

REEDS INC
Form 10-Q
August 14, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2013

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

For the transition period from__ to__

Commission file number

Commission file number: 001-32501

REED'S INC.

(Exact name of registrant as specified in its charter)

Delaware 35-2177773
(State of incorporation) (I.R.S. Employer Identification No.)

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13000 South Spring St. Los Angeles, Ca. 90061

(Address of principal executive offices) (Zip Code)

(310) 217-9400

(Registrant's telephone number, including area code)

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

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

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

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

Large Accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: There were a total of 12,726,425 shares of Common Stock outstanding as of August 8, 2013.

Special Note Regarding Forward-Looking Statements

This Quarterly Report on Form 10-Q, including "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Item 2 of Part I of this report include forward-looking statements. These statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance, or achievements expressed or implied by forward-looking statements.

In some cases, you can identify forward-looking statements by terminology such as "may," "should," "expects," "plans," "anticipates," "believes," "estimates," "predicts," "potential," "proposed," "intended," or "continue" or the negative of these terms or other comparable terminology. You should read statements that contain these words carefully, because they discuss our expectations about our future operating results or our future financial condition or state other "forward-looking" information. There may be events in the future that we are not able to accurately predict or control. Before you invest in our securities, you should be aware that the occurrence of any of the events described in this Quarterly Report could substantially harm our business, results of operations and financial condition, and that upon the occurrence of any of these events, the trading price of our securities could decline and you could lose all or part of your investment. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, growth rates, levels of activity, performance or achievements. We are under no duty to update any of the forward-looking statements after the date of this Quarterly Report to conform these statements to actual results.

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Part I – FINANCIAL INFORMATION**Item 1. Financial Statements****REED’S, INC.****CONDENSED BALANCE SHEETS**

| | June 30, 2013 (unaudited) | December 31, 2012 |
|--|---------------------------------|-------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash | \$816,000 | \$1,163,000 |
| Inventory | 6,385,000 | 5,794,000 |
| Trade accounts receivable, net of allowance for doubtful accounts and returns and discounts of \$365,000 and \$399,000, respectively | 3,235,000 | 1,961,000 |
| Prepaid inventory | 330,000 | 201,000 |
| Prepaid and other current assets | 295,000 | 212,000 |
| Total Current Assets | 11,061,000 | 9,331,000 |
| Property and equipment, net of accumulated depreciation of \$2,600,000 and \$2,351,000, respectively | 3,472,000 | 3,422,000 |
| Brand names | 1,029,000 | 1,029,000 |
| Deferred financing fees, net of amortization of \$49,000 and \$26,000, respectively | 31,000 | 54,000 |
| Total assets | \$15,593,000 | \$13,836,000 |
| LIABILITIES AND STOCKHOLDERS’ EQUITY | | |
| Current Liabilities: | | |
| Accounts payable | \$4,730,000 | \$3,368,000 |
| Accrued expenses | 154,000 | 233,000 |
| Dividends payable | 5,000 | 74,000 |
| Line of credit | 4,072,000 | 3,023,000 |
| Current portion of long term financing obligation | 100,000 | 90,000 |
| Current portion of capital leases payable | 80,000 | 69,000 |
| Current portion of term loan | 155,000 | 176,000 |
| Total current liabilities | 9,296,000 | 7,033,000 |
| Long term financing obligation, less current portion, net of discount of \$550,000 and \$576,000, respectively | 2,181,000 | 2,208,000 |
| Capital leases payable, less current portion | 67,000 | 98,000 |
| Term loan, less current portion | 556,000 | 399,000 |
| Total Liabilities | 12,100,000 | 9,738,000 |

Commitments and contingencies

Stockholders' equity:

| | | |
|--|---------------|---------------|
| Series A Convertible Preferred stock, \$10 par value, 500,000 shares authorized, 10,411 and 10,411 shares issued and outstanding, respectively | 104,000 | 104,000 |
| Series B Convertible Preferred stock, \$10 par value, 500,000 shares authorized, 0 and 45,062 shares issued and outstanding, respectively | — | 456,000 |
| Common stock, \$.0001 par value, 19,500,000 shares authorized, 12,666,117 and 12,084,673 shares issued and outstanding, respectively | 1,000 | 1,000 |
| Additional paid in capital | 24,749,000 | 23,996,000 |
| Accumulated deficit | (21,361,000) | (20,459,000) |
| Total stockholders' equity | 3,493,000 | 4,098,000 |
| Total liabilities and stockholders' equity | \$ 15,593,000 | \$ 13,836,000 |

The accompanying notes are an integral part of these condensed financial statements

REED'S, INC.**CONDENSED STATEMENTS OF OPERATIONS**

For the Three and Six Months Ended June 30, 2013 and 2012

(Unaudited)

| | Three months ended June 30, | | Six months ended June 30, | |
|---|-----------------------------|-------------|---------------------------|--------------|
| | 2013 | 2012 | 2013 | 2012 |
| Sales | \$9,519,000 | \$7,831,000 | \$17,645,000 | \$14,370,000 |
| Cost of tangible goods sold | 6,630,000 | 4,774,000 | 11,629,000 | 9,018,000 |
| Cost of goods sold – idle capacity | 432,000 | 360,000 | 1,024,000 | 670,000 |
| Gross profit | 2,457,000 | 2,697,000 | 4,992,000 | 4,682,000 |
| Operating expenses: | | | | |
| Delivery and handling expenses | 954,000 | 585,000 | 1,860,000 | 1,064,000 |
| Selling and marketing expense | 960,000 | 699,000 | 1,840,000 | 1,421,000 |
| General and administrative expense | 912,000 | 805,000 | 1,900,000 | 1,545,000 |
| Total operating expenses | 2,826,000 | 2,089,000 | 5,600,000 | 4,030,000 |
| Income (loss) from operations | (369,000) | 608,000 | (608,000) | 652,000 |
| Interest expense | (125,000) | (164,000) | (289,000) | (332,000) |
| Net income (loss) | (494,000) | 444,000 | (897,000) | 320,000 |
| Preferred stock dividends | (5,000) | (23,000) | (5,000) | (32,000) |
| Net income (loss) attributable to common stockholders | \$(499,000) | \$421,000 | \$(902,000) | \$288,000 |
| Income (loss) per share available to common stockholders, basic | \$(0.04) | \$0.04 | \$(0.07) | \$0.03 |
| Weighted average number of shares outstanding - basic | 12,543,983 | 11,041,558 | 12,413,958 | 10,981,317 |
| Income (loss) per share available to common stockholders, diluted | \$(0.04) | \$0.04 | \$(0.07) | \$0.02 |
| Weighted average number of shares outstanding - diluted | 12,543,983 | 11,940,343 | 12,413,958 | 11,647,148 |

The accompanying notes are an integral part of these condensed financial statement

REED'S, INC.**CONDENSED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY****For the Six Months Ended June 30, 2013****(unaudited)**

| | Common Stock | | Series A Preferred Stock | | Series B Preferred Stock | | Additional Paid-In Capital | Accumulated Deficit | Total Stockholder Equity |
|---|--------------|---------|-----------------------------|-----------|-----------------------------|-----------|----------------------------------|------------------------|--------------------------------|
| | Shares | Amount | Shares | Amount | Shares | Amount | | | |
| Balance, December 31, 2012 | 12,084,673 | \$1,000 | 10,411 | \$104,000 | 45,602 | \$456,000 | \$23,996,000 | \$(20,459,000) | \$4,098,000 |
| Fair Value of common stock issued for services | 1,250 | — | — | — | — | — | 5,000 | — | 5,000 |
| Proceeds from exercise of stock options | 211,901 | — | — | — | — | — | 30,000 | — | 30,000 |
| Cashless exercise of warrants | 1,189 | — | — | — | — | — | — | — | — |
| Common stock issued upon conversion of Series B preferred stock | 319,214 | — | — | — | (45,602) | (456,000) | 456,000 | — | — |
| Fair value vesting of options issued to employees | — | — | — | — | — | — | 188,000 | — | 188,000 |
| Common stock paid for Series B preferred stock dividend | 47,890 | — | — | — | — | — | 74,000 | — | 74,000 |
| Series A preferred stock dividend | — | — | — | — | — | — | — | (5,000) | (5,000) |
| Net loss | — | — | — | — | — | — | — | (897,000) | (897,000) |
| Balance, June 30, 2013 | 12,666,117 | \$1,000 | 10,411 | \$104,000 | — | — | \$24,749,000 | \$(21,361,000) | \$3,493,000 |

The accompanying notes are an integral part of these condensed financial statements

REED'S, INC.**CONDENSED STATEMENTS OF CASH FLOWS****For the Six Months Ended June 30, 2013 and 2012****(Unaudited)**

| | Six Months Ended June 30, | |
|--|------------------------------|-------------|
| | 2013 | 2012 |
| Cash flows from operating activities: | | |
| Net (loss) income | \$(897,000) | \$320,000 |
| Adjustments to reconcile net (loss) income to net cash (used in) provided by operating activities: | | |
| Depreciation and amortization | 298,000 | 372,000 |
| Fair value of stock options issued to employees | 188,000 | 55,000 |
| Fair value of common stock issued for services and bonus | 5,000 | 20,000 |
| (Decrease) increase in allowance for doubtful accounts | (34,000) | 60,000 |
| Changes in assets and liabilities: | | |
| Accounts receivable | (1,240,000) | (977,000) |
| Inventory | (591,000) | 1,053,000 |
| Prepaid expenses and inventory and other current assets | (212,000) | (98,000) |
| Accounts payable | 1,362,000 | 338,000 |
| Accrued expenses | (79,000) | 14,000 |
| Recycling fees payable | - | (12,000) |
| Net cash (used in) provided by operating activities | (1,200,000) | 1,145,000 |
| Cash flows from investing activities: | | |
| Purchase of property and equipment | (286,000) | (215,000) |
| Net cash used in investing activities | (286,000) | (215,000) |
| Cash flows from financing activities: | | |
| Proceeds from stock option and warrant exercises | 30,000 | 31,000 |
| Principal repayments on long term financing obligation | (43,000) | (33,000) |
| Principal repayments on capital lease obligation | (33,000) | (27,000) |
| Payment of deferred finance fees | - | (4,000) |
| Increased borrowing on note payable | 217,000 | - |
| Principal repayments on notes payable | (81,000) | (75,000) |
| Net borrowing (repayment) on line of credit | 1,049,000 | (144,000) |
| Net cash provided by (used in) financing activities | 1,139,000 | (252,000) |
| Net (decrease) increase in cash | (347,000) | 678,000 |
| Cash at beginning of period | 1,163,000 | 713,000 |
| Cash at end of period | \$816,000 | \$1,391,000 |
| Supplemental disclosures of cash flow information: | | |
| Cash paid during the period for: | | |
| Interest | \$338,000 | \$333,000 |

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Non cash investing and financing activities:

| | | |
|--|-----------|-----------|
| Series A Preferred stock converted to common stock | – | \$137,000 |
| Series B Preferred stock converted to common stock | \$456,000 | \$279,000 |
| Dividends payable in common stock | \$5,000 | \$32,000 |
| Common stock issued in settlement of Series B preferred stock dividend | \$74,000 | \$32,000 |
| Property and equipment acquired through capital lease obligation | \$13,000 | – |

The accompanying notes are an integral part of these condensed financial statements

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REED'S, INC.

NOTES TO CONDENSED FINANCIAL STATEMENTS

Three and Six Months Ended June 30, 2013 and 2012 (UNAUDITED)

1. Basis of Presentation

The accompanying interim condensed financial statements are unaudited, but in the opinion of management of Reeds, Inc. (the "Company"), contain all adjustments, which include normal recurring adjustments necessary to present fairly the financial position at June 30, 2013 and the results of operations and cash flows for the three and six months ended June 30, 2013 and 2012. The balance sheet as of December 31, 2012 is derived from the Company's audited financial statements.

Certain information and footnote disclosures normally included in financial statements that have been prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission, although management of the Company believes that the disclosures contained in these condensed financial statements are adequate to make the information presented herein not misleading. For further information, refer to the financial statements and the notes thereto included in the Company's Annual Report on Form 10-K, as filed with the Securities and Exchange Commission on March 22, 2013.

The results of operations for the three and six months ended June 30, 2013 are not necessarily indicative of the results of operations to be expected for the full fiscal year ending December 31, 2013.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expense during the reporting period. Actual results could differ from those estimates. Those estimates and assumptions include estimates for reserves of uncollectible accounts, inventory obsolescence, analysis of impairments of recorded intangibles, accruals for potential liabilities and assumptions made in valuing stock instruments issued for services.

In presenting the Company's consolidated statement of operations for the three and six months ended June 30, 2012, the Company previously presented \$78,000 and \$138,000, respectively, of inventory adjustments as cost of goods sold – idle capacity. In presenting the Company's consolidated statement of operations for the three and six months ended

June 30, 2013, the Company has reclassified inventory adjustments from cost of goods sold – idle capacity into cost of tangible goods sold.

Income (Loss) per Common Share

Basic earnings (loss) per share is computed by dividing the net income (loss) applicable to common stock holders by the weighted average number of shares of common stock outstanding during the year. Diluted earnings per share is computed by dividing the net income applicable to common stock holders by the weighted average number of common shares outstanding plus the number of additional common shares that would have been outstanding if all dilutive potential common shares had been issued, using the treasury stock method. Potential common shares are excluded from the computation when their effect is antidilutive.

For the three and six months ended June 30, 2012 the calculations of diluted earnings per share included stock options and warrants, calculated under the treasury method, and excluded preferred stock since the effect was antidilutive. For the three and six months ended June 30, 2013 the calculations of basic and diluted loss per share are the same as the effect of stock options, warrants, and preferred stock are antidilutive. The calculation of weighted average shares outstanding – diluted is as follows:

| | Three months ended June 30, | | Six months ended June 30, | |
|---|--------------------------------|-------------|------------------------------|-------------|
| | 2013 | 2012 | 2013 | 2012 |
| Net (loss) income attributable to common stockholders | \$(499,000 |) \$421,000 | \$(902,000 |) \$288,000 |
| Denominator: | | | | |
| Weighted average shares outstanding - basic | 12,543,983 | 11,041,558 | 12,413,958 | 10,981,317 |
| Effect of dilutive instruments: | | | | |
| Warrants and options | – | 898,785 | – | 665,831 |
| Weighted average shares outstanding-diluted | 12,543,983 | 11,940,343 | 12,413,958 | 11,647,148 |

At June 30, 2013, the Company had potentially dilutive securities that consisted of:

| | June 30, 2013 | June 30, 2012 |
|--------------------------|------------------|------------------|
| Warrants | 315,253 | 1,060,806 |
| Options | 740,168 | 998,667 |
| Series A Preferred Stock | 41,644 | 131,764 |
| Series B Preferred Stock | – | 367,549 |
| Total | 1,097,065 | 2,558,786 |

Recent Accounting Pronouncements

There are recent accounting pronouncements issued by the FASB (including its Emerging Issues Task Force), the AICPA, and the Securities Exchange Commission (the "SEC"), such pronouncements are not believed by management to have a material impact on the Company's present or future financial statements.

Concentrations

The Company's cash balances on deposit with banks are guaranteed by the Federal Deposit Insurance Corporation up to \$250,000. The Company may be exposed to risk for the amounts of funds held in one bank in excess of the insurance limit. In assessing the risk, the Company's policy is to maintain cash balances with high quality financial institutions. The Company had cash balances in excess of the guarantee during the three and six months ended June 30, 2013.

During the three months ended June 30, 2013 and 2012, the Company had two customers, which accounted for approximately 34% and 9% of sales in 2013, and 33% and 8% of sales in 2012, respectively. During the six months ended June 30, 2013 and 2012, the Company had two customers, which accounted for approximately 34% and 10% of sales in 2013, and 31% and 10% of sales in 2012, respectively. No other customers accounted for more than 10% of sales in either year. As of June 30, 2013, the Company had accounts receivable due from a customer who comprised \$1,420,000 (39%) of its total accounts receivable and as of December 31, 2012 the Company had accounts receivable due from two customers who comprised \$475,000 (27%), and \$264,000 (15%), respectively, of its total accounts receivable.

Advertising

Advertising costs are expensed as incurred. For the three months ended June 30, 2013 and 2012, advertising costs were \$28,000 and \$7,000, respectively, and for the six months ended June 30, 2013 and 2012, advertising costs were \$52,000 and \$25,000, respectively

Comprehensive Income

For the three and six months ended June 30, 2013 and 2012, the Company had no items of comprehensive income.

Fair Value of Financial Instruments

The Company uses various inputs in determining the fair value of its investments and measures these assets on a recurring basis. Financial assets recorded at fair value in the balance sheets are categorized by the level of objectivity associated with the inputs used to measure their fair value. Authoritative guidance provided by the FASB defines the following levels directly related to the amount of subjectivity associated with the inputs to fair valuation of these financial assets:

Level 1—Quoted prices in active markets for identical assets or liabilities.

Level 2—Inputs, other than the quoted prices in active markets, that are observable either directly or indirectly.

Level 3—Unobservable inputs based on the Company's assumptions.

The Company had no such assets or liabilities recorded to be valued on the basis above at June 30, 2013 or December 31, 2012.

2. Inventory

Inventory consists of the following as of:

| | June 30, 2013 | December 31, 2012 |
|-----------------------------|------------------|-------------------------|
| Raw Materials and packaging | \$4,232,000 | \$3,524,000 |
| Finished Goods | 2,153,000 | 2,270,000 |
| | \$6,385,000 | \$5,794,000 |

During the three months ended June 30, 2013, the Company produced a private label product line for a customer that was rejected. The Company isolated the issue and offered to immediately remedy the issues raised. Such remedy was rejected by the customer. The Company is currently investigating whether the customer had the right to reject the products, under the circumstances. A reserve has been established for the value of the inventory on-hand and the inventory sold to the customer in the total amount of \$412,000. The resolution of this matter is in the preliminary stages and measures are being taken to mitigate the losses from this contract.

3. Property and Equipment

Property and equipment are comprised of the following as of:

| | June 30, 2013 | December 31, 2012 |
|-------------------------|------------------|-------------------------|
| Land | \$1,108,000 | \$1,108,000 |
| Building | 1,781,000 | 1,737,000 |
| Vehicles | 338,000 | 320,000 |
| Machinery and equipment | 2,405,000 | 2,174,000 |
| Office equipment | 440,000 | 434,000 |

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| | | |
|--------------------------|-------------|-------------|
| | 6,072,000 | 5,773,000 |
| Accumulated depreciation | (2,600,000) | (2,351,000) |
| | \$3,472,000 | \$3,422,000 |

Machinery and equipment at June 30, 2013 and December 31, 2012 includes equipment held under capital leases of \$322,000. Accumulated depreciation on equipment held under capital leases was \$192,000 and \$149,000 at June 30, 2013 and December 31, 2012, respectively.

4. Line of Credit

On May 1, 2013 the Company was allowed a \$200,000 overdraft feature on its revolving line of credit. On May 11, 2013, the Company's revolving line of credit was increased from \$3,000,000 to \$4,000,000. At June 30, 2013 and December 31, 2012, the aggregate amount outstanding under the line of credit was \$4,072,000 and \$3,023,000 respectively, and the Company had approximately \$154,000 of availability on this line of credit at June 30, 2013. The interest rate on the revolving line of credit is at the prime rate plus 3.75% (7% at June 30, 2013). The line of credit is based on 85% of eligible accounts receivable and 50% of eligible inventory. The line of credit expires on November 7, 2014 and is secured by substantially all of the Company's assets.

5. Term Loan

On May 1, 2013 the term loan was increased to \$750,000. Other terms of the term loan remain the same. The term loan bears interest at the prime rate plus 11.6%, which shall not be below 14.85%, is secured by all of the unencumbered assets of the Company, and is to be repaid in 48 equal installments of principal and interest of \$21,000.

| | June 30, 2013 | December 31, 2012 |
|----------------------|------------------|-------------------------|
| Term loan | \$711,000 | \$575,000 |
| Less current portion | (155,000) | (176,000) |
| Long term debt | \$556,000 | \$399,000 |

6. Long-term Financing Obligation

In 2009 the Company sold two buildings and its brewery equipment and concurrently entered into a long-term lease agreement for the same property and equipment. In connection with the lease the Company has the option to repurchase the buildings and brewery equipment from 12 months after the commencement date to the end of the lease term at the greater of the fair market value or an agreed upon amount. Since the lease contains a buyback provision and other related terms, the Company determined it had continuing involvement that did not warrant the recognition of a sale; therefore, the transaction has been accounted for as a long-term financing. The proceeds from the sale, net of transaction costs, have been recorded as a financing obligation in the amount of \$3,056,000. Monthly payments under the financing agreement are recorded as interest expense and a reduction in the financing obligation at an implicit rate of 9.9%. The financing obligation is personally guaranteed up to a limit of \$150,000 by the principal shareholder and Chief Executive Officer.

In connection with the financing obligation, the Company issued an aggregate of 400,000 warrants to purchase its common stock at \$1.20 per share for five years. The 400,000 warrants were valued at \$752,000 and reflected as a debt discount, using the Black Scholes option pricing model. The following assumptions were utilized in valuing the 400,000 warrants: strike price of \$2.10 to \$2.25; term of 5 years; volatility of 91.36% to 110.9%; expected dividends 0%; and discount rate of 2.15% to 2.20%. The 400,000 warrants were recorded as valuation discount and are being amortized over 15 years, the term of the purchase option. Amortization of valuation discount during the six months ended June 30, 2013 and 2012 was \$26,000 and \$26,000, respectively.

Long term financing obligation is comprised of the following as of:

| | June 30, 2013 | December 31, 2012 |
|----------------------|------------------|----------------------|
| Financing obligation | \$2,831,000 | \$2,874,000 |
| Valuation discount | (550,000) | (576,000) |

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| | | |
|--------------------------------|-------------|-------------|
| | 2,281,000 | 2,298,000 |
| Less current portion | (100,000) | (90,000) |
| Long term financing obligation | \$2,181,000 | \$2,208,000 |

7. Stockholders' Equity

Preferred Stock

On June 30, 2013, dividends were accrued on the Series A Preferred stock in the amount of \$5,000, and such dividends were paid on July 22, 2013 by issuing 1,064 shares of common stock.

During the six months ended June 30, 2013, the remaining 45,602 shares of Series B Convertible Preferred Stock were converted to 319,214 shares of common stock. Accrued dividends of \$74,000 were paid by issuing 47,890 shares of common stock.

Common Stock

During the six months ended June 30, 2013, the Company issued 1,250 shares of common stock for services at \$4.00 per share with a value of \$5,000 for services rendered.

8. Stock Based Compensation

Stock Options

During the six months ended June 30, 2013, the Company issued 394,000 incentive stock options at the market prices of \$4.00 and \$4.74 per share. Total stock-based compensation recognized on the Company's statement of operations for the three and six months ended June 30, 2013 was \$69,000 and \$188,000, respectively, as compared to 2012 expense of \$29,000 and \$55,000. As of June 30, 2013, the aggregate value of unvested options was \$790,000, which will vest over an average period of two or three years. There were 260,832 stock options exercised in the six months ended June 30, 2013 at exercise prices between \$0.75 and \$2.06. The Company received \$30,000 for 35,000 of such exercises and allowed cash-less exercise of 225,832 of such options and issued 176,901 shares of common stock.

Stock options granted under our equity incentive plans generally vest over 2 to 3 years from the date of grant, 1/2 and 1/3 per year, respectively; and expire 5 years from the date of grant. The following table summarizes stock option activity for the six months ended June 30, 2013:

| | Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Terms (Years) | Aggregate Intrinsic Value |
|----------------------------------|-----------|------------------------------------|---|---------------------------------|
| Outstanding at December 31, 2012 | 607,000 | \$ 1.27 | | |
| Granted | 394,000 | \$ 4.16 | | |
| Exercised | (260,832) | \$ 1.01 | | |
| Forfeited or expired | — | — | | |
| Outstanding at June 30, 2013 | 740,168 | \$ 2.89 | 4.0 | \$1,548,000 |
| Exercisable at June 30, 2013 | 217,418 | \$ 2.03 | 3.4 | \$638,000 |

The aggregate intrinsic value was calculated as the difference between the market price, which was \$5.00 as of June 30, 2013, and the exercise price of the Company's common stock.

The following table summarizes information about stock options at June 30, 2013:

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| Range of Exercise Price | Options Outstanding at June 30, 2013 | | | Options Exercisable at June 30, 2013 | |
|-------------------------|--------------------------------------|---|---------------------------------|--------------------------------------|---------------------------------|
| | Number of Shares | Weighted Average Remaining Contractual Life (years) | Weighted Average Exercise Price | Number of Shares Exercisable | Weighted Average Exercise Price |
| \$0.01 - \$1.99 | 251,168 | 3.4 | \$ 1.25 | 115,334 | \$ 0.64 |
| \$2.00 - \$4.99 | 489,000 | 4.3 | \$ 3.74 | 102,084 | \$ 1.15 |
| \$5.00 - \$6.99 | — | — | — | — | — |
| \$7.00 - \$8.50 | — | — | — | — | — |
| | 740,168 | | | 217,418 | |

Stock Warrants

During the six months ended June 30, 2013, 2,000 warrants were exercised at \$2.25. The Company issued 1,189 shares of common stock. The following table summarizes stock warrant activity for the six months ended June 30, 2013:

| | Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Terms (Years) | Aggregate Intrinsic Value |
|----------------------------------|----------|------------------------------------|---|---------------------------------|
| Outstanding at December 31, 2012 | 317,253 | \$ 2.40 | | |
| Granted | — | — | | |
| Exercised | (2,000) | \$ 2.25 | | |
| Forfeited or expired | — | — | | |
| Outstanding at June 30,2013 | 315,253 | \$ 2.40 | 1.6 | \$ 818,000 |
| Exercisable at June 30,2013 | 315,253 | \$ 2.40 | 1.6 | \$ 818,000 |

The intrinsic value was calculated as the difference between the market price, which was \$5.00 as of June 30, 2013, and the exercise price of the Company's common stock.

9. Income Taxes

For the three and six months ended June 30, 2013, net loss was (\$494,000) and (\$897,000), respectively, and no income tax provision was recorded. For the three and six months ended June 30, 2012, net income was \$444,000 and \$320,000, respectively and our provision for income taxes was zero. We made no provision for income taxes due to our utilization of federal net operating loss carryforwards to offset both regular taxable income and alternative minimum taxable income.

In accordance with Accounting Standards Codification (“ASC”) 740-10, *Income Taxes*, the Company evaluates its deferred tax assets to determine if a valuation allowance is required based on the consideration of all available evidence using a “more likely than not” standard, with significant weight being given to evidence that can be objectively verified. This assessment considers, among other matters, the nature, frequency and severity of current and cumulative losses, forecasts of future profitability; the length of statutory carryover periods for operating losses and tax credit carryovers; and available tax planning alternatives. Our deferred tax assets are composed primarily of U.S. federal net operating loss carryforwards. Based on available objective evidence, management believes it is more likely than not that these deferred tax assets are not recognizable and will not be recognizable until its determined that we have sufficient taxable income. Under ASC 740-10, we may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than fifty percent likelihood of being realized upon ultimate settlement. ASC 740-10 also provides guidance on de-recognition, classification, interest and penalties on income taxes, accounting in interim periods, and disclosures. As of June 30, 2013 or 2012, the Company does not have a liability for unrecognized tax uncertainties.

The following table reconciles the U.S. statutory rates to the Company's effective tax rate for the:

| | Three months ended June 30 (unaudited) | | Six months ended June 30 (unaudited) | |
|--|--|--------|---|--------|
| | 2013 | 2012 | 2013 | 2012 |
| U.S. statutory rate | 34 % | 34 % | 34 % | 34 % |
| State tax net of federal benefit | 5 % | 5 % | 5 % | 5 % |
| Benefit of net operating loss carryforward | (39)% | (39)% | (39)% | (39)% |
| Valuation allowance | — | — | — | — |
| Effective tax rate | —% | — % | — % | —% |

10. Subsequent Events

Subsequent to June 30, 2013, 80,833 incentive stock options were exercised at prices from \$1.14 to \$2.22 per share, and 59,244 shares of common stock were issued in the cash-less exercises. Dividends were paid on accrued Series A preferred stock dividends on July 22, 2013 by issuance of 1,064 shares of common stock.

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our financial statements and the related notes appearing elsewhere in this report. This discussion and analysis may contain forward-looking statements based on assumptions about our future business.

Overview

The results for our second quarter of 2013 reflect continuing strong growth in sales volume generally among all of our products. From an operational standpoint, our primary challenges are to reduce freight & handling costs, reduce sales promotions as a percentage of sales, and to generate efficiencies of scale in our Los Angeles plant while we increase volume.

The challenges to reduce delivery costs and scale our Los Angeles plant are related. As we increase production volume of our branded products in our Los Angeles plant, we will also reduce the cross-country freight that we are currently incurring on those products. Freight rates are increasing and our kombucha requires more expensive refrigerated freight, so we are also seeking efficient ways to lower costs in how we arrange for shipments.

Sales promotions are a necessary part of our business and can increase the rate of sales increases. With our kombucha, we have followed a strategy of higher discounts in order to gain a certain scale in this new business. As the kombucha business gains scale, we will reduce our promotions. We believe that our promotions are an effective and efficient way of increasing sales. The promotions are focused and structured toward specific goals.

As discussed below, our second quarter results reflect a write-off of \$412,000 from a private label contract. Aside from this one-time loss, we would have posted positive income from operations during the quarter and positive EBITDA.

As we complete our plant improvements, we are confident that we will be able to bring down our freight costs by producing products on the west coast. We are looking forward to the continuing solid increases in our Ginger Brew and Virgil's lines, while our Kombucha sales growth accelerates.

Results of Operations

Three months ended June 30, 2013 Compared to Three months ended June 30, 2012

Sales

Sales of \$9,519,000 for the three months ended June 30, 2013 represented an increase of 22% from \$7,831,000 in the prior year same period. Sales growth was driven primarily by increased sales volume in our branded products, as well as a 15% increase in private label product revenues. Kombucha sales began after the 2012 second quarter and have increased to become approximately 9% of our total revenues.

Cost of Tangible Goods Sold

Cost of tangible goods sold consists of the costs of raw materials utilized in the manufacture of products, co-packing fees, repacking fees, in-bound freight charges, inventory adjustments, as well as certain internal transfer costs. Our costs of tangible goods sold of \$6,630,000 for the three months ended June 30, 2013 represents an increase of 39% from the same period in 2012. Aside from sales volume increases, the primary cause of the increase was a reserve established in the amount of \$412,000 covering potential losses from a private label contract.

During the three months ended June 30, 2013, we produced a private label product line for a customer that was rejected by the customer. We isolated the issue and offered to immediately remedy the issues raised. Such remedy was rejected by the customer. We are currently investigating whether the customer had the right to reject the products, under the circumstances. A reserve has been established for the value of the inventory on-hand and the inventory sold to the customer in the total amount of \$412,000. The resolution of this matter is in the preliminary stages and measures are being taken to mitigate the losses from this contract.

Aside from the loss reserve on the private label contract, our per-unit costs of goods sold during the three months ended June 30, 2013 have remained fairly constant overall from the prior year period. Per-unit costs of our 12-ounce sodas decreased by approximately 2% in the quarter ended June 30, 2013, as compared to the prior year period.

Cost of Goods Sold – Idle Capacity

Cost of goods sold – idle capacity consists of direct production costs of our Los Angeles plant in excess of charges allocated to our finished goods in production. Plant costs include labor costs, production supplies, repairs and maintenance, and inventory write-off. Our charges for labor and overhead allocated to our finished goods are determined on a market cost basis, which is lower than our actual costs incurred. Plant costs in excess of production allocations are expensed in the period incurred rather than added to the cost of finished goods produced. Idle capacity expenses increased to \$432,000 in the three months ended June 30, 2013, from \$360,000 in 2012. The 20% increase is primarily due to inefficiencies in producing our kombucha, which has become a much higher portion of our Los Angeles plant output. Our kombucha production runs have become much more efficient recently and we anticipate reductions in our cost of goods sold – idle capacity in the future.

Gross Profit

Our gross profit of \$2,457,000 in the three months ended June 30, 2013 represents a decrease of \$240,000, or 9% from 2012. As a percentage of sales, our gross profit decreased to 26% in 2013 as compared to 34% in 2012. As discussed above, our gross profit was negatively impacted by a loss of \$412,000 on a private label contract, which had a negative effect our gross profit percentage of approximately three basis points. The gross profit percentage decrease is also impacted by an increase in sales promotional discount costs. Since such costs are a deduction from sales, the gross margin percentage is negatively impacted by increased promotional costs. We have been granting substantial discounts on our kombucha, as we expand this product line into new distribution channels and customers, and we have also increased our promotional programs for other branded products. We believe that our promotional investments are effective and are accelerating sales growth.

Delivery and Handling Expenses

Delivery and handling expenses consist of delivery costs to customers and warehouse costs incurred for handling our finished goods after production. Delivery and handling costs increased by 63% to \$954,000 in the three months ended June 30, 2013 compared to 2012. The \$369,000 increase is primarily due to freight cost increases of \$256,000 and warehouse cost increases of \$115,000. The freight cost increases are primarily due to a higher portion of our branded products being manufactured at our copacker in Pennsylvania for west coast customers, requiring additional freight costs for delivery. Also, we have offered delivered terms to several new significant customers. The warehouse cost increases are primarily due to increased volume and the addition of several new cold-storage facilities for our kombucha.

Selling and marketing expenses

Selling and marketing expenses consist primarily of direct charges for staff compensation costs, advertising, sales promotion, marketing and trade shows. Selling and marketing costs increased overall to \$960,000 in the three months ended June 30, 2013 from \$699,000 in 2012. The \$261,000 increase is primarily due to increased compensation and travel costs of \$135,000, increased brokerage commissions of \$69,000, and an increase in trade show and advertising costs of \$55,000. Our sales staff increased to 19 members at June 30, 2013, from 15 at June 30, 2012.

General and Administrative Expenses

General and administrative expenses consist primarily of the cost of executive, administrative, and finance personnel, as well as professional fees. General and administrative expenses increased to \$912,000 during the three months ended June 30, 2013 from \$676,000 in the same period of 2012. Professional, legal and consulting costs increased by \$44,000, accounts receivable reserve allowance increased by \$38,000, and stock option expense increased by \$25,000; offset by a reduction in depreciation costs of \$16,000.

Income/Loss from Operations

Our loss from operations was \$369,000 in the three months ended June 30, 2013, as compared to income of \$608,000 in the same period of 2012. The loss is primarily a result of the accrual for a rejected private label contract, in the amount of \$412,000.

Interest Expense

Interest expense decreased to \$125,000 in the three months ended June 30, 2013, compared to interest expense of \$164,000 in the same period of 2012. The decrease is primarily due to a reversal of over-accrued interest on a long-term liability. The accrued interest was reversed upon full payment of the liability.

Modified EBITDA

The Company defines modified EBITDA (a non-GAAP measurement) as net loss before interest, taxes, depreciation and amortization, and non-cash expense for securities. Other companies may calculate modified EBITDA differently. Management believes that the presentation of modified EBITDA provides a measure of performance that approximates cash flow before interest expense, and is meaningful to investor

MODIFIED EBITDA SCHEDULE

| | Three Months Ended June 30, | |
|---|--------------------------------|-----------|
| | 2013 | 2012 |
| Net (loss) income | \$(494,000) | \$444,000 |
| Modified EBITDA adjustments: | | |
| Depreciation and amortization | 153,000 | 189,000 |
| Interest expense | 125,000 | 164,000 |
| Stock option compensation | 69,000 | 29,000 |
| Other stock compensation for services | – | 5,000 |
| Total EBITDA adjustments | 347,000 | 387,000 |
| Modified EBITDA income (loss) from operations | \$(147,000) | \$831,000 |

Six months ended June 30, 2013 Compared to Six months ended June 30, 2012**Sales**

Sales of \$17,645,000 for the six months ended June 30, 2013 represented an increase of 23% from \$14,370,000 in the prior year same period. Sales growth was driven primarily by increased sales volume in our branded products.

Kombucha sales began after June 30, 2012 and have increased to become approximately 9% of our total revenues.

Cost of Tangible Goods Sold

Cost of tangible goods sold consists of the costs of raw materials utilized in the manufacture of products, co-packing fees, repacking fees, in-bound freight charges, inventory adjustments, as well as certain internal transfer costs. Our costs of tangible goods sold of \$11,629,000 for the six months ended June 30, 2013 represents an increase of 29% from the same period in 2012. Aside from sales volume increases, the primary cause of the increase was a reserve established in the amount of \$412,000 covering potential losses from a private label contract had a negative effect our gross profit percentage of three basis points.

During the three months ended June 30, 2013, we produced a private label product line for a customer that was rejected by the customer. We isolated the issue and offered to immediately remedy the issues raised. Such remedy was rejected by the customer. We are currently investigating whether the customer had the right to reject the products, under the circumstances. A reserve has been established for the value of the inventory on-hand and the inventory sold to the customer in the total amount of \$412,000. The resolution of this matter is in the preliminary stages and measures are being taken to mitigate the losses from this contract.

Aside from the loss reserve on the private label contract, our cost of tangible goods sold increased at a rate of 24% in the 2013 six month period, which is generally consistent with the 23% increase in sales during the same periods.

Cost of Goods Sold – Idle Capacity

Cost of goods sold – idle capacity consists of direct production costs of our Los Angeles plant in excess of charges allocated to our finished goods in production. Plant costs include labor costs, production supplies, repairs and maintenance, and inventory write-off. Our charges for labor and overhead allocated to our finished goods are determined on a market cost basis, which is lower than our actual costs incurred. Plant costs in excess of production allocations are expensed in the period incurred rather than added to the cost of finished goods produced. Idle capacity expenses increased to \$1,024,000 in the six months ended June 30, 2013, from \$670,000 in 2012. The 53% increase is primarily due to inefficiencies in producing our kombucha, which has become a much higher portion of our Los Angeles plant output. Our kombucha production runs have become much more efficient recently and we anticipate reductions in our cost of goods sold – idle capacity in the future.

Gross Profit

Our gross profit of \$4,992,000 in the six months ended June 30, 2013 represents an increase of 7% from 2012. As a percentage of sales, our gross profit decreased to 28% in 2013 as compared to 33% in 2012. As discussed above, our gross profit was negatively impacted by a loss of \$412,000 on a private label contract. The gross profit percentage decrease is also impacted by an increase in promotional discount costs. Since such costs are a deduction from sales, the gross margin percentage is negatively impacted by increased promotional costs. We have been granting substantial discounts on our kombucha, as we expand this product line into new distribution channels and customers, and we have also increased our promotional programs for other branded products. We believe that our promotional investments are effective and are accelerating sales growth.

Delivery and Handling Expenses

Delivery and handling expenses consist of delivery costs to customers and warehouse costs incurred for handling our finished goods after production. Delivery and handling costs increased by 75% to \$1,860,000 in the six months ended June 30, 2013 compared to 2012. The \$796,000 increase is primarily due to freight cost increases of \$721,000 and warehouse cost increases of \$75,000. The freight cost increases are primarily due to a higher portion of our branded products being manufactured at our copacker in Pennsylvania for west coast customers, requiring additional freight costs for delivery. Also, we have offered delivered terms to several new significant customers. The Warehouse cost increases are primarily due to increased volume and the addition of several new cold-storage facilities for our kombucha.

Selling and marketing expenses

Selling and marketing expenses consist primarily of direct charges for staff compensation costs, advertising, sales promotion, marketing and trade shows. Selling and marketing costs increased overall to \$1,840,000 in the six months ended June 30, 2013 from \$1,421,000 in 2012. The \$419,000 increase is primarily due to increased compensation and travel costs of \$216,000, increased brokerage commissions of \$93,000, and trade show and advertising costs of \$88,000. Our sales staff increased to 19 members at June 30, 2013, from 15 at June 30, 2012.

General and Administrative Expenses

General and administrative expenses consist primarily of the cost of executive, administrative, and finance personnel, as well as professional fees. General and administrative expenses increased to \$1,900,000 during the six months ended June 30, 2013 from \$1,545,000 in the same period of 2012. Compensation and stock option expense increased by \$169,000, professional, legal and consulting costs increased by \$99,000 and accounts receivable reserve allowance increased by \$78,000; offset by a reduction in depreciation costs of \$31,000.

Income/Loss from Operations

Our loss from operations was \$608,000 in the six months ended June 30, 2013, as compared to income of \$652,000 in the same period of 2012. The loss is primarily a result of the accrual for a rejected private label contract, in the amount of \$412,000, as well as losses from other operations.

Interest Expense

Interest expense decreased to \$289,000 in the six months ended June 30, 2013, compared to interest expense of \$332,000 in the same period of 2012. The decrease is primarily due to a reversal of over-accrued interest on a long-term liability. The accrued interest was reversed upon full payment of the liability.

Modified EBITDA

The Company defines modified EBITDA (a non-GAAP measurement) as net loss before interest, taxes, depreciation and amortization, and non-cash expense for securities. Other companies may calculate modified EBITDA differently. Management believes that the presentation of modified EBITDA provides a measure of performance that approximates cash flow before interest expense, and is meaningful to investors.

MODIFIED EBITDA SCHEDULE

| | Six Months Ended | |
|---|------------------|-------------|
| | March 31, | |
| | 2013 | 2012 |
| Net income (loss) | \$(897,000) | \$320,000 |
| Modified EBITDA adjustments: | | |
| Depreciation and amortization | 298,000 | 372,000 |
| Interest expense | 289,000 | 332,000 |
| Stock option compensation | 188,000 | 55,000 |
| Other stock compensation for services | 5,000 | 20,000 |
| Total EBITDA adjustments | 780,000 | 779,000 |
| Modified EBITDA income (loss) from operations | \$(117,000) | \$1,099,000 |

Liquidity and Capital Resources

As of June 30, 2013, we had stockholders equity of \$3,493,000 and we had working capital of \$1,765,000, compared to stockholders equity of \$4,098,000 and working capital of \$2,298,000 at December 31, 2012. The decrease in our working capital of \$533,000 was primarily a result of net losses and pay downs on our long-term debt.

Our decrease in cash and cash equivalents to \$816,000 at June 30, 2013 compared to \$1,163,000 at December 31, 2012 was primarily a result of cash used by operating activities of \$1,200,000, costs of plant improvements of \$299,000, and principal payments on debt of \$144,000. Such cash used by operations was offset primarily by net drawdown on our revolving line of credit of \$1,049,000, an increased advance on our term loan of \$217,000, and proceeds from the exercise of stock options and warrants of \$30,000. In addition to our cash position on March 31, 2013, we had availability under our line of credit of approximately \$154,000.

Our Loan and Security Agreement with PMC Financial Services Group, LLC provides a \$4 million revolving line of credit and a \$750,000 term loan. The revolving line of credit is based on 85% of eligible accounts receivable and 50% of eligible inventory. The interest rate on the revolving line of credit is at the prime rate plus 3.75% (7% at December 31, 2012). The term loan is for \$750,000 and bears interest at the prime rate plus 11.6%, which shall not be below 14.85%, is secured by all of the unencumbered assets of the Company, and is to be repaid in 48 equal installments of principal and interest of \$21,000. On May 1, 2013 the term loan was increased back to the original balance of \$750,000 under the same terms as the existing term loan. The Company was also granted an over advance on its revolving line of credit of \$200,000. At June 30, 2013, our term loan balance was \$711,000.

We believe that the Company currently has the necessary working capital to support existing operations for at least the next 12 months. Our primary capital source will be positive cash flow from operations. If our sales goals do not materialize as planned, we believe that the Company can reduce its operating costs and can be managed to maintain positive cash flow from operations. Historically, we have financed our operations primarily through private sales of common stock, preferred stock, convertible debt, a line of credit from a financial institution and cash generated from operations.

We may not generate sufficient revenues from product sales in the future to achieve profitable operations. If we are not able to achieve profitable operations at some point in the future, we eventually may have insufficient working capital to maintain our operations as we presently intend to conduct them or to fund our expansion and marketing and product development plans. In addition, our losses may increase in the future as we expand our manufacturing capabilities and fund our marketing plans and product development. These losses, among other things, have had and may continue to have an adverse effect on our working capital, total assets and stockholders' equity. If we are unable to achieve profitability, the market value of our common stock would decline and there would be a material adverse effect on our financial condition.

If we suffer losses from operations, our working capital may be insufficient to support our ability to expand our business operations as rapidly as we would deem necessary at any time, unless we are able to obtain additional financing. There can be no assurance that we will be able to obtain such financing on acceptable terms, or at all. If adequate funds are not available or are not available on acceptable terms, we may not be able to pursue our business objectives and would be required to reduce our level of operations, including reducing infrastructure, promotions, personnel and other operating expenses. These events could adversely affect our business, results of operations and financial condition. If adequate funds are not available or if they are not available on acceptable terms, our ability to fund the growth of our operations, take advantage of opportunities, develop products or services or otherwise respond to competitive pressures, could be significantly limited.

Critical Accounting Policies and Estimates

Our financial statements are prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP. GAAP requires us to make estimates and assumptions that affect the reported amounts in our financial statements including various allowances and reserves for accounts receivable and inventories, the estimated lives of long-lived assets and trademarks and trademark licenses, as well as claims and contingencies arising out of litigation or other transactions that occur in the normal course of business. The following summarize our most significant accounting and reporting policies and practices:

Revenue Recognition. Revenue is recognized on the sale of a product when the product is shipped, which is when the risk of loss transfers to our customers, and collection of the receivable is reasonably assured. A product is not shipped without an order from the customer and credit acceptance procedures performed. The allowance for returns is regularly reviewed and adjusted by management based on historical trends of returned items. Amounts paid by customers for shipping and handling costs are included in sales. The Company reimburses its wholesalers and retailers for promotional discounts, samples and certain advertising and promotional activities used in the promotion of the Company's products. The accounting treatment for the reimbursements for samples and discounts to wholesalers results in a reduction in the net revenue line item. Reimbursements to wholesalers and retailers for certain advertising activities are included in selling and marketing expenses.

Cost of Tangible Goods Sold - Cost of tangible goods sold consists of the costs of raw materials utilized in the manufacture of products, co-packing fees, repacking fees, in-bound freight charges, as well as certain internal transfer costs. Raw materials account for the largest portion of the cost of sales. Raw materials include cans, bottles, other containers, ingredients and packaging materials.

Cost of goods sold – Idle Capacity - Cost of goods sold – idle capacity consists of direct production costs in excess of charges allocated to finished goods. Our charges for labor and overhead allocated to our finished goods are determined on a cost basis. Plant costs include labor costs, production supplies, repairs and maintenance, and inventory write-off. Plant costs in excess of production allocations are expensed in the period incurred.

Long-Lived Assets. Our management regularly reviews property, equipment and other long-lived assets, including identifiable amortizing intangibles, for possible impairment. This review occurs quarterly or more frequently if events or changes in circumstances indicate the carrying amount of the asset may not be recoverable. If there is indication of impairment of property and equipment or amortizable intangible assets, then management prepares an estimate of future cash flows (undiscounted and without interest charges) expected to result from the use of the asset and its eventual disposition. If these cash flows are less than the carrying amount of the asset, an impairment loss is recognized to write down the asset to its estimated fair value. The fair value is estimated at the present value of the future cash flows discounted at a rate commensurate with management's estimates of the business risks. Quarterly, or earlier, if there is indication of impairment of identified intangible assets not subject to amortization, management compares the estimated fair value with the carrying amount of the asset. An impairment loss is recognized to write down the intangible asset to its fair value if it is less than the carrying amount. Preparation of estimated expected future cash flows is inherently subjective and is based on management's best estimate of assumptions concerning expected future conditions. No impairments were identified during the three months ended June 30, 2013.

Management believes that the accounting estimate related to impairment of our long lived assets, including our trademark license and trademarks, is a "critical accounting estimate" because: (1) it is highly susceptible to change from period to period because it requires management to estimate fair value, which is based on assumptions about cash flows and discount rates; and (2) the impact that recognizing an impairment would have on the assets reported on our balance sheet, as well as net income, could be material. Management's assumptions about cash flows and discount rates require significant judgment because actual revenues and expenses have fluctuated in the past and we expect they will continue to do so.

In estimating future revenues, we use internal budgets. Internal budgets are developed based on recent revenue data for existing product lines and planned timing of future introductions of new products and their impact on our future cash flows.

Accounts Receivable. We evaluate the collectability of our trade accounts receivable based on a number of factors. In circumstances where we become aware of a specific customer's inability to meet its financial obligations to us, a specific reserve for bad debts is estimated and recorded which reduces the recognized receivable to the estimated amount our management believes will ultimately be collected. In addition to specific customer identification of potential bad debts, bad debt charges are recorded based on our historical losses and an overall assessment of past due trade accounts receivable outstanding.

Inventories. Inventories are stated at the lower of cost to purchase and/or manufacture the inventory or the current estimated market value of the inventory. We regularly review our inventory quantities on hand and record a provision for excess and obsolete inventory based primarily on our estimated forecast of product demand and/or our ability to sell the product(s) concerned and production requirements. Demand for our products can fluctuate significantly. Factors that could affect demand for our products include unanticipated changes in consumer preferences, general market conditions or other factors, which may result in cancellations of advance orders or a reduction in the rate of reorders placed by customers. Additionally, our management's estimates of future product demand may be inaccurate, which could result in an understated or overstated provision required for excess and obsolete inventory.

Stock-Based Compensation. We periodically issue stock options and warrants to employees and non-employees in non-capital raising transactions for services and for financing costs. The Company accounts for stock option and warrant grants issued and vesting to employees based on FASB ASC Topic 718 "Compensation – Stock Compensation", whereas the award is measured at its fair value at the date of grant and is amortized ratably over the vesting period. We account for stock option and warrant grants issued and vesting to non-employees in accordance with FASB ASC Topic 505 "Equity" whereby the fair value of the stock compensation is based on the measurement date as determined at either (a) the date at which a performance commitment is reached, or (b) at the date at which the necessary performance to earn the equity instrument is complete.

We estimate the fair value of stock options using the Black-Scholes option-pricing model, which was developed for use in estimating the fair value of options that have no vesting restrictions and are fully transferable. This model requires the input of subjective assumptions, including the expected price volatility of the underlying stock and the expected life of stock options. Projected data related to the expected volatility of stock options is based on the historical volatility of the trading prices of the Company's common stock and the expected life of stock options is based upon the average term and vesting schedules of the options. Changes in these subjective assumptions can materially affect the fair value of the estimate, and therefore the existing valuation models do not provide a precise measure of the fair value of our employee stock options.

We believe there have been no significant changes, during the three month period ended June 30, 2013, to the items disclosed as critical accounting policies and estimates in Management's Discussion and Analysis of Financial

Condition and Results of Operations in the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

Recent Accounting Pronouncements

There were recent accounting pronouncements issued by the FASB (including its Emerging Issues Task Force), the AICPA, and the Securities Exchange Commission (the "SEC"), such pronouncements are not believed by management to have a material impact on the Company's present or future financial statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

A smaller reporting company is not required to provide the information required by this Item.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Securities and Exchange Act of 1934 Rules 13a-15(f). Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of June 30, 2013.

Changes in Internal Control Over Financial Reporting

There have been no changes in the Company's internal control over financial reporting during the three months ended June 30, 2013 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings

We are subject to various legal proceedings from time to time in the ordinary course of business, none of which are required to be disclosed under this Item 1.

Item 1A. Risk Factors

A smaller reporting company is not required to provide the information required by this Item.

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

None

Item 3. Defaults Upon Senior Securities

None

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

On May 11, 2013, the Company's revolving line of credit, made available to the Company pursuant to its credit agreement with PMC Financial Services Group, LLC, dated November 8, 2011, was increased from \$3,000,000 to \$4,000,000.

On August 9, 2013 the Board of Directors adopted the Amended and Restated Bylaws of Reed's Inc. dated August 9, 2013 ("Amended Bylaws"). The Amended Bylaws provide an additional requirement for stockholder nominations and proposals, requiring a representation whether a stockholder intends to be or is part of a group which intends to solicit proxies from stockholders in support of any such nomination or proposal.

Item 6. Exhibits

Exhibit No. Description

| | |
|---------|--|
| 3.1 | Amended and Restated Bylaws of Reed's Inc. dated August 9, 2013.* |
| 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.* |
| 31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.* |
| 32.1 | Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.* |
| 32.2 | Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.* |
| 101.INS | XBRL Instance Document* |
| 101.SCH | XBRL Schema Document* |
| 101.CAL | XBRL Calculation Linkbase Document* |
| 101.DEF | XBRL Definition Linkbase Document* |
| 101.LAB | XBRL Label Linkbase Document* |
| 101.PRE | XBRL Presentation Linkbase Document* |

*filed herewith

In accordance with SEC Release 33-8238, Exhibits 32.1 and 32.2 are being furnished and not filed.

Furnished herewith, XBRL (Extensive Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.

SIGNATURES

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

Reed's, Inc.
(Registrant)

Date: August 14, 2013 /s/ Christopher J. Reed
Christopher J. Reed
President and Chief Executive Officer
(Principal Executive Officer)

Date: August 14, 2013 /s/ James Linesch
James Linesch
Chief Financial Officer

(Principal Financial Officer)