

Seven Arts Entertainment Inc.  
Form 10-Q  
November 19, 2012

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U.S. SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q  
(Mark One)

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

For the quarterly period ended September 30, 2012

OR

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

Commission File Number 001-34250

SEVEN ARTS ENTERTAINMENT, INC.  
(Exact name of small business issuer as specified in its charter)

Nevada  
(State or other jurisdiction of  
incorporation or organization)

45-3138068  
(IRS Employer  
Identification No.)

8439 Sunset Boulevard 4th Floor  
Los Angeles, CA 90069  
(Address of principal executive offices)

(323) 372-3080  
(Issuer's telephone number)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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: Yes  No

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

Large Accredited Filer  Accelerated Filer   
Non-Accredited Filer  Smaller Reporting Company

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Company

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

As of November 14, 2012 there were 23,804,649 shares of Common Stock of the issuer outstanding.

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FORM 10-Q  
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Seven Arts Entertainment, Inc.  
Consolidated Balance Sheets  
As of September 30, 2012 and June 30, 2012

|   | September<br>30,<br>2012<br>(Unaudited) | June 30,<br>2012<br>(Audited) |
|---|---|-------------------------------|
| <b>ASSETS</b>   |   |                               |
| <b>CURRENT ASSETS:</b>  |   |                               |
| Cash and cash equivalents   | \$9,137                                 | \$ 120,658                    |
| Accounts receivable, net of allowance for doubtful accounts of \$171,062 and \$171,062                            | 241,741                                 | 192,035                       |
| Due from related parties  | 1,960,407                               | 2,116,538                     |
| Fee income receivable from related parties  | 5,896,970                               | 5,896,970                     |
| Other receivables and prepayments   | 1,768,410                               | 849,845                       |
| <b>Total Current Assets</b>   | <b>9,876,665</b>                        | <b>9,176,046</b>              |
| Long term receivable from related parties   | 1,643,928                               | 1,643,928                     |
| Film costs, less accumulated amortization of \$10,536,633 and \$10,458,823  | 14,965,355                              | 14,612,609                    |
| Music assets, less amortization of \$408,205 and \$0  | 3,098,323                               | 2,923,474                     |
| Leasehold Improvements, less amortization of \$37,927 and \$0   | 4,808,558                               | 4,551,270                     |
| Property and equipment, net of accumulated depreciation of \$111,501 and \$111,231                                | 16,407                                  | 16,137                        |
| <b>TOTAL ASSETS</b>   | <b>\$34,409,236</b>                     | <b>\$32,923,464</b>           |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |   |                               |
| <b>CURRENT LIABILITIES:</b>   |   |                               |
| Accounts payable  | \$1,393,265                             | \$ 1,152,977                  |
| Accrued liabilities   | 2,718,137                               | 2,758,844                     |
| Due to related parties  | 1,757,743                               | 1,060,905                     |
| Shares to be issued   | 92,207                                  | 200,000                       |
| Participation and residuals   | 127,950                                 | 114,215                       |
| Other loans   | 7,728,830                               | 7,163,731                     |
| Film & production loans   | 6,161,706                               | 6,124,428                     |
| Deferred income   | 922,580                                 | 849,080                       |
| <b>Total Current Liabilities</b>  | <b>20,902,418</b>                       | <b>19,474,180</b>             |
| Provision for earn-out  | 50,000                                  | 50,000                        |
| <b>TOTAL LIABILITIES</b>  | <b>\$20,952,418</b>                     | <b>\$19,424,180</b>           |
| <b>STOCKHOLDERS' EQUITY</b>   |   |                               |
| Convertible redeemable Series A preferred stock at \$10 par value, 125,125 and 0 authorized and outstanding       | \$1,251,250                             | \$ 1,251,250                  |
| Convertible redeemable Series B preferred stock at \$100 par value, 200,000 authorized, 180,000 and 0 outstanding | 4,762,952                               | 4,762,952                     |

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|   |                     |                     |
|---|---------------------|---------------------|
| Convertible redeemable Series B shares held in escrow   | (3,163,636 )        | (3,163,636 )        |
| Common stock; \$0.01 par value; 35,992,964 authorized, 4,166,677 and 1,739,900 issued and outstanding | 41,667              | 17,399              |
| Additional paid in capital  | 20,386,938          | 18,866,060          |
| Treasury stock  | (180,000 )          | -                   |
| Accumulated deficit   | (8,284,741 )        | (8,271,186 )        |
| Comprehensive income  | -                   | (13,555 )           |
| Current Earnings  | (1,357,621 )        | -                   |
| Shareholders' equity  | 13,456,809          | 13,449,284          |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>   | <b>\$34,409,227</b> | <b>\$32,873,464</b> |

The accompanying notes are an integral part of these consolidated financial statements.

Seven Arts Entertainment, Inc.  
Consolidated Statements of Operations  
For the Three Months Ended September 30, 2012 and 2011

|   | 3 Months<br>Ended<br>September<br>30, 2012 | 3 Months<br>Ended<br>September<br>30, 2011 |
|---|--|--|
| Revenue:  |  |  |
| Film revenue  | \$ 229,393                                 | \$ 592,541                                 |
| Music revenue   | 921,195                                    | -  |
| Post production revenue   | 6,450                                      | -  |
| Total revenue   | 1,157,038                                  | 592,541                                    |
| Cost of revenue   |  |  |
| Amortization and impairment of film costs and music assets                                  | 486,015                                    | 463,804                                    |
| Amortization of leasehold improvements  | 37,927                                     | -  |
| Provision for returns   | 231,405                                    | -  |
| Other cost of revenue   | 120,307                                    | 15,340                                     |
| Cost of revenue   | 875,653                                    | 479,144                                    |
| Gross profit  | 281,385                                    | 113,397                                    |
| Operating expenses:   |  |  |
| General and administrative expenses   | 669,948                                    | 681,885                                    |
| Total operating expenses  | 669,948                                    | 681,885                                    |
| Income from operations  | (388,563 )                                 | (568,488 )                                 |
| Non-operating income(expense)   |  |  |
| Other income  | 6,451                                      | -  |
| Interest expense  | (975,509 )                                 | (413,800 )                                 |
| Total non-operating income (expense)  | (969,058 )                                 | (413,800 )                                 |
| Income/(loss) before taxes  | (1,357,621)                                | (982,288 )                                 |
| Provision for income tax (benefit)  | -  | -  |
| Net income (loss)   | \$(1,357,621)                              | \$(982,288 )                               |
| Comprehensive income (loss):  |  |  |
| Net income (loss)   | (1,357,621)                                | (982,288 )                                 |
| Foreign exchange translation gain (loss)  | -  | (1,003 )                                   |
| Comprehensive income (loss)   | \$(1,357,621)                              | (983,291 )                                 |
| Weighted average number of common shares used in the earnings (loss) per share calculation: |  |  |
| Basic   | 2,493,294                                  | 100,224                                    |
| Diluted   | 2,493,294                                  | 100,224                                    |
| Basic earnings/ (loss) per share  | (0.54 )                                    | (9.81 )                                    |
| Diluted earnings/ (loss) per share  | (0.54 )                                    | (9.81 )                                    |

The accompanying notes are an integral part of these consolidated financial statements.



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Seven Arts Entertainment, Inc.

Consolidated Statements of Cash Flows  
Three Months Ended September 30, 2012 and 2011  
(Unaudited)

|   | Three Months<br>Ended<br>September 30,<br>2012 | Three Months<br>Ended<br>September 30,<br>2011 |
|---|--|--|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                |  |  |
| Net loss  | \$ (1,357,612)                                 | \$ (983,291)                                   |
| Adjustments to reconcile net loss to net cash used in operating activities: |  |  |
| Depreciation  | (270)  | 1,688  |
| Amortization and impairment of film costs & music assets                    | 486,015  | 463,804  |
| Amortization of leasehold improvements                                      | 37,927   | -  |
| Stock issued for services   | -  | 10,000   |
| Provision for returns   | 231,405  | -  |
| Increase in accounts receivable   | (49,706)                                       | (73,016)                                       |
| Decrease in due from related parties  | 156,131  | 957,762  |
| Increase in other receivables and prepayments                               | (918,565)                                      | (333,540)                                      |
| Decrease in bank overdraft  | -  | (987)  |
| Increase (decrease) in accounts payable                                     | 240,288  | (739,393)                                      |
| Increase in accrued liabilities   | (134,766)                                      | (1,925,056)                                    |
| Increase in deferred income   | 73,500   | 24,117   |
| Increase in due to related parties  | 696,838  | -  |
| Net cash used in operating activities                                       | (538,815)                                      | (2,597,912)                                    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                |  |  |
| Capitalization of film costs  | (430,556)                                      | (320,880)                                      |
| Capitalization of music assets  | (583,054)                                      | -  |
| Addition of leasehold improvements  | (295,215)                                      | -  |
| Net cash used in investing activities                                       | (1,308,825)                                    | (320,880)                                      |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                |  |  |
| Conversion of debt to common stock  | (2,446,219)                                    | (3,188,028)                                    |
| Proceeds from borrowings  | 1,616,119                                      | -  |
| Shares of common stock issued in satisfaction of debt                       | 2,446,219                                      | -  |
| Issuance of common stock for cash   | 300,000  | -  |
| Acquisition of treasury stock   | (180,000)                                      | -  |
| Shares of common stock issued to PLC for assets                             | -  | 7,880,000                                      |
| Common and preferred stock to be issued                                     | -  | 1,986,722                                      |
| Stock issued in share exchange  | -  | 64,763   |
| Liabilities retained in PLC in share exchange                               | -  | (3,783,988)                                    |
| Net cash provided by financing activities                                   | 1,736,119                                      | 2,959,469                                      |
| <b>NET INCREASE (DECREASE) IN CASH</b>                                      | <b>(111,521)</b>                               | <b>40,677</b>                                  |
| <b>CASH AT BEGINNING OF PERIOD</b>  | <b>120,658</b>                                 | <b>8,785</b>                                   |



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|   |    |             |    |             |
|---|----|-------------|----|-------------|
| CASH AT END OF PERIOD                           | \$ | 9,137       | \$ | 49,462      |
| Supplemental cash flow information:             |    |             |    |             |
| Cash paid for interest                          | \$ | -           | \$ | -           |
| Shares of common stock issued to PLC for assets | \$ | -           | \$ | 7,880,000   |
| Common and preferred stock to be issued         | \$ | -           | \$ | 1,986,722   |
| Stock issued in share exchange                  | \$ | -           | \$ | 64,763      |
| Liabilities retained in PLC in share exchange   | \$ | -           | \$ | (3,783,991) |
| Conversion of debt to common stock              | \$ | (2,446,219) | \$ | (3,188,028) |
| Stock issued for services                       | \$ | -           | \$ | 10,000      |

Seven Arts Entertainment, Inc.

Notes to Consolidated Financial Statements  
September 30, 2012  
(Unaudited)

NOTE 1 – NATURE OF ACTIVITIES AND SIGNIFICANT ACCOUNTING POLICIES

Nature of Activities, History and Organization:

Seven Arts Entertainment, Inc. (herein referred to as “the Company”, “Seven Arts” or “SAE,”), a Nevada Corporation, is the continuation of the business of Seven Arts Pictures Plc. (“PLC”), which was founded in 2002 as an independent motion picture production and distribution company engaged in the development, acquisition, financing, production, and licensing of theatrical motion pictures for exhibition in domestic (i.e., the United States and Canada) and foreign theatrical markets, and for subsequent worldwide release in other forms of media, including home video and pay and free television. The Company currently owns interests in 33 completed motion pictures, subject in certain instances to the prior financial interests of other parties.

As discussed herein, in late February 2012, the Company formed Seven Arts Music, Inc. (“SAM”) and acquired 52 completed sound recordings of the recording artist DMX from David Michery (“Michery”) with the rights to additional albums and acquired 100% of the stock of Big Jake Music (“BJM”). As a result, the Company is also in the business of producing and distributing recorded music.

On June 30, 2012 Seven Arts Filmed Entertainment LLC (“SAFELA”) was transferred to the Company. SAFELA, which is now 60% owned by the Company, has a 30 year lease to operate a film production and post-production facility at 807 Esplanade in New Orleans, Louisiana. The post production facility commenced operations on July 1, 2012.

On June 11, 2010, SAE, was formed and became a wholly owned subsidiary of PLC. As of June 11, 2010, the Company entered into an Asset Transfer Agreement, as amended on January 27, 2011 and again on August 31, 2011, to transfer certain assets with a cost basis from PLC to SAE, in exchange for assumption by SAE of certain indebtedness and for one share of common stock of SAE for each ordinary share of PLC which have been distributed to shareholders. Additionally, 28,571 shares (2,000,000 shares as adjusted for the 1:70 reverse stock split discussed herein) of SAE were issued to PLC in order to satisfy any remaining obligations. This transfer was approved by the PLC shareholders at an Extraordinary General Meeting on June 11, 2010. The purpose of this transfer was to eliminate our status as a foreign private issuer and to assume compliance with all obligations of a domestic issuer under all applicable state and Federal securities laws. Our intention in executing this transaction was to redomicile our business with no change in the economic interests of our shareholders.

On August 31, 2011, NASDAQ approved the substitution of one share of SAE, Inc. stock for the Company's NASDAQ listing, effective at the opening of trading on September 1, 2011. On that date, each of the Company's ordinary shares were exchanged for one share of common stock of SAE, and commenced trading on NASDAQ as the successor to the Company's NASDAQ listing. This transaction was approved by the Company's shareholders at the Company's Extraordinary General Meeting on June 11, 2010. On August 31, 2012, the Company announced a 1:70 reverse stock split, which was effective immediately. All share references herein have been adjusted to reflect this split.

On November 8, 2011, the Company's listing predecessor, PLC, was placed into involuntary creditors liquidation under English law (See Note 12 – Commitments and Contingencies). Certain indebtedness of PLC remained with PLC and will be subject to administration or payment in those administration proceedings. In accordance with the asset

transfer agreement, PLC has been issued 2 million (pre-split)/28,571 post-split shares of common stock of SAE in order to satisfy these obligations.

In connection with the acquisition of the music assets of Michery, the Company issued 50,000 shares of our Series B convertible preferred stock, par value \$100 convertible at approximately \$1.10 per share) to Michery and his assigns and agreed to issue an additional 50,000 shares of the Company's Series B convertible preferred stock to Michery and his assigns if two DMX albums and two Bone Thugs-N-Harmony albums generate an aggregate of net earnings before interest and taxes of \$5,000,000 during the next five fiscal years. The second 50,000 shares are currently held in escrow. Michery is the Chief Executive Officer of SAM.

In connection with the acquisition of the stock of BJM, the Company issued 10,000 shares of the Company's Series B convertible preferred stock, par value \$100 convertible at approximately \$1.10 per share) to Jake Shapiro and his assigns and agreed to issue an additional 70,000 shares of our Series B convertible preferred stock to Shapiro and his assigns if certain specific terms are met 40,000 shares are subject to proving valuation and usage of certain advertising credits and 30,000 shares are subject to an earnout over a two year period. The 70,000 shares are currently held in escrow.

Seven Arts Pictures Louisiana LLC, ("SAPLA"), a related party of the Company, entered into a Credit Agreement with Advantage Capital Community Development Fund LLC dated October 11, 2007, for the acquisition and improvement of the production and post-production facility located at 807 Esplanade Avenue in New Orleans, Louisiana ("807 Esplanade") for aggregate principal advances of up to \$3,700,000. This agreement was guaranteed by the Company's predecessor. Approximately \$3,700,000 plus interest has been drawn under the terms of this Credit Agreement, as of June 30, 2012. The Company has now assumed the liability for \$1,000,000 of this amount plus a contingent sum of \$750,000 (contingent on receipt of the tax credit revenues) due to an agreement with the now mortgagor Palm Finance. A construction loan of \$1,850,000 previously guaranteed by the Company has now also been assumed by the Company, through SAFELA, for the grant of a 30 year lease on the property 807 Esplanade to operate a film production and post-production facility

On August 31, 2012, the Company announced a 1-for-70 reverse split of its common stock effective as of 4:01p.m. EDT. The new CUSIP number is 81783N 201. By virtue of the reverse split, every 70 shares of the outstanding common stock were combined and converted into one share of new common stock with resulting fractional shares rounded up to the next whole share. The Company also announced that it will proportionately reduce the number of its authorized shares of common stock.

Seven Arts also announced that, subject to appropriate and required regulatory filings and approvals, it has declared a warrant dividend to those persons beneficially owning its common stock as of the close of the markets on August 31, 2012. For every ten pre-reverse split shares of common stock held as of such date and time, the holders thereof will be entitled to receive one warrant as a dividend. Until its expiration date, each warrant, once distributed following such approvals, will be exercisable for the purchase of one share of the Company's post-reverse split common stock at a price equivalent to today's post-reverse split closing bid price. The warrants will expire on the earlier of (i) the date that the holder disposes of the common stock in respect of which the warrant dividend was declared, if such disposition occurs on or before the close of the markets on October 31, 2012, or (ii) 5:00 p.m., PST, on January 31, 2013. Seven Arts does not expect that a secondary market will develop for such warrants.

On September 14, 2012 the Company's common stock began trading on the OTC Market's OTCQB marketplace. The Company's common shares trade under the Company's symbol "SAPX." The Company is applying to trade on the highest OTC marketplace, OTCQX, but is trading on the OTCQB tier until the Company is eligible to trade on the OTCQX.

Trading of the Company's common stock on The NASDAQ Capital Market was suspended at the opening of business on September 14, 2012, due to the fact that the Company did not meet the \$1 minimum bid price stock listing requirement of NASDAQ for ten trading days prior to September 20, 2012, the expiration date on the Company's six-month extension to meet this listing requirement.

Capital Structure:

SAE's authorized capital is 250,000,000 shares of capital stock. SAE has authorized the following classes of stock:

35,667,840 shares of common stock authorized, \$.01 par value per share. As of September 30, 2012, there were 4,166,677 shares of common stock outstanding, all of which are fully paid and non-assessable (including the 28,571 shares issued to SAP Plc. as part of the asset transfer agreement approved by the SEC in January 2011). Each outstanding share of common stock entitles the holder thereof to one vote per share on matters submitted to a vote of stockholders.

125,125 shares of Series A Preferred Stock with a \$10.00 par value per share, issued to one shareholder in November 2011. These shares have a conversion price to common stock of \$10.50 per share.

200,000 shares Series B Preferred Stock with a \$100.00 par value per share, issued in February, 2012, 120,000 of such shares are held in escrow subject to earn out provisions. The per share conversion price for the Series B Preferred Stock is \$1.10 per share.

214,007,035 shares of unallocated capital stock

SAE is now a United States issuer and commenced regular quarterly reporting from the first quarter ended September 30, 2011.

Unaudited Financial Statements:

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States of America and the rules of the Securities and Exchange Commission. These financial statements are unaudited and, in the opinion of management, include all adjustments necessary to present fairly the balance sheet, statement of operations, statement of stockholders' equity and statement of cash flows for the periods presented in accordance with accounting principles generally accepted in the United States. The Company was considered a domestic filer as of its September 30, 2011 quarter-end, and filed its first Form 10-Q in October 2012.

Significant Accounting Policies:

The Company's management selects accounting principles generally accepted in the United States of America and adopts methods for their application. The application of accounting principles requires the estimating, matching and timing of revenue and expense. It is also necessary for management to determine, measure and allocate resources and obligations within the financial process according to those principles. The accounting policies used conform to generally accepted accounting principles which have been consistently applied in the preparation of these financial statements.

The financial statements and notes are representations of the Company's management which is responsible for their integrity and objectivity. Management further acknowledges that it is solely responsible for adopting sound accounting practices, establishing and maintaining a system of internal accounting control and preventing and detecting fraud. The Company's system of internal accounting control is designed to assure, among other items, that 1) recorded transactions are valid; 2) valid transactions are recorded; and 3) transactions are recorded in the proper period in a timely manner to produce financial statements which present fairly the financial condition, results of operations and cash flows of the Company for the respective periods being presented.

Basis of Presentation:

The accompanying consolidated financial statements include the accounts of Seven Arts Entertainment, Inc. ("SAE"), and its subsidiaries:

Seven Arts Filmed Entertainment, Limited ("SAFE, Ltd.") (100% owned)  
Seven Arts Music, Inc. ("SAM") (100% owned) and  
Big Jake Music, Inc. ("BJM") (100% owned)  
Seven Arts Filmed Entertainment Louisiana LLC ("SAFELA") (As of June 30, 2012) (60% owned by SAE, 40% owned by Palm Finance)

The Company consolidates its subsidiaries in accordance with Accounting Standards Codification ("ASC") 810, "Business Combinations", and specifically ASC 810-10-15-8 which states, "The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule, ownership by one reporting entity, directly or indirectly, or over 50% of the outstanding voting shares of another entity is a condition pointing toward consolidation." The Company does not have any variable interest or special purpose entities. Going forward, the Company will present Palm Finance's 40% share of SAFELA's profit or loss as a non-controlling interest. As of September 30, 2012, SAFELA's net loss was not material (approximately \$3,000).

The Company prepares its financial statements on the accrual basis of accounting and in accordance with Generally Accepted Accounting Principles of the United States of America ("US GAAP"). All material intercompany balances and transactions are eliminated. Management believes that all adjustments necessary for a fair presentation of the results of the year ended September 30, 2012 and 2011 have been made.

Use of Estimates:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect certain reported amounts and disclosures. The most significant estimates made by management in the preparation of the financial statements relate to ultimate revenue and costs of its films which are used in the amortization and impairment of film costs, estimates for allowances and income taxes. Accordingly, actual results could differ from those estimates.

Recently Issued Accounting Pronouncements:

The Company does not expect the adoption of recently issued accounting pronouncements to have a significant impact on the Company's results of operations, financial position or cash flow.

Revenue Recognition:

FILMS

The Company recognizes revenue from the sale (minimum guarantee or non-refundable advances) or licensing arrangement (royalty agreements) of a film in accordance with ASC 605-15 "Revenue Recognition". Revenue will be recognized only when all of the following criteria have been met:

- a) Persuasive evidence of a sale or licensing arrangement with a customer exists.
- b) The film is complete and, in accordance with the terms of the arrangement, has been delivered or is available for immediate and unconditional delivery. (i.e. the “notice of delivery” (“NOD”) has been sent and there is a master negative available for the customer).
- c) The license period of the arrangement has begun and the customer can begin its exploitation, exhibition, or sale.
- d) The arrangement fee is fixed or determinable.
- e) Collection of the arrangement fee is reasonably assured.

A written agreement with clients (purchase order, letter, contract, etc.), indicating the film name, territory and period is required for the recognition of revenue. Revenue is recognized when the performance criteria in the contracts have been met. The customer generally confirms agreement by their signature on the contract.

Minimum guarantee revenue (i.e., non-refundable advances) is recognized as and when the film is available for delivery to the respective territories. Cash deposits received on the signing of the contracts are recorded as deferred revenue until the film is available for delivery (as described above) at which point the deferred revenue is recognized as revenue. The Company does not recognize any revenues relating to minimum guarantee on any motion picture or related amortization expense on that picture until United States theatrical release if it has agreed with the licensees that delivery or payment of minimum guarantee will be delayed for any material period of time to permit such a theatrical release.

Royalty revenue, which equates to an agreed share of gross receipts of films, is recognized as income as and when the Company is notified of the amounts by the customers through their royalty reports. Revenue is recorded net of any sales or value added taxes charged to customers.

#### MUSIC

Revenue, which equates to an agreed share of gross receipts, is recognized as income when the Company is notified of the amounts by the distribution agent through their distribution reports.

Revenue is recorded:

- a) net of any sales or value added taxes charged to customers
- b) net of discounts agreed with customers
- c) net of returns provision agreed with the distributor and
- d) grossed up for the distribution fee charged by the distribution agent.

Revenue from digital distribution will be reported by the various digital platforms such as iTunes in their periodic reports and posted as received.

#### FEE RELATED REVENUES

Many countries make tax credits available to encourage film production in the territory. Seven Arts benefits from tax credits in:

- a) The UK and several other European territories for their European productions
- b) Canada for their Canadian productions
- c) Louisiana for their US productions
- d) Tax preferred financing deals

These tax credits may be treated as a reduction in the capitalized costs of the film assets they are financing or as producer fees to us if the tax credits are earned and owned by a company in the Group and paid to us as overhead or producer fees.

#### SAPLA REVENUE SHARING FEES

Revenue in the form of fee income is due to the Company from related party, SAPLA (owned by the wife of Peter Hoffman, the Company's CEO) in the amount of the net proceeds from the disposition of the tax credits by SAPLA. In accordance with an intercompany agreement between SAE and SAPLA, all revenues earned by SAPLA are due to SAE.

#### Foreign Currency Transactions and Comprehensive Income:

The Company's functional currency, as well as that of all the Company's subsidiaries, is the US Dollar. The functional currency of the Company's predecessor, was the Pound Sterling ("GBP"), and some transactions which are generated in the United Kingdom are denominated in GBP.

Assets and liabilities generated in a currency other than the functional currency are translated at exchange rates as of the balance sheet date. Revenues and expenses are translated at average rates in effect for the periods presented. The cumulative translation adjustment is included in the accumulated other comprehensive gain (loss) within shareholders' equity. Foreign currency transaction gains and losses arising from exchange rate fluctuations on transactions denominated in a currency other than the functional currency are included in the consolidated results of operations.

Where possible, the Company seeks to match GBP income with GBP expenditures. To date, the Company has not hedged any transactional currency exposure but will keep such exposures under review and where appropriate may enter into such transactions in future.

#### Income Taxes:

The Company has adopted ASC 740-10 "Income Taxes", which requires the use of the liability method in the computation of income tax expense and the current and deferred income taxes payable.

#### Cash and Cash Equivalents:

Cash and cash equivalents includes cash in banks with original maturities of three months or less and are stated at cost which approximates market value, which in the opinion of management, are subject to an insignificant risk of loss in value. The cash and cash equivalents of the Company consisted of cash balances held on deposit with banks, including various accounts denominated in US Dollars, Pounds Sterling and Euros.

#### Accounts Receivable:

Accounts Receivable are carried at their face amount, less an allowance for doubtful accounts. On a periodic basis, the Company evaluates accounts receivable and establishes an allowance for doubtful accounts based on a combination of specific customer circumstances and credit conditions, and on a history of write offs and collections. The Company's



policy is generally not to charge interest on trade receivables after the invoice becomes past due. A receivable is considered past due if payments have not been received within agreed upon invoice terms. Write offs are recorded at a time when a customer receivable is deemed uncollectible. The Company's allowance for doubtful accounts was \$171,062 at both September 30, 2012 and June 30, 2012. Substantially all of the trade receivables in the consolidated financial statements are pledged as security for borrowings by the Company.

#### Due To/Due From Related Parties

In September 2004, the Company's predecessor entered into an agreement with SAP under which SAP provided the services of Mr. Peter Hoffman for the amount of his contracted salary and the Los Angeles office and staff of SAP Inc. to the Company's predecessor at cost. Pursuant to two inter Company agreements, SAP also from time-to-time owned limited liability companies in the United States which distributed the Company's motion pictures for a fee, with all profits ensuing to the benefit of the Company. These companies also provided other services to the Company at no fee other than Mr. Hoffman's salary and the direct third-party costs of SAP's Los Angeles office, all of which were reflected in the Company's financial statements. Portions of Mr. Hoffman's salary have not been paid to him and have been reflected as Due To Related Party. As of September 30, 2012, \$1,744,186 was owed to Mr. Hoffman for unpaid salary and unreimbursed expenses, as well as repayment of cash he advanced the Company or its predecessors. During the quarter ended September 30, 2012, shares were issued in satisfaction of a portion of this liability. These shares are being held as collateral for two loans (JMJ and Tonaquint) and will be returned to the Company if not called as collateral.

These other services may include accounting services, audits of distribution statements, collection of accounts receivable, supervision of production of motion pictures and similar day-to-day aspects of the Company's business. SAP assigned to the Company any proceeds arising from services performed by SAP on its behalf. SAP was granted the power and authority to enter into agreements on the Company's behalf. These agreements have terminated as of December 31, 2011.

SAP directly or through related various Louisiana limited liability companies have, from time-to-time, made non-interest bearing advances to the Company or its subsidiaries or have received advances back from the Company, and have paid expenses on each other's behalf.

#### Fee Income Receivable from Related Party -- Current and Long Term Receivable

Income due from SAPLA under the terms of an intercompany agreement with SAE whereby any revenue earned by SAPLA is due to SAE Inc. Any fees due later than twelve months are classified as Long Term Receivable.

#### Other Receivables and Prepayments:

The Company has entered into contracts for investor relations and consulting services to assist in future fundraising activities. A portion of these services were prepaid with shares of common stock that vested immediately and will be amortized over the period the services are to be provided. Additionally, the Company has approximately \$200,000 and \$125,000 in revenue to be received from digital platforms on the films, *The Pool Boys* and *Drunkboat*, respectively, which has been earned but not received as of September 30, 2012. Also included in other receivables is approximately \$639,000 receivable from the Company's distributor of the DMX album. The Company released the album and shipped approximately 110,000 units this quarter. The receivable is net of a customary allowance for returns.

#### Film Costs:

Film costs include the unamortized costs of completed films which have been produced by the Company or for which the Company has acquired distribution rights, libraries acquired as part of acquisitions of companies and films in progress and in development. For films produced by the Company, capitalized costs include all direct production and financing costs, capitalized interest and production overhead.



Costs of acquiring and producing films are amortized using the individual-film-forecast method, whereby these costs are amortized and participations and residuals costs are accrued in the proportion that current year's revenue bears to management's estimate of ultimate revenue at the beginning of the current year expected to be recognized from the exploitation, exhibition or sale of the films. The majority of a film's costs (approximately 80% or more) are generally amortized within three years of the picture's initial release.

Ultimate revenue includes estimates over a period not to exceed ten years following the date of initial release. Film costs are stated at the lower of amortized cost or estimated fair value. Individual film costs are reviewed on a title-by-title basis, when an event or change in circumstances indicates that the fair value of a film is less than its unamortized cost. The fair value of the film is determined using management's future revenue and cost estimates and a discounted cash flow approach. Impairment is recorded in the amount by which the unamortized costs exceed the estimated fair value of the film. Estimates of future revenue involve measurement uncertainty, and therefore it is possible that reductions in the carrying value of investment in films may be required as a consequence of changes in management's future revenue estimates.

Films are included in the general "library" category when initial release dates are at least three years prior to the acquisition date.

Films in progress include the accumulated costs of productions which have not yet been completed. Films in development include costs of acquiring film rights to books, stage plays or original screenplays and costs to adapt such projects. Such costs are capitalized and, upon commencement of production, are transferred to production costs. Projects in development are written off at the earlier of the date they are determined not to be recoverable or when abandoned.

#### Music Assets:

The initial material assets that were acquired comprise 52 completed sound recordings including two completed albums with "DMX", up to two additional albums from "DMX" and up to five albums from "Bone Thugs-N-Harmony".

Music assets include the unamortized costs of completed albums, singles and videos which have been produced by the Company or for which the Company has acquired distribution rights, libraries acquired as part of acquisitions and albums in progress and in development. For albums produced by the Company, capitalized costs include all direct production and financing costs, capitalized interest and production overhead.

Costs of acquiring and producing music assets will be amortized using the individual-album-forecast method, whereby these costs are amortized in the proportion that current year's revenue bears to management's estimate of ultimate revenue at the beginning of the current year expected to be recognized from the exploitation or sale of the music.

#### Leasehold Improvements:

On June 30, 2012, the Company acquired SAFELA, which was previously a related party company. SAFELA owns, in its capacity, a 30 year lease on 807 Esplanade, New Orleans, Louisiana, which was constructed as a production and post-production facility for the Company's use. Additionally, SAFELA owns the capitalized leasehold improvements in 807 Esplanade and the related debt which financed the construction. Through this acquisition, the Company has capitalized the leasehold improvements and assumed the debt related. As the leasehold improvements and the debt are booked at the same amounts, no net assets were transferred into the Company and no additional consideration has been paid.

The post production facility commenced operations on July 1, 2012. The leasehold improvements are being amortized over the useful life of the lease.

Property & Equipment:

Equipment is carried at the cost of acquisition or construction and depreciated over the estimated useful lives of the assets. Costs associated with repair and maintenance are expensed as incurred. Costs associated with improvements which extend the life, increase the capacity or improve the efficiency of our property and equipment are capitalized and depreciated over the remaining life of the related asset. Gains and losses on dispositions of equipment are reflected in operations. Depreciation and amortization are provided using the straight-line method over the estimated useful lives of the assets, which are 3 to 5 years.

Impairment of Long Lived Assets:

The Company evaluates, on a periodic basis, long-lived assets to be held and used for impairment in accordance with the reporting requirements of ASC 360-10, "Accounting for the Impairment or Disposal of Long-Lived Assets". The evaluation is based on certain impairment indicators, such as the nature of the assets, the future economic benefit of the assets, any historical or future profitability measurements, as well as other external market conditions or factors that may be present. If these impairment indicators are present or other factors exist that indicate that the carrying amount of the asset may not be recoverable, then an estimate of the discounted value of expected future operating cash flows is used to determine whether the asset is recoverable and the amount of any impairment is measured as the difference between the carrying amount of the asset and its estimated fair value. The fair value is estimated using valuation techniques such as market prices for similar assets or discounted future operating cash flows.

Deferred Income:

Any income received from customers before a film is delivered for release (such as deposits on distribution contracts) is recorded as a deferred income until all of the criteria for the Company's revenue recognition policy have been met.

Provision for Earn-Out for David Michery/Big Jake Music:

The Company's Asset Purchase Agreement with David Michery provided for 50,000 of the Company's \$100 par, Convertible Redeemable Series B Preferred Shares, be held in Escrow until the Net EBIT (as defined in the agreement) from distribution of the DMX Albums and two albums embodying the performance of Bone Thugs-n-Harmony exceeds \$5,000,000, as confirmed by the Company's independent auditor. At the end of five years, should the Net EBIT be less than \$5,000,000, the shares will be released on a fractional basis, as defined in the agreement. The Company has determined the current estimate of fair value of the earn-out to be \$0.

In connection with the acquisition of the stock of BJM, the Company issued 10,000 shares of the Company's Series B convertible preferred stock, par value \$100, convertible at approximately \$1.10 per share) to Jake Shapiro and his assigns and agreed to issue an additional 70,000 shares of our Series B convertible preferred stock to Shapiro and his assigns if certain specific terms are met 40,000 shares are subject to proving valuation and usage of certain advertising credits and 30,000 shares are subject to an earn-out over a two year period. The 70,000 shares are currently held in escrow.

The Company has determined the fair value of the earn-out with regard to the proving of the media credits is \$50,000, as of June 30, 2012 which the Board believes is the value of an equivalent public relations campaign for the two projects for which the credits have been used. Mr. Shapiro does have the right to seek an independent valuation.



Asset Transfer Agreement:

On June 11, 2010, Seven Arts Entertainment, Inc. ("SAE"), a Nevada Corporation, was formed and became a wholly owned subsidiary of Seven Arts Pictures Plc. As of June 11, 2010, the Company entered into an Asset Transfer Agreement, as amended on January 27, 2011 and again on August 31, 2011, to transfer all of the assets with a cost basis from PLC to SAE, in exchange for assumption by SAE of certain indebtedness and for one share of common stock of SAE for each ordinary share of PLC which have been distributed to shareholders. Additionally, 28,571 (2,000,000 pre-split) shares of SAE were issued to PLC in order to satisfy any remaining obligations. This transfer was approved by the PLC shareholders at an Extraordinary General Meeting on June 11, 2010. The purpose of this transfer was to eliminate our status as a foreign private issuer and to assume compliance with all obligations of a domestic issuer under all applicable state and Federal securities laws. Our intention in executing this transaction was to redomicile our business with no change in the economic interests of our shareholders.

The assets and certain of the liabilities of SAP Plc. were brought across at net book value. All related party balances of PLC were left in the original company as were the shares in SAFE(UK) Ltd and Cinematic Finance Ltd. All disputed debts were left with the PLC. The "price" paid for the asset transfer was a one for one share issue in SAE Inc. and an issuance of a further 2,000,000 (pre-split) 28,571 post-split ) shares in SAE Inc. The issuance of the 2,000,000 shares was booked at the closing market price on August 31 2011, which was \$0.66/share.

Earnings Per Share:

Basic earnings (loss) per share are computed by dividing net income (loss) by the weighted average number of common shares outstanding for the period. Diluted earnings (loss) per share include the effects of any outstanding options, warrants and other potentially dilutive securities. For the periods presented, there were no potentially dilutive securities outstanding, therefore basic earnings per share equals diluted earnings per share. Basic and diluted earnings per share ("EPS") are based on weighted-average common shares and exclude shares that would have an anti-dilutive effect. In accordance with ASC 260-10-45-19, the Company did not consider any potential common shares in the computation of diluted EPS as of June 30, 2012 and 2011, due to the loss from continuing operations, as they would have an anti-dilutive effect on EPS.

Share Based Payments:

The Company accounts for share based payments using a fair value based method whereby compensation cost is measured at the grant date based on the value of the services received and is recognized over the service period. The Company uses the Black-Scholes pricing model to calculate the fair value of options and warrants issued. In calculating this fair value, there are certain assumptions used such as the expected life of the option, risk-free interest rate, dividend yield, volatility and forfeiture rate. The use of a different estimate for any one of these components could have a material impact on the amount of calculated compensation expense.

Segment Reporting:

The Company now operates in three business segments as a motion picture producer and distributor; as a music label managing the assets of David Michery and Big Jake Music and as a provider of both production and post-production services at its facility at 807 Esplanade in New Orleans. The Company believes that its businesses should be reported as three business segments. (See Note 2 - Segment Information).



## Fair Value Measurements:

ASC Topic 820, "Fair Value Measurements and Disclosures", defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and requires certain disclosures about fair value measurements. In general, fair value of financial instruments are based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon internally developed models that primarily use, as inputs, observable market based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality and the Corporation's credit worthiness, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time.

## Derivative Instruments:

The Company's policy is to not use derivative or hedging financial instruments for trading or speculative purposes, except certain embedded derivatives derived from certain conversion features or reset provisions attached to the convertible debentures, as described in Note 9.

## Reclassification:

Certain prior year balances were reclassified to conform with current year presentation.

## NOTE 2 - SEGMENT INFORMATION

In accordance with ASC 280 "Segment Reporting", operating segments are identified as components of an enterprise about which separate discrete financial information is available for evaluation by the chief operating decision maker, or decision-making group, in making decisions how to allocate resources and assess performance. Our chief decision maker, as defined under the FASB's guidance, is a combination of the Chief Executive Officer and the Chief Financial Officer.

In the quarter ended March 31, 2012, the Company formed a new subsidiary, Seven Arts Music, and acquired music assets from David Michery and purchased the stock of Big Jake Music. This is a new line of business for the Company.

On June 30, 2012, the Company acquired SAFELA, which was previously a related party company. SAFELA owns, in its capacity, a 30 year lease on 807 Esplanade, New Orleans, Louisiana, which was constructed as a production and post-production facility for the Company's use. The post production facility commenced operations on July 1, 2012. This is also a new line of business for the Company.

The table below presents the financial information for the three reportable segments for the year ended September 30, 2012.

|                     | Three Months Ended<br>September 30, 2012 |                |                                 | Total       |
|---------------------|--|----------------|---------------------------------|-------------|
|                     | Film<br>(SAFE)                           | Music<br>(SAM) | Post-<br>Production<br>(SAFELA) |             |
| Revenue             | \$229,393                                | \$921,195      | \$6,450                         | \$1,157,038 |
| Cost of revenue     | (108,549 )                               | (729,177 )     | (37,927 )                       | (875,653 )  |
| Gross profit/(loss) | 120,844                                  | 192,018        | (31,477 )                       | 281,385     |

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|                      |              |           |             |              |
|----------------------|--------------|-----------|-------------|--------------|
| Operating expenses   | (376,242 )   | (32,979 ) | (34,534 )   | (443,755 )   |
| Loss from operations | \$(255,398 ) | \$159,039 | \$(66,011 ) | \$(162,370 ) |
| SAE Inc.             |              |           |             | (226,184 )   |
| Total Operating Loss |              |           |             | \$(388,554 ) |

## Assets

|                        | September 30,<br>2012 | June 30,<br>2012 |
|------------------------|-----------------------|------------------|
| Film assets            | \$ 14,965,355         | \$ 14,612,609    |
| Music assets           | 3,098,323             | 2,923,474        |
| Post-production assets | 4,808,558             | 4,551,270        |

## NOTE 3 – RELATED PARTY DUE TO/DUE FROM

SAP, Inc. directly or through related various Louisiana limited liability companies have from time-to-time made non-interest bearing advances to the Company or its subsidiaries or have received advances back from the Company. The net balances of these combined accounts due to the Company as of September 30, 2012 and June 30, 2012 were \$202,664 and \$1,055,632, respectively.

| As of September 30, 2012 | SAE          | SAFE         | CONSOLIDATED<br>BALANCE |
|--------------------------|--------------|--------------|-------------------------|
| SAP Inc.                 | \$ 1,807,088 | \$ (20,850)  | \$ 1,786,238            |
| SAP LOU                  | 161,861      | -            | 161,861                 |
| Peter Hoffman            | (1,727,627)  | (16,559)     | (1,744,186)             |
| SAFE (UK)                | -            | (13,557)     | (13,557)                |
| SAP PLC                  | 73,680       | (61,372)     | 12,308                  |
|                          | \$ 315,002   | \$ (112,338) | \$ 202,664              |

SAP, Inc. has pledged an interest in its shares of the Company's stock to secure certain indebtedness for which SAP, Inc. and the Company are jointly liable such as the Apollo and Armadillo debts. The stock of SAP, Inc. (previously owned by Peter Hoffman) was transferred to the listing predecessor of SAE on September 1, 2011.

## SAP Inc. and Louisiana Companies:

The Company's Chief Executive Officer, Peter Hoffman, controls several companies, including (prior to September 10, 2011) Seven Arts Pictures, Inc. ("SAP, Inc.") that are not part of the Company but from which it obtains or transfers distribution rights or other assets related to the business and which control production of the motion pictures. The agreements with Mr. Hoffman, and the companies controlled by him, provide that all revenues related to the Company's business payable to Mr. Hoffman or any of these related party companies is due to the Company, except Mr. Hoffman's salary, bonus and stock ownership. None of these affiliates are variable interest or special purpose entities.

Pursuant to a related party agreement, SAP, Inc. holds ownership of limited liability corporations in the United States, with all distribution rights and profits thereof being due to SAFE, Ltd. In addition, they have also provided other services for Seven Arts Pictures Plc. and SAFE, Ltd. and SAE, Inc. at no fee other than Mr. Hoffman's salary and the direct third party costs of the Los Angeles office, all of which are reflected in the financial statements of SAFE, Ltd. These other services include any reasonable requests of the management of the Company including accounting services, audits of distribution statements, collection of accounts receivable, supervision of production of motion pictures and similar day-to-day aspects of the Company's business. Effective January 1, 2012 no further such transactions are intended.

**Peter Hoffman:**

In September 2004, the Company's predecessor entered into an agreement with SAP under which SAP provided the services of Mr. Peter Hoffman for the amount of his contracted salary and the Los Angeles office and staff of SAP Inc. to the Company's predecessor at cost. Pursuant to two inter Company agreements, SAP also from time-to-time owned limited liability companies in the United States which distributed the Company's motion pictures for a fee, with all profits ensuing to the benefit of the Company. These companies also provided other services to the Company at no fee other than Mr. Hoffman's salary and the direct third-party costs of SAP's Los Angeles office, all of which were reflected in the Company's financial statements. Portions of Mr. Hoffman's salary have not been paid to him and have been reflected as Due To Related Party. As of September 30, 2012, \$1,744,186 was owed to Mr. Hoffman for unpaid salary and unreimbursed expenses, as well as repayment of cash he advanced the Company or its predecessors. During the quarter ended September 30, 2012, shares were issued in satisfaction of a portion of this liability. These shares are being held as collateral for two loans (JMJ and Tonaquint) and will be returned to the Company if not called as collateral.

**807 Esplanade Guarantee:**

Seven Arts Pictures Louisiana LLC, ("SAPLA") a related party of the Company, entered into a Credit Agreement with Advantage Capital Community Development Fund LLC dated October 11, 2007, for the acquisition and improvement of the production and post-production facility located at 807 Esplanade Avenue in New Orleans, Louisiana for aggregate principal advances of up to \$3,700,000. This agreement was guaranteed by the Company's predecessor. Approximately \$3,700,000 plus interest has been drawn under the terms of this Credit Agreement, as of September 30, 2012. As of June 30, 2012, the Company assumed the liability for \$1,000,000 of this amount plus a contingent sum of \$750,000 due to Advantage Capital (contingent on receipt of tax credit revenues) due to an agreement with the now mortgagor Palm Finance.

A construction loan of \$1,850,000 previously guaranteed by the Company has now been assumed by the Company for 807 Esplanade.

**807 Esplanade Advances:**

On February 28, 2012, the Company took out a convertible loan of \$200,000 from Rowett Capital Ltd. These have been loaned to 807 Esplanade to cover outstanding interest payments due on the construction loan on 807 Esplanade previously guaranteed by the Company. Three additional convertible loans were taken out totaling \$600,000 and then loaned onto SAPLA to pay down the construction loan on the property 807 Esplanade, as to not further delay the construction and opening of the facility, for which the Company will have a 30 year lease to operate a post-production facility.

**Loan Arrangements:**

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In connection with the loan of \$500,000 with JMJ Financial entered into on June 27, 2012, and a new loan entered into in the first quarter of fiscal 2013 with Tonaquint Inc. of \$435,000, the Company sold to Mr. Hoffman, at market price, who in turn will pledge 8,000,000 shares to JMJ and have pledged 7,000,000 shares to Tonaquint of our common stock, respectively, in exchange for a portion of the Company's existing indebtedness to Mr. Hoffman. Mr. Hoffman has agreed to return these shares to the Company if not utilized by the pledges.

NOTE 4 – FEE INCOME RECEIVABLE FROM RELATED PARTY

Under the terms of the related party agreement between SAPLA and SAE Inc. all income generated by SAPLA is due to SAE Inc. as fee income. SAPLA is due to receive approximately \$9,447,544 from disposition of Louisiana and Federal historic rehabilitation and film infrastructure tax credits for the restoration and the establishment of a post-production facility at 807 Esplanade.

SAPLA will pay the proceeds from disposition of such tax credits to SAE Inc. as fee income. The Company has provided a reserve of \$1,906,646 against this receipt to allow for cost of disposing the credits and a further reserve against potential disallowance of any expenditures by Louisiana or Federal taxing authorities, which is not anticipated by Management.

SAPLA has filed for historical rehabilitation tax credits available from the United States (26%) and Louisiana (25%) on approximately \$9,500,000 of historical rehabilitation expenses paid in connection with the renovation of the building and property at 807 Esplanade Avenue in New Orleans, Louisiana (the “Property”) and reflected in a compilation of expenses by an independent accounting firm. SAPLA has filed the Part I application for historic rehabilitation credits and has received the Part II and Part III approvals from the United States Department of Parks with respect to the Property. SAPLA will allocate the Federal historic rehabilitation credits to investors in its lessee, 807 Esplanade Ave. MT LLC (“MT”), and receive cash or reduction in indebtedness as a result of such allocation. SAPLA will assign the Louisiana historic rehabilitation for cash.

SAPLA has also filed for Louisiana film infrastructure tax credits (40%) on all of its investment of approximately \$11,500,000 in connection with the Property to date, as reflected in an audit report of an independent accounting firm (which also includes audits of all rehabilitation expenses). SAPLA has approval from Louisiana that the Property is a certified state film infrastructure project and SAFELA, as lessee of MT, is now operating a production and post-production facility at the Property.

Louisiana has certified approximately \$6,500,000 of film infrastructure expenditure, the tax credits accruing on which SAPLA will assign for cash, with the remaining expenses remaining under consideration by the Louisiana Department of Economic Development (“LED”). SAPLA has received no objections to any of its film rehabilitation expenses from LED as reflected in the audit report submitted to LEDF on July 2, 2012. Under a published Opinion of the Attorney General of Louisiana, the Louisiana tax credits vest upon certification as a film infrastructure project which occurred in 2008. Revenue is not recognized until the required audit or compilation is complete and available to be submitted to the appropriate agency. The reserve established by the Company against the revenue to be received from SAPLA from disposition of the tax credits reflects potential discounts on the assignment of credits for cash and any potential reduction in the amount of expenses that may be subject to credits by objection of any Federal or Louisiana agency, even though the Company has at present no reason to believe there will be any such reductions.

NOTE 5 – FILM COSTS

Film costs as of September 30, 2012 and June 30, 2012 are as follows:

|   | September<br>30,<br>2012 | June 30,<br>2012 |
|---|--------------------------|------------------|
| Film Costs, beginning of period                   | \$14,612,609             | \$23,133,559     |
| Additions to film costs during the period         | 430,556                  | 1,934,873        |
| Total film costs                                  | 15,043,165               | 25,068,432       |
| Less: Amortization and impairment for the period  | (77,810 )                | (3,996,576 )     |
| Less: One time revaluation due to asset transfer  | -                        | (6,459,247 )     |
| Total film costs, net of accumulated amortization | \$14,965,355             | \$14,612,609     |

Amortization of film costs was \$77,810 and \$3,996,576 for the three months ended September 30, 2012 and the year ended June 30, 2012. The Company reviews capitalized film costs for impairment whenever events or changes in circumstances indicate that the carrying amounts of such assets may not be recoverable or at least once per year. Determination of recoverability is based on an estimate of future cash flows resulting from the use of the asset, and its eventual disposition. Measurement of an impairment loss for the assets is based on the fair value of the asset as estimated using a discounted cash flow model. The Company had a one-time revaluation due to asset transfer of \$6,459,247 as at June 30, 2012.

#### NOTE 6 – MUSIC ASSETS

Music assets as of September 30, 2012 and June 30, 2012 are as follows:

|   | September<br>30,<br>2012 | June 30,<br>2012 |
|---|--------------------------|------------------|
| Music assets, beginning of period                   | \$2,923,474              | \$-              |
| Additions to music assets during the period         | 583,054                  | 2,923,474        |
| Total music assets                                  | 3,506,528                | 2,923,474        |
| Less: Accumulated amortization                      | (408,205 )               | -                |
| Total music assets, net of accumulated amortization | \$3,098,323              | \$2,923,474      |

The initial material assets that were acquired comprise 52 completed sound recordings including two completed albums with “DMX”, up to two additional albums from “DMX” and up to five albums from “Bone Thugs-N-Harmony”.

The music assets were recorded at the value of the preferred stock issued, and capitalized costs incurred in the production of the current DMX album and related videos.

Due to the decline in the common stock price, the Company reviewed the redemption value of the Preferred Stock to common and, as agreed by the Board of Directors, revalued the Preferred Stock at the 10 day volume weighted closing bid price of the Company’s common stock on September 30, 2012 (\$0.29/share), as if all shares of Series B Preferred Stock issued and not in escrow were converted in common stock at the conversion price of \$1.10 per share. No earnout provision has been made for any shares of Preferred Stock not now issued, as management does not believe the conditions for release of such shares will be met.

The Company reviews capitalized music assets for impairment whenever events or changes in circumstances indicate that the carrying amounts of such assets may not be recoverable or at least once per year. Determination of recoverability is based on an estimate of future cash flows resulting from the use of the asset, and its eventual disposition. Measurement of an impairment loss for the assets is based on the fair value of the asset as estimated using a discounted cash flow model. As of September 30, 2012, amortisation and impairment of \$408,205 has been

booked.

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## NOTE 7 – LEASEHOLD IMPROVEMENTS

On June 30, 2012, the Company acquired SAFELA, which was previously a related party company. SAFELA owns, in its capacity, a 30 year lease on 807 Esplanade, New Orleans, Louisiana, which was constructed as a production and post-production facility for the Company’s use. Additionally, SAFELA owns the capitalized leasehold improvements in 807 Esplanade and the related debt which financed the construction. Through this acquisition, the Company has capitalized the leasehold improvements and assumed the debt related. As the leasehold improvements and the debt are booked at the same amounts, no net assets were transferred into the Company and no additional consideration has been paid.

The post production facility commenced operations on July 1, 2012. The leasehold improvements will be amortized over the useful life of the lease.

## NOTE 8 – INCOME TAXES

The Company has adopted ASC 740-10, “Income Taxes”, which requires the use of the liability method in the computation of income tax expense and the current and deferred income taxes payable (deferred tax liability) or benefit (deferred tax asset). Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized.

During the period ended September 30, 2012 the Company had a net loss of \$(1,357,612), increasing the deferred tax asset approximately \$461,588 at the statutory tax rate of 34%. Deferred tax assets at September 30, 2012 consisted of the following:

Deferred tax asset related to:

|  | September<br>30,<br>2012 | June 30,<br>2012 |
|--|--------------------------|------------------|
| Prior Year                               | \$2,812,203              | \$-              |
| Tax Benefit (Expense) for Current Period | 461,588                  | 2,812,203        |
| Deferred Tax Asset                       | 3,273,791                | 2,812,203        |
| Less: Valuation Allowance                | (3,273,791)              | (2,812,203)      |
| Net Deferred Tax Asset                   | \$-                      | \$-              |

The net deferred tax asset generated by the loss carry forward has been fully reserved and will expire in 2019 through 2032. The realization of deferred tax benefits is contingent upon future earnings and is fully reserved at September 30, 2012.

## NOTE 9 – LOANS PAYABLE

The Company has the following indebtedness as of September 30, 2012:

| Lender                                |                       |    |           |        |   |                        |
|---------------------------------------|-----------------------|----|-----------|--------|---|------------------------|
| Film and Production Loans             |                       |    |           |        |   |                        |
| Palm Finance                          |                       | \$ | 4,408,003 | 18     | % | Forebearance agreement |
| Palm Finance                          |                       | \$ | -         | 18     | % | Forebearance agreement |
| Palm Finance                          |                       | \$ | 1,699,278 | 18     | % | Forebearance agreement |
| 120db Film Finance LLC                |                       | \$ | 4,425     | stated |   | Due on demand          |
| Cold Fusion Media Group LLC           |                       | \$ | 50,000    | 10     | % | Due on demand          |
| Total Film and Production Loans       |                       | \$ | 6,161,706 |        |   |                        |
| Other                                 |                       |    |           |        |   |                        |
| Trafalgar Capital (in liquidation)    |                       | \$ | 565,454   | 9      | % | Due on demand          |
| JMJ Financial                         | 29/06/2012 27/10/2012 | \$ | 525,069   | 10     | % | Due on Demand          |
| GHP Note                              |                       | \$ | 137,573   |        |   | Due on Demand          |
| LotusCapital                          | 08/08/2012 07/12/2012 | \$ | 100,726   |        |   |                        |
| Tonaquint                             | 22/08/2012            | \$ | 312,650   | 8      | % |                        |
|                                       |                       | \$ | 1,641,471 |        |   |                        |
| Convertibles                          |                       |    |           |        |   |                        |
| Aegis - Tripod                        | 15/12/2011 30/06/2012 | \$ | 37,499    | 12.0   | % | Due on demand          |
| Aegis – CMS                           | 15/12/2011 30/06/2012 | \$ | 37,498    | 12.0   | % | Due on demand          |
| Aegis - Rachel                        | 15/12/2011 30/06/2012 | \$ | 37,498    | 12.0   | % | Due on demand          |
| Runway                                | 11/01/2012 30/09/2012 | \$ | 212,051   | 12.0   | % | Due on demand          |
| Tripod                                | 16/01/2012 30/06/2012 | \$ | 55,721    | 12.0   | % | Due on demand          |
| Isaac Loan                            | 20/01/2012            | \$ | 104,990   | 12.0   | % | Due on demand          |
| Sendero                               | 24/01/2012 30/09/2012 | \$ | 277,945   | 12.0   | % | Due on demand          |
| Tripod - \$150k                       | 01/02/2012 01/02/2013 | \$ | 166,372   | 12.0   | % | Due on demand          |
| Hanover                               | 23/02/2012 23/08/2012 | \$ | 377,285   | 10.0   | % | Due on demand          |
| Briskin - \$50k                       | 04/04/2012 10/10/2012 | \$ | 54,993    | 10.0   | % | Due on demand          |
| Briskin - \$40k                       | 13/04/2012 22/10/2012 | \$ | 43,661    | 10.0   | % | Due on demand          |
| Briskin - \$60k                       | 17/04/2012 22/10/2012 | \$ | 65,492    | 10.0   | % | Due on demand          |
| Briskin - \$45k                       | 14/05/2012 22/10/2012 | \$ | 48,594    | 10.0   | % | Due on demand          |
| Firerock - \$62,500                   | 21/06/2012 21/12/2012 | \$ | 32,671    | 10.0   | % |                        |
| Agua Alta (Cold Fusion)               | 25/06/2012 25/06/2013 | \$ | 106,148   | 12.0   | % |                        |
| Beaufort                              | 26/06/2012 26/06/2013 | \$ | 53,058    | 12.0   | % |                        |
| Beaufort \$75k                        | 19/07/2012 19/07/2013 | \$ | 76,500    | 10.0   | % |                        |
| Beaufort \$50k                        | 19/07/2012 19/07/2013 | \$ | 51,000    | 10.0   | % |                        |
| Beaufort \$150k (Simply Stockbroking) | 26/07/2012 25/01/2013 | \$ | 152,712   | 10.0   | % |                        |
| Beaufort \$350k (Simply Stockbroking) | 31/07/2012 30/08/2012 | \$ | 355,849   | 10.0   | % | Due on demand          |
| Tangiers                              | 08/08/2012            | \$ | 50,726    | 10.0   | % |                        |
| Beaufort \$25k                        | 14/08/2012 08/02/2013 | \$ | 25,322    | 10.0   | % |                        |
| Tangiers                              | 24/09/2012 08/10/2012 | \$ | 50,082    | 10.0   | % | Due on demand          |

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\$ 2,473,669

807 Esplanade

Beaufort - \$100k (807 Esplanade) 06/04/2012 05/04/2013 \$ 108,779 12 %

Old Capital - \$250k (807 Esplanade) 31/05/2012 30/05/2013 \$ 267,425 12 %

Palm Finance - mortgage and construction loan \$ 3,237,486 15 % Forebearance agreement

SAFELA loans outstanding \$ 3,613,690

Total Other Loans \$ 7,728,830

TOTAL LOANS \$ 13,890,536

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The Company has evaluated these convertible notes for embedded derivative features and has determined that no derivative liability exists. Convertible debts are all convertible to common stock on maturity at the option of the lender. They all bear interest at varying rates and convert at different times and at fixed or variable conversion prices according to the contract.

\*The Company does not agree with interest charged by Palm on the 2011 forgiven interest on these two film loans and believes the dispute will be resolved once the loans are repaid.

\*\* In connection with this loan of \$500,000 with JMJ Financial, and a new loan entered into with Tonaquint Inc. of \$435,000, the Company issued to Mr. Hoffman, the Company's CEO, who in turn will pledge 8,000,000 shares to JMJ and has pledged 7,000,000 shares of common stock to Tonaquint, in exchange for a portion of our existing indebtedness to Mr. Hoffman. Mr. Hoffman has agreed to return these shares to the Company if not levied on by the pledges.

The Company converted \$779,874 of the film and production loans into 1,316,099 shares of common stock during the three months ended September 30, 2012.

#### Palm Agreement

The Company entered into two senior financing loan and security agreements with Palm to finance the production costs of The Pool Boys, Autopsy and Nine Miles Down dated May 7, 2007 and December 17, 2007. These loans are secured by the revenues to be collected from these motion pictures. The revenues so far collected have been insufficient to repay the majority of these loans, primarily as result of management's decision to delay the release of these films.

In July, 2011 the Company entered into an amended financing agreement with Palm to refinance the existing indebtedness secured by the production and post-production facility in New Orleans, Louisiana under which Palm has acquired the existing credit facility of \$3,700,000 plus accrued interest of an affiliate SAPLA for \$1,000,000 of this amount plus a contingent sum of \$750,000 (contingent on receipt of the tax credit revenues) and advanced an additional \$1,800,000 to complete renovation and construction of this facility. Palm's advance and interest at the rate of 15% per annum are due and payable within five years and are secured by the property at 807 Esplanade Avenue in New Orleans and Louisiana film infrastructure and historical rehabilitation credits, as well as Federal historical rehabilitation credits associated with the Property.

Under the amended agreement:

- a) the group guaranteed the debt on the post production facility and
- b) Palm forgave a total of \$4,458,624 of principal and interest on the two production loans as well as
- c) reduced the liability on the New Orleans production facility by \$1,950,000 in exchange for the group guaranteeing the production facility debt.
- d) Palm's advance and interest at the rate of 15% per annum are due and payable within five years and
- e) are secured by the property at 807 Esplanade Avenue in New Orleans and Louisiana film infrastructure and historical rehabilitation credits, as well as Federal historical rehabilitation credits associated with the Property and cross guaranteed the Company, its affiliates and CEO, Peter Hoffman.

In June, 2012 as detailed in Note 7 the Esplanade debt was assumed by SAFELA in exchange for a 30 year lease on the facility. SAFELA was in turn acquired by the Company. At September 30, 2012 and June 30, 2012 debt and accrued interest under the amended agreement total \$9,287,079 and \$8,946,000 respectively.

Trafalgar

SAP Plc. Borrowed £1,000,000 (approximately \$1,651,000 ) as a convertible debenture from Trafalgar Capital Special Investment Fund (“Trafalgar”) that came due on June 30, 2009. We were unable to repay the debenture and as a result, we defaulted on a payment of £1,000,000 plus interest to Trafalgar Capital Special Investment Fund in June 2009.

On September 2, 2009 the Group repaid Trafalgar \$1,000,000 as a partial payment against this loan, with the remaining balance subject to repayment in cash or convertible to the shares of common stock of the Group at the conversion terms as agreed between Trafalgar and the Group. On June 22, 2010 an amended agreement was entered into with Trafalgar for an extension of the due date of the convertible debentures to December 31, 2010, and the Group agreed to issue 971 shares of common stock to settle a portion of the debt. Trafalgar agreed to reduce the loan amount from the proceeds it received from selling the shares of common stock. The transaction was consummated subsequent to the date of the financial statements and all 971 had been sold by December 31, 2010. Subsequent to June 30, 2010, a further amended agreement was entered into with Trafalgar for an extension of the due date of the convertible debentures to March 31, 2011, and the Group agreed to issue 1214 shares of common stock to settle a portion of the debt. Trafalgar agreed to reduce the loan amount from the proceeds it received from selling the 1,214 shares of common stock. The current balance outstanding on the loan after sale of these shares is approximately \$565,000.

NOTE 11 – EQUITY TRANSACTIONS

First Quarter Ended September 30, 2012:

On August 31, 2011, NASDAQ approved the substitution of one share of SAE, Inc. stock for the Company's NASDAQ listing, effective at the opening of trading on September 1, 2011. On that date, each of the Company's ordinary shares were exchanged for one share of common stock of SAE, and commenced trading on NASDAQ as the successor to the Company's NASDAQ listing. This transaction was approved by the Company’s shareholders at the Company’s Extraordinary General Meeting on June 11, 2010.

The Company is authorized to issue 35,992,964 common shares at a par value of \$0.01 per share. These shares have full voting rights. At September 30, 2012 and June 30, 2012, there were 4,166,677 and 1,739,900 common shares outstanding. The shareholders agreed to increase the authorized shares to 250,000,000 from 50,000,000 at the Company’s shareholder meeting in February 2012 . The shareholders also approved a 1:10 reverse split at this AGM. The Board of Directors approved a 1:70 reverse split on August 31, 2012 but to do so had to reduce the authorized common stock back down to 35,992,964 shares.

During the three months ending September 30, 2012, Company issued 2,418,206 shares at an average price of \$1.13 per share in satisfaction of \$2,446,219 of outstanding loans payable and accrued interest and 8,571 shares for \$300,000 cash.

- 258,055 common shares were issued in part payment of the Palm debt to the value of \$133,500 at an average conversion price of \$0.52/share.
- 1,058,044 common shares were issued in satisfaction of the Schism debt of \$646,374 at an average conversion price of \$0.61/share
- 482,697 common shares were issued in satisfaction of various convertible loans totaling \$586,114 was converted at an average conversion price of \$1.21/ share.(High of \$2.42 and low of \$0.57)
- 90,720 common shares were issued for expenses totalling \$179,800 for the music company at \$1.98/share

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|           |  |
|-----------|--|
| 44,711    | common shares were issued for consulting services totalling \$54,200 provided under the S-8 authority at \$1.21/share                                  |
| 244,149   | common shares were issued for general expenses totalling \$357,232 provided under the 3a9 authority at \$1.42/share.(High of \$2.45 and low of \$0.70) |
| 75,715    | common shares were issued to lenders as fees for loan arrangements of \$159,000 at \$2.10/share  |
| 85,714    | common shares were issued as collateral for a loan totalling \$180,000 at \$2.10/share   |
| 8,571     | common shares were issued for \$300,000 cash (average of \$35.00/share)  |
| 80,586    | common shares were issued to cover 807 Esplanade construction fees totalling \$150,000 at \$1.86/share adjustment for reverse split shares             |
| (2,185)   |  |
| 2,426,777 | Total shares issued in the quarter   |

#### Warrants and Options:

During the twelve months ended June 30, 2012, the Company issued 1,429 options to each of the seven members of the board of directors. These options have a five year term and a strike price equal to the closing price of the Company's stock at the date of issue. Each director was issued 714 options with a strike price of \$30.80 on October 14, 2011 and 714 options with a strike price of \$27.30 on December 6, 2011. Half of the options vested on December 31, 2011 and the remaining half will vest on December 31, 2012.

During the quarter ended June 30, 2012, the Company contracted to issue 28,571 options to David Michery in conjunction with his employment agreement with the Company. These options have a strike price of \$12.60 and vest and shall be exercisable in equal monthly instalments over the term of his employment agreement, which is February 22, 2012 through December 31, 2016. These options have not yet been issued.

During the quarter ended June 30, 2012, the Company has agreed to issue 714 options per year to Jake Shapiro in conjunction with his employment agreement with the Company. These options have a strike price equal to the closing price of the Company's stock at the date of issue, with the exception of the first year, which the strike price was set at \$55.30 per share.

The Company measures compensation expense related to stock options with the Black Scholes option pricing model, and recognizes expense over the vesting period.

On June 29, 2012, 119,048 warrants were issued to JMJ Financial in conjunction with a loan agreement. These options have a strike price of \$2.10.

In 2012, the Company filed two Form S-8's in connection with the registration under the Securities Act of 1933, as amended. 285,715 shares of common stock were issued under the Company's 2012 Stock Incentive Plan.

#### Convertible Redeemable Preferred Stock

125,125 shares of Series A Cumulative Convertible \$10.00 Preferred Stock with a dividend rate of 8% (payable quarterly) were issued in November 2011. The conversion price into common stock of the Company is \$10.50/share.

180,000 Series B convertible preferred stock, \$100.00 par value have been issued to two shareholders although 120,000 of such shares are held in escrow subject to earnout. The shares were issued to acquire music assets for the Company. These shares in escrow are shown on the balance sheet as a reduction in equity. The per-share conversion price for the Series B Preferred Stock is \$1.10. Due to the decline in the common stock price, the Company reviewed the redemption value of the Preferred Stock to common and, as agreed by the Board of Directors, revalued the Preferred Stock at the 10 day volume weighted closing bid price of the Company's common stock on September 30, 2012 (\$0.29/share), as if all shares of Series B Preferred Stock issued and not in escrow were converted in common stock at the conversion price of \$1.10 per share.

#### NOTE 12 – EARNINGS PER SHARE

Basic and diluted earnings per share ("EPS") are based on weighted-average common shares and generally exclude shares that would have an anti-dilutive effect. In accordance with ASC 260-10-45-19, the Company did not consider any potential common shares in the computation of diluted EPS as of September 30, 2012, due to the loss from continuing operations, as including them would have an anti-dilutive effect on EPS.



NOTE 13 – COMMITMENTS AND CONTINGENCIES

Creditors Liquidation of SAP Plc.

The Company's listing predecessor Seven Arts Pictures Plc. ('PLC') was placed by the English Companies Court into compulsory liquidation on November 8, 2011. The Company's CEO, Mr. Peter Hoffman, as a director of PLC had sought an administration order but this request was denied by the Courts as a result of inter alia the opposition of Parallel Pictures LLC ('Parallel'). PLC's principal creditors have appointed a liquidator for the orderly winding up of its remaining assets not transferred to the Company pursuant to the Asset Transfer Agreement, effective January 27, 2011. Based on discussions with the liquidator, our management believes this liquidation proceeding will have no material effect on the cost, business or market value of common stock.

#### Further Share Issue to SAE Inc.

On June 11, 2010, Seven Arts Entertainment, Inc. (“SAE”), a Nevada Corporation, was formed and became a 100% owned subsidiary of Seven Arts Pictures Plc. As of June 11, 2010, the Company entered into an Asset Transfer Agreement, as amended on January 27, 2011 and again on August 31, 2011, to transfer all of the assets with a cost basis from PLC to SAE, in exchange for assumption by SAE of certain indebtedness and for one share of common stock of SAE for each ordinary share of PLC which have been distributed to shareholders. Additionally, 2,000,000 shares of SAE were issued to PLC in order to satisfy any remaining obligations. SAE Inc. may issue more shares of its common stock to resolve any claim made on the liquidation of PLC. The 2,000,000 pre-split shares were originally booked on January 27, 2012 at the market price on the day the SEC approved the transaction which was \$3.94/share. Management now believe the shares should be booked at the August 31, 2012 market price of \$0.66/share which is the date from which the shares in SAE were tradeable.

#### 807 Esplanade Guarantee

Seven Arts Pictures Louisiana LLC, a related party and/or an affiliate of the Company, entered into a Credit Agreement with Advantage Capital Community Development Fund LLC dated October 11, 2007, for the acquisition and improvement of the production and post-production facility located at 807 Esplanade Avenue in New Orleans, Louisiana (“807 Esplanade”) for aggregate principal advances of up to \$3,700,000. This agreement was guaranteed by the Company’s predecessor. Approximately \$3,700,000 plus interest has been drawn under the terms of this Credit Agreement, as of June 30, 2012. The Company has now assumed the liability for \$1,000,000 of this amount plus a contingent sum of \$750,000 due to Advantage Capital (contingent on receipt of the tax credit revenues) due to an agreement with the now mortgagor Palm Finance. A construction loan of \$1,850,000 previously guaranteed by the Company has now been assumed by the Company. The Company has a 30 year lease on the property to operate a production and post-production facility.

#### Armadillo

The Company has guaranteed a \$1,000,000 note plus interest due to Armadillo by the Employee Benefit Trust of the Company’s listing predecessor resulting from the purchase of Seven Arts preferred stock from Armadillo.

#### Fireworks Litigation

SAFE prevailed in a motion for summary adjudication in the Supreme Court of Ontario, Canada on February 10, 2011 in an action against CanWest Entertainment and two of its affiliates (“CanWest”) confirming our ownership of five motion pictures, “Rules of Engagement”, “An American Rhapsody”, “Who Is Cletus Tout”, “Onega”, and “The Believer” (collectively, the “Copyrights”). SAFE filed an action in England on September 7, 2011 in the High Court of England and Wales against Content Media Corporation (“Content”) and Paramount Picture Corp. (“Paramount”) to recover the Copyrights and substantial damages for the use of the copyrighted works after their purported acquisition from CanWest. We may incur up to \$200,000 or more in legal expenses to pursue this claim but expect to recover those fees from Content. We also filed an action on May 27, 2011 in the United States District Court for the Central District of California for copyright infringement against Paramount. This action was dismissed based on the applicable statute of limitations and is currently on appeal to the Ninth Circuit Court of Appeals.

#### Jonesfilm

The Company’s subsidiary, SAFE, PLC, CineVisions, and CEO Peter Hoffman were the subject of two arbitration awards of attorney fees totaling approximately \$900,000, with interest and charges, both of which were reduced to judgment in favor of Jonesfilm (“JF”) in Superior Court of the State of California for the County of Los Angeles and in

United States District Court for the Central District of California. The Company paid approximately \$525,000, the amount of the first arbitration award plus interest and charges, in November 2011. Management believes the Company has no further liability in this matter. JF asserted on or about October 6, 2010 in an enforcement of judgment action in the United States District Court for the Eastern District of Louisiana against PLC, SAFE, SAP and Mr. Hoffman that the Company is liable as the “successor in interest” to the remaining arbitration award which was sentenced in the United States District Court for the Central District of California on June 19, 2007, which the Company denies.

#### Arrowhead Target Fund

Seven Arts Future Flows (“SFF”) a limited liability company owned by SAP, now owned by PLC (in liquidation), obtained financing from Arrowhead) of approximately \$8,300,000 (the “Arrowhead Loan”). SFF secured the Arrowhead Loan with liens on 12 motion pictures that generated final revenues to the Group of \$820,026 in the Fiscal Year Ended June 30, 2009; \$2,739,800 in the Fiscal Year Ended March 31, 2008 and \$544,478 in the three month period ended June 30, 2008. The only liability is to repay the Arrowhead Loan from the proceeds of the film assets pledged against the Arrowhead Loan. The Company is not required to repay the Arrowhead Loan from any of its other assets or revenues. SAFE was the collateral agent of the film assets.

The Arrowhead Loan became due in February 2009 and SFF has not paid the outstanding principle and accrued interest. Arrowhead has the right to foreclose on the pledged film assets, but has not done so. SFF has received a default notice and as a result Arrowhead is now collecting directly all sums otherwise receivable by us with respect to these motion pictures, and has appointed a new servicing agent for these motion pictures. As a result, the Company can no longer control the licensing of these motion pictures. Failure to repay or refinance the Arrowhead Loan could result in a material disposition of assets through the loss of the Company’s rights to the 12 motion pictures and related loss of revenues in amounts that are difficult to predict.

As a result of the foregoing, we removed all assets accounts relating to the 12 motion pictures pledged to Arrowhead and the corresponding limited recourse indebtedness from our consolidated balance sheet at fiscal year ended June 30, 2009, due to the fact that the loan was a limited recourse loan and we have no further obligations to Arrowhead beyond the pledged film assets.

Arrowhead filed an action on September 22, 2010 in The Supreme Court of the State of New York which seeks recovery from PLC, Mr. Hoffman and his wife, SAFE, CineVisions, SFF and SAP of the monies that we retained under our interpretation of the relevant agreements with Arrowhead. In addition, Arrowhead has made substantial additional claims against us, Mr. Hoffman and SAP regarding claimed breaches of the terms of the operative agreements, including failure to account properly, failure to turn over materials, failure to remit monies collected, and similar matters. Arrowhead’s claims against us for these alleged breaches are \$8,300,000 although it has not stated any basis for this amount.

The Company moved to dismiss the Arrowhead action against all defendants other than SFF. On August 9, 2011, the New York Supreme Court granted the motion and dismissed all defendants except SFF and SAFE in its capacity as a collateral agent, which is not a material element of Arrowhead claim. We continue to believe that Arrowhead’s claims against us are without substantial merit. Arrowhead has refiled its claim against the dismissed defendants in the Supreme Court of New York. On April 17, 2012 against the same defendants under an “alter ego” theory. SAFE and SFF have moved to dismiss these claims.

#### Arrowhead Capital Partners Ltd. – AGC Loan

PLC and several of our affiliates were named as defendants in an action by Arrowhead Capital Partners Ltd. filed in the Supreme Court of New York, County of New York, purportedly served on May 24, 2010, seeking to collect \$1,000,000 plus interest (the “ACG Loan”) due to Arrowhead Consulting Group LLC (“ACG”), as well as to foreclose on the collateral granted as part of the Cheyne Loan described in note 13 to our financial statements under “Production Loans”. The ACG Loan is fully subordinated to repayment of the Cheyne Loan, which has not been repaid. One of SAE’s subsidiaries has acquired all Cheyne’s rights under the subordination provision of the Cheyne Loan. As a result, our management does not believe that ACG has the right to maintain this action to collect any monies or to foreclose on any collateral pursuant to the Cheyne Loan. ACG obtained summary judgment against PLC and certain of our former affiliates which is now on appeal. We expect this action will be stayed by reason of the liquidation proceedings

of PLC discussed under “Liquidation of Seven Arts Pictures Plc.”

### Investigation into Claim for Tax Credits (SAPLA)

The US Attorney in New Orleans is investigating claims for Louisiana film infrastructure tax credits, including such tax credits to be claimed by Seven Arts Pictures Louisiana LLC, (“SAPLA”) an affiliate of the Company. This investigation appears to include investigation as to whether certain expenses claimed by this affiliate were improper or fraudulent. All such claimed expenses were audited by independent auditors in Louisiana and reviewed by counsel. Management believes that this investigation will not have any material adverse effect on or operations or the total tax credits to be received by our affiliates, but could result in charges against current or former employees of this affiliate, including Mr. Hoffman, based on prior audits. The tax credits receivable by SAPLA (of which the State and Federal rehabilitation credits have been approved) are based on new tax credit audits carried out in Louisiana, not the audits mentioned here.

### Parallel Actions

On June 28, 2011, PLC (predecessor) filed an action in the High Court of England and Wales against Parallel to collect sums due to PLC with respect to acquisition of distribution rights in Russia to four motion pictures and to confirm Parallel’s obligations under both a signed and unsigned investment agreement with respect to the motion picture project Winter Queen. On the same day, Parallel filed a petition to wind up and liquidate PLC in the Companies Courts of England based on its claim of repayment of \$1,000,000 of investment made by Parallel in Winter Queen. PLC is not a part of the Company. On September 19, 2011, Parallel filed a new action against PLC and us in the Los Angeles County Superior Court of California, asserting the same claims as in the winding up petition and seeking to enjoin the proposed administration proceedings in England. Its request for a preliminary injunction was denied by the Superior Court. Parallel in California has been stayed by reason of the “Recognition Order” described in “Liquidation of Seven Arts Pictures plc.” But Parallel may be permitted to pursue its remedies in the Los Angeles Superior Court proceedings depending on actions of the liquidator.

### HMRC Investigation

On July 19, 2011 Officers of Her Majesty’s Revenue & Customs (“HMRC”) attended the offices of PLC in London. Documents were retained appertaining to arrangements involving the subscription for shares in a number of companies which had lost value, resulting in subscribers making claims to tax relief.

PLC’s participation in these transactions was limited to its transfer of rights to certain motion pictures to the investors in return for their investments in the production and release costs of those pictures and making available the provision of loans to fund a portion of those investments. PLC received no tax benefits from the transactions, which were made on arms-length terms. PLC believes that it is not a subject of the HMRC investigation.

In connection with the transactions, PLC did not make any representations or warranties to any party, including the investors, regarding any potential tax benefits related to the transactions. Prior to the closing of the transactions, the investors obtained and made available to PLC, an opinion of prominent Queen’s counsel, specializing in United Kingdom tax laws, that the transactions were permitted and acceptable under the terms of the applicable United Kingdom revenue laws. PLC remains confident that the transactions were permitted and acceptable under the terms of the applicable United Kingdom revenue laws.

HMRC has requested interviews with three officers of PLC to discuss whether those officers were involved in the arrangements for subscription of shares in the relevant companies, the first of which with Ms. Elaine New, CFO, occurred in April 2012 and a second in May 2012. PLC is fully cooperating with the investigation. PLC believes there is no basis for any claim of responsibility of any of its officers or employees. Based on facts currently known by PLC, there is no need for it to record a contingent liability in its financial statements in connection with the

investigation or the related transactions.

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#### NOTE 14 – FAIR VALUE MEASUREMENTS

Cash, accounts receivable, accounts payable and other accrued expenses and other current assets and liabilities are carried at amounts which reasonably approximate their fair values because of the relatively short maturity of those instruments.

ASC 820, “Fair Value Measurements and Disclosures”, establishes a framework for measuring fair value. That framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under ASC 820 are described as follows:

Level 1 - Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that the Company has the ability to access.

Level 2 - Inputs to the valuation methodology include:

- quoted prices for similar assets or liabilities in active markets;
- quoted prices for identical or similar assets or liabilities in inactive markets;
- inputs other than quoted prices that are observable for the asset or liability;
- inputs that are derived principally from or corroborated by observable market data by correlation or other means.

If the asset or liability has a specified (contractual) term, the Level 2 input must be observable for substantially the full term of the asset or liability.

Level 3 - Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The asset or liability’s fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques used need to maximize the use of observable inputs and minimize the use of unobservable inputs.

The preceding method described may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, although the Company believes its valuation method is appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date. As of June 30, 2012 and June 30, 2011, all of the Company’s financial assets and liabilities were considered current and due to the short maturity the carrying amounts are considered to approximate fair value.



NOTE 15 – RECENT ACCOUNTING PRONOUNCEMENTS

In May 2011, the FASB issued guidance intended to achieve common fair value measurements and related disclosures between U.S. GAAP and international accounting standards. The amendments primarily clarify existing fair value guidance and are not intended to change the application of existing fair value measurement guidance. However, the amendments include certain instances where a particular principle or requirement for measuring fair value or disclosing information about fair value measurements has changed. This guidance was effective for the periods beginning after December 15, 2011, and early application is prohibited. The Company adopted these amendments on January 1, 2012; and the requirements did not have a material effect.

In June 2011, the FASB issued Accounting Standards Update (“ASU”) No. 2011-05, “Comprehensive Income — Presentation of Comprehensive Income.” ASU No. 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of stockholders’ equity. It requires an entity to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In December 2011, the FASB issued ASU 2011-12, “Comprehensive Income — Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in ASU 2011-05,” to defer the effective date of the specific requirement to present items that are reclassified out of accumulated other comprehensive income to net income alongside their respective components of net income and other comprehensive income. All other provisions of this update, which are to be applied retrospectively, were effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Company adopted these amendments on January 1, 2012; and the requirements did not have a material effect.

In December 2011, the FASB issued ASU No. 2011-11, “Balance Sheet — Disclosures about Offsetting Assets and Liabilities.” ASU 2011-11 requires entities to disclose information about offsetting and related arrangements of financial instruments and derivative instruments and will be applied retrospectively for all comparative periods presented. ASU 2011-11 is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. The Company currently believes that this ASU will have no significant impact on its consolidated financial statements.

NOTE 16 – SUBSEQUENT EVENTS

The Company issued the following shares of common stock subsequent to September 30, 2012:

New Stock Issuances through November 12, 2012

Between October 1, 2012 and November 14, 2012, the Company issued 19,637,942 common shares at an average price of \$0.14 per share. The total number of shares outstanding on November 14, 2012 was 23,804,649.

|           |   |
|-----------|---|
| 6,680,095 | common shares were issued in satisfaction of Schism debt totalling \$ 369,384 was converted at an average conversion price of \$0.06 share.(High of \$0.09 and low of \$0.04)               |
| 1,708,863 | common shares were issued in satisfaction of various convertible loans totalling \$ 130,333 was converted at an average conversion price of \$0.08 share.(High of \$0.14 and low of \$0.07) |
| 391,667   | common shares were issued for consulting services totalling \$82,500 provided under the S-8 authority at \$0.21/share   |
| 3,454,545 | common shares were issued at \$0.29 on conversion of 38,000 Series B preferred shares   |

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|            |   |
|------------|---|
| 7,000,000  | common shares were issued to Peter Hoffman at a share price of \$0.17 in satisfaction of a debt of \$1,190,000                |
| 300,000    | common shares (restricted) were issued to David Furth at a share price of \$0.06  |
| 102,802    | common shares were issued in satisfaction of a debt totalling \$ 29,813 was converted at a conversion price of \$0.29 /share. |
| 19,637,972 |   |

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Departure of Directors or Certain Officers; Election of Directors; Appointment of Certain Officers; Compensatory Arrangements of Certain Officers.

Robert Kaiser and Brett Pogany tendered their resignations as members of our Board of Directors, effective September 17, 2012. Mr. Kaiser was the chair of the audit committee. Both made note of their concern that we had not completed implementation of our Board-approved internal control procedures. Management believes that all such internal control procedures, as approved by our Board, have been implemented. These procedures were filed in our Annual Report on Form 10-K for the fiscal year ended June 30, 2012.

On October 15, 2012, we increased the number of our directors to eight with the addition of David Furth. Mr. Furth, in addition to three of our current directors, is an “independent director” under the SEC independence standards applicable to us. David Furth is the managing director of Gi2 LLC, where he has managed hedge fund and private equity investments focusing on rapidly growing international companies in retail software, technology, and health care since July 2008. Prior to his tenure at Gi2, commencing January 2005 Mr Furth was Senior Vice President and Portfolio Manager at Provident Investment Counsel, where he managed a \$450 million growth stock portfolio. Mr. Furth attended Stanford University for his undergraduate degree and then the Kellogg School of Management at Northwestern University for his MBA.

## ITEM 2. MANAGEMENT’S DISCUSSION AND ANALYSIS

### FORWARD-LOOKING STATEMENTS

Certain statements in this document might constitute “forward-looking statements”. Some, but not all, forward-looking statements can be identified by the use of words such as “anticipate,” “believe,” “plan,” “estimate,” “expect,” and “intend.” Statements that an action or event “may,” “might,” “could,” “should,” or “will” be taken or occur, or other similar expressions, are also forward-looking statements. Although the Company has attempted to identify important factors that could cause actual results to differ materially from expected results, such forward-looking statements involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of the Company, or other future events, to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Such factors include, among others, the following risks: the need for additional financing; uncertainties and risks related to carrying on business in foreign countries; risks associated with third party infringement of copyrights and other intellectual property, especially the unauthorized duplication of motion picture DVDs and unauthorized distribution of motion pictures through the world wide web; risks associated with the lack of enforcement of applicable copyright and intellectual property laws, especially in foreign countries; risks associated with changing copyright and applicable intellectual property laws, especially in foreign countries; risks associated with changing distribution models for motion pictures, especially on the world wide web; risks associated with restrictions of motion picture content, especially in foreign countries; reliance on key personnel; the potential for conflicts of interest among certain officer, directors or promoters of the Company; the absence of dividends; currency fluctuations; competition; dilution; the volatility of the Company’s ordinary share price and volume; and tax consequences to United States Shareholders. Except as required by law, the Company undertakes no obligation to revise any forward-looking statements because of new information, future events or otherwise.

### Company Overview:

The following discussion should be read in conjunction with the preceding financial statements and footnotes thereto contained in this report. This discussion contains forward-looking statements, which are based on our assumptions about the future of our business. Our actual results may differ materially from those contained in the forward-looking statements.

We are an independent motion picture production company engaged in developing, financing, producing and licensing theatrical motion pictures with budgets in the range of \$2 million to \$15 million for exhibition in domestic (i.e. the United States and Canada) and foreign theatrical markets and for subsequent post-theatrical worldwide release in other forms of media, including DVD, home video, pay-per-view, and free television. Our pictures generally receive either a wide theatrical release (1,000 to 3,000 theaters in the United States) or only a limited theatrical release (50-300 theaters in the United States), or may even be released directly to post-theatrical markets, primarily DVD. Our pictures that receive limited theatrical release or post-theatrical release typically benefit from lower prints and advertising ("P & A") cost and, in turn, improved gross profit margins. We determine the size of a theatrical release in the United States based on distributor and our estimates of the commercial prospects of theatrical box office and our own evaluation of the level of expected theatrical release costs as opposed to our estimation of potential theatrical box office in the United States.

No one picture had a principal or controlling share of gross revenues or operating profits in these periods.

## Film Company

We license distribution rights in our motion pictures in the United States and in most foreign territories prior to and during the production or upon the acquisition of rights to distribute a picture. We share in the commissions generated by the sales of the pictures. Sale of a license to distribute a motion picture prior to its delivery is termed a "pre-sale" and may occur at any time during the development and production process. In a typical license agreement, we license a picture to a distributor before it is produced or completed for an advance from the licensee, which advance is recoverable by the distributor from our share of the revenues generated by the distribution of the picture in the licensee's territory, after deduction of the distributor's expenses and distributor fee. The advance usually is in the form of a cash deposit plus a letter of credit or "bank letter" for the balance payable 10-20% on execution (i.e., the cash deposit) and the balance on delivery (i.e., the letter of credit or "bank letter"). The license grants the distributor the right to the post-theatrical release of the picture in all or certain media in their territory for a predetermined time period. After this time, the distribution rights revert back to us and we are then free to re-license the picture. The license specifies that the distributor is entitled to recoup its advance from the revenue generated by the release of the picture in all markets in its territory, as well as its release costs and distribution fees.

After the distributor has recouped its advance, costs, and fees, any remaining revenue is shared with us according to a predetermined formula. This is known as an "overage" and can be a significant source of revenue for us from successful films. However, a film's poor reception in one market does not preclude it from achieving success in another market and generating significant additional revenue for us in the form of an "overage" in that territory. In all of our licensing arrangements, we retain ownership of our films and maintain our control of each copyright. We intend to continue the practice of retaining underlying rights to our film projects in order to continue to build our motion picture library to license or sell in the future.

We create a separate finance plan for each motion picture we produce. Accordingly, the sources of the funds for production of each motion picture vary according to each finance plan. We utilize financing based on state and foreign country tax credits (e.g. Louisiana, United Kingdom and Hungary) and direct subsidies, "mezzanine" or "gap" funds, which are senior to our equity, and senior secured financing with commercial banks or private lenders, together in certain cases with a limited investment from us, which is customarily less than 10% of the production budget. Since each finance plan is unique to each motion picture, we cannot generalize as to the amount we will utilize any of these sources of funds for a particular motion picture. We generally obtain some advances or guarantees prior to commitment to production of a motion picture project, but those amounts may not be substantial on smaller budgeted motion picture (e.g., under \$10,000,000), and in certain cases we have committed to production with an insubstantial amount of advances and guarantees. Unless we can manage the risks of production through the use of these financing techniques, we will not likely commit to production of larger budget motion pictures (e.g., over \$15,000,000), and we have never in the past committed to such productions, without substantial advances or guarantees from third-party distributors, or the equivalent in "non-recourse" financings.

## Music Company

Seven Arts Music Inc ("SAM") became a wholly owned subsidiary of the Company on February 23, 2012, although set-up costs had been incurred as early as September 2011. The delivery of the first of the DMX albums acquired from David Michery was released on September 11, 2012 and initial costs in creating the first album for Bone Thugs-N-Harmony are being incurred for delivery in November 2012. Several other new artists are being considered by SAM.

### Post-Production Facility

As of June 30, 2012 SAFELA was transferred to the Company. SAFELA, which is 60% owned by the Company, has a 30 year lease to run a production and post-production facility at 807 Esplanade Avenue in New Orleans, Louisiana ("807 Esplanade"). The facility commenced operations on July 1, 2012.

### Company Outlook

The principal factors that affected our results of operations have been the number of motion pictures delivered in a fiscal period, the distribution rights of motion pictures produced by others acquired in a fiscal period, the choice of motion pictures produced or acquired by us, management's and talents' execution of the screenplay and production plan for each picture, the distribution and market reactions to the motion pictures once completed, management's ability to obtain financing and to re-negotiate financing on beneficial terms, the performance of our third-party distributors and our ability to take advantage of tax-incentivized financing. These factors will continue to be, in our opinion, the principal factors affecting future results of operation and our future financial condition. No particular factor has had a primary or principal effect on our operations and financial condition in the periods discussed below.

Our revenues principally consist of amounts we earned from third-party distributors of its motion pictures. We recognize revenue from license fees as and when a motion picture is delivered to the territory to which the license relates if we have a contractual commitment and the term of license has begun or upon receipt of a royalty statement or other reliable information from a distributor of the amounts due to us from distribution of that picture. A motion picture is "delivered" when we have completed all aspects of production and may make playable copies of the motion picture for exhibition in a medium of exhibition such as theatrical, video, or television distribution.

We also recognize revenue beyond an initial license fee from our share of gross receipts on motion pictures which we recognize as revenue when we are notified of the amounts that are due to us. In some fiscal periods, a significant portion of our revenue is derived from sources other than motion picture distribution, including the cancellation of debt and interest income on a financing transaction.

We have also benefited significantly from our ability to raise third party film equity investments such as in tax advantaged transactions under which we transfer to third party investor's tax benefits for motion picture production and distribution. These types of investments have enabled us to substantially reduce the cost basis of our motion pictures and even to record significant fee-related revenues.

## RESULTS OF OPERATIONS

### Results of Operations for the Three-Month Period Ended September 30, 2012 vs. 2011

We generated a net loss of \$1,357,621 for the three months ended September 30, 2012, compared to \$983,291 for the three months ended September 30, 2011. A discussion of the key components of our statements of operations and material fluctuations for the three months ended September 30, 2012 and 2011 is provided below.

#### Revenue

- A) Film revenue totalled \$229,393 for the three months ended June 30, 2012, compared to \$592,541 for the three months ended June 30, 2011. A comparison of the 2012 and 2011 sales is as follows:
- The majority of 2012 sales came from the accrued sales for the US release of the movie “Drunk Boat” September 2012. On-going royalty income was also received spread over “Pool Boys”, ”Knife Edge” ”Night of the Demons” and “Nine Miles Down”
  - The majority of 2011 sales came from the US digital release of the movie “The Pool Boys” in September 2011. A significant sale to a third party distributor was also made on the title in Canada during the period. A small amount of royalty income spread over several titles was also received.
- B) The music division released the first album from its main artist DMX on September 11, 2012. Accrued revenues of \$927,645 have been booked with a returns provision of 25% (\$231,405) showing as cost of sales. Costs to produce the album have been capitalized into music assets.
- C) The post production facility commenced operations during the period but as construction is still on-going revenues were small.

There were no fee-related revenues in either period.

#### Cost of Sales

- A) The costs of acquiring and producing films are amortized using the individual-film-forecast method, whereby these costs are amortized and participations and residuals costs are accrued in proportion to that the current year’s revenue bear’s to management’s estimates of ultimate revenue expected to be recognized from the exploitation or sale of the films.
- An amortization charge of \$77,809 was made in the period to September 30, 2012 spread over several titles but mainly “Pool Boys” and “Knife Edge” in line with revenue forecasts.
  - The equivalent charge during the quarter ended September 30, 2011 was \$463,804 mainly related to the release of “Pool Boys”.
- B) The music company assets have also been amortised in proportion to that the current year’s revenue bears to management’s estimates of ultimate revenue expected to be recognized from the exploitation or sale of the album. A charge of \$408,205 has been levied for the period. No amortization was recorded in the previous year.
- C) The leasehold improvements have been written off over the 30 year period of the lease.





Other costs of sales in the period totalled \$120,307 versus \$ 15,340 in the same quarter in 2011 due to the addition of two new divisions especially the music division where 15% distribution fee is payable to the music distributor Fontana.

#### Administration Expenses

General and administrative expenses decreased from \$681,885 for the three months ended September 30, 2011 to \$681,885 for the three-months ended September 30, 2012.

Apart from the addition of the two new divisions (additional cost of \$67,513) the net increase is primarily due to the following:

- \$210,000 distribution costs relating to the digital and theatrical release of “The Pool Boys” in September 2011 compared to \$120,307 in 2012.
- \$111,000 of additional legal and professional costs in the 2012 period compared to 2011 mainly related to the set-up of certain loans taken out during the period as well as advisory fees relating to our NASDAQ listing.
- Travel and entertainment costs have increased by \$50,000 between 2011 and 2012. This increase is attributable to the increased trips of the directors between the US and the UK and travel costs for our auditors for each quarterly review, which did not happen in 2011.

Interest charges in the three months to September 30, 2012 were \$975,509 compared to \$413,800 in the same period in 2011. The 2012 total includes an additional \$141,000 related to SAFELA for the mortgage and construction loan and \$25,000 related to the music company. Neither of these charges was included in the 2011 total.

Interest on movie and production loans was \$450,000 during the first quarter ended September 30, 2012 versus September 30, 2011 of \$366,000. The 2012 amount includes disputed interest expense that was not included in the 2011 charge. The 2012 amount also includes \$214,000 of corporate loan interest on loans that were entered into subsequent to March 31, 2011.

No tax expense was recognized in either period.

#### LIQUIDITY AND CAPITAL RESOURCES

Management assesses the Company’s liquidity in terms of its ability to generate cash to fund its operating, investing and financing activities and whether it will be sufficient to allow it to continue investing in existing businesses, consummating strategic acquisitions, paying interest and servicing debt and managing its capital structure on a short and long-term basis.

### Short Term Liquidity

The Company has a retained deficit of \$8,284,741 as of September 30, 2012. Management believes that, as a result of the proceeds derived from the proposed offering (registration statement, Form S-1, to be filed November 2012), and based on historical revenues generated from the licensing of the distribution rights on our motion pictures and the new revenues generated from the music division and post-production facility, we will have sufficient working capital to operate for the next twelve months. Fiscal 2013 will be a year of exploitation of the developed music and post-production businesses, as well as consolidation having strengthened the balance sheet through conversion of debt to equity. This is still anticipated to lead to positive cash flow from operations during fiscal 2013.

We currently borrow funds for the financing of each of our motion pictures from several production lenders. There can be no assurances given that the Group will be able to borrow funds to finance our motion pictures in the future.

### Long Term Liquidity

The long term liquidity needs of the Company, are projected to be met primarily through the cash flow provided by operations. Cash flow from Operating Activities is expected to become positive in fiscal 2013 due to the impact of the release of the first DMX album, the operation of the post-production facility and on-going film revenues.

### Cash Flows

**Operating Activities:** Net cash used in operating activities in the quarter ended September 30, 2012 was \$538,815. An increase in other receivables from music company revenue was offset by a provision for returns, amortization of film costs and music assets and during the year and amortization of leasehold improvements.

**Investing Activities:** Net cash used in investing activities in the quarter ended September 30, 2012 was \$1,308,825 which is attributable to cost associated with the development of music assets, additions to film costs for films currently in development and leasehold improvements for the post-production facility.

**Financing Activities:** Net cash provided by financing activities during the year ended June 30, 2012 was \$1,736,119 mainly due to the proceeds from additional debt and issuance of common stock for cash.

### Capital Resources

As of September 30, 2012, the Company did not have any outstanding capital commitments. As of the date of this filing the Company had no other commitments than disclosed in the Company's financial statements and notes to the financial statements.

**WORKING CAPITAL:** Working capital at September 30, 2012 was \$(11,075,753), which is consistent with our position as of June 30, 2012 of ( \$10,298,134).

Working capital is negative due to the fact that all the loans are classified as current even with longer-term workout agreements. The receivables for the fee income from related parties will be paid out over the next four years and, accordingly, are reported long and short-term. The majority of the other loans are convertible to stock so will have little or no cash impact.

Additionally, the mortgage and construction loans on 807 Esplanade are current liabilities with corresponding leasehold improvements being recorded as non-current assets.

SHAREHOLDER'S EQUITY/(DEFICIT): Shareholder's Equity at September 30, 2012 was \$13,456,818 increasing slightly from June 30, 2012 \$13,449,284. The change was primarily due to the conversion of debt to equity through the issuance of common shares set-off against the revaluation of the shares pledged to certain loans.

Historically, we have successfully raised additional operating capital through private equity funding sources or loans from affiliates. However, no assurances can be given that we will be able to obtain sufficient working capital through the sale of common stock and/or borrowing or that the development and implementation of our business plan will generate sufficient future revenues to sustain on-going operations.

#### Employees

As of September 30, 2012, Seven Arts had 15 employees and independent contractors, providing full time services. Our affiliates employ many part time employees for production of our motion pictures, but we do not engage temporary employees on any regular or material basis. We are not signatory to any labor union collective bargaining agreements, but our affiliates in the United States are signatory to the current Writer's Guild of America, Directors Guild of America and IATSE Low Budget Agreements and have in the past been signatory to the Screen Actors Guild Agreement. Our employees have ranged from a low of six to a high of fourteen over the last three fiscal years.

#### Off-Balance Sheet Arrangements

We have no off-balance sheet arrangements.

#### Litigation

##### Fireworks Litigation

The Company prevailed in a motion for summary adjudication on February 10, 2011 in an action against CanWest Entertainment and two of its affiliates ("CanWest") confirming the Company's ownership of five motion pictures "Rules of Engagement", "An American Rhapsody," "Who Is Cletis Tout," "Onegin," and "The Believer", (the "Copyrights"). The Company has filed an action in England against Content Media Corporation ("Content") and Paramount Picture Corp. ("Paramount") to recover the Copyrights and substantial damages for the use of the copyrighted works after their purported acquisition from CanWest. The Company may incur up to \$200,000 in legal expenses to pursue this claim but expects to recover those fees from Content.

##### Jones Film

Seven Arts Pictures plc ("PLC"), the Company's listing predecessor, its then subsidiary Seven Arts Filmed Entertainment Limited ("SAFE") and Seven Arts Pictures Inc. ("SAP"), were the subject of two arbitration awards of attorney fees totalling approximately \$900,000, with interest and charges, both of which were reduced to judgment in favour of Jonesfilm ("JF"). PLC has accrued a provisional liability in the amount of \$800,000 including approximately \$100,000 of accrued interest at June 30, 2011. The Company paid approximately \$525,000, the amount of the first arbitration award plus interest and charges, in November, 2011, Management believes the Company has no further liability in this matter. JF asserts that the Company is liable as the "successor in interest" to PLC, which the Company denies.



#### Arrowhead Target Fund

Seven Arts Future Flow I (“SFF”), a limited liability Company owned by SAP Inc., a Company previously controlled by Mr. Hoffman, obtained financing from the Arrowhead Target Fund, Ltd. (“Arrowhead”) of approximately \$8,300,000 (the “Arrowhead Loan”). SFF secured the Arrowhead Loan with liens on 12 motion pictures that generated revenues of \$820,026 in the Fiscal Year Ended June 30, 2009, \$2,739,800 in the Fiscal Year Ended September 30, 2008 and \$544,478 in the three month period ended June 30, 2009. The Company’s only liability is to repay the Arrowhead Loan from the proceeds of the film assets pledged against the Arrowhead Loan. The Company is not required to repay the Arrowhead Loan from any of its other assets or revenues. SAE’s subsidiary, SAFE, Ltd. was the collateral agent of the film assets.

The Arrowhead Loan became due in February 2009 and SFF has not paid the outstanding principle and interest due thereon. Arrowhead has the right to foreclose on the pledged film assets, but has not done so at the present time. SFF has received a default notice to this effect and as a result Arrowhead is now collecting directly all sums receivable by the Company with respect to these motion pictures, and has appointed a new servicing agent for these motion pictures with the result that the Company no longer controls the licensing of these motion pictures. Failure to repay or refinance the Arrowhead Loan could result in a material disposition of assets through the loss of the Company’s rights to the twelve motion pictures and related loss of revenues in amounts that are difficult to predict.

As a result of the foregoing, the Company has removed all assets accounts relating to the twelve motion pictures pledged to Arrowhead and has removed the corresponding limited recourse indebtedness from the Company’s consolidated balance sheet at fiscal year ended June 30, 2009, due to the fact that the loan was a limited recourse loan and the Company had no further obligations to Arrowhead beyond the pledged film assets.

Arrowhead filed an action on September 22, 2010 which seeks recovery from the Company of the monies which the Company has retained under its interpretation of the relevant agreements with Arrowhead. In addition, Arrowhead makes substantial additional claims against the Company, Mr. Hoffman and SAP Inc. regarding claimed breaches of the terms of the operative agreements, including failure to properly account, failure to turn over materials, failure to remit monies collected, and similar matters. The claims against the Company for these breaches of warranties for damages are \$8,300,000 although Arrowhead states no basis for this amount.

The Company had moved to dismiss the action against all defendants other than Seven Arts Future Flows I LLC, which is not part of the Company. On August 9, 2011, the New York Supreme Court granted the Company’s motion and dismissed all defendants except Seven Arts Filmed Entertainment Limited in its capacity as a collateral agent, which is not a material element of Arrowhead claim. The Company continues to believe that Arrowhead’s claims against the Company are without substantial merit.

Arrowhead has purported to refile its claim against the Company and the other defendants. The Company will seek dismissal of these claims on the same grounds. The Company continues to believe that Arrowhead’s claims against the Company are without substantial merit.

#### Arrowhead Capital Partners – AGC Loan

The Company’s predecessor and several affiliates were named as defendants in an action by Arrowhead Capital Partners Ltd filed in the Supreme Court of New York County of New York State purportedly served on May 24, 2010, seeking to collect \$1,000,000 plus interest (the “ACG Loan”) due to Arrowhead Consulting Group LLC (“ACG”) as well as foreclosure on the collateral granted as part of the Cheyne Loan described above in Note 13 under “Production Loans”. The ACG Loan is fully subordinated to repayment of the Cheyne Loan, which has not been repaid, and a subsidiary of the Company has been assigned all Cheyne’s rights under the subordination provision of the Cheyne

Loan. As a result Management does not believe that ACG has the right to maintain this action to collect any monies or to foreclose on any collateral pursuant to the Cheyne Loan. The Company intends to vigorously defend against this action and has filed a motion for summary judgement to dismiss this action.

#### Investigation into Claim for Tax Credits (SAPLA)

The US Attorney in New Orleans is investigating claims for Louisiana film infrastructure tax credits including such tax credits to be claimed by an affiliate of the Company, Seven Arts Pictures Louisiana LLC and has issued subpoenas for discovery of documents in the possession of the Company related to their tax credits.

This investigation appears to include investigation as to whether certain expenses claimed by this affiliate were improper or fraudulent. All such claimed expenses were audited by independent auditors in Louisiana and reviewed by counsel. None of these expenses or credits has been included in the Company's financial statements for any period. Management believes that this investigation will have no material adverse effect on the Company's operations or the total tax credits to be received by the Company's affiliates, but could result in charges against current or former employees of this affiliate based on prior audits, including Mr. Hoffman.

#### Parallel Action

On June 28, 2011, Seven Arts Pictures Plc. ("PLC") filed an action in the High Court of England against Parallel Media LLC ("Parallel") to collect sums due to PLC with respect to acquisition of distribution rights in Russia to four motion pictures and to confirm Parallel's obligations under both a signed and unsigned investment agreement with respect to the motion picture project Winter Queen. On the same day Parallel filed a petition to wind up and liquidate PLC in the Companies Courts of England based on its claim of repayment of \$1,000,000 of investment made by Parallel in Winter Queen. PLC is no longer part of the Company. On September 19, 2011, Parallel filed a new action against PLC and SAE in the Superior Court of California, asserting the same claims as in the winding up petition and seeking to enjoin the proposed administration proceedings in England. A request for a preliminary injunction was denied by the Superior Court.

#### HMRC Investigation

On July 19, 2011 Officers of Her Majesty's Revenue & Customs ("HMRC") attended the offices of Seven Arts Pictures Plc. (the "Company") in London. Documents were retained appertaining to arrangements involving the subscription for shares in a number of companies which had lost value, resulting in subscribers making claims to tax relief.

The Company's participation in these transactions was limited to the Company's predecessor's transfer of rights to certain motion pictures to the investors in return for their investments in the production and release costs of those pictures and making available the provision of loans to fund a portion of those investments. The Company received no tax benefits from the transactions, which were made on arms-length terms. The Company believes that it is not a subject of the HMRC investigation.

In connection with the transactions, the Company did not make any representations or warranties to any party, including the investors, regarding any potential tax benefits related to the transactions. Prior to the closing of the transactions the investors obtained and made available to the Company, an opinion of prominent Queen's counsel, specializing in United Kingdom tax laws, that the transactions were permitted and acceptable under the terms of the applicable United Kingdom revenue laws. The Company remains confident that the transactions were permitted and acceptable under the terms of the applicable United Kingdom revenue laws.

HMRC has requested interviews with three officers of the Company to discuss whether those officers were involved in the arrangements for subscription of shares in the relevant companies, the first of which is scheduled for March 6, 2012. The Company is fully cooperating with the investigation. The Company believes there is no basis for any claim of responsibility of any of its officers or employees. Based on facts currently known by the Company, there is no need for it to record a contingent liability in its financial statements in connection with the investigation or the related transactions.





ITEM 3: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable to Smaller Reporting Companies

ITEM 4T: CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

We carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of December 31, 2011. This evaluation was accomplished under the supervision and with the participation of our chief executive officer /principal executive officer, and chief financial officer/principal financial officer who concluded that our disclosure controls and procedures are not effective.

Based upon an evaluation conducted for the period ended March 31, 2012, our Chief Executive and Chief Financial Officer as of September 30, 2011 and as of the date of this Report, has concluded that as of the end of the periods covered by this report, we have identified the following material weakness of our internal controls:

Lack of sufficient accounting staff which results in a lack of segregation of duties necessary for a good system of internal control and financial statement presentation.

Changes in Internal Controls over Financial Reporting

We have not yet made any changes in our internal controls over financial reporting that occurred during the period covered by this report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II

Items No. 1, 3, 4, 5 - Not Applicable.

ITEM 6 - EXHIBITS AND REPORTS ON FORM 8-K

(a) During the three months ended September 30, 2012 and subsequent to June 30, 2012, the Company filed Form 8-Ks:

- On July 11 2012
- On July 24 2012
- On August 6,2012
- On August 20, 2012
- On August 30, 2012
- On September 7, 2012
- On September 14, 2012
- On September 28, 2012

Also

- An S-8 was filed on July 6., 2012
- An S-3 was filed on August 20, 2012
- A Pre14A was filed on July 30, 2012 and again on August 9, 2012 (revised on August 24 2012 and again on September 11, 2012)

(b) Exhibits

Exhibit Number

31.1 Certification of Chief Executive Officer, pursuant to Rule 13a-14(a) of the Exchange Act, as enacted by Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of Chief Financial Officer, pursuant to Rule 13a-14(a) of the Exchange Act, as enacted by Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of Chief Executive Officer and Chief Financial Officer, pursuant to 18 United States Code Section 1350, as enacted by Section 906 of the Sarbanes-Oxley Act of 2002.

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SIGNATURES

In accordance with 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.

SEVEN ARTS PICTURES, INC.

Date: November, 2012

By: /s/ Peter Hoffman  
Peter Hoffman, CEO