

JONES SODA CO
Form 10-Q
August 10, 2018
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

June

30, 2014

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

For the Quarterly Period Ended June 30, 2018

OR

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

For the transition period from to

Commission File Number: 000-28820

JONES SODA CO.

(Exact name of registrant as specified in its charter)

Washington
(State or other jurisdiction of
incorporation or organization)

52-2336602
(I.R.S. Employer
Identification No.)

66 South Hanford Street, Suite 150
Seattle, Washington
(Address of principal executive offices)

98134
(Zip Code)

(206) 624-3357

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer (do not check if a smaller reporting company)

Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

As of August 10, 2018, there were 41,464,373 shares of the registrant's common stock issued and outstanding.

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FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2018

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EXPLANATORY NOTE

Unless otherwise indicated or the context otherwise requires, all references in this Quarterly Report on Form 10-Q (this “Report”) to “we,” “us,” “our,” “Jones,” “Jones Soda,” and the “Company” are to Jones Soda Co., a Washington corporation and our wholly-owned subsidiaries, Jones Soda Co. (USA) Inc. and Jones Soda (Canada) Inc.

In addition, unless otherwise indicated or the context otherwise requires, all references in this Annual Report to “Jones Soda” refer to our premium beverages, including Jones® Soda and Lemoncocco® sold under the trademarked brand name “Jones Soda Co.®”

CAUTIONARY NOTICE REGARDING FORWARD LOOKING STATEMENTS

We desire to take advantage of the “safe harbor” provisions of the Private Securities Litigation Reform Act of 1995. This Report contains a number of forward-looking statements that reflect management’s current views and expectations with respect to our business, strategies, products, future results and events, and financial performance. All statements made in this Report other than statements of historical fact, including statements that address operating performance, the economy, events or developments that management expects or anticipates will or may occur in the future, including statements related to case sales, revenues, profitability, distributor channels, new products, adequacy of funds from operations, cash flows and financing, our ability to continue as a going concern, potential strategic transactions, statements regarding future operating results and non-historical information, are forward-looking statements. In particular, the words such as “believe,” “expect,” “intend,” “anticipate,” “estimate,” “may,” “will,” “can,” “plan,” “could,” “future,” “continue,” variations of such words, and similar expressions identify forward-looking statements, but are not the exclusive means of identifying such statements and their absence does not mean that the statement is not forward-looking.

Readers should not place undue reliance on these forward-looking statements, which are based on management’s current expectations and projections about future events, are not guarantees of future performance, are subject to risks, uncertainties and assumptions and apply only as of the date of this Report. Our actual results, performance or achievements could differ materially from historical results as well as from the results expressed in, anticipated or implied by these forward-looking statements. Except as required by law, we undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

In particular, our business, including our financial condition and results of operations and our ability to continue as a going concern may be impacted by a number of factors, including, but not limited to, the following:

- Our ability to successfully execute on our growth strategy and operating plans;
- Our ability to establish, maintain and expand distribution arrangements with independent distributors, retailers, brokers and national retail accounts, most of whom sell and distribute competing products, and upon whom we rely to employ sufficient efforts in managing and selling our products, including re-stocking the retail shelves with our products;
 - Our ability to respond to any changes in, and to maintain, our private label relationship with 7-Eleven;
- The timing and amount of reorders for 7-Select®, including the impact on our inventory, revenue and cash flow;
- Competition in the fountain business, particularly from Coke and Pepsi;
- Entrance into and increased focus on the craft beverage segment by Coke and Pepsi;
- Our ability to compete successfully against much larger, well-funded, established companies currently operating in the beverage industry;
- Our ability to respond to changes in the consumer beverage marketplace, including potential reduced consumer demand due to health concerns (including obesity) and legislative initiatives against sweetened beverages;

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- Our ability to successfully develop and launch new products that match consumer beverage trends;
- Consumer response to our products and new initiatives;
- Imposition of new taxes, including potential taxes on sugar-sweetened beverages;
- Our ability to manage our operating expenses and generate cash flow from operations, or our ability to secure additional financing if our case sales goals take longer to achieve than anticipated;
- Changes in pricing and SKUs of our products;
- Our ability to manage our inventory levels and to predict the timing and amount of our sales;
- Our reliance on third-party contract manufacturers of our products and the geographic locations of their facilities, which could make management of our distribution efforts inefficient or unprofitable;

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- Our ability to secure a continuous supply and availability of raw materials, as well as other factors affecting our supply chain including increases in raw material costs and shortages of glass in the supply chain;
- Fluctuations in fuel and freight costs;
 - Fluctuations in currency exchange rates, particularly between the United States and Canadian dollars;
- Our ability to source our flavors on acceptable terms from our key flavor suppliers;
 - Our ability to attract and retain key personnel, including retaining the services of our CEO, which would directly affect our efficiency and operations and could materially impair our ability to execute our growth strategy;
- Our inability to protect our trademarks and trade secrets, which may prevent us from successfully marketing our products and competing effectively;
- Our ability to create and maintain brand name recognition and acceptance of our products, which is critical to our success in our competitive, brand-conscious industry;
- Our ability to maintain brand image and product quality and avoid risks from other product issues such as product recalls;
- Litigation or legal proceedings, which could expose us to significant liabilities and damage our reputation;
- Our ability to maintain effective disclosure controls and procedures and internal control over financial reporting;
- Our ability to maintain an effective information technology infrastructure;
- Dilutive and other adverse effects on our existing shareholders and our stock price arising from future securities issuances;
- Our ability to access the capital markets for any future equity financing, and any actual or perceived limitations to our common stock by being traded on the OTCQB Marketplace, including the level of trading activity, volatility or market liquidity;
- Regional, national or global economic conditions that may adversely impact our business and results of operations; and
- Our ability to comply with the many regulations to which our business is subject.

For a discussion of some of the factors that may affect our business, results and prospects, see “Item 1A. Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2017 filed with the Securities and Exchange Commission on March 29, 2018. Readers are also urged to carefully review and consider the various disclosures made by us in this Report and in our other reports we file with the Securities and Exchange Commission, including our periodic reports on Forms 10-Q and current reports on Form 8-K, and those described from time to time in our press releases and other communications, which attempt to advise interested parties of the risks and factors that may affect our business, prospects and results of operations.

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PART 1 – FINANCIAL INFORMATION

ITEM 1.FINANCIAL STATEMENTS

JONES SODA CO.

CONDENSED CONSOLIDATED BALANCE SHEETS

	June 30, 2018 (Unaudited)	December 31, 2017 (Unaudited)
	(In thousands, except share amounts)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 964	\$ 397
Accounts receivable, net of allowance for doubtful accounts of \$16 and \$7	2,358	1,247
Inventory	1,553	1,557
Prepaid expenses and other current assets	113	141
Total current assets	4,988	3,342
Fixed assets, net of accumulated depreciation of \$472 and \$568	80	39
Other assets	33	8
Total assets	\$ 5,101	\$ 3,389
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 1,121	\$ 949
Line of credit	290	858
Accrued expenses	664	626
Taxes payable	4	1
Total current liabilities	2,079	2,434
Convertible subordinated notes payable, net	2,512	-
Deferred rent	10	12
Shareholders' equity:		
Common stock, no par value:		
Authorized — 100,000,000; issued and outstanding shares — 41,464,373 shares	53,822	53,822
Additional paid-in capital	9,294	8,861
Accumulated other comprehensive income	347	391
Accumulated deficit	(62,963)	(62,131)
Total shareholders' equity	500	943
Total liabilities and shareholders' equity	\$ 5,101	\$ 3,389

See accompanying notes to condensed consolidated financial statements.

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JONES SODA CO.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Three months ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
	(In thousands, except share amounts)			
Revenue	\$ 3,927	\$ 3,933	\$ 6,764	\$ 7,468
Cost of goods sold	3,014	2,872	5,235	5,554
Gross profit	913	1,061	1,529	1,914
Operating expenses:				
Selling and marketing	661	548	1,215	1,092
General and administrative	534	548	1,073	1,031
	1,195	1,096	2,288	2,123
Loss from operations	(282)	(35)	(759)	(209)
Interest expense	(77)	(20)	(98)	(35)
Other income (expense), net	6	8	40	7
Loss before income taxes	(353)	(47)	(817)	(237)
Income tax expense, net	(10)	(8)	(15)	(15)
Net loss	\$ (363)	\$ (55)	\$ (832)	\$ (252)
Net loss per share - basic and diluted	\$ (0.01)	\$ (0.00)	\$ (0.02)	\$ (0.01)
Weighted average basic and diluted common shares outstanding	41,464,373	41,410,142	41,464,373	41,389,138

See accompanying notes to condensed consolidated financial statements.

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JONES SODA CO.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(Unaudited)

	Three months ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
	(In thousands)			
Net loss	\$ (363)	\$ (55)	\$ (832)	\$ (252)
Other comprehensive income (loss):				
Foreign currency translation adjustment	(27)	37	(44)	39
Total comprehensive loss	\$ (390)	\$ (18)	\$ (876)	\$ (213)

See accompanying notes to condensed consolidated financial statements.

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JONES SODA CO.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Six months ended June 30,	
	2018	2017
	(In thousands)	
OPERATING ACTIVITIES:		
Net loss	\$ (832)	\$ (252)
Adjustments to reconcile net loss to net cash used in operating activities:		
Gain on insurance claim	(36)	-
Depreciation and amortization	11	5
Stock-based compensation	83	79
Change in allowance for doubtful accounts	9	8
Changes in operating assets and liabilities:		
Accounts receivable	(1,146)	(475)
Inventory	21	(239)
Prepaid expenses and other current assets	28	-
Other assets	(25)	-
Accounts payable	173	646
Accrued expenses	44	(45)
Taxes payable	2	(9)
Other liabilities	(2)	-
Net cash used in operating activities	(1,670)	(282)
INVESTING ACTIVITIES:		
Purchase of fixed assets	(52)	(15)
Proceeds from insurance claim on property damage	36	-
Net cash used in investing activities	(16)	(15)
FINANCING ACTIVITIES:		
Proceeds from issuance of convertible notes, net	2,833	-
Proceeds (repayments) from line of credit	(568)	259
Proceeds from exercise of stock options	-	46
Net cash provided by financing activities	2,265	305
Net increase in cash and cash equivalents	579	8
Effect of exchange rate changes on cash	(12)	4
Cash and cash equivalents, beginning of period	397	733
Cash and cash equivalents, end of period	\$ 964	\$ 745
Supplemental disclosure:		
Cash paid during period for:		
Interest	\$ 22	\$ 31

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Income taxes	10	25
Supplemental disclosure of non-cash transactions:		
Beneficial conversion feature on convertible notes	\$ 350	\$ -

See accompanying notes to condensed consolidated financial statements.

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JONES SODA CO.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Nature of Operations and Summary of Significant Accounting Policies

Jones Soda Co. develops, produces, markets and distributes premium beverages which it sells and distributes primarily in the United States and Canada through its network of independent distributors and directly to its national and regional retail accounts.

We are a Washington corporation and have two operating subsidiaries, Jones Soda Co. (USA) Inc. and Jones Soda (Canada) Inc. (together, our “Subsidiaries”).

Basis of presentation and consolidation

The accompanying condensed consolidated balance sheet as of December 31, 2017, which has been derived from our audited consolidated financial statements, and unaudited interim condensed consolidated financial statements as of June 30, 2018, have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) and the Securities and Exchange Commission (“SEC”) rules and regulations applicable to interim financial reporting. The condensed consolidated financial statements include our accounts and the accounts of our Subsidiaries. All intercompany transactions between us and our Subsidiaries have been eliminated in consolidation.

In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all material adjustments, consisting only of those of a normal recurring nature, considered necessary for a fair presentation of our financial position, results of operations and cash flows at the dates and for the periods presented. The operating results for the interim periods presented are not necessarily indicative of the results expected for the full year. These financial statements should be read in conjunction with the audited financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2017.

Liquidity

As of June 30, 2018, we had cash and cash-equivalents of approximately \$1.0 million and working capital of approximately \$2.9 million. Cash used in operations during the six months ended June 30, 2018 totaled approximately \$1.7 million compared to \$282,000 used in operations for the same period a year ago. The increase in cash used in operations compared to the same period a year ago is primarily due to timing of the collection of receivables. We reported a net loss of \$832,000 for the six months ended June 30, 2018.

We have experienced recurring losses from operations and negative cash flows from operating activities. This situation creates uncertainties about our ability to execute our business plan, finance operations, and initially indicated substantial doubt about the Company’s ability to continue as a going concern. On March 23, 2018, we received proceeds of \$2,800,000 and on April 18, 2018, we received an additional \$120,000 in proceeds, in each case in

connection with the note purchase agreement described in Note 4. We believed that this recent financing alleviated the conditions which initially indicated substantial doubt about our ability to continue as a going concern.

Specifically, as of the date of filing of the Company's most recent Form 10-Q on May 11, 2018, based on management's assessment, the Company believed that it had sufficient cash to meet its funding requirements for the next twelve months. However, we have experienced and continue to experience negative cash flows from operations, as well as an ongoing requirement for additional capital to support working capital needs. Therefore, currently, based upon the Company's near term anticipated level of operations and expenditures, management believes that cash on hand, excluding cash available under the Company's line of credit, is not sufficient to enable the Company to fund operations for twelve months from the date the financial statements included in this Report are issued. The line of credit is not included in the assessment as it is renewable during December 2018, and renewal is not certain to occur. In view of these conditions, the ability of the Company to continue as a going concern is in substantial doubt and dependent upon achieving a profitable level of operations and on the ability of the Company to obtain necessary financing to fund ongoing operations. The consolidated financial statements included in this Report do not give effect to any adjustments which will be necessary should the Company be unable to continue as a going concern and therefore be required to realize its assets and discharge its liabilities in other than the normal course of business and at amounts different from those reflected in the accompanying consolidated financial statements.

We have a revolving secured credit facility with CapitalSource Business Finance Group (the "Loan Facility"). The Loan Facility allows us to borrow a maximum aggregate amount of up to \$3.2 million based on eligible accounts receivable and inventory. As of June 30, 2018, our accounts receivable and inventory eligible borrowing base was approximately \$2.1 million, of which we had drawn down approximately \$290,000. See Note 3 for further information.

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We may require additional financing to support our working capital needs in the future. The amount of additional capital we may require, the timing of our capital needs and the availability of financing to fund those needs will depend on a number of factors, including our strategic initiatives and operating plans, the performance of our business and the market conditions for available debt or equity financing. Additionally, the amount of capital required will depend on our ability to meet our sales goals and otherwise successfully execute our operating plan. We believe it is imperative that we meet these sales objectives in order to lessen our reliance on external financing in the future. We intend to continually monitor and adjust our operating plan as necessary to respond to developments in our business, our markets and the broader economy. Although we believe various debt and equity financing alternatives will be available to us to support our working capital needs, financing arrangements on acceptable terms may not be available to us when needed. Additionally, these alternatives may require significant cash payments for interest and other costs or could be highly dilutive to our existing shareholders. Any such financing alternatives may not provide us with sufficient funds to meet our long-term capital requirements. If necessary, we may explore strategic transactions that we consider to be in the best interest of the Company and our shareholders, which may include, without limitation, public or private offerings of debt or equity securities, a rights offering, and other strategic alternatives; however, these options may not ultimately be available or feasible when needed.

Seasonality and other fluctuations

Our sales are seasonal and we experience fluctuations in quarterly results as a result of many factors. We historically have generated a greater percentage of our revenues during the warm weather months of April through September. Sales may fluctuate materially on a quarter to quarter basis or an annual basis when we launch a new product or fill the “pipeline” of a new distribution partner or a large retail partner such as 7-Eleven. Sales results may also fluctuate based on the number of SKUs selected or removed by our distributors and retail partners through the normal course of serving consumers in the dynamic, trend-oriented beverage industry. As a result, management believes that period-to-period comparisons of results of operations are not necessarily meaningful and should not be relied upon as any indication of future performance or results expected for the fiscal year.

Revenue Recognition

The Company recognizes revenue under ASC 606, Revenue from Contracts with Customers. The core principle of the revenue standard is that a company should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. The Company only applies the five-step model to contracts when it is probable that the Company will collect the consideration it is entitled to in exchange for the goods and services transferred to the customer. The following five steps are applied to achieve that core principle:

Step 1: Identify the contract with the customer

Step 2: Identify the performance obligations in the contract

Step 3: Determine the transaction price

Step 4: Allocate the transaction price to the performance obligations in the contract

Step 5: Recognize revenue when the company satisfies a performance obligation

See Note 6, Segment information, for information on revenue disaggregated by geographic area.

Because the Company's agreements generally have an expected duration of one year or less, the Company has elected the practical expedient in ASC 606-10-50-14(a) to not disclose information about its remaining performance obligations.

The Company's performance obligations are satisfied at the point in time when products are received by the customer, which is when the customer has title and the significant risks and rewards of ownership. Therefore, the Company's contracts have a single performance obligation (shipment of product). The Company primarily receives fixed consideration for sales of product. Shipping and handling amounts paid by customers are primarily for online orders, included in revenue, and total \$54,000 and \$55,000 for the three months ended June 30, 2018 and 2017, respectively. Shipping and handling amounts paid by customers are primarily for online orders, included in revenue, and totaled \$100,000 and \$93,000 for the six months ended June 30, 2018 and 2017, respectively. Sales tax and other similar taxes are excluded from revenue.

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Revenue is recorded net of provisions for discounts, slotting fees payable by us to retailers to stock our products and promotion allowances, which are typically agreed to upfront with the customer and do not represent variable consideration. Discounts, slotting fees and promotional allowances vary the consideration the Company is entitled to in exchange for the sale of products to distributors. The Company estimates these discounts, slotting fees and promotional allowances in the same period that the revenue is recognized for products sales to customers. The amount of revenue recognized represents the amount that will not be subject to a significant future reversal of revenue. The liability for promotional allowances is included in accrued expenses on the consolidated balance sheets. Amounts paid for slotting fees are recorded as prepaid expenses on the consolidated balance sheets and amortized over the corresponding term. For the quarters ended June 30, 2018 and 2017, our revenue was reduced by \$388,000 and \$421,000 respectively, for slotting fees and promotion allowances. For the six months ended June 30, 2018 and 2017, our revenue was reduced by \$647,000 and \$730,000 respectively, for slotting fees and promotion allowances.

All sales to distributors and customers are generally final. In limited instances the Company may accept returned product due to quality issues or distributor terminations and in such situations the Company would have variable consideration. To date, returns have not been material. The Company's customers generally pay within 30 days from the receipt of a valid invoice. The Company offers prompt pay discounts of up to 2% to certain customers typically for payments made within 15 days. Prompt pay discounts are estimated in the period of sale based on experience with sales to eligible customers. Early pay discounts are recorded as a deduction to the accounts receivable balance presented on the consolidated balance sheets.

The accounts receivable balance primarily includes balances from trades sales to distributors and retail customers. The allowance for doubtful accounts is the best estimate of the amount of probable credit losses in existing accounts receivable. The Company determines the allowance for doubtful accounts based primarily on historical write-off experience. Account balances that are deemed uncollectible are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. Allowances for doubtful accounts of \$16 and \$7 as of June 30, 2018 and December 31, 2017, respectively, were netted against accounts receivable. No impairment losses were recognized as of June 30, 2018 and December 31, 2017, respectively. Changes in accounts receivable are primarily due to the timing and magnitude of orders of products, the timing of when control of products is transferred to distributors and the timing of cash collections.

Deferred financing costs

We defer costs related to the issuance of debt which are included on the accompanying balance sheets as a deduction from the debt liability. Deferred financing costs are amortized over the term of the related loan and are included as a component of interest expense on the accompanying consolidated statements of operations.

Use of estimates

The preparation of the condensed consolidated financial statements requires management to make a number of estimates and assumptions relating to the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Significant items subject to such estimates and assumptions include, but are not limited to, inventory valuation, depreciable lives and valuation of capital assets, valuation allowances for receivables, trade promotion liabilities, stock-based compensation expense, valuation allowance for deferred income tax assets, contingencies, and forecasts supporting the going concern assumption and related disclosures. Actual results could differ from those estimates.

Recent accounting pronouncements

In July 2017, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2017-11 (“ASU 2017-11”), which allows companies to exclude a down round feature when determining whether a financial instrument is considered indexed to the entity’s own stock. As a result, financial instruments with down round features are no longer classified as liabilities and embedded conversion options with down round features are no longer bifurcated. For equity-classified freestanding financial instruments, such as warrants, an entity will treat the value of the effect of the down round, when triggered, as a dividend and a reduction of income available to common shareholders in computing basic earnings per share. For convertible instruments with embedded conversion options that have down round features, an entity will recognize the intrinsic value of the feature only when the feature becomes beneficial. The guidance in ASU 2017-11 is effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. We early adopted ASU 2017-11 effective January 1, 2018 without a material impact on our consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, “Revenue from Contracts with Customers (Topic 606),” (“ASU 2014-09”). ASU 2014-09 supersedes the revenue recognition requirements in ASC 605 - Revenue Recognition (“ASC 605”) and most industry-specific guidance throughout ASC 605. The FASB has issued numerous updates that provide clarification on a number of specific issues as well as requiring additional disclosures. The core principle of ASC 606 requires that an entity recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration

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to which the company expects to be entitled in exchange for those goods or services. We adopted ASC 606 effective January 1, 2018 using the full retrospective approach. The adoption of ASU 2014-09 did not have a material impact on our consolidated financial position, results of operations, equity or cash flows and there were no other significant changes impacting the timing or measurement of our revenue or business processes and controls.

In February 2016, the FASB issued ASU No. 2016-02, Leases: Topic 842 (“ASU 2016-2”), which replaces existing lease guidance. ASU 2016-2 requires lessees to recognize a lease liability and a lease asset for all leases, including operating leases, with a term greater than twelve months to its balance sheets. ASU 2016-2 also expands the required quantitative and qualitative disclosures surrounding leases. ASU 2016-2 is effective for us beginning January 1, 2019. Early adoption is permitted. While we expect adoption to lead to an increase in the assets and liabilities recorded on our balance sheets, we are still evaluating the overall impact on our consolidated financial statements.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments: Credit Losses (“ASU 2016-13”), which changes the impairment model for most financial instruments, including trade receivables from an incurred loss method to a new forward-looking approach, based on expected losses. The estimate of expected credit losses will require entities to incorporate considerations of historical information, current information and reasonable and supportable forecasts. This ASU is effective for us in the first quarter of 2020 and must be adopted using a modified retrospective transition approach. We are currently evaluating the potential impact the adoption of ASU 2016-13 will have on its consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows: Classification of Certain Cash Receipts and Cash Payments (“ASU 2016-15”), which clarifies how certain cash receipts and cash payments are presented and classified in the statement of cash flows. This ASU was effective for us in the first quarter of 2018 with early adoption permitted and must be applied retrospectively to all periods presented. We adopted ASU 2016-15 during 2018 without a material impact on our consolidated financial statements.

2. Inventory

Inventory consisted of the following (in thousands):

	June 30, 2018	December 31, 2017
Finished goods	\$ 1,072	\$ 1,106
Raw materials	481	451
	\$ 1,553	\$ 1,557

Finished goods primarily include product ready for shipment, as well as promotional merchandise held for sale. Raw materials primarily include ingredients, concentrate and packaging.

3. Line of Credit

We have a revolving secured Loan Facility with CapitalSource Business Finance Group (“CapitalSource”), pursuant to which we, through our Subsidiaries, may borrow a maximum aggregate amount of up to \$3.2 million, subject to

satisfaction of certain conditions. The current term of the Loan Facility expires on December 27, 2018, unless renewed.

Under this Loan Facility, as amended in January and December 2016, we may periodically request advances equal to the lesser of: (a) \$3.2 million, or (b) the borrowing base which is, in the following priority, the sum of: (i) 85% of eligible U.S. accounts receivable, plus (ii) 50% of eligible Canadian accounts receivable not to exceed \$300,000 (subject to any reserve amount established by CapitalSource), plus (iii) 35% of finished goods inventory not to exceed \$475,000, or 50% of eligible accounts receivable collateral. As of June 30, 2018, our accounts receivable and inventory eligible borrowing base was approximately \$2.1 million, of which we had drawn down approximately \$290,000. As amended by the December 2016 renewal, advances under the Loan Facility bear interest at the prime rate plus 0.75%, where prime may not be less than 0%, and a loan fee of 0.10% on the daily loan balance and is payable monthly. The Loan Facility provides for a minimum cumulative amount of interest of \$30,000 per year to be paid to CapitalSource, regardless of whether or not we draw on the Loan Facility.

CapitalSource has the right to terminate the Loan Facility at any time upon 120 days' prior written notice. All present and future obligations of our Subsidiaries under the Loan Facility are guaranteed by us and are secured by a first priority security interest in all of our assets. The Loan Facility contains customary representations and warranties as well as affirmative and negative covenants. As of June 30, 2018, we were in compliance with all covenants under the Loan Facility. During 2018, the draws on the Loan Facility were used to fulfill working capital needs. We will continue to utilize the Loan Facility, as needed, for working capital needs in the future.

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4. Convertible Subordinated Notes Payable

On March 23, 2018, and April 18, 2018 we issued and sold an aggregate principal amount of \$2,920,000 of convertible subordinated promissory notes (the “Convertible Notes”) to institutional investors, our management team, and other individual accredited investors.

The Convertible Notes have a four-year term from the date of issuance and bear interest at 6% per annum until maturity. The holders can convert the Convertible Notes at any time into the number of shares of our common stock equal to the quotient obtained by dividing (i) the amount of the unpaid principal and interest on such Convertible Note by (ii) \$0.32 (the “Conversion Price”). The Conversion Price is subject to anti-dilution adjustment on a broad-based, weighted average basis if we issue shares or equity-linked instruments at a conversion price below \$0.32 per share. No payments of principal or interest are due until the maturity.

The Convertible Notes are subordinated in right of payment to the prior payment in full of all of our Senior Indebtedness, which is defined as amounts due in connection with our indebtedness for borrowed money to banks, commercial finance lenders (CapitalSource), or other lending institutions regularly engaged in the business of lending money, with certain restrictions.

The fair value of our common stock on the March 23, 2018 closing date for the issuance of the Convertible Notes was \$0.36 per share, therefore, the Convertible Notes contained a beneficial conversion feature with an aggregate intrinsic value of \$350,000. The fair value of our common stock on the April 18, 2018 closing date for the issuance of the Convertible Notes was \$0.30 per share, which did not result in an additional beneficial conversion feature. The resulting debt discount for the Convertible Notes issued on March 23, 2018 is presented as a direct deduction from the carrying value of the Convertible Notes and was recorded with an increase to additional paid-in capital. The discount along with the related closing costs amounting to \$87,000 will be amortized through interest expense over the term of the Convertible Notes. The balance of notes payable is presented net of unamortized discounts amounting to \$408,000 at June 30, 2018. The principal balance of notes payable to related parties amounted to \$120,000 at June 30, 2018.

5. Shareholders' Equity

Under the terms of our 2011 Incentive Plan (the “Plan”), the number of shares authorized under the Plan may be increased each January 1st by an amount equal to the lesser of (a) 1,300,000 shares, (b) 4.0% of our outstanding common stock as of the end of our immediately preceding fiscal year, and (c) a lesser amount determined by the Board of Directors (the “Board”), provided that the number of shares that may be granted pursuant to awards in a single year may not exceed 10% of our outstanding shares of common stock on a fully diluted basis as of the end of the immediately preceding fiscal year. Effective January 1, 2018, the total number of shares of common stock authorized under the Plan was 10,784,032 shares.

Under the terms of the Plan, the Board may grant awards to employees, officers, directors, consultants, agents, advisors and independent contractors. Awards may consist of stock options, stock appreciation rights, stock awards, restricted stock, stock units, performance awards or other stock or cash-based awards. Stock options are granted with an exercise price equal to the closing price of our stock on the date of grant, and generally have a ten-year term and vest over a period of 48 months with the first 25% of the shares subject to the option vesting one year from the grant date and the remaining 75% of the shares subject to the option vesting in equal monthly increments over the subsequent 36 months. Restricted stock awards generally vest over one year. As of June 30, 2018, there were 4,734,482 shares of unissued common stock authorized and available for future awards under the Plan.

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(a) Stock options:

A summary of our stock option activity is as follows:

	Outstanding Options	Weighted
	Number of Shares	Average
		Exercise
		Price
Balance at January 1, 2018	4,016,653	\$ 0.54
Options granted	395,000	0.37
Options cancelled/expired	(388,750)	1.00
Balance at June 30, 2018	4,022,903	\$ 0.47
Exercisable, June 30, 2018	3,012,923	\$ 0.48
Vested and expected to vest	3,775,125	\$ 0.47

(b) Restricted stock awards:

Effective as of January 1, 2018, equity compensation for non-employee director service will be an annual restricted stock unit award that vests over one year with a value of \$15,000 based on the closing share price of the first business day in January.

A summary of our restricted stock activity is as follows:

	Restricted Shares	Weighted-Average Grant Date Fair Value	Weighted-Average Contractual Life
Non-vested restricted stock at January 1, 2018	-	\$ -	-
Granted	202,705	0.37	-
Cancelled/expired	(81,082)	0.37	-
Non-vested restricted stock at June 30, 2018	202,705	\$ 0.37	9.5

(c) Stock-based compensation expense:

Stock-based compensation expense is recognized using the straight-line attribution method over the employees' requisite service period. We recognize compensation expense for only the portion of stock options or restricted stock expected to vest. Therefore, we apply estimated forfeiture rates that are derived from historical employee attrition. If the actual number of forfeitures differs from those estimated by management, additional adjustments to stock-based compensation expense may be required in future periods.

At June 30, 2018, we had unrecognized compensation expense related to stock options and non-vested restricted stock of \$197,000 to be recognized over a weighted-average period of 2.3 years.

The following table summarizes the stock-based compensation expense (in thousands):

	Three months ended June 30, 2018		Six months ended June 30, 2017	
Type of awards:				
Stock options	\$ 30	\$ 38	\$ 61	\$ 79
Restricted stock	4	—	22	—
	\$ 34	\$ 38	\$ 83	\$ 79
Income statement account:				
Selling and marketing	\$ 14	13	\$ 29	\$ 29
General and administrative	20	25	54	50
	\$ 34	\$ 38	\$ 83	