

ACME COMMUNICATIONS INC  
Form 10-Q  
November 09, 2005

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

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

**For the Quarterly Period Ended September 30, 2005**

Commission File Number: 000-27105

**ACME COMMUNICATIONS, INC.**

(Exact name of registrant as specified in its charter)

|   |   |
|---|---|
| Delaware  | 33-0866283                              |
| (State or other jurisdiction of<br>incorporation or organization) | (I.R.S. employer<br>identification no.) |

2101 E. Fourth Street, Suite 202 A  
Santa Ana, California, 92705  
(714) 245-9499

(Address and telephone number of principal executive offices)

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, and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

As of November 8, 2005, ACME Communications, Inc. had 16,772,415 shares of common stock outstanding (including 725,652 shares held in treasury).

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## ACME COMMUNICATIONS, INC.

## FORM 10 Q

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**ACME Communications, Inc. and Subsidiaries**  
**Consolidated Balance Sheets**

(in thousands, except for par value data)

|   | <b>September 30,<br/>2005</b> | <b>December 31,<br/>2004</b> |
|---|-------------------------------|------------------------------|
|   | <b>(unaudited)</b>            |                              |
| <b>ASSETS</b>   |                               |                              |
| <b>Current assets:</b>  |                               |                              |
| Cash and cash equivalents   | \$ 1,625                      | \$ 1,679                     |
| Restricted cash   | 50                            | 64                           |
| Accounts receivable, net  | 8,064                         | 9,174                        |
| Current portion of programming rights   | 8,849                         | 11,107                       |
| Prepaid expenses and other current assets   | 748                           | 911                          |
| Assets held for sale  | 21,046                        | --                           |
| <b>Total current assets</b>   | <b>40,382</b>                 | <b>22,935</b>                |
| Property and equipment, net   | 25,135                        | 29,840                       |
| Programming rights, net of current portion  | 11,337                        | 17,047                       |
| Intangible assets, net  | 86,831                        | 96,791                       |
| Other assets  | 3,738                         | 4,549                        |
| <b>Total assets</b>   | <b>\$ 167,423</b>             | <b>\$ 171,162</b>            |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |                               |                              |
| <b>Current liabilities:</b>   |                               |                              |
| Accounts payable  | \$ 5,516                      | \$ 6,964                     |
| Accrued liabilities   | 4,361                         | 4,583                        |
| Current portion of programming rights payable   | 7,771                         | 12,329                       |
| Current portion of obligations under lease  | 47                            | 45                           |
| Income taxes payable  | 41                            | 50                           |
| Notes payable under revolving credit facility   | 31,667                        | --                           |
| Note payable under second-lien term loan  | 20,000                        | --                           |
| Liabilities held for sale   | 8,542                         | --                           |
| <b>Total current liabilities</b>  | <b>77,946</b>                 | <b>23,971</b>                |
| Programming rights payable, net of current portion  | 12,302                        | 16,851                       |
| Obligations under lease, net of current portion   | 907                           | 943                          |
| Other liabilities   | 86                            | 167                          |
| Deferred income taxes   | 10,464                        | 8,900                        |
| Notes payable under revolving credit facility   | --                            | 24,554                       |
| Note payable under second-lien term loan  | --                            | 20,000                       |
| <b>Total liabilities</b>  | <b>101,704</b>                | <b>95,386</b>                |
| Minority interest   | 877                           | 624                          |
| <b>Stockholders' equity:</b>  |                               |                              |
| Preferred stock, \$.01 par value; 10,000,000 shares authorized, no shares issued or outstanding   | --                            | --                           |
| Common stock, \$.01 par value; 50,000,000 shares authorized, 16,772,415 shares issued and outstanding at September 30, 2005 and December 31, 2004 | 168                           | 168                          |
| Additional paid-in capital  | 132,038                       | 132,038                      |
| Accumulated deficit   | (62,364)                      | (52,054)                     |
| Less: Treasury stock, at cost; 725,652 shares   | (5,000)                       | (5,000)                      |
| <b>Total stockholders' equity</b>   | <b>64,842</b>                 | <b>75,152</b>                |
| <b>Total liabilities and stockholders' equity</b>   | <b>\$ 167,423</b>             | <b>\$ 171,162</b>            |

See the notes to the consolidated financial statements



**ACME Communications, Inc. and Subsidiaries**  
**Consolidated Statements of Operations**  
**(Unaudited)**

(In thousands, except per share data)

|   | Three Months Ended<br>September 30, |            | Six Months Ended<br>September 30, |             |
|---|-------------------------------------|------------|-----------------------------------|-------------|
|   | 2005                                | 2004       | 2005                              | 2004        |
| Net revenues  | \$ 10,097                           | \$ 9,429   | \$ 30,364                         | \$ 28,860   |
| Operating expenses:   |                                     |            |                                   |             |
| Cost of service:  |                                     |            |                                   |             |
| Programming, including program amortization   | 4,180                               | 3,869      | 12,437                            | 11,375      |
| Other costs of service (excluding depreciation and amortization of \$1,176 and \$1,061 for the three months ended September 30, 2005 and 2004, respectively, and \$3,508 and \$3,249 for the nine months ended September 30, 2005 and 2004, respectively) | 1,522                               | 1,419      | 4,850                             | 4,501       |
| Selling, general and administrative expenses  | 3,964                               | 3,779      | 11,649                            | 11,673      |
| Depreciation and amortization   | 1,186                               | 1,074      | 3,529                             | 3,275       |
| Corporate expenses  | 887                                 | 949        | 2,519                             | 2,768       |
| Operating expenses  | 11,739                              | 11,090     | 34,984                            | 33,592      |
| Operating loss  | (1,642)                             | (1,661)    | (4,620)                           | (4,732)     |
| Other income (expenses):  |                                     |            |                                   |             |
| Interest income   | 3                                   | 2          | 6                                 | 6           |
| Interest expense  | (946)                               | (472)      | (2,513)                           | (1,147)     |
| Gain on sale of construction permit   | --                                  | --         | 1,202                             | --          |
| Other, net  | 43                                  | (2)        | 47                                | 29          |
| Loss before income taxes, minority interest and discontinued operations   | (2,542)                             | (2,133)    | (5,878)                           | (5,844)     |
| Income tax expense  | (563)                               | (814)      | (1,719)                           | (1,922)     |
| Loss before minority interest and discontinued operations   | (3,105)                             | (3,947)    | (7,597)                           | (7,766)     |
| Minority interest   | 149                                 | 264        | 461                               | 721         |
| Loss from continuing operations   | (2,956)                             | (2,683)    | (7,136)                           | (7,045)     |
| Discontinued operations:  |                                     |            |                                   |             |
| Loss from discontinued operations   | (952)                               | (1,464)    | (3,174)                           | (3,245)     |
| Income tax expense  | --                                  | (411)      | --                                | (411)       |
| Loss from discontinued operations   | (952)                               | (1,875)    | (3,174)                           | (3,656)     |
| Net loss  | \$ (3,908)                          | \$ (4,558) | \$ (10,310)                       | \$ (10,701) |
| Net loss per share, basic and diluted   |                                     |            |                                   |             |
| Continuing operations   | \$ (0.18)                           | \$ (0.17)  | \$ (0.44)                         | \$ (0.43)   |
| Discontinued operations   | (0.06)                              | (0.12)     | (0.20)                            | (0.22)      |
| Net loss per share  | \$ (0.24)                           | \$ (0.28)  | \$ (0.64)                         | \$ (0.65)   |
| Weighted average basic and diluted common shares outstanding  | 16,047                              | 16,077     | 16,047                            | 16,527      |

See the notes to the consolidated financial statements

**ACME Communications, Inc. and Subsidiaries**  
**Consolidated Statement of Stockholders' Equity**  
**(Unaudited)**

(In thousands)

|                               | Common Stock |        | Additional | Accumulated | Treasury   | Total         |
|-------------------------------|--------------|--------|------------|-------------|------------|---------------|
|                               | Shares       | Amount | Paid-in    | Deficit     | Stock      | Stockholders' |
|                               |              |        | Capital    |             |            | Equity        |
| Balance at December 31, 2004  | 16,772       | \$ 168 | \$ 132,038 | \$ (52,054) | \$ (5,000) | \$ 75,152     |
| Net loss                      | --           | --     | --         | (10,310)    | --         | (10,310)      |
|                               |              | >      |            |             |            |               |
| Balance at September 30, 2005 | 16,772       | \$ 168 | \$ 132,038 | \$ (62,364) | \$ (5,000) | \$ 64,842     |

See the notes to the consolidated financial statements

**ACME Communications, Inc. and Subsidiaries**  
**Consolidated Statements of Cash Flows**  
**(Unaudited)**

(In thousands)

Nine Months Ended  
September 30,

**2005**      **2004**

|  | 2005       | 2004       |
|--|------------|------------|
| Cash flows from operating activities:  |            |            |
| Net loss from continuing operations  | \$ (7,136) | \$ (7,045) |
| Adjustments to reconcile loss to net cash used in operating activities:          |            |            |
| Minority interest  | (461)      | (721)      |
| Provision for doubtful accounts receivable                                       | 294        | 276        |
| Depreciation and amortization  | 3,529      | 3,275      |
| Amortization of program rights   | 6,490      | 6,098      |
| Amortization of debt issuance costs  | 732        | 578        |
| Amortization of deferred compensation  | --         | 34         |
| Gain on sale of construction permit  | (1,202)    | --         |
| Deferred taxes   | 1,564      | 1,697      |
| Changes in assets and liabilities:   |            |            |
| (Increase) decrease in accounts receivables                                      | 591        | (185)      |
| (Increase) decrease in prepaid expenses and other current assets                 | 187        | (352)      |
| Increase in other assets   | (836)      | (137)      |
| Increase (decrease) in accounts payable  | (1,239)    | 13         |
| Increase in accrued liabilities  | 576        | 904        |
| Increase (decrease) in taxes payable   | (9)        | 322        |
| Payments of programming rights payable   | (6,599)    | (5,811)    |
| Increase (decrease) in other liabilities   | (72)       | 11         |
| Net cash used in operating activities  | (3,591)    | (1,043)    |
| Cash flows from investing activities:  |            |            |
| Purchase of property and equipment   | (1,730)    | (5,382)    |
| Purchases of and deposits for station interests                                  | --         | (177)      |
| Proceeds from sale of assets   | 185        | --         |
| Proceeds from sale of construction permit  | 1,500      | --         |
| Net cash used in investing activities  | (45)       | (5,559)    |
| Cash flows from financing activities:  |            |            |
| Contributions by minority stockholder  | 714        | 1,350      |
| Net borrowings under revolving credit facility                                   | 7,113      | 13,231     |
| Payment of financing costs on credit facilities                                  | (564)      | (374)      |
| Cash restricted as escrow deposits and collateral under capital lease facilities | 14         | 1,920      |
| Payments on capital lease obligations  | (34)       | (2,037)    |
| Purchase of treasury stock   | --         | (5,000)    |
| Proceeds from the issuance of common stock                                       | --         | 40         |
| Net cash provided by financing activities  | 7,243      | 9,130      |
| Increase in net cash from continuing operations                                  | 3,607      | 2,528      |
| Cash used in discontinued operations   | (3,661)    | (2,065)    |
| Increase (decrease) in cash  | (54)       | 463        |
| Cash at beginning of period  | 1,679      | 1,197      |
| Cash at end of period  | \$ 1,625   | \$ 1,660   |
| Cash payments for:   |            |            |
| Interest   | \$ 3,165   | \$ 1,503   |
| Taxes  | \$ 146     | \$ 314     |

**ACME Communications, Inc. and Subsidiaries**  
**Consolidated Statements of Cash Flows**  
**(Unaudited)**

**(In thousands)**

Non-cash transactions:

|   |          |          |
|---|----------|----------|
| Program rights in exchange for program rights payable | \$ 7,489 | \$ 8,458 |
|---|----------|----------|

See the notes to the consolidated financial statements

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**ACME Communications, Inc. and Subsidiaries**  
**Notes to Consolidated Financial Statements**  
**(Unaudited)**

**(1) Formation and Description of the Business****Formation & Presentation**

ACME Communications, Inc. was formed on July 23, 1999, in preparation for and in conjunction with an initial public offering of its stock.

The accompanying consolidated financial statements are presented for ACME Communications, Inc. ( ACME or the Company ) and its wholly-owned subsidiaries. Segment information is not presented since all of the Company's revenues are attributed to a single reportable segment.

On August 8, 2005, the Company announced that it had entered into a transaction to sell its station KUWB serving the Salt Lake City marketplace to a subsidiary of Clear Channel Communications Inc. The transaction is contingent upon Clear Channel selling its radio station in the market and subject to regulatory approval. In accordance with U.S. generally accepted accounting principles, the statements of operations and cash flows reflect the results of this station as discontinued operations for all periods presented. See Note 10 for additional information.

The Company adopted the provisions of FASB Interpretation No. 46R ( FIN 46R ), Consolidation of Variable Interest Entities , effective January 1, 2004. On that same date, the Company's joint venture with Emmis Communications ( Emmis ) to produce *The Daily Buzz*, a weekday morning three-hour television news show, became effective. Under the agreement, the Company made an initial contribution of property and equipment with an agreed fair value and book value of \$750,000 and Emmis is required to contribute the next \$750,000 in capital equipment purchased by the venture. At September 30, 2005, Emmis had contributed approximately \$705,000 in capital equipment purchases. Until and unless Emmis completes this equalizing contribution, under FIN 46R, the Company is deemed the primary beneficiary of the venture and accordingly, has consolidated the venture into its financial statements. The creditors of the venture have no recourse against the Company or Emmis. In accordance with FIN 46R, Emmis' share of the net production costs which were funded through capital contributions to the venture during the three and nine months ended September 30, 2005 were \$149,000 and \$461,000, respectively, compared to its share of net production costs of \$264,000 and \$721,000 for the three and nine months ended September 30, 2004, respectively. These amounts have been reflected as minority interest in the accompanying consolidated statement of operations.

The consolidated financial statements for the periods presented include the consolidated accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated for all periods presented.

**Description of the Business**

ACME Communications is a holding company with no independent operations other than through its wholly-owned subsidiary, ACME Television. ACME Television, through its wholly-owned subsidiaries, owns and operates the following ten commercially licensed, full-power, broadcast television stations located throughout the United States, including KWBR in Roswell, New Mexico, which is a satellite station of KWBQ:

| <u>Station</u> | <u>Channel</u> | <u>Marketplace</u>                      | <u>Market Rank<sup>(1)</sup></u> | <u>Network Affiliation</u> |
|----------------|----------------|---|----------------------------------|----------------------------|
| KUWB           | 30             | Salt Lake City, Utah                    | 36                               | WB                         |
| KWBQ/KWBR      | 19/21          | Albuquerque-Santa Fe, New Mexico        | 47                               | WB                         |
| KASY           | 50             | Albuquerque-Santa Fe, New Mexico        | 47                               | UPN                        |
| WBDT           | 26             | Dayton, Ohio                            | 56                               | WB                         |
| WBXX           | 20             | Knoxville, Tennessee                    | 59                               | WB                         |
| WTVK           | 46             | Ft. Myers-Naples, Florida               | 68                               | WB                         |
| WIWB           | 14             | Green Bay-Appleton, Wisconsin           | 69                               | WB                         |
| WBUI           | 23             | Champaign-Springfield-Decatur, Illinois | 82                               | WB                         |
| WBUI           | 57             | Madison, Wisconsin                      | 85                               | WB                         |

(1) based on television households per Nielsen Market Research for the 2005 / 2006 season.

The Company also owns the right to acquire for \$3.0 million a construction permit to build a new WB Network affiliate in Lexington, KY. The acquisition of the Lexington construction permit is dependent upon the Federal Communications Commission approving the underlying application.

**(2) Presentation of Interim Consolidated Financial Statements**

The accompanying consolidated financial statements for the three and nine months ended September 30, 2005 and 2004 are unaudited and have been prepared in accordance with accounting principles generally accepted in the United States of America, the instructions to this Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, such financial statements include all adjustments (consisting of normal recurring accruals) considered necessary for the fair presentation of the financial position and the results of operations, and cash flows for these periods. As permitted under the applicable rules and regulations of the Securities and Exchange Commission, these financial statements do not include all disclosures and footnotes normally included with annual consolidated financial statements, and accordingly, should be read in conjunction with the consolidated financial statements, and the notes thereto, included in the Company's 2004 Annual Report on Form 10-K filed with the SEC on March 16, 2005. The results of operations presented in the accompanying consolidated financial statements are not necessarily indicative of the results that may be expected for the year ending December 31, 2005.

The accompanying consolidated balance sheet as of December 31, 2004 is derived from the audited consolidated financial statements included in the Company's 2004 Annual Report.

Certain amounts previously reported in 2004 have been reclassified to conform to the 2005 financial statement presentation.

**(3) Accounting for Stock Options**

The Company has adopted Statement of Financial Accounting Standards No. 123 ( SFAS No. 123 ), Accounting for Stock-Based Compensation, which establishes a fair value based method of accounting for stock-based compensation. SFAS No. 123 encourages but does not require entities to adopt its provisions in place of the provisions of Accounting Principles Board Opinion No. 25 ( APB No. 25 ), Accounting for Stock Issued to Employees . SFAS No. 123 permits entities to recognize the expense of all stock-based awards over the vesting period of the awards. The expense is calculated based on the fair value at the date of grant. Alternatively, APB No. 25 requires that the expense of stock-based employee compensation be recognized based on the difference, if any, between the quoted market price of the stock and the amount the employee must pay to acquire the stock. APB No. 25 specifies various dates to be used to determine the quoted market price, depending on whether the terms of the stock-based compensation award are fixed or variable. Under SFAS No. 123 if an entity elects to follow APB No. 25 it must provide pro forma net income (loss) disclosure for employee stock option grants made, as if the fair-value-based method defined in SFAS No. 123 had been applied. The Company has elected to apply the provisions of APB No. 25. Had the Company chosen to adopt the provisions of Statement of Financial Accounting Standards No. 123, as amended by SFAS No. 148 Accounting for Stock-Based Compensation Transition and Disclosure, and recognized compensation cost based upon the fair value of all options granted (including those granted at or above fair market value) at the date of grant, the Company's net loss and net loss per share for the three months and nine months ended September 30, 2005 and 2004 would have been:

| <b>Amount in thousands, except per share data</b>  | <b>For the Three Months<br/>Ended September 30,</b> |             | <b>For the Nine Months<br/>Ended September 30,</b> |             |
|--|---|-------------|--|-------------|
|  | <b>2005</b>   | <b>2004</b> | <b>2005</b>  | <b>2004</b> |
| Net loss, as reported  | \$ (3,908)  | \$ (4,558)  | \$ (10,310)  | \$ (10,701) |
| Add: Stock-based employee compensation expense included in reported net loss                           | --  | 11          | --   | 34          |
| Deduct: Total stock-based compensation expense determined under fair-value based method for all awards | (130)   | (496)       | (339)  | (1,524)     |
| Pro forma net loss   | \$ (4,038)  | \$ (5,043)  | \$ (10,649)  | \$ (12,191) |
| Net loss per share, basic and diluted:   |   |             |  |             |
| As reported  | \$ (0.24)   | \$ (0.28)   | \$ (0.64)  | \$ (0.65)   |
| Pro forma  | \$ (0.25)   | \$ (0.31)   | \$ (0.66)  | \$ (0.74)   |

On August 8, 2005, the Company issued stock options for 907,500 shares to executive employees (other than the Company's Chief Executive, Chief Operating and Chief Financial Officer) at an average exercise price of \$6.50 per share in exchange for the termination of 432,000 shares at an average exercise price of \$7.55 per share. The closing price of the Company's stock that day was \$4.22 per share. The forfeited shares were fully vested and the new shares vest over three years. The exchange of shares represents an effective repricing and is therefore subject to variable compensation accounting. Since the exercise prices for the new shares are in excess of the closing price of the Company's stock at September 30, 2005, no compensation expense has been recorded in the accompanying statement of operations. The incremental value of the new options in excess of the value of the forfeited shares at the new grant date is being amortized over the three-year expected life for purposes of the above pro forma calculations.

#### **(4) Income Taxes**

Prior to January 1, 2002, the Company recorded deferred tax liabilities relating to the difference in the book basis and tax basis of goodwill and intangibles. The future reversals of those deferred tax liabilities were utilized to support the realization of deferred tax assets (primarily consisting of net operating loss carryforwards) and the corresponding deferred tax benefits recorded by the Company. As a result of the adoption of SFAS No. 142, effective January 1, 2002 those deferred tax liabilities no longer reverse on a scheduled basis and can no longer be utilized to support the realization of deferred tax assets.

#### **(5) Notes Payable Under Revolving Credit Facility and Second-Lien Term Loan**

The Company's senior credit agreement permits maximum borrowings thereunder of \$60.0 million, contains financial covenants, is secured by all the assets of the Company and matures in November 2008. The Company also has a \$20.0 million Second-Lien Term Loan ( SLTL ) that matures in May 2009. The SLTL agreement contains covenants similar to those contained in the Company's senior credit agreement.

Costs associated with the procuring or amending of the Company's credit facilities, including loan fees and related professional fees, are included in long-term other assets and are amortized on a straight-line basis over the term, including amended terms, of the facilities. Amortization of these costs is recorded as interest expense and approximates the result of the effective interest method.

As of September 30, 2005, there was approximately \$31.7 million outstanding under the revolving credit facility at an average interest rate of approximately 8.6% per annum and \$20.0 million outstanding under the second-lien term loan agreement at an interest rate of approximately 10.9%. Approximately \$19.3 million of additional borrowings were available under the revolving credit facility as of September 30, 2005.

On November 7, 2005, the Company and its lenders amended both facility agreements. The amendments changed the minimum EBITDA covenant effective September 30, 2005 for the twelve months then ended and also imposed certain restrictions on the Company's ability to repurchase its common stock until such time that the Company reaches certain dollar thresholds of station sales, including its pending Salt Lake City station sale. At September 30, 2005 the Company was in compliance with all covenants contained in both loan agreements.

The Company will not be in compliance with the minimum EBITDA covenants of the loan agreements beginning with the quarter ended December 31, 2005. Since such non-compliance would give the lenders the right to demand immediate repayment of the loans, the Company has classified the debt under both agreements as current liabilities at September 30, 2005.

#### **(6) Barter and Trade Transactions**

Revenue and expenses associated with barter agreements in which broadcast time is exchanged for programming rights are recorded at the estimated average rate of the airtime exchanged. Barter revenue amounted to \$917,000 and \$871,000 during the three-month periods ended September 30, 2005 and 2004, respectively and \$2,821,000 and \$2,790,000 during the nine month periods ended September 30, 2005 and 2004, respectively. Trade transactions, which represent the exchange of advertising time for goods or services, are recorded at the estimated fair value of the products or services received based on comparable cash transactions. Barter and trade revenue is recognized when advertisements are broadcast. Merchandise or services received from airtime trade sales are charged to expense or capitalized and expensed when used.

#### **(7) Sale of Construction Permit**

On April 14, 2005, the Company concurrently acquired a construction permit for the Flint, Michigan marketplace for \$3.0 million and sold that construction permit for \$4.5 million. Net of related expenses, the Company recorded a gain on the sale of approximately \$1.2 million.

**(8) Loss Per Common Share**

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The Company calculates loss per share in accordance with Statement of SFAS No. 128, Earnings Per Share. SFAS No. 128 requires a presentation of basic earnings per share (EPS) and diluted EPS. Basic EPS includes no dilution and is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution from securities that could share in the earnings of the Company. In calculating diluted EPS, no potential shares of common stock are to be included in the computation when a loss from continuing operations available to common stockholders exists. The statement requires dual presentation of basic and diluted EPS by entities with complex capital structures.

Stock options outstanding amounted to 2,471,446 shares at September 30, 2005 and 2,383,048 shares at September 30, 2004 and were not included in the computation of diluted EPS because an inclusion of such shares would have been anti-dilutive since there were net losses in all periods presented.

#### **(9) Recent Accounting Pronouncement**

In December 2004, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payments* (SFAS 123(R)), which requires companies to measure and recognize compensation expense for all stock-based payments at fair value. SFAS 123(R) was to be effective for all interim periods beginning after June 15, 2005; however, on April 14, 2005, the Securities and Exchange Commission changed the effective date to fiscal years that begin after June 15, 2005. Therefore, SFAS 123(R) will be effective for us on January 1, 2006. The Company is currently evaluating the impact of SFAS 123(R) on its financial position and results of operations.

#### **(10) Discontinued Operations**

On August 8, 2005, the Company reached an agreement to sell KUWB, its Salt Lake City station, to units of Clear Channel Communications, Inc (Clear Channel) for \$18.5 million in an asset sale. Consummation of the transaction is contingent on Clear Channel selling a radio station it owns in the Salt Lake City market and subject to approval by the Federal Communications Commission. If our transaction with Clear Channel hasn't closed by April 8, 2006, either party can terminate the KUWB sale agreement. The Company believes it is highly probable that the sale of the station will be consummated within the coming year and, accordingly, has treated the station's results of operations for all periods presented in the accompanying financial statements as discontinued operations.

KUWB's net revenue for the three months and nine months ended September 30, 2005 was \$1,667,000 and \$5,048,000, respectively. Its net revenue for the three months and nine months ended September 30, 2004 was \$1,897,000 and \$5,698,000, respectively.

Assets held for sale at September 30, 2005 consist principally of KUWB's programming rights of \$8,311,000, property and equipment, net, of \$2,124,000 and intangible assets of \$9,960,000. Liabilities held for sale at September 30, 2005 consist of KUWB's programming rights payable of \$8,542,000.

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

#### **Forward-looking Statements**

*This Quarterly Report on Form 10-Q includes forward-looking statements. We have based these forward-looking statements on our current expectations and projections about future events. In some cases, you can identify forward-looking statements by terminology such as may, will, could, likely, expect, believe or hopeful or the negative of such terms or other comparable terminology. Forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our and the television broadcast industry's actual results, levels of activity, performance, achievements and prospects to be materially different from those expressed or implied by such forward-looking statements. These risks, uncertainties and other factors include those identified in our 2004 Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 16, 2005.*

*We are under no duty to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, after the date of this Quarterly Report on Form 10-Q. In light of these risks, uncertainties and assumptions, the forward-looking events discussed in this Quarterly Report on Form 10-Q might not occur.*

The following discussion should be read in conjunction with the Company's consolidated financial statements and related notes included elsewhere in this report on Form 10-Q.

**Overview**

On August 8, 2005, we entered into a transaction to sell our station KUWB serving the Salt Lake City marketplace and, in accordance with U.S. generally accepted accounting principles, our statements of operations and cash flows reflect the results of this station as discontinued operations for all periods presented.

Our continuing television stations are regionally diverse and range in size (based on television households) from the 47th through the 85th largest markets in the nation. All but one of our stations are affiliates of The WB Television Network. Our second station in the Albuquerque Santa Fe marketplace is a UPN affiliate.

We derive revenues primarily from the sale of advertising time to local, regional and national advertisers. Our revenues depend on popular programming that attracts audiences in the demographic groups targeted by advertisers, allowing us to sell advertising time at satisfactory rates. Our revenues also depend significantly on factors such as the national and local economy and the level of local competition.

Our revenues are generally highest during the fourth quarter of each year, primarily due to increased expenditures by advertisers in anticipation of holiday season consumer spending and an increase in viewership during this period. We generally pay commissions to advertising agencies on local, regional and national advertising and to national sales representatives on national advertising. Our revenues reflect deductions from gross revenues for commissions payable to advertising agencies and national sales representatives.

Our primary ongoing operating expenses are costs of services, selling, general and administrative expenses, corporate expenses and depreciation and amortization. Costs of services include programming costs, which consist primarily of amortization of broadcast rights relating to syndicated programs as well as costs associated with the production of our morning news show, *The Daily Buzz*, music rights fees and network compensation expense. Other costs of service include advertising expenses, targeted at viewers, which are net of any reimbursement received or due to us for such advertising and promotion from The WB Network, UPN or from other program suppliers, and engineering and transmission related expenses. Selling, general and administrative expenses primarily include salaries, sales commissions to account executives, ratings services expenses, insurance and various related overhead expenses. Corporate expenses reflect costs of corporate management, which includes senior management and other centralized management support staff, along with investor relations expense, professional fees, directors and officers insurance and other related corporate overhead.

The first eleven months of 2004 included significant political advertising demand in certain of our markets. We do not directly benefit from such political spending, but the increased demand for commercial inventory generally had a positive effect on our ability to increase pricing and market share of non-political advertising expenditures. In 2005, with no material political advertising demand in our markets, most affiliates of the ABC, CBS and NBC networks, who were the primary beneficiaries of this advertising in 2004, have been competing aggressively to recapture non-political advertising dollars. We believe this aggressive competition will likely continue through November 2005. In addition to this competitive factor, national advertising demand during the third quarter and first nine months 2005 has been very weak. In comparison, non-political local advertising demand in our markets, excluding Salt Lake City, has been relatively healthy, growing approximately 8% for both the third quarter and first nine months of 2005 compared to the corresponding periods of 2004.

All but one of our stations are WB Network affiliates. The WB Network has experienced ratings declines over the past two seasons and several of our seven WB affiliated stations have suffered declines in ratings and viewership as a result. These declines have a direct effect on our ability to generate advertiser revenue. We are encouraged by the quality of The WB's new programs this fall and remain hopeful the network will return to a positive ratings trend this season. Also, the WB will reprogram weekday afternoons starting in January 2006 with shows targeting adult demographics. The Kids WB! block has become a drag on station revenue and ratings as the cable networks have taken control of that business. We believe the new schedule represents a growth opportunity for ACME.

As disclosed previously, the Company believes it will more likely be a seller than buyer in future television station transactions. There has been a marked increase over the past several months of television station sales at valuations in excess of implied public market values. We are cautiously optimistic that this improving transaction environment will generate new and renewed interest in further transactions and we continue to discuss possible transactions with potential buyers of our stations. The sale of our Salt Lake City station, while contingent on the buyer selling one of its radio stations in the market and subject to approval by the Federal Communications Commission, is expected to be completed either in the first or second quarter of 2006. Under the terms of a shared services agreement with Clear Channel, it is required to reimburse the Company for the station's operating losses, excluding depreciation and certain other items, up to a maximum amount of \$60,000 per month until closing.

## Results of Operations

### The Three Months Ended September 30, 2005 vs. September 30, 2004

Net revenues increased 7% to \$10.1 million for the third quarter ended September 30, 2005 compared to \$9.4 million for the same period a year ago. This increase reflects a near 186% increase in revenues related to our *The Daily Buzz* weekday morning news show and a 4% increase at our station group.

Programming expenses increased 8% to \$4.2 million for the third quarter of 2005 compared to \$3.9 million for the third quarter of 2004 due primarily to the impact of the fall 2004 season syndicated launch of *Malcolm in the Middle* and to an increase in news costs at *The Daily Buzz* compared to the third quarter of 2004. Other costs of service increased 7% to \$1.5 million compared to \$1.4 million for the third quarter of 2004 due principally to higher utility and property tax costs related to our Madison station's new transmission facilities completed last fall. Selling, general and administrative costs increased 5% to \$4.0 million compared to the prior year's third quarter expense of \$3.8 million primarily on higher compensation expense and ratings service costs.

Depreciation and amortization for the third quarter increased 10% to \$1.2 million, compared to \$1.1 million in the third quarter of 2004. This increase primarily reflects new depreciation expense on the Madison transmission facility build-out and the upgrade to HDTV of three of our stations in 2004.

Corporate expenses decreased 7% to \$887,000 for the third quarter of 2005 as compared to \$949,000 for the third quarter of 2004. This decrease primarily reflects reduced professional fees that were lower in our second year of compliance with Section 404 provisions of the Sarbanes Oxley Act and lower insurance costs.

Interest expense, net of interest expense allocated to discontinued operations, increased 100% to \$946,000 in the third quarter of 2005 compared to \$472,000 in the third quarter of 2004. This increase reflects our higher debt balances during the third quarter of 2005 compared to the third quarter 2004 and higher average borrowing rates.

We recorded a tax expense for continuing operations of \$563,000 during the third quarter of 2005, including a deferred tax expense of \$512,000, compared to a tax expense of \$814,000 in the corresponding quarter of 2004. This deferred tax expense relates to deferred tax liabilities associated with the amortization for tax purposes of our intangible assets.

Minority interest income, which relates to our *The Daily Buzz* joint venture with Emmis Communications, decreased to \$149,000 in the third quarter of 2005 from \$264,000 in the third quarter of 2004 due to the venture's reduced net losses on higher station licensing revenue.

Our loss from discontinued operations, which reflects the losses from our station in Salt Lake City and allocated interest expense, was \$952,000 for the third quarter of 2005 compared to \$1.5 million for the third quarter of 2004, which included a \$607,000 write-down in program rights, principally related to *The Drew Carey Show*. In the third quarter of 2004 we also incurred an additional \$411,000 in tax expense related to the 2003 sale of our St. Louis and Portland stations.

Our net loss for the third quarter of 2005 was \$3.9 million compared to a net loss of \$4.6 million for the third quarter of 2004.

#### **The Nine Months Ended September 30, 2005 vs. September 30, 2004**

Net revenues increased 5% to \$30.4 million for the first nine months of 2005 compared to \$28.9 million for the same period a year ago. This increase reflects the strong performance of *The Daily Buzz*, which increased its revenues during the period 296% compared to the first nine months of 2004 and a 2% increase at our station group net revenues.

Programming expenses increased 9% to \$12.4 million compared to \$11.4 million for the first nine months of 2004 due primarily to the impact of the fall 2004 season syndicated launch of *Malcolm in the Middle* and a \$441,000 increase in production costs related to *The Daily Buzz*. Other costs of service increased 8% to \$4.9 million for the first nine months of 2005 compared to \$4.5 million for the corresponding nine-month period a year ago primarily due to increased engineering costs related to higher repairs and maintenance and to our new transmission facility in Madison completed in September 2004. Selling, general and administrative costs were essentially unchanged at \$11.6 million for the first nine months of 2005 compared to \$11.7 million for the year earlier period.

Depreciation and amortization for the nine months ended September 30, 2005 increased 8% to \$3.5 million, compared to \$3.3 million for the nine months ended September 30, 2004. This increase reflects new depreciation expense on the new Madison facilities and the significant digital transmission related equipment placed into service during 2004.

Corporate expenses decreased 9% to \$2.5 million for the first nine months of 2005 as compared to \$2.8 million for the first nine months of 2004. This decrease primarily reflects reduced insurance costs and professional fees that were lower in our second year of compliance with Section 404 provisions of the Sarbanes Oxley Act.



In April 2005, we simultaneously acquired and then sold a construction permit in the Flint, Michigan marketplace and recognized a net gain on the sale of \$1.2 million.

Interest expense, net of interest expense allocated to discontinued operations, increased 119% to \$2.5 million for the nine months ended September 30, 2005 compared to \$1.1 million for the nine months ended September 30, 2004. This increase reflects our higher debt balances and higher average borrowing rates during the first nine months of 2005 compared to the corresponding period of 2004.

We recorded tax expense for continuing operations of \$1.7 million during the first nine months of 2005 compared to tax expense of \$1.9 million in the corresponding nine months of 2004.

Our loss from discontinued operations before taxes, which reflects the losses from our station in Salt Lake City, including allocated interest expense, was essentially unchanged at \$3.2 million for both the nine months of 2005 and 2004. Also included in our 2004 discontinued operating results is \$411,000 in tax expense related to the 2003 sale of our St. Louis and Portland stations.

Our net loss for the first nine months of 2005 was \$10.3 million compared to a net loss of \$10.7 million for the first nine months of 2004.

### **Liquidity and Capital Resources**

Cash flow used by operating activities was \$3.6 million for the nine months ended September 30, 2005 compared to cash flow used by operating activities of \$1.0 million for the first nine months of 2004. This increase in cash flow usage of \$2.6 million relates primarily to increased cash interest payments, reduced station operating results and higher working capital usage.

Cash flow used in investing activities during the first nine months of 2005 was \$45,000 compared to \$5.6 million used during the first nine months of 2004. This reduced usage reflects the \$1.7 million in proceeds from the sale of our Flint construction permit and related fixed assets in April 2005, and a \$3.6 million decrease in capital expenditures for the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004. The 2004 period usage also included the additional purchase consideration for a full-power satellite station in the Albuquerque-Santa Fe market acquired in the first quarter of 2004.

Cash flow provided by financing activities was \$7.2 million during the first nine months of 2005 compared to \$9.1 million provided by financing activities for the first nine months of 2004. The reduction in these cash flows relates primarily to the reduced funding related to our lower capital expenditures net of additional funding for operating losses and interest payments.

Our revolving credit agreement and second-lien term loan agreement mature on November 8, 2008 and May 8, 2009, respectively. On March 10, 2005, we amended certain of the quarterly financial covenants for calendar 2005 in both agreements. We did not amend these covenants for 2006 or beyond. On November 7, 2005, our lenders again amended our minimum EBITDA (earnings before interest, taxes, depreciation and amortization) covenant, effective September 30, 2005, for the twelve months ended that date and we were in compliance with all of the loans' covenants as of September 30, 2005.

We will not, however, be in compliance with our minimum EBITDA requirements under these financial covenants beginning with the quarter ended December 31, 2005. Based on these covenant issues, and because both the revolver and second-lien term loan lenders have the right to demand immediate repayment of the loans if we do not meet these covenants, we have classified the debt under both agreements as current liabilities as of September 30, 2005.

As noted, we have entered into an agreement to sell KUWB, our Salt Lake City station, to Clear Channel Communications for \$18.5 million. We will be discussing with our lenders during the coming months amending our credit agreements to reflect this sale and resetting financial covenants through the balance of the loan terms. We cannot assure you that we will be successful in completing the sale of KUWB, or the sale of any of our other stations on acceptable terms or, in the absence of any sales, be able to obtain from our lenders any waiver or amendment on terms favorable to us, or be successful in replacing our credit facilities, if necessary. We are a net borrower, with cash operating losses, capital expenditures and the occasional repurchases of our common stock being financed through our revolving credit facility. If we were in default under our credit facilities and unable to secure alternative funding or replace or renegotiate existing facilities, as a net borrower, we would not be able to fund existing operations unless we sold assets, and such sales could be at less than full price.

As of September 30, 2005, there was approximately \$31.7 million outstanding under the revolving credit facility at an average rate of 8.6% per annum and \$20.0 million outstanding under the second-lien term loan agreement at a rate of 10.9%. Approximately \$19.3 million of additional borrowings were available under the revolving credit facility as of September 30, 2005.

Our credit agreements allow us to repurchase up to an additional \$15 million in our common stock in addition to the \$5 million repurchased in 2004. The aforementioned November 7, 2005 amendment, however, limits our ability to repurchase shares until such time that we achieve certain dollar thresholds of station sales, including the pending sale of our Salt Lake City station. Further, the November 7, 2005 amendment requires us to pay down our senior credit facility with the proceeds of the Salt Lake City station sale and permanently reduce our maximum borrowings by that amount.

Our November 8, 2004 Board authorization to repurchase of up to \$10 million in our common stock expires on December 31, 2005. To date, we have not repurchased any of our common stock under this latest authorization. Past stock repurchases have been funded by borrowings under our revolving credit facility. Future stock repurchases, if they occur, will be funded through either borrowings under our revolving credit facility or through station sales, or both.

On April 14, 2005, we concurrently acquired and then sold our interest in the Flint construction permit and generated a net gain on these transactions of approximately \$1.2 million. The net cash generated from this sale was used to pay down our outstanding borrowings under our revolver. We expect that any future acquisitions (and related capital expenditures) of television stations, including that of our Lexington construction permit, would be financed through borrowings or possibly through additional equity financings.

### **Critical Accounting Policies and Estimates**

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to broadcast rights, bad debts, intangible assets, income taxes, and contingencies and litigation. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Our critical accounting policies are fully disclosed in our annual report on Form 10-K filed with the SEC on March 16, 2005. There have been no material changes to these policies during the quarter ended September 30, 2005.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

The Company's credit facilities have variable interest rates. Accordingly, the Company's interest expense could be materially affected by future fluctuations in the applicable interest rates. At September 30, 2005, the Company had outstanding borrowings of \$51.7 million under its credit facilities at an effective annual borrowing rate of 9.5%. Based on the outstanding borrowings at September 30, 2005, a 1% increase in our effective borrowing rate would increase our annual interest expense by approximately \$517,000.

### **Item 4. Controls and Procedures**

Disclosure controls and procedures are designed to ensure that information required to be disclosed in our periodic reports filed or submitted under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the required time periods. As of September 30, 2005, the end of the period covered by this report, the Company carried out an evaluation under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer of the effectiveness of our disclosure controls and procedures. Based on our evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that such controls and procedures were effective.

There were no changes in the Company's internal controls over financial reporting during the quarter ended September 30, 2005 that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

**PART II OTHER INFORMATION**

**Item 2. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities**

On November 8, 2004, the Board of Directors authorized the Company to repurchase up to \$10.0 million of our common stock in open market and private transactions through December 31, 2005. We have not acquired any shares to date under this program.

**Item 6. Exhibits and Reports on Form 8-K.**

**(a) Exhibits.**

- 10.1 Asset Purchase Agreement Dated August 8, 2005 between ACME Television of Utah, LLC, ACME Television Licenses of Utah, LLC, Clear Channel Broadcasting, Inc. and Clear Channel Broadcasting Licenses, Inc.
- 10.2 Second Amendment to the Second Amended and Restated Loan and Security Agreement by and among ACME Television, LLC, the Lenders that are signatories thereto and Wells Fargo Foothill, Inc., as Arranger and Administrative Agent, dated November 7, 2005.
- 10.3 Second Amendment to the Loan and Security Agreement by and among ACME Television, LLC, the Lenders that are signatories thereto and Fortress Credit Corp., as Arranger and Administrative Agent, dated November 7, 2005.
- 31.1 Certification of Chief Executive Officer pursuant to Rules 13a-14(a) under the Securities and Exchange Act of 1934, as amended
- 31.2 Certification of Chief Financial Officer pursuant to Rules 13a-14(a) under the Securities and Exchange Act of 1934, as amended
- 32 Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

**SIGNATURE**

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.

Date: November 9, 2005

ACME Communications, Inc.

By:

/s/ Thomas D. Allen

Thomas D. Allen

Executive Vice President, CFO &

Principal Accounting Officer

**EXHIBIT INDEX**

**Exhibit**

**Number Description**

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