, the "Warrants"), to accredited investors (the "Investors") for an aggregate purchase price of \$35.9 million (the "March Financing").

Immediately prior to the March Financing, holders of a majority of our voting securities approved by written consent (the "Shareholder Consent") (a) an amendment to our Articles of Incorporation, increasing the number of our authorized shares of the common stock ("Common Stock") from 150,000,000 to 300,000,000, (b) a change of control which may occur as a result of the Financing, and (c) our issuance, in connection with the transactions contemplated by the Financing documents, of Common Stock in excess of 19.99% of the number of shares of Common Stock outstanding immediately prior to the Financing.

While such actions were approved by a majority of our shareholders prior to the financing, we were not permitted to effect them until we satisfied certain information requirements to our shareholders not party to the Shareholder Consent. As a result, the Shareholder Consent did not become effective until May 3, 2005.

The Preferred Shares have a face value of \$1,000 per share ("Stated Value") and are convertible at any time at the option of the holder into shares ("Conversion Shares") of common stock at the rate of \$0.55 per Conversion Share, subject to certain anti-dilution adjustments, including for issuances of Common Stock for consideration below the conversion price. The Preferred Shares are also mandatorily convertible at our option, subject to satisfaction of certain conditions, commencing June 10, 2005, which is 30 days following the effective date of the registration statement registering the common shares underlying the Series D Preferred Stock. Under certain limited circumstances within our control, the holders will also have the right to require us to redeem their Preferred Shares at their Stated Value. Cumulative dividends will accrue on the Preferred Shares on an annualized basis in an amount equal to 6% of their Stated Value until they are converted or redeemed and will be payable quarterly in arrears, beginning April 1, 2005, in cash or, at our option, subject to satisfaction of certain conditions, in shares of Common Stock ("Dividend Shares") valued at 93% of the average of the daily volume weighted average per-share price of the Common Stock for the five trading days prior to the applicable payment date. The Preferred Shares are non-voting. Subject to certain exceptions for accounts receivable and equipment and capital lease financings, we may not incur additional indebtedness for borrowed money or issue additional securities that are senior to or pari passu to the Preferred Shares without the prior written consent of holders of at least two thirds of the Preferred Shares then outstanding.

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Each Warrant is exercisable to purchase one share of Common Stock (collectively, the "Warrant Shares"), at an exercise price of \$0.56 per share for a period of five years commencing September 23, 2005, subject to certain anti-dilution adjustments, including for issuances of Common Stock for consideration below the exercise price. In addition, once exercisable, the Warrants permit cashless exercises during any period when the Warrant Shares are not covered by an effective resale registration statement.

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The Over-Allotment Warrants are exercisable until August 9, 2005 for the purchase of Additional Shares and Additional Warrants, at an exercise price equal to the Stated Value of the Additional Shares purchased, with the purchase of each Additional Share including an Additional Warrant exercisable for a number of Warrant Shares equal to 50% of the Conversion Shares underlying such Additional Share.

As part of the March Financing, Forest Hill Select Fund L.P. and related entities (the "Forest Hill Entities") exchanged the 1.8 million shares of Common Stock and 400,000 October Warrants previously purchased by them in October 2004 for \$900,000 of the Offering Securities.

In connection with the March Financing, we also entered into an agreement (the "Herrick Agreement") with Herrick and Huntingdon (collectively, the "Herrick Entities"), pursuant to which, concurrently with the March Financing:

- o all \$5.784 million principal amount of our convertible notes owned by the Herrick Entities (the "Herrick Notes") and 10,684 of their shares of our Series A Preferred Stock were converted into an aggregate of approximately 12.2 million shares of Common Stock (the "Herrick Shares"), at their stated conversion rate of \$0.56 per share;
- o we also agreed to redeem the remaining 14,316 shares of Series A Preferred Stock held by the Herrick Entities and all 43,527 of their shares of our Series C Convertible Preferred Stock of the Company (collectively, the "Redemption Securities") for \$5.8 million, the aggregate stated capital of such shares, on the earlier of the effective date of the Shareholder Consent and June 1, 2005, and both the Redemption Securities and the redemption price were placed into escrow pending such date;
- o the Herrick Entities waived certain of their registration rights and we agreed to include the Herrick Shares for resale in the Financing Registration Statement, so long as such Herrick Shares are owned by the Herrick Entities and not otherwise transferred, including, but not limited to, in the Herrick Financing (as defined below); and
- o the Herrick Entities consented to the terms of the Financing and the agreements entered into in connection with the Financing, as we were required to obtain such consents pursuant to the terms of the Herrick Notes, the Series A Preferred Stock and the Series C Preferred Stock.
- o Herrick and Huntingdon also entered into a voting agreement and proxy with us pursuant to which they agreed not to take any action to contradict or negate the Shareholder Consent.

We received \$35 million of gross proceeds (not including the securities exchanged by the Forest Hill Entities for \$900,000 of the purchase price) in the

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March Financing. Merriman Curhan Ford & Co. ("Merriman") acted as a financial advisor with respect to certain of the investors in the March Financing for which it received compensation from us of \$2,625,000 plus a five-year warrant to purchase 7,159,091 shares of Common Stock at an exercise price of \$0.69 per share, the market price of our common stock on March 21, 2005, commencing on May 3, 2005, the effective date of the Shareholder Consent. Merriman also received a structuring fee from us with respect to the Financing in the amount of \$175,000. In addition, we issued to Satellite Strategic Finance Associates, LLC and Satellite Finance Partners, Ltd., investors in the Financing, warrants to purchase an aggregate of 250,000 shares of our common stock (identical to the Warrants), and reimbursed them \$55,000 for expenses, for consulting services rendered by it in connection with the Financing. We also incurred legal, accounting and other costs of \$617,000.

Concurrently with the March Financing, we repaid from net March Financing proceeds all of the principal and accrued and unpaid interest due on our outstanding senior notes issued on April 28, 2004, in the aggregate amount of approximately \$9.4 million. We reported a loss on early extinguishment of debt of \$579,000 in the first quarter of 2005 to reflect the write-off of unamortized finance charges related to the repayment of this debt.

We used approximately \$2,271,000 of the proceeds from the Financing to pay all accrued and unpaid interest to the Herrick Entities on convertible notes and the Series A Preferred Stock and Series C Preferred Stock.

As of August 11, 2005, 14,837 shares of Series D preferred Stock have been converted into 27,129,551 shares of common stock and 21,063 shares of Series D Preferred Stock are outstanding.

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On August 9, 2005, the period to exercise warrants to purchase additional shares of the Series D Preferred Stock granted to the investors in the March sale of Series D Convertible Preferred Stock was extended to November 9, 2005.

Activity during the six months ended June 30, 2005.

For the six months ended June 30, 2005, cash increased by \$11.2 million, as we had net cash used in operating activities of \$2.2 million, used net cash of \$580,000 in investing activities and had cash provided by financing activities of \$14.0 million. Net cash used in operating activities principally consisted of the net loss of \$22.2 million and increases in prepaid expenses of \$194,000 partially offset by the non-cash charges consisting of the deemed dividend for beneficial conversion feature of Series D preferred Stock of \$17.4 million, the loss on early extinguishment of debt of \$579,000, depreciation and amortization expenses of \$43,000, amortization of deferred financing costs and original issue discount of \$210,000, non-current accrued interest and dividends payable of \$306,000; as well as decreases in accounts receivable, inventory and royalty advances of \$631,000, 132,000 and 99,000, and increases in accounts payable and accrued expenses of \$687,000.

The decreases in accounts receivable and inventory are primarily attributable the reduction in sales as described above. The increase in prepaid expenses is principally due to the timing of payments of marketing costs and other costs related to the download business and certain Radio Spirit's catalog costs. The increase in accounts payable and accrued expenses is principally due to the accrual for preferred dividends on the Series D Preferred Stock and termination costs. The decrease in royalty advances relates to the change in strategy for our Audio Book Club, as we are no longer licensing and manufacturing products as described above.

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Net cash used in investing activities consists of acquisition of fixed assets of \$580,000, principally computer equipment and the cost of the development of the new websites offering downloadable audio.

During the six months ended June 30, 2005, we received net cash proceeds of the sale of Series D Preferred Stock of \$31.5 million, as described above, repaid debt in the amount of \$9.4 million, repaid accrued interest, dividends and fees relating to the debt of \$2.4 million and redeemed Series A and Series C Preferred Stock in the amount of \$5.8 million.

RECENT ACCOUNTING PRONOUNCEMENTS

CONSOLIDATION OF VARIABLE INTEREST ENTITIES

In March 2005, the FASB issued Staff Position (FSP) No. FIN 46(R)-5, Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities. This FSP clarifies that when applying the variable interest consolidation model, a reporting enterprise should consider whether it holds an implicit variable interest in a variable interest entity (VIE) or potential VIE when specific conditions exist. FSP No. FIN 46(R)-5 is effective as of April 1, 2005. The Company does not anticipate an impact from the adoption of this statement.

SHARE-BASED PAYMENT

In December 2004, the FASB issued SFAS No. 123(R), "Share-Based Payment," which is a revision of SFAS No. 123, "Accounting for Stock-Based Compensation". SFAS 123(R) requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. The compensation cost will be measured based on the fair value of the equity or liability instruments issued. The Statement is effective as of the beginning of the annual period beginning after June 15, 2005. We do not yet know the impact that any future share-based payment transactions will have on our financial position or results of operations.

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INVENTORY COSTS

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs." SFAS 151 amends ARB No. 43, "Inventory Pricing", to clarify the accounting for certain costs as period expense. The Statement is effective for fiscal years beginning after June 15, 2005; however, early adoption of this Statement is permitted. The Company does not anticipate an impact from the adoption of this statement.

ACCOUNTING CHANGES AND ERROR CORRECTIONS

In May 2005, the FASB issued SFAS No. 154 "Accounting Changes and Error Corrections--A Replacement of APB Opinion No. 20 and FASB Statement No. 3". This Statement requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. This Statement does not change the guidance for reporting the correction of an error in previously issued financial statements or a change in accounting estimate. The provisions of this Statement shall be effective for accounting changes and correction of errors made in fiscal years beginning after December 15, 2005. The Company is not able to assess at this time the future impact of this Statement on its consolidated financial position or results of operations.

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CERTAIN TRANSACTIONS

In addition to the transactions described above with the Herrick Entities and the Forest Hill entities, as of March 31, 2005, we owed to Norton Herrick, and his affiliates \$31,410 for reimbursement of certain expenses and services incurred in prior years. From December 31, 2004 through June 30, 2005, we paid Herrick a total of \$284,000, and have agreed to pay Herrick the remaining \$31,410 on August 1, 2005.

QUARTERLY FLUCTUATIONS

Our operating results vary from period to period as a result of purchasing patterns of our members and customers, member attrition, the timing and popularity of new audiobook releases and product returns.

We believe that a significant portion of our sales of old-time radio and classic video programs are gift purchases by consumers. Therefore, we tend to experience increased sales of these products in the fourth quarter in anticipation of the holiday season and the second quarter in anticipation of Fathers' Day.

ITEM 3: QUANTITATIVE AND QUALITATIVE DISCLOSURES OF MARKET RISK

The Company has no exposure to market risk for changes in interest rates. The Company has total debt outstanding as of August 11, 2005 of \$652,000, all of which is at fixed rates. Changes in the prime rate or LIBOR would not have an impact on our fair values, cash flows, or earnings for the six months ended June 30, 2005.

ITEM 4. CONTROLS AND PROCEDURES

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002 (the Act), beginning with our Annual Report on Form 10-K for the fiscal year ending December 31, 2006, we will be required to furnish a report by our management on our internal control over financial reporting. This report will contain, among other matters, an assessment of the effectiveness of our internal control over financial reporting as of the end of our fiscal year, including a statement as to whether or not any material weakness in our internal control over financial reporting identified by management. If we identify one or more material weaknesses in our internal control over financial reporting, we will be unable to assert our internal control over financial reporting is effective. This report will also contain a statement that our independent registered public accountants have issued an attestation report on management's assessment of such internal controls and a conclusion on the operating effectiveness of those controls.

Management acknowledges its responsibility for internal controls over financial reporting and seeks to continually improve those controls. In order to achieve compliance with Section 404 of the Act within the prescribed period, we are currently performing the system and process documentation and evaluation needed to comply with Section 404, which is both costly and challenging. We believe our process, which we began in the first quarter of 2005 and, we believe, will continue through 2006 for documenting, evaluating and monitoring our internal control over financial reporting is consistent with the objectives of Section 404 of the Act.

As of the end of the period covered by this report, an evaluation was carried out under the supervision and with the participation of our management,

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including the Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), of the effectiveness of our disclosure controls and procedures. Based on that evaluation, the CEO and CFO have concluded that our disclosure controls and procedures are effective at the reasonable assurance level to timely alert them of information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934. During the quarter ended June 30, 2005 there were no changes in our internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

PART II - OTHER INFORMATION

ITEM 5: OTHER INFORMATION

On August 9, 2005, the period to exercise warrants to purchase additional shares of the Series D Preferred Stock granted to the investors in the March sale of Series D Convertible Preferred Stock was extended to November 9, 2005.

ITEM 6: EXHIBITS

Exhibits

- | | |
|------|---|
| 10.1 | Form of 2004 Stock Incentive Plan Non-Qualified Stock Option Agreement for Officers |
| 10.2 | Form of 2004 Stock Incentive Plan Non-Qualified Stock Option Agreement for Directors |
| 31.1 | Chief Executive Officer Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Chief Financial Officer Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of Jeffrey Dittus, Chief Executive Officer of MediaBay, Inc., pursuant to 18 U.S.C Section 1350, as Adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of Robert Toro, Chief Financial Officer of MediaBay, Inc., pursuant to 18 U.S.C Section 1350, as Adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 20 |

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SIGNATURES

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

MEDIABAY, INC.

Dated: August 15, 2005

By: /s/ Jeffrey Dittus

Jeffrey Dittus
Chief Executive Officer

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Dated August 15, 2005

By: /s/ Robert Toro

Robert Toro
Chief Financial Officer
(principal accounting and financial
officer)