LRAD Corp
Form 10-Q
May 07, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark one)

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

For the quarterly period ended March 31, 2012

or

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

For the transition period from ______ to ______.

Commission File Number: 000-24248

LRAD CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**87-0361799**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**
15378 Avenue of Science, Ste 100, San Diego, California	**92128**
(Address of principal executive offices)	**(Zip Code)**

(858) 676-1112

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). x Yes ¨ No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer	¨	Accelerated filer	x
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	x

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

The number of shares of Common Stock, $0.00001 par value, outstanding on April 26, 2012 was 32,374,499.

LRAD CORPORATION

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

LRAD Corporation

CONDENSED CONSOLIDATED BALANCE SHEETS

	March 31, 2012 (Unaudited)	September 30, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	$ 13,884,772	$ 13,870,762
Restricted cash	606,250	606,250
Accounts receivable	2,133,263	5,098,148
Inventories, net	3,192,703	2,735,520
Prepaid expenses and other	591,071	663,601
Assets of discontinued operations		6,250
Total current assets	20,408,059	22,980,531
Restricted cash	39,406	
Property and equipment, net	67,811	75,468
Intangible assets, net	200,592	225,969
Prepaid expenses and other - noncurrent	1,156,360	1,218,750
Total assets	$ 21,872,228	$ 24,500,718
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 437,498	$ 1,040,202
Accrued liabilities	536,217	2,899,211
Liabilities of discontinued operations		9,263
Total current liabilities	973,715	3,948,676
Other liabilities - noncurrent	323,687	276,744
Total liabilities	1,297,402	4,225,420
Commitments and contingencies (Note 11)		
Stockholders equity:		
Preferred stock, $0.00001 par value; 5,000,000 shares authorized; none issued and outstanding		
Common stock, $0.00001 par value; 50,000,000 shares authorized; 32,374,499 shares issued and outstanding each period	324	324
Additional paid-in capital	85,951,030	85,673,560
Accumulated deficit	(65,376,528)	(65,398,586)
Total stockholders equity	20,574,826	20,275,298
Total liabilities and stockholders equity	$ 21,872,228	$ 24,500,718

See accompanying notes

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LRAD Corporation

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Three months ended March 31,		Six months ended March 31,	
	2012	2011	2012	2011
Revenues:				
Product sales	$ 2,340,731	$ 15,297,871	$ 5,885,784	$ 17,435,860
Contract and other	59,710	205,204	126,292	272,603
Total revenues	2,400,441	15,503,075	6,012,076	17,708,463
Cost of revenues	1,083,438	4,635,260	2,946,479	5,848,273
Gross profit	1,317,003	10,867,815	3,065,597	11,860,190
Operating expenses:				
Selling, general and administrative	1,193,294	4,390,379	2,249,853	5,444,105
Research and development	429,390	665,690	810,708	1,044,910
Total operating expenses	1,622,684	5,056,069	3,060,561	6,489,015
(Loss) Income from operations	(305,681)	5,811,746	5,036	5,371,175
Interest income	6,778	4,506	19,722	8,190
(Loss) income from continuing operations before income taxes	(298,903)	5,816,252	24,758	5,379,365
Income tax (benefit) expense	(7,015)	112,095	2,700	112,095
(Loss) income from continuing operations	(291,888)	5,704,157	22,058	5,267,270
Income from discontinued operations, net of tax		105		81,625
Net (loss) income	$ (291,888)	$ 5,704,262	$ 22,058	$ 5,348,895
Net (loss) income per common share - continuing operations:				
Basic	$ (0.01)	$ 0.18	$ 0.00	$ 0.17
Diluted	$ (0.01)	$ 0.17	$ 0.00	$ 0.17
Net income per common share - discontinued operations:				
Basic	$ 0.00	$ 0.00	$ 0.00	$ 0.00
Diluted	$ 0.00	$ 0.00	$ 0.00	$ 0.00
Net (loss) income per common share:				
Basic	$ (0.01)	$ 0.18	$ 0.00	$ 0.17
Diluted	$ (0.01)	$ 0.17	$ 0.00	$ 0.17
Weighted average common shares outstanding:				
Basic	32,374,499	31,687,779	32,374,499	31,154,649
Diluted	32,374,499	32,606,414	33,006,994	32,068,244

See accompanying notes

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LRAD Corporation

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	For the six months ended March 31, 2012	2011
Operating Activities:		
Net income	$ 22,058	$ 5,348,895
Less: Net income from discontinued operations (Note 16)		81,625
Income from continuing operations	22,058	5,267,270
Adjustments to reconcile net income to net cash provided by operating activities of continuing operations:		
Depreciation and amortization	45,011	83,992
Provision for doubtful accounts		(24,000)
Warranty provision	(40,007)	106,258
Inventory obsolescence	(98,686)	18,861
Share-based compensation	277,470	210,670
Loss on impairment of patents	11,197	20,433
Changes in operating assets and liabilities:		
Restricted cash	(39,406)	(3,031,250)
Accounts receivable	2,964,885	1,797,555
Inventories	(358,497)	(513,522)
Prepaid expenses and other	72,530	(593,651)
Prepaid expenses - noncurrent	62,390	(1,312,500)
Accounts payable	(602,704)	(106,583)
Warranty settlements	(15,014)	(21,327)
Accrued liabilities	(2,261,030)	(439,871)
Net provided by operating activities of continuing operations	40,197	1,462,335
Net cash (used in) provided by operating activities of discontinued operations (Note 16)	(3,013)	79,037
Net cash provided by operating activities	**37,184**	**1,541,372**
Investing Activities:		
Purchase of equipment	(22,342)	(21,859)
Patent costs paid	(832)	(761)
Net cash used in investing activities	**(23,174)**	**(22,620)**
Financing Activities:		
Proceeds from exercise of common stock warrants		4,346,613
Proceeds from exercise of stock options		109,910
Net cash provided by financing activities		**4,456,523**
Net increase in cash and cash equivalents	14,010	5,975,275
Cash and cash equivalents, beginning of period	13,870,762	5,421,167
Cash and cash equivalents, end of period	**$ 13,884,772**	**$ 11,396,442**
Supplemental Disclosure of Cash Flow Information		
Cash paid for taxes	$ 60,015	$ 209,550

See accompanying notes

LRAD Corporation

Notes to Interim Condensed Consolidated Financial Statements (unaudited)

1. OPERATIONS

LRAD Corporation, a Delaware corporation (the Company), is engaged in the design, development and commercialization of directed sound technologies and products. The principal markets for the Company s proprietary sound reproduction technologies and products are in North America, Europe, Middle East and Asia.

2. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

General

The accompanying unaudited interim condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information, the instructions to Form 10-Q and applicable sections of Regulation S-X. Certain information and note disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to those rules and regulations, although, in the opinion of management, the interim financial statements reflect all adjustments necessary and that disclosures included therein are adequate in order to make the financial statements not misleading. The condensed consolidated balance sheet as of September 30, 2011 was derived from the Company s most recent audited financial statements. Operating results for the three and six month periods are not necessarily indicative of the results that may be expected for the year. The interim condensed financial statements and notes thereto should be read in conjunction with the Company s audited financial statements and notes thereto for the year ended September 30, 2011 included in the Company s Annual Report on Form 10-K, as filed with the Securities and Exchange Commission (SEC) on December 5, 2011.

Principles of Consolidation

The Company has a currently inactive wholly owned subsidiary, American Technology Holdings, Inc., which the Company formed to conduct international marketing, sales and distribution activities. The condensed consolidated financial statements include the accounts of this subsidiary after elimination of intercompany transactions and accounts.

Discontinued Operations

The financial statements presented herein reflect the spin-off of the Company s Hypersonic Sound (HSS) business as a stand-alone company on September 27, 2010. The results of operations include some continued activity by the Company to fulfill remaining sales and warranty obligations following the spin-off, are designated as discontinued operations in the accompanying financial statements. Amounts reflected as discontinued operations in the accompanying Condensed Consolidated Statements of Operations include direct and allocated costs attributable to the former HSS business, but do not include allocations of general corporate overhead costs.

Reclassifications

Where necessary, the prior year s information has been reclassified to conform to the current year presentation. These reclassifications had no effect on previously reported results of operations or retained earnings.

3. FAIR VALUE MEASUREMENTS

At March 31, 2012, there was no difference between the carrying value and fair market value of the Company s cash equivalents. For certain financial instruments, including accounts receivable, accounts payable and accrued expenses, the carrying amounts approximate fair value due to their relatively short maturities.

4. RESTRICTED CASH

Restricted cash was reported as follows:

	March 31, 2012	September 30, 2012
Current asset	$ 606,250	$ 606,250
Noncurrent asset	39,406	
	$ 645,656	$ 606,250

The Company s assets included restricted cash, which was pledged to support bank guarantees for product warranty of product delivered on a sales contract in the quarter ended March 31, 2011. The current portion covered the first year of product warranty, and the noncurrent portion was recently issued and will be renewed annually for seven years to cover each year of the extended warranty and maintenance agreement. The current portion will become unrestricted and transferred to cash and cash equivalents in the current fiscal year upon completion of the first year warranty term, and the noncurrent will remain for the duration of the seven year term. These assets are carried at cost, which approximates market value.

5. INVENTORIES

Inventories consisted of the following:

	March 31, 2012	September 30, 2011
Finished goods	$ 813,168	$ 505,749
Work in process	217,218	168,622
Raw materials	2,580,185	2,368,245
	3,610,571	3,042,616
Reserve for obsolescence	(417,868)	(307,096)
	$ 3,192,703	$ 2,735,520

6. PROPERTY AND EQUIPMENT

Property and equipment consisted of the following:

	March 31, 2012	September 30, 2011
Machinery and equipment	$ 530,753	$ 521,719
Office furniture and equipment	767,476	775,662
Leasehold improvements	268,107	262,258
	1,566,336	1,559,639
Accumulated depreciation	(1,498,525)	(1,484,171)
	$ 67,811	$ 75,468

	Six months ended	
	March 31, 2012	March 31, 2011
Depreciation expense	$ 29,999	$ 67,974

7. INTANGIBLE ASSETS

Intangible assets consisted of the following:

	March 31, 2012	September 30, 2011
Cost	$ 441,347	$ 458,912
Accumulated amortization	(240,755)	(232,943)

	$ 200,592	$ 225,969

	Six months ended	
	March 31, 2012	**March 31, 2011**
Amortization expense	$ 15,012	$ 16,018
Loss on impairment of patents	11,197	20,433
	$ 26,209	$ 36,451

Each quarter, the Company reviews the ongoing value of its capitalized patent costs. In the first six months of fiscal 2012 and 2011, some of these assets were identified as being associated with patents that are no longer consistent with its business strategy. As a result of this review, the Company recorded a loss as shown above from the impairment of patents that were previously capitalized.

8. PREPAID MAINTENANCE AGREEMENT

At March 31, 2011, prepaid expenses included $1,500,000 paid to a third party provider in connection with the Company s obligations under a sales contract to a foreign military service to provide repair and maintenance services over an eight year period for products sold under this contract. The total prepaid expense is being amortized on a straight-line basis at an annual rate of $187,500 over this eight-year period, and is being recognized as a component of cost of sales. Accordingly, as of March 31, 2012, $187,500 of the total prepayment was classified as a current asset and $1,125,000 was classified as noncurrent.

9. ACCRUED LIABILITIES AND OTHER LIABILITIES NONCURRENT

Accrued liabilities consisted of the following:

	March 31, 2012	September 30, 2011
Payroll and related	$ 367,038	$ 2,628,210
Warranty reserve	163,694	265,658
Customer deposits	2,960	4,543
Deferred revenue	2,525	800
Other		
Total	$ 536,217	$ 2,899,211

Other liabilities noncurrent consisted of the following:

Deferred revenue noncurrent	$ 270,141	$ 270,141
Extended warranty	53,546	6,603
Total	$ 323,687	$ 276,744

Deferred Revenue

Deferred revenue at March 31, 2012 and September 30, 2011 included $270,559 and $270,941, respectively, collected from a license agreement in advance of recognized revenue, and $2,106 and $0 of customer prepayments, respectively.

Warranty Reserve

Changes in the warranty reserve during the six months ended March 31, 2012 and 2011 were as follows:

	Three Month Ended March 31,		Six Months Ended March 31,	
	2012	2011	2012	2011
Beginning balance	$ 323,476	$ 214,321	$ 272,261	$ 245,106
Warranty provision	(104,317)	121,205	(40,007)	106,258
Warranty settlements	(1,919)	(5,489)	(15,014)	(21,327)
Ending balance	$ 217,240	$ 330,037	$ 217,240	$ 330,037
Short-term warranty reserve	163,694	321,279	$ 163,694	$ 321,279
Long-term warranty reserve	53,546	8,758	53,546	8,758
	$ 217,240	$ 330,037	$ 217,240	$ 330,037

10. INCOME TAXES

At March 31, 2012, the Company had federal net operating losses (NOLs) and related state NOLs. In accordance with Financial Accounting Standards Board Accounting Standards Codification (ASC) Topic 740, Accounting for Income Taxes (ASC 740), the Company recorded a full valuation allowance as it is more likely than not that some or all of the deferred tax assets will not be realized in the future.

The Company did not record a tax provision during the six months ended March 31, 2012 as the Company expects its annual effective tax rate to be zero.

ASC 740 requires the Company to recognize in its financial statements uncertainties in tax positions taken that may not be sustained upon examination by the taxing authorities. If interest or penalties are assessed, the Company would recognize these charges as income tax expense. The Company has not recorded any income tax expense or benefit for uncertain tax positions.

The Company is subject to taxation in the U.S. and various state jurisdictions. All of the Company s historical tax years are subject to examination by the Internal Revenue Service and various state jurisdictions due to the generation of NOL and credit carryforwards.

11. COMMITMENTS AND CONTINGENCIES

Bank and Other Cash Equivalent Deposits in Excess of FDIC Insurance Limits

The Company maintains cash and cash equivalent accounts with Federal Deposit Insurance Corporation (FDIC) insured financial institutions. Under provisions of the Dodd Frank Wall Street Reform and Consumer Protection Act (Dodd Frank Act), unlimited FDIC insurance is provided for all funds in non-interest bearing transaction accounts through December 31, 2012. In addition, certain of the Company s interest bearing collateral money market and savings accounts are each insured up to $250,000 by the FDIC. The Company s exposure for amounts in excess of FDIC insured limits at March 31, 2012 was approximately $10,800,000. The Company has not experienced any losses in such accounts.

Litigation

The Company may at times be involved in litigation in the ordinary course of business. The Company will, from time to time, when appropriate in management s estimation, record adequate reserves in the Company s financial statements for pending litigation. Currently, there are no pending material legal proceedings to which the Company is a party or to which any of its property is subject.

Bonus Plan

The Company has an incentive bonus plan for fiscal year 2012 designed to motivate its employees to achieve the Company s financial objectives. All of the Company s employees are entitled to participate in the incentive plan. Target Bonus Amounts (Target) vary based on a percentage of the employee s base salary, which range from 10% to 50% of base salary, and a bonus payment may be made at three levels, including at 50% of Target, at 100% of Target and at 200% of Target, depending upon the achievement by the Company of specified earnings per share goals. Included in such calculation is the cost of the incentive plan. For purposes of the earnings per share calculation, the number of shares outstanding will also be held constant as of October 1, 2011. During the six months ended March 31, 2012, the Company did not record any bonus expense in connection with the 2012 plan, compared to $583,202 recorded during the three and six months ended March 31, 2011 in connection with the 2011 plan.

12. SHARE-BASED COMPENSATION

Stock Option Plans

At March 31, 2012, the Company had one equity incentive plan, the 2005 Equity Incentive Plan (2005 Equity Plan). The 2005 Equity Plan, as amended, authorizes for issuance as stock options, stock appreciation rights, or stock awards an aggregate of 3,250,000 new shares of common stock to employees, directors or consultants. The total plan reserve includes these new shares and shares reserved under prior plans, allowing for the issuance of up to 4,999,564 shares. At March 31, 2012, there were options outstanding covering 3,969,714 shares of common stock under the 2005 Equity Plan and an additional 963,602 shares of common stock available for grant.

Stock Option Activity

The following table summarizes information about stock option activity during the six months ended March 31, 2012:

	Number of Shares	Weighted Average Exercise Price
Outstanding October 1, 2011	4,181,339	$ 2.40
Granted	10,000	$ 1.51
Canceled/expired	(721,625)	$ 4.43
Outstanding March 31, 2012	3,469,714	$ 1.98

Exercisable March 31, 2012	3,189,622	$	1.98

Options outstanding are exercisable at prices ranging from $0.46 to $3.58 and expire over the period from 2012 to 2022 with an average life of 2.07 years. The aggregate intrinsic value of options outstanding and exercisable at March 31, 2012 was $1,029,372 and $1,007,699, respectively.

Share-Based Compensation

The Company recorded share-based compensation expense and classified it in the condensed consolidated statements of operations as follows:

	Three months ended March 31,		Six months ended March 31,	
	2012	2011	2012	2011
Cost of revenue	$ 6,244	$ 6,330	$ 13,125	$ 13,152
Selling, general and administrative	117,803	76,831	236,202	165,017
Research and development	14,137	14,206	28,143	32,501
Total	$ 138,184	$ 97,367	$ 277,470	$ 210,670

The weighted-average estimated fair value of employee stock options granted during the periods below were calculated using the Black-Scholes option pricing model with the following weighted-average assumptions above (annualized percentages).

	Six months ended March 31,	
	2012	2011
Volatility	82.0%	89.0% - 93.0%
Risk-free interest rate	1.10%	0.99% - 1.77%
Forfeiture rate	10.0%	10.0%
Dividend yield	0.0%	0.0%
Expected life in years	6.4	3.4 - 4.0
Weighted average fair value of options granted during the year	$1.07	$1.61

The Company has never paid cash dividends and has no present intention to pay cash dividends. Expected volatility is based on the historical volatility of the Company s common stock over the period commensurate with the expected life of the options. The risk-free interest rate is based on rates published by the Federal Reserve Board. The expected life is based on observed and expected time to post-vesting exercise. The expected forfeiture rate is based on past experience and employee retention data. Forfeitures are estimated at the time of the grant and revised in subsequent periods if actual forfeitures differ from those estimates or if the Company updates its estimated forfeiture rate. Such amounts will be recorded as a cumulative adjustment in the period in which the estimate is changed.

Since the Company has a NOL carryforward as of March 31, 2012, no excess tax benefit for the tax deductions related to share-based awards was recognized for the six months ended March 31, 2012 and 2011. As of March 31, 2012, there was approximately $500,000 of total unrecognized compensation cost related to non-vested share-based employee compensation arrangements. The cost is expected to be recognized over a weighted-average period of 1.3 years.

13. STOCK PURCHASE WARRANTS

At March 31, 2012, the Company had 1,627,945 shares purchasable under outstanding warrants (the 2011 Warrants) at an exercise price of $2.67, which are exercisable through February 4, 2016. The Company entered into a Registration Rights Agreement with the holders of the 2011 Warrants (Warrant Holders). Under this agreement, if the Warrant Holders are unable to re-sell the shares purchased upon exercise of the 2011 Warrants, the Company will be obligated to pay liquidated damages to the purchasers in the amount of $0.0267 per day per applicable share, but not to exceed a total of $0.534 per applicable share or a maximum of $869,323. This obligation will be effective for the five year term of the Warrants, or until all 2011 Warrants have been exercised.

14. (LOSS) INCOME PER SHARE

The following table sets forth the computation of basic and diluted earnings per share:

	Three Months Ended March 31, 2012	Three Months Ended March 31, 2011	Six Months Ended March 31, 2012	Six Months Ended March 31, 2011
Basic				
(Loss) income from continuing operations	$ (291,888)	$ 5,704,157	$ 22,058	$ 5,267,270
Income from discontinued operations		105		81,625
(Loss) income available to common stockholders	$ (291,888)	$ 5,704,262	$ 22,058	$ 5,348,895
Weighted average common shares outstanding	32,374,499	31,687,779	32,374,499	31,154,649
Basic (loss) income per common share, continuing operations	$ (0.01)	$ 0.18	$	$ 0.17
Basic income per common share, discontinued operations	$	$	$	$
Basic (loss) income per common share	$ (0.01)	$ 0.18	$	$ 0.17
Diluted				
(Loss) income from continuing operations	$ (291,888)	$ 5,704,157	$ 22,058	$ 5,267,270
Income from discontinued operations		105		81,625
(Loss) income available to common stockholders	$ (291,888)	$ 5,704,262	$ 22,058	$ 5,348,895
Weighted average common shares outstanding	32,374,499	31,687,779	32,374,499	31,154,649
Assumed exercise of dilutive options and warrants		918,635	632,495	913,595
Weighted average dilutive shares outstanding	32,374,499	32,606,414	33,006,994	32,068,244
Diluited (loss) income per common share, continuing operations	$ (0.01)	$ 0.17	$	$ 0.17
Diluted income per common share, discontinued operations	$	$	$	$
Diluted (loss) income per common share	$ (0.01)	$ 0.17	$	$ 0.17
Potentially dilutive securities outstanding at period end excluded from the diluted computation as the inclusion would have been antidilutive:				
Options	2,004,075	2,220,700	1,994,075	2,220,700
Warrants	1,627,945	1,627,945	1,627,945	1,627,945
Total	3,632,020	3,848,645	3,622,020	3,848,645

15. MAJOR CUSTOMERS

For the three months ended March 31, 2012, revenues from two customers accounted for 22% and 10% of revenues, respectively, and for the six months ended March 31, 2012, revenues from two customers accounted for 14% and 16% of revenues, with no other single customer accounting for more than 10% of revenues. At March 31, 2012, accounts receivable from two customers accounted for 46% and 11% of total accounts receivable, respectively, with no other single customer accounting for more than 10% of the accounts receivable balance.

For the three and six months ended March 31, 2011, revenues from one customer accounted for 78% and 68% of revenues, respectively, with no other single customer accounting for more than 10% of revenues. At March 31, 2011, accounts receivable from three customers accounted for 25%, 17% and 11% of total accounts receivable, with no other single customer accounting for more than 10% of the accounts receivable balance.

16. DISCONTINUED OPERATIONS REPORTING

The Company spun-off its wholly-owned subsidiary Parametric Sound Corporation (Parametric) effective September 27, 2010. The prior year results of operations relating to the HSS business have been presented as discontinued operations in the Condensed Consolidated Statement of Operations. The prior year Condensed Consolidated Balance Sheets also identify assets and liabilities retained by the Company to fulfill remaining warranty obligations for previous HSS shipments. There were no discontinued operations financing or investing activities in the prior year. Current year results of operations and the assets and liabilities related to the HSS business are immaterial and are not reported as discontinued operations. The components of the Condensed Consolidated Statements of Operations, which are presented as discontinued operations, are as follows:

	Three months ended March 31, 2011	Six months ended March 31, 2011
Total revenues	$ 10,900	$ 142,484
Cost of revenues	(10,795)	(60,859)
Total income from discontinued operations	$ 105	$ 81,625

The components of the Condensed Consolidated Balance Sheets, which are presented as discontinued operations are as follows:

	September 30, 2011
Assets:	
Inventories, net	$ 6,250
Total current assets	$ 6,250
Liabilities:	
Warranty reserve	$ 9,263
Total current liabilities	$ 9,263
Net assets	$ (3,013)

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

The discussion and analysis set forth below is presented to show the results of continuing operations only, and does not discuss the results of discontinued operations from our former HSS business (see Note 16 for further information on the discontinued operations). It should be read in conjunction with the accompanying unaudited interim condensed consolidated financial statements and the related notes included under Item 1 of this Quarterly Report on Form 10-Q, together with Management s Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the year ended September 30, 2011.

Forward Looking Statements

This report contains certain statements of a forward-looking nature relating to future events or future performance. Words such as expects, anticipates, intends, plans, believes, seeks, estimates and similar expressions or variations of such words are intended to identify forward-looking statements, but are not the only means of identifying forward-looking statements. Prospective investors are cautioned that such statements are only predictions and that actual events or results may differ materially. In evaluating such statements, prospective investors should specifically consider various factors identified in this report and any matters set forth under Part I, Item 1A (Risk Factors) of our Annual Report on Form 10-K, which could cause actual results to differ materially from those indicated by such forward-looking statements.

Overview

We are a pioneer of highly intelligible, long range directed sound technologies and products. We aggressively seek to create markets for our products, and we are increasing our focus and investment in worldwide sales and marketing activities as we also continue to invest in product development.

In the quarter ended March 31, 2012, we had revenues of $2,400,441 compared to $15,503,075 in the quarter ended March 31, 2011. The quarter ended March 31, 2011 included delivery of a $12.1 million order to a foreign military customer, which was not repeated in the current year. We continue to pursue global opportunities, but orders have been slow due to military budget constraints. Gross margin for the quarter was 55% of net revenues, compared to 70% of net revenues for the quarter ended March 31, 2011, which was driven by higher margins on the foreign military order, which also resulted in a large commission payment of $3,062,000 in operating expenses. On a quarter over quarter basis, our revenues are expected to remain uneven.

Our LRAD-X product line uses directionality and focused acoustic output to clearly transmit critical information, instructions and warnings 1,500 meters and beyond. The LRAD-X product line features clear voice intelligibility and is available in a number of packages and form factors that meet stringent military environmental requirements. Through the use of powerful voice commands and deterrent tones, large safety zones can be created while determining the intent and influencing the behavior of potential security threats. Our LRAD-X product line provides a complete range of systems from single user portable to permanently installed, remotely operated. In fiscal 2011, we added wireless capability to our LRAD 100X product. Our LRAD products have been competitively selected over other commercially available systems by U.S. and several foreign militaries. Our LRAD-X product line includes the following:

- **LRAD 2000X** launched in fiscal 2012 to meet the requirements of larger security applications is our largest and loudest acoustic hailing system and broadcasts highly intelligible voice communication that can be clearly heard and understood over five miles away.

- **LRAD 1000X** selected by the U.S. Navy as its acoustic hailing device (AHD) for Block 0 of the Shipboard Protection System can be manually operated to provide long distance hailing and warning with highly intelligible communication. This unit is available in both fully integrated and remotely operated electronics.

- **LRAD 500X** selected by the U.S. Navy and U.S. Army as their AHD for small vessels and vehicles is lightweight and can be easily transported to provide security personnel long-range communications and a highly effective hailing and warning capability where needed.

- **LRAD 300X** is a lightweight mid-range AHD developed for small vessels and manned and unmanned vehicles and aircraft. This unit is available in both fully integrated and remotely operated electronics.

- **LRAD 100X** is a self-contained, battery-powered, portable system designed for use in a variety of mass notification, law enforcement and commercial security applications. This unit is ideally suited for short-range perimeter security and communications and is available in a wireless version.

- **LRAD-RX** selected by the U.S. Navy in 2010 in a competitive bid as its AHD for Block 2 of the Shipboard Protection System is our prescription for remotely controlled security. It enables system operators to detect and communicate with an intruder over long distances. LRAD-RX features an LRAD 1000X emitter head, integrated camera, high-intensity searchlight and a newly developed, robust, and Internet protocol-addressable full pan and tilt drive system for precise aiming and tracking. LRAD-RX can also be integrated with radar to provide automated intruder alerts. Because of its automated capabilities, LRAD-RX reduces manpower requirements and false alarms while providing an intelligent, cost-effective security solution.

In the quarter ended March 31, 2012, we received our first order for the newly developed LRAD 360º product, which is designed with 360 degree directionality to provide features needed for mass notification and emergency warning capabilities. The LRAD 360º is targeted for market applications including campus, border and perimeter security, tsunami, hurricane and tornado warnings, bird safety and control, and asset protection.

Overall Business Outlook

We continue to experience positive responses to our expanding LRAD-X product line and increased global acceptance of our LRAD products. We believe we have a solid technology and product foundation for business growth. We have strong market opportunities within the government, military and commercial maritime sectors due to increasing terrorist and piracy activity and growing global unrest. We are also experiencing growing interest from wind farms and mining operations with wildlife safety and control issues. We have continued to strengthen our selling network through the addition of in-house business development talent as well as key integrators and sales representatives within the U.S. and in a number of worldwide locations. However, we continue to face challenges in fiscal 2012 due to international market conditions that severely restrict credit and disrupt major economies, as well as uncertainty within the U.S. government budgeting process and restrictions that may be placed on military spending. A further or continued deterioration in financial markets and confidence in major economies, continued delays in U.S. government spending or extended reductions in military spending could negatively impact the expected continued growth of our business.

Critical Accounting Policies

We have identified a number of accounting policies as critical to our business operations and the understanding of our results of operations. These are described in our consolidated financial statements located in Management s Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended September 30, 2011. The impact and any associated risks related to these policies on our business operations is discussed below and throughout Management s Discussion and Analysis of Financial Condition and Results of Operations when such policies affect our reported and expected financial results.

The methods, estimates and judgments we use in applying our accounting policies, in conformity with generally accepted accounting principles in the U.S., have a significant impact on the results we report in our financial statements. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. The estimates affect the carrying values of assets and liabilities. Actual results may differ from these estimates under different assumptions or conditions.

Comparison of Results of Operations for the Three Months Ended March 31, 2012 and 2011

Revenues

The following table sets forth for the periods indicated certain items of our condensed consolidated statement of operations expressed in dollars and as a percentage of net revenues. The financial information and the discussion below should be read in conjunction with the condensed consolidated financial statements and notes contained in this report.

	Three months ended					
	March 31, 2012		March 31, 2011		Increase/(Decrease)	
	Amount	% of Net Revenue	Amount	% of Net Revenue	Amount	%
Revenues:						
Product sales	$ 2,340,731	97.5%	$ 15,297,871	98.7%	$ (12,957,140)	(84.7%)
Contract and other	59,710	2.5%	205,204	1.3%	(145,494)	(70.9%)
	2,400,441	100.0%	15,503,075	100.0%	(13,102,634)	(84.5%)
Cost of revenues	1,083,438	45.1%	4,635,260	29.9%	(3,551,822)	(76.6%)
Gross profit	1,317,003	54.9%	10,867,815	70.1%	(9,550,812)	(87.9%)
Operating Expenses:						
Selling, general and administrative	1,193,294	49.7%	4,390,379	28.3%	(3,197,085)	(72.8%)
Research and development	429,390	17.9%	665,690	4.3%	(236,300)	(35.5%)
	1,622,684	67.6%	5,056,069	32.6%	(3,433,385)	(67.9%)
(Loss) income from operations	(305,681)	(12.7%)	5,811,746	37.5%	(6,117,427)	(105.3%)
Other Income	6,778	0.3%	4,506	0.0%	2,272	50.4%
(Loss) income from continuing operations before income taxes	(298,903)	(12.5%)	5,816,252	37.5%	(6,115,155)	(105.1%)
Income tax (benefit) expense	(7,015)	(0.3%)	112,095	0.7%	(119,110)	(106.3%)
Income from discontinued operations		0.0%	105	0.0%	(105)	(100.0%)
Net income	$ (291,888)	(12.2%)	$ 5,704,262	36.8%	$ (5,996,150)	(105.1%)

The decrease in revenues was primarily due to a $12.1 million order that was delivered in the quarter ended March 31, 2011, that was not repeated in the quarter ended March 31, 2012. Due to the budgetary cycles of our customer base and the lack of established markets for our proprietary products, we expect continued uneven quarterly revenues in future periods.

At March 31, 2012, we had aggregate deferred revenue of $272,665 representing $270,559 collected from a license agreement in advance of recognized revenue and $2,106 of customer prepayments. This revenue component is subject to significant variability based on the timing, amount and recognition of new arrangements or payment terms.

Gross Profit

The decrease in gross profit in the quarter was primarily due to a much higher margin in the prior year as a result of the $12.1 million foreign military order in the quarter, lower product cost due to volume pricing, and higher fixed absorption due to the increased production levels to fulfill the large foreign military order. The gross profit in the quarter ended March 31, 2012, included a reduction in the warranty reserve upon completion of the one year warranty period for the large foreign military order, compared to an increase for the reserve in the prior year and lower freight cost, offset by an increase for amortization of prepaid expenses to support the large military sale in fiscal 2011.

Our products have varying gross margins, so product sales mix will materially affect gross profits. In addition, our margins vary based on the sales channels through which our products are sold in a given period. We continue to implement product updates and changes, including raw material and component changes that may impact product costs. With such product updates and changes we have limited warranty cost experience and estimated future warranty costs can impact our gross margins. We do not believe that historical gross profit margins should be relied upon as an indicator of future gross profit margins.

Selling, General and Administrative Expenses

Selling, general and administrative expenses reflected a $2,959,376 reduction in commission expense, primarily related to the large military order in the prior year, and a $316,100 reduction in bonus expense as a result of not meeting current year performance targets, offset by an increase in bad debt expense due to a $50,819 recovery in the prior year and a $40,972 increase in non-cash share-based compensation expense.

We incurred non-cash share-based compensation expenses allocated to selling, general and administrative expenses in the three months ended March 31, 2012 and 2011 of $117,803 and $76,831, respectively.

We may expend additional resources on the marketing and selling of our products in future periods as we identify ways to optimize potential opportunities. In addition, commission expenses will fluctuate based on the nature of our sales. This may result in increased selling, general and administrative expenses in the future.

Research and Development Expenses

Research and development expenses decreased by $166,216 for bonus expense as a result of not meeting current year performance targets, $31,133 due to lower product development costs and $22,396 due to lower salaries.

Included in research and development expenses for the three months ended March 31, 2012 and 2011 was $14,137 and $14,206 of non-cash share-based compensation costs, respectively.

Each quarter, we review the ongoing value of our capitalized patent costs and in the second fiscal quarter we identified some of these assets as being associated with patents that are no longer consistent with our business strategy. As a result of this review, we reduced the value of our previously capitalized patents by $580 during the quarter ended March 31, 2012, compared to an impairment of $18,685 in the three months ended March 31, 2011.

Research and development costs vary period to period due to the timing of projects, the availability of funds for research and development and the timing and extent of the use of outside consulting, design and development firms. We continually improve our product offerings and we have further expanded the product line-up in 2012 and 2011 with new products, customizations and enhancements. Based on current plans, we expect research and development costs to continue in the current fiscal year on a basis comparable to the prior year.

(Loss) Income from Operations

The decrease in income from operations was primarily attributable to the decrease in revenues and gross margin, partially offset by a reduction in operating expenses.

Other Income

During the three months ended March 31, 2012, we earned $2,272 more in interest income from our cash and cash equivalents balances compared to the three months ended March 31, 2011 as a result of a higher balance in interest bearing accounts.

Net (Loss) Income

The decrease in net income was primarily the result of lower revenues and gross margin in the quarter, partially offset by a reduction in operating expenses. We also recognized an income tax benefit of $7,015 during the quarter ended March 31, 2012, compared to an income tax provision of $112,095 in the quarter ended March 31, 2011, based on the taxable loss and income during the respective quarters.

Comparison of Results of Operations for the Six Months Ended March 31, 2012 and 2011

Revenues

The following table sets forth for the periods indicated certain items of our condensed consolidated statement of operations expressed in dollars and as a percentage of net revenues. The financial information and the discussion below should be read in conjunction with the condensed consolidated financial statements and notes contained in this report.

	Six months ended					
	March 31, 2012		March 31, 2011			
		% of Net		% of Net	Increase/(Decrease)	
	Amount	Revenue	Amount	Revenue	Amount	%
Revenues:						
Product sales	$ 5,885,784	97.9%	$ 17,435,860	98.5%	$ (11,550,076)	(66.2%)
Contract and other	126,292	2.1%	272,603	1.5%	(146,311)	(53.7%)
	6,012,076	100.0%	17,708,463	100.0%	(11,696,387)	(66.0%)
Cost of revenues	2,946,479	49.0%	5,848,273	33.0%	(2,901,794)	(49.6%)
Gross profit	3,065,597	51.0%	11,860,190	67.0%	(8,794,593)	(74.2%)
Operating Expenses:						
Selling, general and administrative	2,249,853	37.4%	5,444,105	30.7%	(3,194,252)	(58.7%)
Research and development	810,708	13.5%	1,044,910	5.9%	(234,202)	(22.4%)
	3,060,561	50.9%	6,489,015	36.6%	(3,428,454)	(52.8%)
Income from operations	5,036	0.1%	5,371,175	30.3%	(5,366,139)	(99.9%)
Other Income	19,722	0.3%	8,190	0.0%	11,532	140.8%
Income from continuing operations before income taxes	24,758	0.4%	5,379,365	30.4%	(5,354,607)	(99.54%)
Income tax expense	2,700	0.0%	112,095	0.6%	(109,395)	(97.6%)
Income from discontinued operations	-	0.0%	81,625	0.5%	(81,625)	(100.0%)
Net income	$ 22,058	0.4%	$ 5,348,895	30.2%	$ (5,326,837)	(99.6%)

The decrease in revenues was primarily attributable to the shipment of $12.1 million of LRAD systems to a foreign military during the six-month period ended March 31, 2011 that was not repeated in the current year. We expect continued uneven quarterly revenues in future periods due to the lack of established markets for our proprietary products.

At March 31, 2012, we had aggregate deferred revenue of $272,665 representing $270,559 collected from a license agreement in advance of recognized revenue and $2,106 of customer prepayments. This revenue component is subject to significant variability based on the timing, amount and recognition of new arrangements or payment terms.

Gross Profit

The decrease in gross profit was primarily due to a much higher margin in the prior year as a result of the $12.1 million foreign military order, lower product cost due to volume pricing, and higher fixed absorption due to the increased production levels to fulfill the large foreign military order. The gross profit in the six-months ended March 31, 2012, included a reduction in the warranty reserve upon completion of the one year warranty period for the large foreign military order, compared to an increase for the reserve in the prior year, and lower freight cost, offset by an increase for amortization of prepaid expenses to support the large military sale in fiscal 2011.

Our products have varying gross margins, so product sales mix will materially affect gross profits. In addition, our margins vary based on the sales channels through which our products are sold in a given period. We continue to make product updates and changes, including raw material and component changes that may impact product costs. With such product updates and changes we have limited warranty cost experience and estimated future warranty costs can impact our gross margins. We do not believe that historical gross profit margins should be relied upon as an indicator of future gross profit margins.

Selling, General and Administrative Expenses

The decrease in selling general and administrative expenses was primarily attributed to a decrease of $2,939,397 for sales commission, primarily related to the foreign military sale, $316,095 decrease in bonus expense as a result of not meeting current year performance targets, and a decrease in bank fees due to higher fees in the prior year for bank guarantees related to the foreign military sale, partially offset by a $71,185 increase in non-cash share-based compensation expense for new option grants and a $34,571 increase in salaries and consultants due to an increase in business development staff.

We incurred non-cash share-based compensation expenses allocated to selling, general and administrative expenses in the six months ended March 31, 2012 and 2011 of $236,202 and $165,017, respectively.

We may expend additional resources on the marketing and selling of our products in future periods as we identify ways to optimize potential opportunities. In addition, commission expenses may fluctuate based on the nature of our sales. This may result in increased selling, general and administrative expenses in the future.

Research and Development Expenses

The decrease in research and development expense was primarily due to a $166,216 decrease in accrued bonuses as a result of not meeting current year performance targets, $28,279 due to decreased staffing, $15,153 decrease in development costs and $9,236 for reduced patent impairment costs and other reductions.

Included in research and development expenses for the six months ended March 31, 2012 and 2011 was $28,143 and $32,501 of non-cash share-based compensation costs, respectively.

Each quarter, we review the ongoing value of our capitalized patent costs and in the current fiscal year to date identified some of these assets as being associated with patents that are no longer consistent with our business strategy. As a result of this review, we reduced the value of our previously capitalized patents by $11,197 during the six months ended March 31, 2012, compared to an impairment of $20,433 in the six months ended March 31, 2011.

Research and development costs vary period to period due to the timing of projects, the availability of funds for research and development and the timing and extent of the use of outside consulting, design and development firms. We continually improve our product offerings and we have further expanded the product line-up in recent years with new products, customizations and enhancements. Based on current plans, we expect research and development costs to continue in the current fiscal year on a basis comparable to the prior year.

Income from Operations

The decrease in income from operations was primarily attributable to the decrease in revenues and gross margin, partially offset by decreased operating expense.

Other Income

During the six months ended March 31, 2012, we earned $11,532 more in interest income from our cash and cash equivalents balances compared to the six months ended March 31, 2011.

Net Income

The decrease in net income was primarily the result of decreased revenues and gross margins, partially offset by decreased operating expenses. In addition, we recorded an income tax provision of $2,700 during the six months ended March 31, 2012, compared to a provision of $112,095 in the six months ended March 31, 2011.

Liquidity and Capital Resources

Cash and cash equivalents at March 31, 2012 was $13,884,772, compared to $13,870,762 at September 30, 2011. In addition, at March 31, 2011, we had $645,656 of cash, which we pledged to support bank guarantees related to a customer sales contract that was previously included as cash and cash equivalents. We reclassified $606,250 as restricted cash in the year ended September 30, 2011 and $39,406 in the quarter ended March 31, 2012. We expect the $606,250 to be reclassified as cash and cash equivalents during the fiscal year ended September 30, 2012. The change in cash and cash equivalents was primarily the result of a reduction in accounts receivable from strong year-end shipments in September 30, 2011, offset by a reduction in accrued liabilities as a result of the payment of fiscal 2011 bonuses and related payroll taxes. Cash, inventory and accounts receivable are our sources of liquidity at this time.

At March 31, 2012 and 2011, exclusive of discontinued operations, our current assets exceeded our current liabilities by $19,434,344 and $19,034,868, respectively.

Principal factors that could affect the availability of our internally generated funds include:

- ability to meet sales projections;
- government spending levels;

- introduction of competing technologies;
- product mix and effect on margins;
- ability to reduce current inventory levels; and
- product acceptance in new markets.

Principal factors that could affect our ability to obtain cash from external sources include:

- volatility in the capital markets; and
- market price and trading volume of our common stock.

Based on our current cash position, and assuming currently planned expenditures and level of operations, we believe we have sufficient capital to fund operations for the next twelve months. However, we operate in a rapidly evolving and unpredictable business environment that may change the timing or amount of expected future cash receipts and expenditures. Accordingly, there can be no assurance that we may not be required to raise additional funds through the sale of equity or debt securities or from credit facilities. Additional capital, if needed, may not be available on satisfactory terms, or at all.

Cash Flows

Operating Activities

Our net cash provided by operating activities from continuing operations was $40,197 for the six months ended March 31, 2012, compared to $1,462,335 for the six months ended March 31, 2011, which included $22,058 of net income, increased by expenses not requiring the use of cash of $194,985, $2,964,885 from reduced accounts receivable and $134,920 from reduced current and non-current prepaid expenses. Our net cash used in operating activities included $2,261,030 for reduced accrued liabilities, which was primarily for a reduction of payroll liabilities for the payout of the fiscal year 2011 bonus payment in the first fiscal quarter of 2012, $602,704 for reduced accounts payable, $358,497 for increased inventory, $15,014 for increased warranty settlements and $39,406 for the increase in restricted cash. Operating cash provided by continuing operations during the six months ended March 31, 2011 included $5,267,270 of net income, increased by expenses not requiring the use of cash of $416,214, and 1,797,555 from reduced accounts receivable. Our net cash used in operating activities included $3,031,250 for increased restricted cash, $1,906,151 for increased current and non-current prepaid expenses primarily related to warranty services to support our foreign military contract, $513,522 for increased inventory, $439,871 for decreased accrued liabilities, $106,583 for decreased accounts payable and $21,327 for increased warranty settlements.

At March 31, 2012, we had net accounts receivable of $2,133,263, compared to $5,098,148 in accounts receivable at September 30, 2011. The level of trade accounts receivable for the quarter ended March 31, 2012 represented approximately 81 days of revenue, compared to 73 days of revenue for the quarter ended September 30, 2011. Our receivables can vary significantly due to overall sales volumes and due to quarterly variations in sales and timing of shipments to and receipts from large customers and the timing of contract payments.

Investing Activities

We use cash in investing activities primarily for the purchase of tooling, computer equipment and software, and investment in new or existing patents. Cash used in investing activities for equipment and patents was $23,174 for the six months ended March 31, 2012 and $22,620 for the six months ended March 31, 2011. We anticipate some additional expenditure for equipment and patents during the balance of fiscal year 2012.

Financing Activities

In the six months ended March 31, 2012, we did not receive any proceeds from financing activities. We received $4,346,613 and $109,910 from the exercise of common stock warrants and stock options in the six months ended March 31, 2011, respectively.

Recent Accounting Pronouncements

There were no adopted or pending recent accounting pronouncements that are expected to have a material impact on our consolidated financial statements for the six months ended March 31, 2012.

Item 3. Qualitative and Quantitative Disclosures about Market Risk.

Interest Rate Risk

The Company s interest income is sensitive to fluctuations in the general level of U.S. interest rates. Changes in U.S. interest rates affect the interest earned on the Company s cash and cash equivalents. The Company s exposure to market risk for changes in interest rates is minimal as a result of maintaining cash in savings accounts and short term money market accounts. The Company currently does not have any debt that could be subject to interest fluctuation or market risk.

Foreign Currency Risk

We consider our direct exposure to foreign exchange rate fluctuations to be minimal. Currently, all sales to customers and all arrangements with third-party manufacturers, with one exception, provide for pricing and payment in U.S. dollars, and, therefore, are not subject to exchange rate fluctuations. Increases in the value of the U.S. dollar relative to other currencies could make our products more expensive, which could negatively impact our ability to compete. Conversely, decreases in the value of the U.S. dollar relative to other currencies could result in our suppliers raising their prices to continue doing business with us. Fluctuations in currency exchange rates could affect our business in the future.

Item 4. Controls and Procedures.

We are required to maintain disclosure controls and procedures designed to ensure that material information related to us, including our consolidated subsidiaries, is recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms.

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our principal executive officer and our principal financial officer, we conducted an evaluation of our disclosure controls and procedures as such term is defined under Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934. Based on this evaluation, our principal executive officer and our principal financial officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level as of March 31, 2012.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal control over financial reporting during our fiscal quarter ended March 31, 2012 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Our process for evaluating controls and procedures is continuous and encompasses constant improvement of the design and effectiveness of established controls and procedures and the remediation of any deficiencies, which may be identified during this process.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

We may at times be involved in litigation in the ordinary course of business. We will also, from time to time, when appropriate in management s estimation, record adequate reserves in our financial statements for pending litigation. Currently, there are no pending material legal proceedings to which we are party or to which any of our property is subject.

Item 1A. Risk Factors

As a Smaller Reporting Company as defined by Rule 12b-2 of the Exchange Act and in item 10(f)(1) of Regulation S-K, we are electing scaled disclosure reporting obligations and therefore are not required to provide the information requested by this item.

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

None.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Mine Safety Disclosures

Not Applicable.

Item 5. Other Information.

None.

Item 6. Exhibits

31.1	Certification of Thomas R. Brown, Principal Executive Officer, pursuant to Rule 13a-14(a) or 15d-14(a) of the Securities and Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.*
31.2	Certification of Katherine H. McDermott, Principal Financial Officer, pursuant to Rule 13a-14(a) or 15d-14(a) of the Securities and Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.*
32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, executed by Thomas R. Brown, Principal Executive Officer and Katherine H. McDermott, Principal Financial Officer.*

99.1	Press release dated May 7, 2012 regarding fiscal Q2 2012 financial results. (This exhibit has been furnished and shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, nor shall it be deemed incorporated by reference in any filing under the Securities Act of 1933, except as shall be expressly set forth by specific reference in such filing.)*
101.INS**	XBRL Instance Document
101.SCH**	SBRL Taxonomy Extension Schema Document
101.CAL**	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB**	XBRL Taxonomy Extension Label Linkbase Document
101.PRE**	XBRL Taxonomy Extension Presentation Linkbase Document

* Filed concurrently herewith.

** Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934 and otherwise are not subject to liability.

SIGNATURES

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

LRAD CORPORATION

Date: May 7, 2012

By: /s/ KATHERINE H. MCDERMOTT

Katherine H. McDermott, Chief Financial Officer
(Principal Financial Officer)

> above $0.90 $ 27,000,000 $ 4,663,400 $ 547,586 $ $ 5,210,986 $ 32,210,986

Our general partner will be entitled to cause the minimum quarterly distribution amount and the target distribution levels to be reset on more than one occasion, provided that it may not make a reset election except at a time when it has received incentive distributions for the prior four consecutive fiscal quarters based on the highest level of incentive distributions that it is entitled to receive under our partnership agreement.

Percentage Allocations of Available Cash from Operating Surplus

The following table illustrates the percentage allocations of available cash from operating surplus between the unitholders and our general partner based on the specified target distribution levels. The amounts set forth under Marginal Percentage Interest in Distributions are the percentage interests of our general partner and the unitholders in any available cash from operating surplus we distribute up to and including the corresponding amount in the column Total Quarterly Distribution Per Unit, until available cash from operating surplus we distribute reaches the next target distribution level, if any. The percentage interests shown for the unitholders and the general partner for the minimum quarterly distribution are also applicable to quarterly distribution amounts that are less than the minimum quarterly distribution. The percentage interests set forth below for our general partner assumes a 1.7% general partner interest and assumes that our general partner has contributed any additional capital to maintain its 1.7% general partner interest and has not transferred its incentive distribution rights.

	Total Quarterly Distribution per Unit	**Marginal Percentage Interest in Distributions**	
	Target Amount	**Unitholders**	**General Partner**
Minimum Quarterly Distribution	$0.35	98.3%	1.7%
First Target Distribution	up to $0.4025	98.3%	1.7%
Second Target Distribution	above $0.4025 up to $0.4375	85.3%	14.7%
Third Target Distribution	above $0.4375 up to $0.525	75.3%	24.7%
Thereafter	above $0.525	50.3%	49.7%

Distributions from Capital Surplus

How Distributions from Capital Surplus Will Be Made. Our partnership agreement requires that we make distributions of available cash from capital surplus, if any, in the following manner:

first, to all unitholders and the general partner, in accordance with their pro rata interest, until we distribute for each common unit that was issued in our initial public offering, an amount of available cash from capital surplus equal to the initial public offering price;

second, to the common unitholders and the general partner, in accordance with their pro rata interest, until we distribute for each common unit, an amount of available cash from capital surplus equal to any unpaid arrearages in payment of the minimum quarterly distribution on the common units; and

thereafter, we will make all distributions of available cash from capital surplus as if they were from operating surplus.

Effect of a Distribution from Capital Surplus. Our partnership agreement treats a distribution of capital surplus as the repayment of the initial unit price from this initial public offering, which is a return of capital. The initial public offering price less any distributions of capital surplus per unit is referred to as the unrecovered initial unit price. Each time a distribution of capital surplus is made, the minimum quarterly distribution and the target distribution levels will be reduced in the same proportion as the corresponding reduction in the unrecovered initial unit price. Because distributions of capital surplus will reduce the minimum quarterly distribution, after any of these distributions are made, it may be easier for the general partner to receive incentive distributions and for the subordinated units to convert into common units. However, any distribution of capital surplus before the unrecovered initial unit price is reduced to zero cannot be applied to the payment of the minimum quarterly distribution or any arrearages.

Once we distribute capital surplus on a unit issued in our initial public offering in an amount equal to the initial unit price, our partnership agreement specifies that the minimum quarterly distribution and the target distribution levels will be reduced to zero. Our partnership agreement specifies that we then make all future distributions from operating surplus, with 48% being paid to the general partner, plus the general partner s pro rata interest, and the remainder being paid to all unitholders. This assumes the general partner has not transferred the incentive distribution rights.

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Adjustment to the Minimum Quarterly Distribution and Target Distribution Levels

In addition to adjusting the minimum quarterly distribution and target distribution levels to reflect a distribution of capital surplus, if we combine our units into fewer units or subdivide our units into a greater number of units, our partnership agreement specifies that the following items will be proportionately adjusted:

- the minimum quarterly distribution;
- target distribution levels;
- the unrecovered initial unit price;
- the number of common units issuable during the subordination period without a unitholder vote; and
- the number of common units into which a subordinated unit is convertible.

For example, if a two-for-one split of the common units should occur, the minimum quarterly distribution, the target distribution levels and the unrecovered initial unit price would each be reduced to 50% of its initial level, the number of common units issuable during the subordination period without unitholder vote would double and each subordinated unit would be convertible into two common units. Our partnership agreement provides that we not make any adjustment by reason of the issuance of additional units for cash or property.

In addition, if legislation is enacted or if existing law is modified or interpreted by a governmental taxing authority, so that we become taxable as a corporation or otherwise subject to taxation as an entity for federal, state or local income tax purposes, our partnership agreement specifies that the minimum quarterly distribution and the target distribution levels for each quarter will be reduced by multiplying each distribution level by a fraction, the numerator of which is available cash for that quarter and the denominator of which is the sum of available cash for that quarter plus the general partner s estimate of our aggregate liability for the quarter for such income taxes payable by reason of such legislation or interpretation. To the extent that the actual tax liability differs from the estimated tax liability for any quarter, the difference will be accounted for in subsequent quarters.

Distributions of Cash Upon Liquidation

General. If we dissolve in accordance with the partnership agreement, we will sell or otherwise dispose of our assets in a process called liquidation. We will first apply the proceeds of liquidation to the payment of our creditors. We will distribute any remaining proceeds to the unitholders and the general partner, in accordance with their capital account balances, as adjusted to reflect any gain or loss upon the sale or other disposition of our assets in liquidation.

The allocations of gain and loss upon liquidation are intended, to the extent possible, to entitle the holders of outstanding common units to a preference over the holders of outstanding subordinated units upon our liquidation, to the extent required to permit common unitholders to receive their unrecovered initial unit price plus the minimum quarterly distribution for the quarter during which liquidation occurs plus any unpaid arrearages in payment of the minimum quarterly distribution on the common units. However, there may not be sufficient gain upon our liquidation to enable the holders of common units to fully recover all of these amounts, even though there may be cash available for distribution to the holders of subordinated units. Any further net gain recognized upon liquidation will be allocated in a manner that takes into account the incentive distribution rights of the general partner.

Manner of Adjustments for Gain. The manner of the adjustment for gain is set forth in the partnership agreement. If our liquidation occurs before the end of the subordination period, we will allocate any gain to the partners in the following manner:

first, to the general partner and the holders of units who have negative balances in their capital accounts to the extent of and in proportion to those negative balances;

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second, to the common unitholders and the general partner, in accordance with their pro rata interest, until the capital account for each common unit is equal to the sum of: (1) the unrecovered initial unit price; (2) the amount of the minimum quarterly distribution for the quarter during which our liquidation occurs; and (3) any unpaid arrearages in payment of the minimum quarterly distribution;

third, to the subordinated unitholders and the general partner, in accordance with their pro rata interest, until the capital account for each subordinated unit is equal to the sum of: (1) the unrecovered initial unit price; and (2) the amount of the minimum quarterly distribution for the quarter during which our liquidation occurs;

fourth, to all unitholders and the general partner, in accordance with their pro rata interest, until we allocate under this paragraph an amount per unit equal to: (1) the sum of the excess of the first target distribution per unit over the minimum quarterly distribution per unit for each quarter of our existence; less (2) the cumulative amount per unit of any distributions of available cash from operating surplus in excess of the minimum quarterly distribution per unit that we distributed to the unitholders and the general partner, in accordance with their pro rata interest, for each quarter of our existence;

fifth, 13% to the general partner, plus the general partner s pro rata interest, and the remainder to all unitholders pro rata, until we allocate under this paragraph an amount per unit equal to: (1) the sum of the excess of the second target distribution per unit over the first target distribution per unit for each quarter of our existence; less (2) the cumulative amount per unit of any distributions of available cash from operating surplus in excess of the first target distribution per unit that we distributed 13% to the general partner, plus the general partner s pro rata interest, and the remainder to all unitholders pro rata for each quarter of our existence;

sixth, 23% to the general partner, plus the general partner s pro rata interest, and the remainder to all unitholders pro rata, until we allocate under this paragraph an amount per unit equal to: (1) the sum of the excess of the third target distribution per unit over the second target distribution per unit for each quarter of our existence; less (2) the cumulative amount per unit of any distributions of available cash from operating surplus in excess of the second target distribution per unit that we distributed 23% to the general partner, plus the general partner s pro rata interest, and the remainder to all unitholders pro rata for each quarter of our existence; and

thereafter, 48% to the general partner, plus the general partner s pro rata interest, and the remainder to all unitholders.

If the liquidation occurs after the end of the subordination period, the distinction between common units and subordinated units will disappear, so that clause (3) of the second bullet point above and all of the third bullet point above will no longer be applicable.

Manner of Adjustments for Losses. If our liquidation occurs before the end of the subordination period, we will generally allocate any loss to the general partner and the unitholders in the following manner:

first, to holders of subordinated units in proportion to the positive balances in their capital accounts and the general partner, in accordance with their pro rata interest, until the capital accounts of the subordinated unitholders have been reduced to zero;

second, to the holders of common units in proportion to the positive balances in their capital accounts and the general partner, in accordance with their pro rata interest, until the capital accounts of the common unitholders have been reduced to zero; and *thereafter,* 100% to the general partner.

If the liquidation occurs after the end of the subordination period, the distinction between common units and subordinated units will disappear, so that all of the first bullet point above will no longer be applicable.

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Adjustments to Capital Accounts. Our partnership agreement requires that we make adjustments to capital accounts upon the issuance of additional units. In this regard, our partnership agreement specifies that we allocate any unrealized and, for tax purposes, unrecognized gain or loss resulting from the adjustments to the unitholders and the general partner in the same manner as we allocate gain or loss upon liquidation. In the event that we make positive adjustments to the capital accounts upon the issuance of additional units, our partnership agreement requires that we allocate any later negative adjustments to the capital accounts resulting from the issuance of additional units or upon our liquidation in a manner which results, to the extent possible, in the general partner s capital account balances equaling the amount which they would have been if no earlier positive adjustments to the capital accounts had been made.

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MATERIAL TAX CONSEQUENCES

This section is a summary of the material tax consequences that may be relevant to prospective unitholders who are individual citizens or residents of the United States and, unless otherwise noted in the following discussion, is the opinion of Vinson & Elkins L.L.P., counsel to our general partner and us, insofar as it relates to legal conclusions with respect to matters of United States federal income tax law. This section is based upon current provisions of the Internal Revenue Code, existing and proposed regulations to the extent noted and current administrative rulings and court decisions, all of which are subject to change. Later changes in these authorities may cause the tax consequences to vary substantially from the consequences described below. Unless the context otherwise requires, references in this section to us or we are to DCP Midstream Partners and the operating partnership.

This section does not address all federal income tax matters that affect us or the unitholders. Furthermore, this section focuses on unitholders who are individual citizens or residents of the United States and has only limited application to corporations, estates, trusts, non-resident aliens or other unitholders subject to specialized tax treatment, such as tax-exempt institutions, foreign persons, individual retirement accounts (IRAs), real estate investment trusts (REITs) or mutual funds. Accordingly, each prospective unitholder is urged to consult, and depend on, his own tax advisor in analyzing the federal, state, local and foreign tax consequences particular to him of the ownership or disposition of common units.

All statements as to matters of law and legal conclusions, but not as to factual matters, contained in this section, unless otherwise noted, are the opinion of Vinson & Elkins L.L.P. and are based on the accuracy of the representations made by us.

No ruling has been or will be requested from the IRS regarding any matter that affects us or prospective unitholders. Instead, we will rely on opinions and advice of Vinson & Elkins L.L.P. Unlike a ruling, an opinion of counsel represents only that counsel s best legal judgment and does not bind the IRS or the courts. Accordingly, the opinions and statements made herein may not be sustained by a court if contested by the IRS. Any contest of this sort with the IRS may materially and adversely impact the market for the common units and the prices at which common units trade. In addition, the costs of any contest with the IRS, principally legal, accounting and related fees, will result in a reduction in cash available for distribution to our unitholders and our general partner and thus will be borne directly or indirectly by the unitholders and the general partner. Furthermore, the tax treatment of us, or of an investment in us, may be significantly modified by future legislative or administrative changes or court decisions. Any modifications may or may not be retroactively applied.

For the reasons described below, Vinson & Elkins L.L.P. has not rendered an opinion with respect to the following specific federal income tax issues:

(1) the treatment of a unitholder whose common units are loaned to a short seller to cover a short sale of common units (please read Tax Consequences of Unit Ownership Treatment of Short Sales);

(2) whether our monthly convention for allocating taxable income and losses is permitted by existing Treasury Regulations (please read Disposition of Common Units Allocations Between Transferors and Transferees); and

(3) whether our method for depreciating Section 743 adjustments is sustainable in certain cases (please read Tax Consequences of Unit Ownership Section 754 Election).

Partnership Status

A partnership is not a taxable entity and incurs no federal income tax liability. Instead, each partner of a partnership is required to take into account his share of items of income, gain, loss and deduction of the partnership in computing his federal income tax liability, regardless of whether cash distributions are made to him by the partnership. Distributions by a partnership to a partner are generally not taxable to the partner unless the amount of cash distributed to him is in excess of his adjusted basis in his partnership interest.

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Section 7704 of the Internal Revenue Code provides that publicly-traded partnerships will, as a general rule, be taxed as corporations. However, an exception, referred to as the Qualifying Income Exception, exists with respect to publicly-traded partnerships of which 90% or more of the gross income for every taxable year consists of qualifying income. Qualifying income includes income and gains derived from the transportation, storage and processing of crude oil, natural gas and products thereof and fertilizer. Other types of qualifying income include interest (other than from a financial business), dividends, gains from the sale of real property and gains from the sale or other disposition of capital assets held for the production of income that otherwise constitutes qualifying income. We estimate that less than 7% of our current gross income is not qualifying income; however, this estimate could change from time to time. Based upon and subject to this estimate, the factual representations made by us and the general partner and a review of the applicable legal authorities, Vinson & Elkins L.L.P. is of the opinion that at least 90% of our current gross income constitutes qualifying income.

No ruling has been or will be sought from the IRS and the IRS has made no determination as to our status or the status of the operating partnership for federal income tax purposes or whether our operations generate qualifying income under Section 7704 of the Internal Revenue Code. Instead, we will rely on the opinion of Vinson & Elkins L.L.P. on such matters. It is the opinion of Vinson & Elkins L.L.P. that, based upon the Internal Revenue Code, its regulations, published revenue rulings and court decisions and the representations set forth below, we will be classified as a partnership and our operating company will be disregarded as an entity separate from us for federal income tax purposes.

In rendering its opinion, Vinson & Elkins L.L.P. has relied on factual representations made by us and the general partner. The representations made by us and our general partner upon which counsel has relied are:

(a) Neither we nor the operating company has elected or will elect to be treated as a corporation;

(b) For each taxable year, more than 90% of our gross income has been and will be income that Vinson & Elkins L.L.P. has opined or will opine is qualifying income within the meaning of Section 7704(d) of the Internal Revenue Code; and

(c) Each hedging transaction that we treat as resulting in qualifying income has been and will be appropriately identified as a hedging transaction pursuant to applicable Treasury Regulations, and has been and will be associated with oil, gas, or products thereof that are held or to be held by us in activities that Vinson & Elkins L.L.P. has opined or will opine result in qualifying income.

If we fail to meet the Qualifying Income Exception, other than a failure that is determined by the IRS to be inadvertent and that is cured within a reasonable time after discovery (in which case the IRS may also require us to make adjustments with respect to our unitholders or pay other amounts) we will be treated as if we had transferred all of our assets, subject to liabilities, to a newly formed corporation, on the first day of the year in which we fail to meet the Qualifying Income Exception, in return for stock in that corporation, and then distributed that stock to the unitholders in liquidation of their interests in us. This deemed contribution and liquidation should be tax-free to unitholders and us so long as we, at that time, do not have liabilities in excess of the tax basis of our assets. Thereafter, we would be treated as a corporation for federal income tax purposes.

If we were treated as an association taxable as a corporation in any taxable year, either as a result of a failure to meet the Qualifying Income Exception or otherwise, our items of income, gain, loss and deduction would be reflected only on our tax return rather than being passed through to the unitholders, and our net income would be taxed to us at corporate rates. In addition, any distribution made to a unitholder would be treated as either taxable dividend income, to the extent of our current or accumulated earnings and profits, or, in the absence of earnings and profits, a nontaxable return of capital, to the extent of the unitholder s tax basis in his common units, or taxable capital gain, after the unitholder s tax basis in his common units is reduced to zero. Accordingly, taxation as a corporation would result in a material reduction in a unitholder s cash flow and after-tax return and thus would likely result in a substantial reduction of the value of the units.

The remainder of this section is based on Vinson & Elkins L.L.P. s opinion that we will be classified as a partnership for federal income tax purposes.

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Unitholders who have become limited partners of DCP Midstream Partners will be treated as partners of DCP Midstream Partners for federal income tax purposes. Also:

(a) assignees who have executed and delivered transfer applications, and are awaiting admission as limited partners, and

(b) unitholders whose common units are held in street name or by a nominee and who have the right to direct the nominee in the exercise of all substantive rights attendant to the ownership of their common units will be treated as partners of DCP Midstream Partners for federal income tax purposes.

As there is no direct or indirect controlling authority addressing the federal tax treatment of assignees of common units who are entitled to execute and deliver transfer applications and thereby become entitled to direct the exercise of attendant rights, but who fail to execute and deliver transfer applications, the opinion of Vinson & Elkins L.L.P. does not extend to these persons. Furthermore, a purchaser or other transferee of common units who does not execute and deliver a transfer application may not receive some federal income tax information or reports furnished to record holders of common units unless the common units are held in a nominee or street name account and the nominee or broker has executed and delivered a transfer application for those common units.

A beneficial owner of common units whose units have been transferred to a short seller to complete a short sale would appear to lose his status as a partner with respect to those units for federal income tax purposes. Please read Tax Consequences of Unit Ownership Treatment of Short Sales.

Income, gain, deductions or losses would not appear to be reportable by a unitholder who is not a partner for federal income tax purposes, and any cash distributions received by a unitholder who is not a partner for federal income tax purposes would therefore appear to be fully taxable as ordinary income. These holders are urged to consult their own tax advisors with respect to their status as partners in DCP Midstream Partners for federal income tax purposes.

Tax Consequences of Unit Ownership

Flow-Through of Taxable Income. We will not pay any federal income tax. Instead, each unitholder will be required to report on his income tax return his share of our income, gains, losses and deductions without regard to whether corresponding cash distributions are received by him. Consequently, we may allocate income to a unitholder even if he has not received a cash distribution. Each unitholder will be required to include in income his allocable share of our income, gains, losses and deductions for our taxable year ending with or within his taxable year. Our taxable year ends on December 31.

Treatment of Distributions. Cash distributions made by us to a unitholder generally will not be taxable to him for federal income tax purposes to the extent of his tax basis in his common units immediately before the distribution. Cash distributions made by us to a unitholder in an amount in excess of his tax basis in his common units generally will be considered to be gain from the sale or exchange of the common units, taxable in accordance with the rules described under Disposition of Common Units below. To the extent that cash distributions made by us cause a unitholder s at risk amount to be less than zero at the end of any taxable year, he must recapture any losses deducted in previous years. Please read Limitations on Deductibility of Losses.

Any reduction in a unitholder s share of our liabilities for which no partner, including the general partner, bears the economic risk of loss, known as nonrecourse liabilities, will be treated as a distribution of cash to that unitholder. A decrease in a unitholder s percentage interest in us because of our issuance of additional common units will decrease his share of our nonrecourse liabilities, and thus will result in a corresponding deemed distribution of cash, which may constitute a non-pro rata distribution. A non-pro rata distribution of money or property may result in ordinary income to a unitholder, regardless of his tax basis in his common units, if the distribution reduces the unitholder s share of our unrealized receivables, including depreciation recapture, and/or substantially appreciated inventory items, both as defined in Section 751 of the Internal Revenue Code, and collectively, Section 751 Assets. To that extent, he will be treated as having been distributed his proportionate share of the Section 751 Assets and then having exchanged those assets with us

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in return for the non-pro rata portion of the actual distribution made to him. This latter deemed exchange will generally result in the unitholder s realization of ordinary income. That income will equal the excess of (1) the non-pro rata portion of that distribution over (2) the unitholder s tax basis (generally zero) for the share of Section 751 Assets deemed relinquished in the exchange.

Basis of Common Units. A unitholder s initial tax basis for his common units will be the amount he paid for the common units plus his share of our nonrecourse liabilities. That basis will be increased by his share of our income and by any increases in his share of our nonrecourse liabilities. That basis will be decreased, but not below zero, by distributions to him from us, by his share of our losses, by any decreases in his share of our nonrecourse liabilities and by his share of our expenditures that are not deductible in computing taxable income and are not required to be capitalized. A unitholder will have no share of our debt that is recourse to the general partner, but will have a share, generally based on his share of profits, of our nonrecourse liabilities. Please read Disposition of Common Units Recognition of Gain or Loss.

Limitations on Deductibility of Losses. The deduction by a unitholder of his share of our losses will be limited to the tax basis in his units and, in the case of an individual unitholder, estate, trust, or a corporate unitholder (if more than 50% of the value of the corporate unitholder s stock is owned directly or indirectly by or for five or fewer individuals or certain tax-exempt organizations) to the amount for which the unitholder is considered to be at risk with respect to our activities, if that is less than his tax basis. A unitholder subject to these limitations must recapture losses deducted in previous years to the extent that distributions cause his at-risk amount to be less than zero at the end of any taxable year. Losses disallowed to a unitholder or recaptured as a result of these limitations will carry forward and will be allowable as a deduction in a later year to the extent that his at-risk amount is subsequently increased provided such losses do not exceed such unitholder s tax basis in his units. Upon the taxable disposition of a unit, any gain recognized by a unitholder can be offset by losses that were previously suspended by the at-risk limitation but may not be offset by losses suspended by the basis limitation. Any loss previously suspended by the at-risk limitations in excess of that gain would no longer be utilizable.

In general, a unitholder will be at risk to the extent of his tax basis in his units, excluding any portion of that basis attributable to his share of our nonrecourse liabilities, reduced by any amount of money he borrows to acquire or hold his units, if the lender of those borrowed funds owns an interest in us, is related to the unitholder or can look only to the units for repayment, or any portion of that basis representing amounts otherwise protected against loss because of a guarantee, stop loss agreement or other similar arrangement. A unitholder s at-risk amount will increase or decrease as the tax basis of the unitholder s units increases or decreases, other than tax basis increases or decreases attributable to increases or decreases in his share of our nonrecourse liabilities.

In addition to the basis and at-risk limitations on the deductibility of losses, the passive loss limitations generally provide that individuals, estates, trusts and some closely-held corporations and personal service corporations are permitted to deduct losses from passive activities, which are generally defined as trade or business activities in which the taxpayer does not materially participate, only to the extent of the taxpayer s income from those passive activities. The passive loss limitations are applied separately with respect to each publicly-traded partnership. Consequently, any passive losses we generate will only be available to offset our passive income generated in the future and will not be available to offset income from other passive activities or investments, including our investments or a unitholder s investments in other publicly-traded partnerships, or salary or active business income. Passive losses that are not deductible because they exceed a unitholder s share of income we generate may generally be deducted in full when he disposes of his entire investment in us in a fully taxable transaction with an unrelated party. Further, a unitholder s share of our net income may be offset by any suspended passive losses from that unitholder s investment in us, but may not be offset by that unitholder s current or carryover losses from other passive activities, including those attributable to other publicly traded partnerships.

The passive loss limitations are applied after other applicable limitations on deductions, including the at-risk rules and the basis limitation.

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Limitations on Interest Deductions. The deductibility of a non-corporate taxpayer s investment interest expense is generally limited to the amount of that taxpayer s net investment income. Investment interest expense includes:

interest on indebtedness properly allocable to property held for investment;

our interest expense attributable to portfolio income; and

the portion of interest expense incurred to purchase or carry an interest in a passive activity to the extent attributable to portfolio income.

The computation of a unitholder s investment interest expense will take into account interest on any margin account borrowing or other loan incurred to purchase or carry a unit. Net investment income includes gross income from property held for investment and amounts treated as portfolio income under the passive loss rules, less deductible expenses, other than interest, directly connected with the production of investment income, but generally does not include gains attributable to the disposition of property held for investment or qualified dividend income. The IRS has indicated that net passive income earned by a publicly-traded partnership will be treated as investment income to its unitholders. In addition, the unitholder s share of our portfolio income will be treated as investment income.

Entity-Level Collections. If we are required or elect under applicable law to pay any federal, state or local income tax on behalf of any unitholder or the general partner or any former unitholder, we are authorized to pay those taxes from our funds. That payment, if made, will be treated as a distribution of cash to the unitholder on whose behalf the payment was made. If the payment is made on behalf of a unitholder whose identity cannot be determined, we are authorized to treat the payment as a distribution to all current unitholders. We are authorized to amend the partnership agreement in the manner necessary to maintain uniformity of intrinsic tax characteristics of units and to adjust later distributions, so that after giving effect to these distributions, the priority and characterization of distributions otherwise applicable under the partnership agreement is maintained as nearly as is practicable. Payments by us as described above could give rise to an overpayment of tax on behalf of a unitholder in which event the unitholder would be required to file a claim in order to obtain a credit or refund.

Allocation of Income, Gain, Loss and Deduction. In general, if we have a net profit, our items of income, gain, loss and deduction will be allocated among the general partner and the unitholders in accordance with their percentage interests in us. At any time that distributions are made to the common units in excess of distributions to the subordinated units, or that incentive distributions are made to the general partner, gross income will be allocated to the recipients to the extent of those distributions. If we have a net loss, that amount of loss will be allocated first to the general partner and the unitholders in accordance with their percentage interests in us to the extent of their positive capital accounts and then to our general partner.

Specified items of our income, gain, loss and deduction will be allocated to account for the difference between the tax basis and fair market value of our assets at the time of an offering, referred to in this discussion as Contributed Property. The effect of these allocations, referred to as Section 704(c) Allocations, to a unitholder who purchases common units from us in an offering will be essentially the same as if the tax basis of our assets were equal to their fair market value at the time of the offering. In the event we issue additional common units or engage in certain other transactions in the future Reverse Section 704(c) Allocations, similar to the Section 704(c) Allocations described above, will be made to all holders of partnership interests immediately prior to such other transactions to account for the difference between a partner s book capital account, credited with the fair market value of our Contributed Property at that time, and tax capital account, credited with the tax basis of our Contributed Property, referred to in this discussion as the Book-Tax Disparity. In addition, items of recapture income will be allocated to the extent possible to the unitholder who was allocated the deduction giving rise to the treatment of that gain as recapture income in order to minimize the recognition of ordinary income by other unitholders. Finally, although we do not expect that our operations will result in the creation of negative capital accounts, if negative capital accounts nevertheless result, items of our income and gain will be allocated in an amount and manner sufficient to eliminate the negative balance as quickly as possible.

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An allocation of items of our income, gain, loss or deduction, other than an allocation required by the Internal Revenue Code to eliminate the Book-Tax Disparity will generally be given effect for federal income tax purposes in determining a partner s share of an item of income, gain, loss or deduction only if the allocation has substantial economic effect. In any other case, a partner s share of an item will be determined on the basis of his interest in us, which will be determined by taking into account all the facts and circumstances, including:

his relative contributions to us;

the interests of all the partners in profits and losses;

the interest of all the partners in cash flow; and

the rights of all the partners to distributions of capital upon liquidation.

Vinson & Elkins L.L.P. is of the opinion that, with the exception of the issues described in Section 754 Election and Disposition of Common Units Allocations Between Transferors and Transferees, allocations under our partnership agreement will be given effect for federal income tax purposes in determining a unitholder s share of an item of income, gain, loss or deduction.

Treatment of Short Sales. A unitholder whose units are loaned to a short seller to cover a short sale of units may be considered as having disposed of those units. If so, he would no longer be treated for tax purposes as a partner with respect to those units during the period of the loan and may recognize gain or loss from the disposition. As a result, during this period:

any of our income, gain, loss or deduction with respect to those units would not be reportable by the unitholder;

any cash distributions received by the unitholder as to those units would be fully taxable; and

all of these distributions would appear to be ordinary income.

Vinson & Elkins L.L.P. has not rendered an opinion regarding the treatment of a unitholder where common units are loaned to a short seller to cover a short sale of common units; therefore, unitholders desiring to assure their status as partners and avoid the risk of gain recognition from a loan to a short seller should modify any applicable brokerage account agreements to prohibit their brokers from loaning their units. The IRS has announced that it is actively studying issues relating to the tax treatment of short sales of partnership interests. Please also read Disposition of Common Units Recognition of Gain or Loss.

Alternative Minimum Tax. Each unitholder will be required to take into account his distributive share of any items of our income, gain, loss or deduction for purposes of the alternative minimum tax. The current minimum tax rate for noncorporate taxpayers is 26% on the first $175,000 of alternative minimum taxable income in excess of the exemption amount and 28% on any additional alternative minimum taxable income. Prospective unitholders are urged to consult with their tax advisors as to the impact of an investment in units on their liability for the alternative minimum tax.

Tax Rates. In general, the highest effective United States federal income tax rate for individuals currently is 35% and the maximum United States federal income tax rate for net capital gains of an individual where the asset disposed of was held for more than twelve months at the time of disposition is currently 15% and is scheduled to remain at 15% for years 2008 through 2010 and then increase to 20% beginning January 1, 2011.

Section 754 Election. We have made the election permitted by Section 754 of the Internal Revenue Code. That election is irrevocable without the consent of the IRS. The election will generally permit us to adjust a common unit purchaser s tax basis in our assets (inside basis) under Section 743(b) of the Internal Revenue Code to reflect his purchase price. The Section 743(b) adjustment does not apply to a person who purchases common units directly from us and it belongs only to the purchaser and not to other unitholders. For purposes of this discussion, a unitholder s inside basis in our assets has two components: (1) his share of our tax basis in our assets (common basis) and (2) his Section 743(b) adjustment to that basis.

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Where the remedial allocation method is adopted (which we have adopted as to property other than certain goodwill properties), the Treasury Regulations under Section 743 of the Internal Revenue Code require a portion of the Section 743(b) adjustment that is attributable to recovery property under Section 168 of the Internal Revenue Code whose book basis is in excess of its tax basis to be depreciated over the remaining cost recovery period for the property s unamortized Book-Tax Disparity. Under Treasury Regulation Section 1.167(c)-l(a)(6), a Section 743(b) adjustment attributable to property subject to depreciation under Section 167 of the Internal Revenue Code, rather than cost recovery deductions under Section 168, is generally required to be depreciated using either the straight-line method or the 150% declining balance method. If we elect a method other than the remedial method, the depreciation and amortization methods and useful lives associated with the Section 743(b) adjustment, therefore, may differ from the methods and useful lives generally used to depreciate the inside basis in such properties. Under our partnership agreement, the general partner is authorized to take a position to preserve the uniformity of units even if that position is not consistent with these and any other Treasury Regulations. Please read Tax Treatment of Operations Uniformity of Units.

Although Vinson & Elkins L.L.P. is unable to opine as to the validity of this approach because there is no direct or indirect controlling authority on this issue, we intend to depreciate the portion of a Section 743(b) adjustment attributable to unrealized appreciation in the value of Contributed Property, to the extent of any unamortized Book-Tax Disparity, using a rate of depreciation or amortization derived from the depreciation or amortization method and useful life applied to the property s unamortized Book-Tax Disparity, or treat that portion as non-amortizable to the extent attributable to property the common basis of which is not amortizable. This method is consistent with the methods employed by other publicly traded partnerships but is arguably inconsistent with Treasury Regulation Section 1.167(c)-1(a)(6), which is not expected to directly apply to a material portion of our assets. To the extent this Section 743(b) adjustment is attributable to appreciation in value in excess of the unamortized Book-Tax Disparity, we will apply the rules described in the Treasury Regulations and legislative history. If we determine that this position cannot reasonably be taken, we may take a depreciation or amortization position under which all purchasers acquiring units in the same month would receive depreciation or amortization, whether attributable to common basis or a Section 743(b) adjustment, based upon the same applicable rate as if they had purchased a direct interest in our assets. This kind of aggregate approach may result in lower annual depreciation or amortization deductions than would otherwise be allowable to some unitholders. Please read Tax Treatment of Operations Uniformity of Units. A unitholder s tax basis for his common units is reduced by his share of our deductions (whether or not such deductions were claimed on an individual s income tax return) so that any position we take that understates deductions will overstate the common unitholder s basis in his common units, which may cause the unitholder to understate gain or overstate loss on any sale of such units. Please read Disposition of Common Units Recognition of Gain or Loss. The IRS may challenge our position with respect to depreciating or amortizing the Section 743(b) adjustment we take to preserve the uniformity of the units. If such a challenge were sustained, the gain from the sale of units might be increased without the benefit of additional deductions.

A Section 754 election is advantageous if the transferee s tax basis in his units is higher than the units share of the aggregate tax basis of our assets immediately prior to the transfer. In that case, as a result of the election, the transferee would have, among other items, a greater amount of depreciation and depletion deductions and his share of any gain or loss on a sale of our assets would be less. Conversely, a Section 754 election is disadvantageous if the transferee s tax basis in his units is lower than those units share of the aggregate tax basis of our assets immediately prior to the transfer. Thus, the fair market value of the units may be affected either favorably or unfavorably by the election. A basis adjustment is required regardless of whether a Section 754 election is made in the case of a transfer of an interest in us if we have a substantial built-in loss immediately after the transfer, or if we distribute property and have a substantial basis reduction. Generally a built-in loss or a basis reduction is substantial if it exceeds $250,000.

The calculations involved in the Section 754 election are complex and will be made on the basis of assumptions as to the value of our assets and other matters. For example, the allocation of the Section 743(b) adjustment among our assets must be made in accordance with the Internal Revenue Code. The IRS could seek to reallocate some or all of any Section 743(b) adjustment allocated by us to our tangible assets to goodwill instead. Goodwill, as an intangible asset, is generally nonamortizable or amortizable over a longer period of time or under a less accelerated method than our tangible assets. We cannot assure you that the determinations we make will not be successfully challenged by the IRS and that the deductions resulting from them will not be reduced or disallowed altogether. Should the IRS require a different basis adjustment to be made, and should, in our opinion, the expense of compliance exceed the benefit of the election, we may seek permission from the IRS to revoke our Section 754 election. If permission is granted, a subsequent purchaser of units may be allocated more income than he would have been allocated had the election not been revoked.

Tax Treatment of Operations

Accounting Method and Taxable Year. We use the year ending December 31 as our taxable year and the accrual method of accounting for federal income tax purposes. Each unitholder will be required to include in income his share of our income, gain, loss and deduction for our taxable year ending within or with his taxable year. In addition, a unitholder who has a taxable year ending on a date other than December 31 and who disposes of all of his units following the close of our taxable year but before the close of his taxable year must include his share of our income, gain, loss and deduction in income for his taxable year, with the result that he will be required to include in income for his taxable year his share of more than one year of our income, gain, loss and deduction. Please read Disposition of Common Units Allocations Between Transferors and Transferees.

Initial Tax Basis, Depreciation and Amortization. The tax basis of our assets will be used for purposes of computing depreciation and cost recovery deductions and, ultimately, gain or loss on the disposition of these assets. The federal income tax burden associated with the difference between the fair market value of our assets and their tax basis immediately prior to an offering will be borne by the general partner, its affiliates and our other unitholders immediately prior to such offering. Please read Tax Consequences of Unit Ownership Allocation of Income, Gain, Loss and Deduction.

To the extent allowable, we may elect to use the depreciation and cost recovery methods that will result in the largest deductions being taken in the early years after assets subject to these allowances are placed in service. Because our general partner may determine not to adopt the remedial method of allocation with respect to any difference between the tax basis and the fair market value of goodwill immediately prior to this or any future offering, we may not be entitled to any amortization deductions with respect to any goodwill conveyed to us on formation or held by us at the time of any future offering. Please read Uniformity of Units. Property we subsequently acquire or construct may be depreciated using accelerated methods permitted by the Internal Revenue Code.

If we dispose of depreciable property by sale, foreclosure, or otherwise, all or a portion of any gain, determined by reference to the amount of depreciation previously deducted and the nature of the property, may be subject to the recapture rules and taxed as ordinary income rather than capital gain. Similarly, a partner who has taken cost recovery or depreciation deductions with respect to property we own will likely be required to recapture some or all of those deductions as ordinary income upon a sale of his interest in us. Please read Tax Consequences of Unit Ownership Allocation of Income, Gain, Loss and Deduction and Disposition of Common Units Recognition of Gain or Loss.

The costs incurred in selling our units (called syndication expenses) must be capitalized and cannot be deducted currently, ratably or upon our termination. There are uncertainties regarding the classification of costs as organization expenses, which we may amortize, and as syndication expenses, which we may not amortize. The underwriting discounts and commissions we incur will be treated as syndication expenses.

Valuation and Tax Basis of Our Properties. The federal income tax consequences of the ownership and disposition of units will depend in part on our estimates of the relative fair market values, and the initial tax bases, of our assets. Although we may from time to time consult with professional appraisers regarding valuation matters, we will make many of the relative fair market value estimates ourselves. These estimates and determinations of basis are subject to challenge and will not be binding on the IRS or the courts. If the estimates of fair market value or basis are later found to be incorrect, the character and amount of items of income, gain, loss or deductions previously reported by unitholders might change, and unitholders might be

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required to adjust their tax liability for prior years and incur interest and penalties with respect to those adjustments.

Disposition of Common Units

Recognition of Gain or Loss. Gain or loss will be recognized on a sale of units equal to the difference between the amount realized and the unitholder s tax basis for the units sold. A unitholder s amount realized will be measured by the sum of the cash or the fair market value of other property he receives plus his share of our nonrecourse liabilities. Because the amount realized includes a unitholder s share of our nonrecourse liabilities, the gain recognized on the sale of units could result in a tax liability in excess of any cash received from the sale.

Prior distributions from us in excess of cumulative net taxable income for a common unit that decreased a unitholder s tax basis in that common unit will, in effect, become taxable income if the common unit is sold at a price greater than the unitholder s tax basis in that common unit, even if the price received is less than his original cost.

Except as noted below, gain or loss recognized by a unitholder, other than a dealer in units, on the sale or exchange of a unit held for more than one year will generally be taxable as long term capital gain or loss. Capital gain recognized by an individual on the sale of units held more than twelve months will generally be taxed at a maximum rate of 15% through December 31, 2010. However, a portion, which will likely be substantial, of this gain or loss will be separately computed and taxed as ordinary income or loss under Section 751 of the Internal Revenue Code to the extent attributable to assets giving rise to depreciation recapture or other unrealized receivables or to inventory items we own. The term unrealized receivables includes potential recapture items, including depreciation recapture. Ordinary income attributable to unrealized receivables, inventory items and depreciation recapture may exceed net taxable gain realized upon the sale of a unit and may be recognized even if there is a net taxable loss realized on the sale of a unit. Thus, a unitholder may recognize both ordinary income and a capital loss upon a sale of units. Net capital loss may offset capital gains and no more than $3,000 of ordinary income, in the case of individuals, and may only be used to offset capital gain in the case of corporations.

The IRS has ruled that a partner who acquires interests in a partnership in separate transactions must combine those interests and maintain a single adjusted tax basis for all those interests. Upon a sale or other disposition of less than all of those interests, a portion of that tax basis must be allocated to the interests sold using an equitable apportionment method, which generally means that the tax basis allocated to the interest sold equals an amount that bears the same relation to the partner s tax basis in his entire interest in the partnership as the value of the interest sold bears to the value of the partner s entire interest in the partnership. Treasury Regulations under Section 1223 of the Internal Revenue Code allow a selling unitholder who can identify common units transferred with an ascertainable holding period to elect to use the actual holding period of the common units transferred. Thus, according to the ruling, a common unitholder will be unable to select high or low basis common units to sell as would be the case with corporate stock, but, according to the regulations, may designate specific common units sold for purposes of determining the holding period of units transferred. A unitholder electing to use the actual holding period of common units transferred must consistently use that identification method for all subsequent sales or exchanges of common units. A unitholder considering the purchase of additional units or a sale of common units purchased in separate transactions is urged to consult his tax advisor as to the possible consequences of this ruling and application of the Treasury Regulations.

Specific provisions of the Internal Revenue Code affect the taxation of some financial products and securities, including partnership interests, by treating a taxpayer as having sold an appreciated partnership interest, one in which gain would be recognized if it were sold, assigned or terminated at its fair market value, if the taxpayer or related persons enter(s) into:

a short sale;

an offsetting notional principal contract; or

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a futures or forward contract with respect to the partnership interest or substantially identical property.

Moreover, if a taxpayer has previously entered into a short sale, an offsetting notional principal contract or a futures or forward contract with respect to the partnership interest, the taxpayer will be treated as having sold that position if the taxpayer or a related person then acquires the partnership interest or substantially identical property. The Secretary of the Treasury is also authorized to issue regulations that treat a taxpayer that enters into transactions or positions that have substantially the same effect as the preceding transactions as having constructively sold the financial position.

Allocations Between Transferors and Transferees. In general, our taxable income and losses will be determined annually, will be prorated on a monthly basis and will be subsequently apportioned among the unitholders in proportion to the number of units owned by each of them as of the opening of the applicable exchange on the first business day of the month (the Allocation Date). However, gain or loss realized on a sale or other disposition of our assets other than in the ordinary course of business will be allocated among the unitholders on the Allocation Date in the month in which that gain or loss is recognized. As a result, a unitholder transferring units may be allocated income, gain, loss and deduction realized after the date of transfer.

Although simplifying conventions are contemplated by the Internal Revenue Code and most publicly traded partnerships use similar simplifying conventions, the use of this method may not be permitted under existing Treasury Regulations. Accordingly, Vinson & Elkins L.L.P. is unable to opine on the validity of this method of allocating income and deductions between transferor and transferee unitholders. If this method is not allowed under the Treasury Regulations, or only applies to transfers of less than all of the unitholder s interest, our taxable income or losses might be reallocated among the unitholders. We are authorized to revise our method of allocation between transferor and transferee unitholders, as well as unitholders whose interests vary during a taxable year, to conform to a method permitted under future Treasury Regulations.

A unitholder who owns units at any time during a quarter and who disposes of them prior to the record date set for a cash distribution for that quarter will be allocated items of our income, gain, loss and deductions attributable to that quarter but will not be entitled to receive that cash distribution.

Notification Requirements. A unitholder who sells any of his units is generally required to notify us in writing of that sale within 30 days after the sale (or, if earlier, January 15 of the year following the sale). A purchaser of units who purchases units from another unitholder is also generally required to notify us in writing of that purchase within 30 days after the purchase. Upon receiving such notifications, we are required to notify the IRS of that transaction and to furnish specified information to the transferor and transferee. Failure to notify us of a purchase may, in some cases, lead to the imposition of penalties. However, these reporting requirements do not apply to a sale by an individual who is a citizen of the United States and who effects the sale or exchange through a broker who will satisfy such requirements.

Constructive Termination. We will be considered to have been terminated for tax purposes if there is a sale or exchange of 50% or more of the total interests in our capital and profits within a twelve-month period. For purposes of determining whether the 50% threshold is reached, multiple sales of the same interest are counted only once. A constructive termination results in the closing of our taxable year for all unitholders. In the case of a unitholder reporting on a taxable year other than a fiscal year ending December 31, the closing of our taxable year may result in more than twelve months of our taxable income or loss being includable in his taxable income for the year of termination. A constructive termination occurring on a date other than December 31 will result in us filing two tax returns (and unitholders receiving two Schedules K-1) for one fiscal year and the cost of the preparation of these returns will be borne by all common unitholders. We would be required to make new tax elections after a termination, including a new election under Section 754 of the Internal Revenue Code, and a termination would result in a deferral of our deductions for depreciation. A termination could also result in penalties if we were unable to determine that the termination had occurred. Moreover, a termination might either accelerate the application of, or subject us to, any tax legislation enacted before the termination.

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Uniformity of Units

Because we cannot match transferors and transferees of units, we must maintain uniformity of the economic and tax characteristics of the units to a purchaser of these units. In the absence of uniformity, we may be unable to completely comply with a number of federal income tax requirements, both statutory and regulatory. A lack of uniformity can result from a literal application of Treasury Regulation Section 1.167(c)-1(a)(6). Any non-uniformity could have a negative impact on the value of the units. Please read Tax Consequences of Unit Ownership Section 754 Election.

We intend to depreciate the portion of a Section 743(b) adjustment attributable to unrealized appreciation in the value of Contributed Property, to the extent of any unamortized Book-Tax Disparity, using a rate of depreciation or amortization derived from the depreciation or amortization method and useful life applied to the property s unamortized Book-Tax Disparity, or treat that portion as nonamortizable, to the extent attributable to property the common basis of which is not amortizable, consistent with the regulations under Section 743 of the Internal Revenue Code, even though that position may be inconsistent with Treasury Regulation Section 1.167(c)-1(a)(6) which is not expected to directly apply to a material portion of our assets. Please read Tax Consequences of Unit Ownership Section 754 Election. To the extent that the Section 743(b) adjustment is attributable to appreciation in value in excess of the unamortized Book-Tax Disparity, we will apply the rules described in the Treasury Regulations and legislative history. If we determine that this position cannot reasonably be taken, we may adopt a depreciation and amortization position under which all purchasers acquiring units in the same month would receive depreciation and amortization deductions, whether attributable to a common basis or Section 743(b) adjustment, based upon the same applicable rate as if they had purchased a direct interest in our property. If this position is adopted, it may result in lower annual depreciation and amortization deductions than would otherwise be allowable to some unitholders and risk the loss of depreciation and amortization deductions not taken in the year that these deductions are otherwise allowable. This position will not be adopted if we determine that the loss of depreciation and amortization deductions will have a material adverse effect on the unitholders. If we choose not to utilize this aggregate method, we may use any other reasonable depreciation and amortization method to preserve the uniformity of the intrinsic tax characteristics of any units that would not have a material adverse effect on the unitholders. The IRS may challenge any method of depreciating the Section 743(b) adjustment described in this paragraph. If this challenge were sustained, the uniformity of units might be affected, and the gain from the sale of units might be increased without the benefit of additional deductions. Please read Disposition of Common Units Recognition of Gain or Loss.

Tax-Exempt Organizations and Other Investors

Ownership of units by employee benefit plans, other tax-exempt organizations, non-resident aliens, foreign corporations, and other foreign persons raises issues unique to those investors and, as described below, may have substantially adverse tax consequences to them.

Employee benefit plans and most other organizations exempt from federal income tax, including individual retirement accounts and other retirement plans, are subject to federal income tax on unrelated business taxable income. Virtually all of our income allocated to a unitholder which is a tax-exempt organization will be unrelated business taxable income and will be taxable to them.

Non-resident aliens and foreign corporations, trusts or estates that own units will be considered to be engaged in business in the United States because of the ownership of units. As a consequence they will be required to file federal tax returns to report their share of our income, gain, loss or deduction and pay federal income tax at regular rates on their share of our net income or gain. Under rules applicable to publicly traded partnerships, we will withhold tax, at the highest effective applicable rate, from cash distributions made quarterly to foreign unitholders. Each foreign unitholder must obtain a taxpayer identification number from the IRS and submit that number to our transfer agent on a Form W-8 or applicable substitute form in order to obtain credit for these withholding taxes. A change in applicable law may require us to change these procedures.

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In addition, because a foreign corporation that owns units will be treated as engaged in a United States trade or business, that corporation may be subject to the United States branch profits tax at a rate of 30%, in addition to regular federal income tax, on its share of our income and gain, as adjusted for changes in the foreign corporation s U.S. net equity, which is effectively connected with the conduct of a United States trade or business. That tax may be reduced or eliminated by an income tax treaty between the United States and the country in which the foreign corporate unitholder is a qualified resident. In addition, this type of unitholder is subject to special information reporting requirements under Section 6038C of the Internal Revenue Code.

A foreign unitholder who sells or otherwise disposes of a unit will be subject to U.S. federal income tax on gain realized from the sale or disposition of that unit to the extent the gain is effectively connected with a U.S. trade or business of the foreign unitholder. Under a ruling published by the IRS, interpreting the scope of effectively connected income, a foreign unitholder would be considered to be engaged in a trade or business in the U.S. by virtue of the U.S. activities of the partnership, and part or all of that unitholder s gain would be effectively connected with that unitholder s indirect U.S. trade or business. Moreover, under the Foreign Investment in Real Property Tax Act, a foreign unitholder of a publicly traded partnership would be subject to U.S. federal income tax or withholding tax upon the sale or disposition of a unit to the extent of the unitholder s share of the partnership s U.S. real property holdings if he owns 5% or more of the units at any point during the five-year period ending on the date of such disposition. Therefore, foreign unitholders may be subject to federal income tax on gain from the sale or disposition of their units.

Administrative Matters

Information Returns and Audit Procedures. We intend to furnish to each unitholder, within 90 days after the close of each calendar year, specific tax information, including a Schedule K-1, which describes his share of our income, gain, loss and deduction for our preceding taxable year. In preparing this information, which will not be reviewed by counsel, we will take various accounting and reporting positions, some of which have been mentioned earlier, to determine his share of income, gain, loss and deduction. We cannot assure you that those positions will yield a result that conforms to the requirements of the Internal Revenue Code, Treasury Regulations or administrative interpretations of the IRS. Neither we nor counsel can assure prospective unitholders that the IRS will not successfully contend in court that those positions are impermissible. Any challenge by the IRS could negatively affect the value of the units.

The IRS may audit our federal income tax information returns. Adjustments resulting from an IRS audit may require each unitholder to adjust a prior year s tax liability, and possibly may result in an audit of his own return. Any audit of a unitholder s return could result in adjustments not related to our returns as well as those related to our returns.

Partnerships generally are treated as separate entities for purposes of federal tax audits, judicial review of administrative adjustments by the IRS and tax settlement proceedings. The tax treatment of partnership items of income, gain, loss and deduction are determined in a partnership proceeding rather than in separate proceedings with the partners. The Internal Revenue Code requires that one partner be designated as the Tax Matters Partner for these purposes. The partnership agreement names the general partner as our Tax Matters Partner.

The Tax Matters Partner will make some elections on our behalf and on behalf of unitholders. In addition, the Tax Matters Partner can extend the statute of limitations for assessment of tax deficiencies against unitholders for items in our returns. The Tax Matters Partner may bind a unitholder with less than a 1% profits interest in us to a settlement with the IRS unless that unitholder elects, by filing a statement with the IRS, not to give that authority to the Tax Matters Partner. The Tax Matters Partner may seek judicial review, by which all the unitholders are bound, of a final partnership administrative adjustment and, if the Tax Matters Partner fails to seek judicial review, judicial review may be sought by any unitholder having at least a 1% interest in profits or by any group of unitholders having in the aggregate at least a 5% interest in profits. However, only one action for judicial review will go forward, and each unitholder with an interest in the outcome may participate.

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A unitholder must file a statement with the IRS identifying the treatment of any item on his federal income tax return that is not consistent with the treatment of the item on our return. Intentional or negligent disregard of this consistency requirement may subject a unitholder to substantial penalties.

Nominee Reporting. Persons who hold an interest in us as a nominee for another person are required to furnish to us:

(a) the name, address and taxpayer identification number of the beneficial owner and the nominee;

(b) whether the beneficial owner is

(1) a person that is not a United States person,

(2) a foreign government, an international organization or any wholly owned agency or instrumentality of either of the foregoing, or

(3) a tax-exempt entity;

(c) the amount and description of units held, acquired or transferred for the beneficial owner; and

(d) specific information including the dates of acquisitions and transfers, means of acquisitions and transfers, and acquisition cost for purchases, as well as the amount of net proceeds from sales.

Brokers and financial institutions are required to furnish additional information, including whether they are United States persons and specific information on units they acquire, hold or transfer for their own account. A penalty of $50 per failure, up to a maximum of $100,000 per calendar year, is imposed by the Internal Revenue Code for failure to report that information to us. The nominee is required to supply the beneficial owner of the units with the information furnished to us.

Accuracy-Related Penalties. An additional tax equal to 20% of the amount of any portion of an underpayment of tax that is attributable to one or more specified causes, including negligence or disregard of rules or regulations, substantial understatements of income tax and substantial valuation misstatements, is imposed by the Internal Revenue Code. No penalty will be imposed, however, for any portion of an underpayment if it is shown that there was a reasonable cause for that portion and that the taxpayer acted in good faith regarding that portion.

For individuals a substantial understatement of income tax in any taxable year exists if the amount of the understatement exceeds the greater of 10% of the tax required to be shown on the return for the taxable year or $5,000. The amount of any understatement subject to penalty generally is reduced if any portion is attributable to a position adopted on the return:

(1) for which there is, or was, substantial authority, or

(2) as to which there is a reasonable basis and the relevant facts of that position are disclosed on the return.

If any item of income, gain, loss or deduction included in the distributive shares of unitholders might result in that kind of an understatement of income for which no substantial authority exists but for which a reasonable basis for the tax treatment of such item exists, we must disclose the relevant facts on our return. In such a case, we will make a reasonable effort to furnish sufficient information for unitholders to make adequate disclosure on their returns and to take other actions as may be appropriate to permit unitholders to avoid liability for this penalty. More stringent rules apply to tax shelters, a term that in this context does not appear to include us.

A substantial valuation misstatement exists if the value of any property, or the adjusted basis of any property, claimed on a tax return is 150% or more of the amount determined to be the correct amount of the valuation or adjusted basis. No penalty is imposed unless the portion of the underpayment attributable to a substantial valuation misstatement exceeds $5,000 ($10,000 for most corporations). If the valuation claimed on a return is 200% or more than the correct valuation, the penalty imposed increases to 40%.

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Reportable Transactions. If we were to engage in a reportable transaction, we (and possibly you and others) would be required to make a detailed disclosure of the transaction to the IRS. A transaction may be a reportable transaction based upon any of several factors, including the fact that it is a type of tax avoidance transaction publicly identified by the IRS as a listed transaction or that it produces certain kinds of losses for partnerships, individuals, S corporations, and trusts in excess of $2 million in any single year, or $4 million in any combination of tax years. Our participation in a reportable transaction could increase the likelihood that our federal income tax information return (and possibly your tax return) would be audited by the IRS. Please read Information Returns and Audit Procedures.

Moreover, if we were to participate in a reportable transaction with a significant purpose to avoid or evade tax, or in any listed transaction, you may be subject to the following provisions of the American Jobs Creation Act of 2004:

- accuracy-related penalties with a broader scope, significantly narrower exceptions, and potentially greater amounts than described above at Accuracy-Related Penalties,
- for those persons otherwise entitled to deduct interest on federal tax deficiencies, nondeductibility of interest on any resulting tax liability and
- in the case of a listed transaction, an extended statute of limitations.

We do not expect to engage in any reportable transactions.

State, Local and Other Tax Considerations

In addition to federal income taxes, you likely will be subject to other taxes, including state and local income taxes, unincorporated business taxes, and estate, inheritance or intangible taxes that may be imposed by the various jurisdictions in which we do business or own property or in which you are a resident. We currently do business or own property in the states of Colorado, Wyoming, Oklahoma, Louisiana, Texas, Arkansas, Pennsylvania, New York, Vermont, Massachusetts, Rhode Island, Maine, Connecticut, Indiana, Kentucky, Maryland, New Hampshire, Ohio, Tennessee, Virginia and West Virginia. Each of these states, except Texas and Wyoming currently impose a personal income tax on individuals. Most of these states impose an income tax on corporations and other entities. We may also own property or do business in other states in the future. Although an analysis of those various taxes is not presented here, each prospective unitholder is urged to consider their potential impact on his investment in us. You may not be required to file a return and pay taxes in some states because your income from that state falls below the filing and payment requirement. You will be required, however, to file state income tax returns and to pay state income taxes in many of the states in which we do business or own property, and you may be subject to penalties for failure to comply with those requirements. In some states, tax losses may not produce a tax benefit in the year incurred and also may not be available to offset income in subsequent taxable years. Some of the states may require us, or we may elect, to withhold a percentage of income from amounts to be distributed to a unitholder who is not a resident of the state. Withholding, the amount of which may be greater or less than a particular unitholder s income tax liability to the state, generally does not relieve a non-resident unitholder from the obligation to file an income tax return. Amounts withheld may be treated as if distributed to unitholders for purposes of determining the amounts distributed by us. Please read Tax Consequences of Unit Ownership Entity-Level Collections. Based on current law and our estimate of our future operations, the general partner anticipates that any amounts required to be withheld will not be material.

It is the responsibility of each unitholder to investigate the legal and tax consequences, under the laws of pertinent states and localities, of his investment in us. Vinson & Elkins L.L.P. has not rendered an opinion on the state or local tax consequences of an investment in us. We strongly recommend that each prospective unitholder consult, and depend upon, his own tax counsel or other advisor with regard to those matters. It is the responsibility of each unitholder to file all state and local, as well as United States federal tax returns, that may be required of him.

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SELLING UNITHOLDERS

This prospectus covers the offering for resale of up to 5,386,732 common units by selling unitholders. Each of the selling unitholders acquired its common units in connection with a private placement in June 2007 or August 2007. We are registering the common units described below pursuant to registration rights agreements entered into by us and the selling unitholders in connection with the private placements.

No offer or sale may be made by a unitholder unless that unitholder is listed in the table below. The selling unitholders may sell all, some or none of the common units covered by this prospectus. Please read Plan of Distribution. We will bear all costs, fees and expenses incurred in connection with the registration of the common units offered by this prospectus. Brokerage commissions and similar selling expenses, if any, attributable to the sale of common units will be borne by the selling unitholders.

No such sales may occur unless the selling unitholder has notified us of his or her intention to sell our common units and this prospectus has been declared effective by the SEC, and remains effective at the time such selling unitholder offers or sells such common units. We are required to update this prospectus to reflect material developments in our business, financial position and results of operations.

The following table sets forth, the name of each selling unitholder, the amount of common units beneficially owned and the percentage of common units outstanding owned by each selling unitholder prior to the offering, the number of common units being offered for each selling unitholder s account, and the amount to be owned and the percentage of common units outstanding owned by each selling unitholder following the completion of the offering (assuming each selling unitholder sells all of the common units covered by this prospectus). The percentages of common units outstanding have been calculated based on 16,840,326 common units outstanding as of January 10, 2008. Unless otherwise indicated, the selling unitholders have held no position or office or had any other material relationship with us or any of our affiliates or predecessors, other than as a unitholder, during the past three years.

We have prepared the table and the related notes based on information supplied to us by the selling unitholders. We have not sought to verify such information. Additionally, some or all of the selling unitholders may have sold or transferred some or all of the units listed below in exempt or non-exempt transactions since the date on which the information was provided to us. Other information about the selling unitholders may change over time.

	Common Units Beneficially Owned Prior to this Offering		Units Offered in this Offering	Common Units Beneficially Owned Following this Offering	
Name of Selling Unitholder	**Number**	**Percentage Owned**		**Number**	**Percentage Owned**
GPS Income Fund LP(1)	161,528	*	115,513	46,015	*
Kidron Partners III LP(1)	693,641	4.12%	693,641		
Eagle Income Appreciation Partners, LP(1)	235,861	1.40%	92,486	143,375	*
Eagle Income Appreciation II, LP(1)	23,122	*	23,122		
Hartz Capital Investments, LLC(1)	115,607	*	115,607		
Royal Bank of Canada(1)	620,754	3.69%	578,127	42,627	*
	423,825	2.52%	404,625	19,200	*

Tortoise Energy Infrastructure Corporation(1)					
MSDW Strategic Investments, Inc.(1)	779,938	4.63%	115,607	664,331	3.94%
Energy Income and Growth Fund(1)	86,705	*	86,705		
Fiduciary/Claymore MLP Opportunity Fund(1)	635,480	3.77%	86,705	548,775	3.26%
The Northwestern Mutual Life Insurance Company(1)	115,607	*	115,607		
ING Life Insurance and Annuity Company(1)	263,584	1.57%	263,584		

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Name of Selling Unitholder	Common Units Beneficially Owned Prior to this Offering		Units Offered in this Offering	Common Units Beneficially Owned Following this Offering	
	Number	Percentage Owned		Number	Percentage Owned
ING USA Annuity and Life Insurance Company(1)	156,069	*	156,069		
Security Life of Denver Insurance Company(1)	110,983	*	110,983		
Reliastar Life Insurance Company of New York(1)	4,624	*	4,624		
Reliastar Life Insurance Company(1)	42,775	*	42,775		
Lehman Brothers MLP Opportunity Fund L.P(2)(3)	1,655,548	9.83%	1,655,548		
Banc of America Capital Investors V, L.P(2)(4)	476,190	2.83%	476,190		
William E. Pritchard III(2)	119,047	*	119,047		
Frank D. Tsuru(2)	47,619	*	47,619		
George W. Passela(2)	23,810	*	23,810		
W. Mark Low(2)	23,810	*	23,810		
George W. Francisco IV(2)	17,857	*	17,857		
Jack E. Vaughn(2)	11,905	*	11,905		
Alexander M. McLean(2)	2,381	*	2,381		
Jeff Lowe(2)	1,785	*	1,785		
William Sawyer(2)	1,000	*	1,000		
Total	6,851,055	40.68%	5,386,732		

* Less than 1%

(1) These common units were acquired on June 19, 2007 in a private placement of 3,005,780 common units with certain institutional investors.

(2) These common units were acquired on August 29, 2007 in a private placement of 2,380,952 common units in connection with the acquisition certain subsidiaries of Momentum Energy Group Inc., or MEG. This private placement was completed pursuant to a purchase agreement with certain prior owners of MEG or affiliates of such owners.

(3) Lehman Brothers MLP Opportunity Fund LP is an affiliate of Lehman Brothers Inc., a registered broker-dealer. Lehman Brothers MLP Opportunity Fund LP has represented to us that it is not acting as an underwriter in this offering, it purchased the shares it is offering under this prospectus in the ordinary course of business, and at the time of such purchase, it had no agreements or understandings, directly or indirectly, with any person to distribute the securities. Lehman Brothers MLP Opportunity Fund LP s general partner is an indirect wholly-owned subsidiary of Lehman Brothers Holdings Inc., a public reporting company.

(4)

Banc of America Capital Investors V, L.P. is an affiliate of Bank of America, National Association, or Bank of America. Bank of America is a syndicate member in our Amended Credit Agreement with a 6.1% commitment percentage.

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PLAN OF DISTRIBUTION

We are registering the common units on behalf of the selling unitholders. As used in this prospectus, selling unitholders includes donees and pledgees selling common units received from a named selling unitholder after the date of this prospectus.

Under this prospectus, the selling unitholders intend to offer our securities to the public:

- through one or more broker-dealers;
- through underwriters; or
- directly to investors.

The selling unitholders may price the common units offered from time to time:

- at fixed prices;
- at market prices prevailing at the time of any sale under this registration statement;
- at prices related to prevailing market prices;
- varying prices determined at the time of sale; or
- at negotiated prices.

We will pay the costs and expenses of the registration and offering of the common units offered hereby. We will not pay any underwriting fees, discounts and selling commissions allocable to each selling unitholder s sale of its respective common units, which will be paid by the selling unitholders. Broker-dealers may act as agent or may purchase securities as principal and thereafter resell the securities from time to time:

- in or through one or more transactions (which may involve crosses and block transactions) or distributions;
- on the New York Stock Exchange or such other national exchange on which our common units are listed at such time;
- through the writing of options;
- in the over-the-counter market; or
- in private transactions.

Broker-dealers or underwriters may receive compensation in the form of underwriting discounts or commissions and may receive commissions from purchasers of the securities for whom they may act as agents. If any broker-dealer purchases the securities as principal, it may effect resales of the securities from time to time to or through other broker-dealers, and other broker-dealers may receive compensation in the form of concessions or commissions from the purchasers of securities for whom they may act as agents. In no event will any compensation to be paid to FINRA members in connection with this offering exceed 10% plus 0.5% for bona fide due diligence.

To the extent required, the names of the specific managing underwriter or underwriters, if any, as well as other important information, will be set forth in prospectus supplements. In that event, the discounts and commissions the selling unitholders will allow or pay to the underwriters, if any, and the discounts and commissions the underwriters may allow or pay to dealers or agents, if any, will be set forth in, or may be calculated from, the prospectus supplements. Any underwriters, brokers, dealers and agents who participate in any sale of the securities may also engage in transactions with, or perform services for, us or our affiliates in the ordinary course of their businesses.

In addition, the selling unitholders have advised us that they may sell common units in compliance with Rule 144, if available, or pursuant to other available exemptions from the registration requirements under the Securities Act, rather than pursuant to this prospectus.

To the extent required, this prospectus may be amended or supplemented from time to time to describe a specific plan of distribution.

In connection with offerings under this shelf registration and in compliance with applicable law, underwriters, brokers or dealers may engage in transactions which stabilize or maintain the market price of the securities at levels above those which might otherwise prevail in the open market. Specifically, underwriters, brokers or dealers may over-allot in connection with offerings, creating a short position in the securities for their own accounts. For the purpose of covering a syndicate short position or stabilizing the price of the securities, the underwriters, brokers or dealers may place bids for the securities or effect purchases of the securities in the open market. Finally, the underwriters may impose a penalty whereby selling concessions allowed to syndicate members or other brokers or dealers for distribution the securities in offerings may be reclaimed by the syndicate if the syndicate repurchases previously distributed securities in transactions to cover short positions, in stabilization transactions or otherwise. These activities may stabilize, maintain or otherwise affect the market price of the securities, which may be higher than the price that might otherwise prevail in the open market, and, if commenced, may be discontinued at any time.

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LEGAL MATTERS

Vinson & Elkins L.L.P. will pass upon the validity of the securities offered in this registration statement. If certain legal matters in connection with an offering of the securities made by this prospectus and a related prospectus supplement are passed on by counsel for the underwriters of such offering, that counsel will be named in the applicable prospectus supplement related to that offering.

EXPERTS

The consolidated balance sheet of DCP Midstream GP, LP as of December 31, 2006, incorporated in this prospectus by reference from DCP Midstream Partners, LP s Current Report on Form 8-K dated April 20, 2007, has been audited by Deloitte & Touche LLP, independent auditors, as stated in their report, which is incorporated herein by reference, and has been so incorporated in reliance upon the report of such firm given upon their authority as experts in accounting and auditing.

The consolidated balance sheet of DCP Midstream, LLC as of December 31, 2006, incorporated in this prospectus by reference from DCP Midstream Partners, LP s Current Report on Form 8-K dated April 20, 2007, has been audited by Deloitte & Touche LLP, independent auditors, as stated in their report, which is incorporated herein by reference, and has been so incorporated in reliance upon the report of such firm given upon their authority as experts in accounting and auditing.

The combined financial statements of the East Texas Midstream Business as of December 31, 2006 and 2005 and for each of the three years in the period ended December 31, 2006, incorporated in this prospectus by reference from DCP Midstream Partners, LP s Current Report on Form 8-K/A dated October 16, 2007, have been audited by Deloitte & Touche LLP, independent auditors, as stated in their report, which has been incorporated herein by reference (which report expresses an unqualified opinion and includes an explanatory paragraph relating to the preparation of the combined financial statements of the East Texas Midstream Business from the separate records maintained by DCP Midstream, LLC), and have been so incorporated in reliance upon the report of such firm given upon their authority as experts in accounting and auditing.

The consolidated financial statements of Momentum Energy Group, Inc and Subsidiaries as of June 30, 2007, December 31, 2006, and 2005 and for the six month period ended June 30, 2007, the years ended December 31, 2006 and 2005, and for the period August 24, 2004 (date of inception) through December 31, 2004, incorporated in this prospectus by reference from DCP Midstream Partners, LP s Current Report on Form 8-K/A dated October 3, 2007, have been audited by Deloitte & Touche LLP, independent auditors, as stated in their report, which is incorporated herein by reference, and have been so incorporated in reliance upon the report of such firm given upon their authority as experts in accounting and auditing.

The consolidated financial statements and the related consolidated financial statement schedule of DCP Midstream Partners, LP (the Company), as of December 31, 2006 and 2005 and for the three years in the period ended December 31, 2006, which give retroactive effect to the July 1, 2007 acquisition by the Company of a 25% limited liability interest in DCP East Texas Holdings, LLC (East Texas), a 40% limited liability interest in Discovery Producer Services, LLC (Discovery), and a nontrading derivative instrument (the Swap) from DCP Midstream, LLC (Midstream), which has been accounted for in a manner similar to a pooling of interests as described in Note 4 to the consolidated financial statements, incorporated in this prospectus by reference from the Company s Current Report on Form 8-K dated January 15, 2008, have been audited by Deloitte & Touche LLP, as stated in their report, based in part on the report of Ernst & Young LLP as it relates to Discovery, which is incorporated herein by reference (which report expresses an unqualified opinion on the consolidated financial statements and financial statement schedule and includes explanatory paragraphs referring to (1) the preparation of the portion of the Company s consolidated financial statements attributable to operations prior to December 7, 2005 from the separate records of Midstream, and (2) the basis of presentation of the consolidated financial statements of the Company to retroactively reflect the Company s acquisition of the wholesale propane logistics business and the preparation of the portion of the Company s consolidated financial statements attributable to the wholesale propane logistics business from the separate records maintained by Midstream, and (3) the preparation of the portion of the Company s consolidated financial statements attributable to East Texas, Discovery, and the Swap from the separate records maintained by Midstream). Such consolidated financial statements of the Company have been so incorporated herein in

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reliance upon the respective reports of such firms given upon their authority as experts in accounting and auditing. All of the foregoing firms are independent registered public accounting firms.

The supplemental consolidated balance sheet of DCP Midstream GP, LP (the Company), as of December 31, 2006, which gives retroactive effect to the July 1, 2007 acquisition by the Company of a 25% limited liability interest in DCP East Texas Holdings, LLC (East Texas), a 40% limited liability interest in Discovery Producer Services, LLC (Discovery), and a nontrading derivative instrument (the Swap) from DCP Midstream, LLC (Midstream), which has been accounted for in a manner similar to a pooling of interests as described in Note 4 to the supplemental consolidated financial statements, incorporated in this prospectus by reference from DCP Midstream Partners, LP s Current Report on Form 8-K dated October 17, 2007, has been audited by Deloitte & Touche LLP, as stated in their report, based in part on the report of Ernst & Young LLP as it relates to Discovery, which is incorporated herein by reference. Such supplemental consolidated financial statements of the Company have been so incorporated herein in reliance upon the respective reports of such firms given upon their authority as experts in accounting and auditing. Deloitte & Touche LLP are independent auditors and Ernst & Young LLP are independent registered public accountants.

The consolidated financial statements of Discovery Producer Services LLC at December 31, 2006 and 2005, and for each of the three years in the period ended December 31, 2006, have been audited by Ernst & Young LLP, independent registered public accounting firm, as set forth in their report thereon, appearing in DCP Midstream Partners, LP s Current Report on Form 8-K dated October 3, 2007, incorporated by reference herein, and is incorporated by reference in reliance upon such report given on the authority of such firm as experts in accounting and auditing.