

REEDS INC  
Form 10-Q  
August 11, 2011

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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, 2011

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

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REED'S INC.

(Exact name of registrant as specified in its charter)

Delaware  
(State of incorporation)

35-2177773  
(I.R.S. Employer Identification No.)

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

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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 | <input type="radio"/> | Accelerated filer         | <input type="radio"/>            |
| Non-accelerated filer   | <input type="radio"/> | Smaller reporting company | <input checked="" type="radio"/> |

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 10,831,107 shares of Common Stock outstanding as of August 2, 2011.

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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,<br>2011    | December 31,<br>2010 |
|------------------------------------------------------------------------------------------------------------------------------------------------|---------------------|----------------------|
| (unaudited)                                                                                                                                    |                     |                      |
| <b>ASSETS</b>                                                                                                                                  |                     |                      |
| Current assets:                                                                                                                                |                     |                      |
| Cash                                                                                                                                           | \$1,114,000         | \$1,084,000          |
| Inventory                                                                                                                                      | 4,578,000           | 4,555,000            |
| Trade accounts receivable, net of allowance for doubtful accounts and returns and discounts of \$105,000 and \$105,000, respectively           | 2,006,000           | 1,295,000            |
| Prepaid inventory                                                                                                                              | 384,000             | 138,000              |
| Prepaid and other current assets                                                                                                               | 146,000             | 78,000               |
| <b>Total Current Assets</b>                                                                                                                    | <b>8,228,000</b>    | <b>7,150,000</b>     |
| Property and equipment, net of accumulated depreciation of \$1,444,000 and \$1,178,000, respectively                                           | 3,613,000           | 3,650,000            |
| Brand names                                                                                                                                    | 1,029,000           | 1,029,000            |
| Deferred financing fees, net of amortization of \$25,000 and \$8,000, respectively                                                             | 29,000              | 47,000               |
| <b>Total assets</b>                                                                                                                            | <b>\$12,899,000</b> | <b>\$11,876,000</b>  |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                                                                                    |                     |                      |
| Current Liabilities:                                                                                                                           |                     |                      |
| Accounts payable                                                                                                                               | \$2,891,000         | \$2,586,000          |
| Accrued expenses                                                                                                                               | 179,000             | 162,000              |
| Dividends payable                                                                                                                              | 87,000              | 44,000               |
| Recycling fees payable                                                                                                                         | 263,000             | 325,000              |
| Line of credit                                                                                                                                 | 2,387,000           | 2,038,000            |
| Current portion of long term financing obligation                                                                                              | 63,000              | 55,000               |
| Current portion of capital leases payable                                                                                                      | 43,000              | 39,000               |
| Current portion of note payable                                                                                                                | 18,000              | 71,000               |
| <b>Total current liabilities</b>                                                                                                               | <b>5,931,000</b>    | <b>5,320,000</b>     |
| Long term financing obligation, less current portion, net of discount of \$651,000 and \$677,000, respectively                                 | 2,261,000           | 2,268,000            |
| Capital leases payable, less current portion                                                                                                   | 124,000             | 146,000              |
| <b>Total Liabilities</b>                                                                                                                       | <b>8,316,000</b>    | <b>7,734,000</b>     |
| Commitments and contingencies                                                                                                                  |                     |                      |
| Stockholders' equity:                                                                                                                          |                     |                      |
| Series A Convertible Preferred stock, \$10 par value, 500,000 shares authorized, 46,621 shares issued and outstanding                          | 466,000             | 466,000              |
| Series B Convertible Preferred stock, \$10 par value, 500,000 shares authorized, 81,866 and 85,766 shares issued and outstanding, respectively | 819,000             | 858,000              |
| Common stock, \$.0001 par value, 19,500,000 shares authorized, 10,824,708 and 10,446,090 shares issued and outstanding, respectively           | 1,000               | 1,000                |

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|                                            |               |               |
|--------------------------------------------|---------------|---------------|
| Additional paid in capital                 | 22,645,000    | 21,701,000    |
| Accumulated deficit                        | (19,348,000 ) | (18,884,000 ) |
| Total stockholders' equity                 | 4,583,000     | 4,142,000     |
| Total liabilities and stockholders' equity | \$12,899,000  | \$11,876,000  |

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, 2011 and 2010  
 (Unaudited)

|                                                                       | Three months ended June 30, |              | Six months ended June 30, |              |
|-----------------------------------------------------------------------|-----------------------------|--------------|---------------------------|--------------|
|                                                                       | 2011                        | 2010         | 2011                      | 2010         |
| Sales                                                                 | \$6,191,000                 | \$4,905,000  | \$11,331,000              | \$8,917,000  |
| Cost of tangible goods sold                                           | 3,762,000                   | 3,062,000    | 7,083,000                 | 5,450,000    |
| Cost of goods sold – idle capacity                                    | 493,000                     | 314,000      | 895,000                   | 555,000      |
| Gross profit                                                          | 1,936,000                   | 1,529,000    | 3,353,000                 | 2,912,000    |
| Operating expenses:                                                   |                             |              |                           |              |
| Delivery and handling expenses                                        | 544,000                     | 360,000      | 932,000                   | 677,000      |
| Selling and marketing expense                                         | 601,000                     | 538,000      | 1,181,000                 | 1,062,000    |
| General and administrative expense                                    | 676,000                     | 672,000      | 1,331,000                 | 1,324,000    |
| Total operating expenses                                              | 1,821,000                   | 1,570,000    | 3,444,000                 | 3,063,000    |
| Income (loss) from operations                                         | 115,000                     | (41,000 )    | (91,000 )                 | (151,000 )   |
| Interest expense                                                      | (170,000 )                  | (123,000 )   | (329,000 )                | (272,000 )   |
| Net loss                                                              | (55,000 )                   | (164,000 )   | (420,000 )                | (423,000 )   |
| Preferred stock dividends                                             | (33,000 )                   | (36,000 )    | (44,000 )                 | (50,000 )    |
| Net loss attributable to common stockholders                          | \$(88,000 )                 | \$(200,000 ) | \$(464,000 )              | \$(473,000 ) |
| Loss per share available to common stockholders,<br>basic and diluted | \$(0.01 )                   | \$(0.02 )    | \$(0.04 )                 | \$(0.05 )    |
| Weighted average number of shares outstanding -<br>basic and diluted  | 10,818,170                  | 10,215,185   | 10,719,256                | 10,025,991   |

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

REED'S, INC.  
 CONDENSED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY  
 For the Six months ended June 30, 2011  
 (unaudited)

|                                                                             | Common Stock |         | Series A<br>Preferred Stock |           | Series B<br>Preferred Stock |           | Additional<br>Paid-In<br>Capital | Accumulated<br>Deficit | Total<br>Stockholders'<br>Equity |
|-----------------------------------------------------------------------------|--------------|---------|-----------------------------|-----------|-----------------------------|-----------|----------------------------------|------------------------|----------------------------------|
|                                                                             | Shares       | Amount  | Shares                      | Amount    | Shares                      | Amount    |                                  |                        |                                  |
| Balance,<br>December 31,<br>2010                                            | 10,446,090   | \$1,000 | 46,621                      | \$466,000 | 85,766                      | \$858,000 | \$21,701,000                     | \$(18,884,000)         | \$4,142,000                      |
| Fair Value of<br>common stock<br>issued<br>for services                     | 34,112       | -       | -                           | -         | -                           | -         | 77,000                           | -                      | 77,000                           |
| Common stock<br>issued upon<br>conversion of<br>Series B<br>preferred stock | 27,300       | -       | -                           | -         | (3,900)                     | (39,000)  | 39,000                           | -                      | -                                |
| Sale of<br>common stock                                                     | 304,880      | -       | -                           | -         | -                           | -         | 672,000                          | -                      | 672,000                          |
| Exercise of<br>warrants                                                     | 11,000       | -       | -                           | -         | -                           | -         | 25,000                           | -                      | 25,000                           |
| Fair value<br>vesting of<br>options issued<br>to employees                  | -            | -       | -                           | -         | -                           | -         | 103,000                          | -                      | 103,000                          |
| Fair value<br>warrants issued<br>for services                               | -            | -       | -                           | -         | -                           | -         | 26,000                           | -                      | 26,000                           |
| Series A<br>preferred stock<br>dividend                                     | -            | -       | -                           | -         | -                           | -         | -                                | (23,000)               | (23,000)                         |
| Series B<br>preferred stock<br>dividend                                     | -            | -       | -                           | -         | -                           | -         | -                                | (21,000)               | (21,000)                         |
| Common stock<br>paid for Series<br>B preferred<br>stock dividend            | 1,326        | -       | -                           | -         | -                           | -         | 2,000                            | -                      | 2,000                            |
| Net loss                                                                    | -            | -       | -                           | -         | -                           | -         | -                                | (420,000)              | (420,000)                        |
| Balance, June<br>30, 2011                                                   | 10,824,708   | \$1,000 | 46,621                      | \$466,000 | 81,866                      | \$819,000 | \$22,645,000                     | \$(19,348,000)         | \$4,583,000                      |

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, 2011 and 2010  
(Unaudited)

|                                                                                 | Six Months Ended June 30, |              |
|---------------------------------------------------------------------------------|---------------------------|--------------|
|                                                                                 | 2011                      | 2010         |
| Cash flows from operating activities:                                           |                           |              |
| Net loss                                                                        | \$(420,000 )              | \$(423,000 ) |
| Adjustments to reconcile net loss to net cash used in operating activities:     |                           |              |
| Depreciation and amortization                                                   | 308,000                   | 305,000      |
| Fair value of stock options issued to employees                                 | 103,000                   | 104,000      |
| Fair value of warrants issued for services                                      | 26,000                    | -            |
| Fair value of common stock issued for services and bonus                        | 77,000                    | 175,000      |
| Increase in allowance for doubtful accounts                                     | -                         | 15,000       |
| Changes in assets and liabilities:                                              |                           |              |
| Accounts receivable                                                             | (711,000 )                | (525,000 )   |
| Inventory                                                                       | (23,000 )                 | (725,000 )   |
| Prepaid expenses and inventory and other current assets                         | (314,000 )                | (246,000 )   |
| Accounts payable                                                                | 305,000                   | 552,000      |
| Accrued expenses                                                                | 19,000                    | 10,000       |
| Recycling fees payable                                                          | (62,000 )                 | (63,000 )    |
| Net cash used in operating activities                                           | (692,000 )                | (821,000 )   |
| Cash flows from investing activities:                                           |                           |              |
| Purchase of property and equipment                                              | (229,000 )                | (172,000 )   |
| Net cash used in investing activities                                           | (229,000 )                | (172,000 )   |
| Cash flows from financing activities:                                           |                           |              |
| Proceeds from issuance of common stock, net of offering costs                   | 672,000                   | -            |
| Proceeds from issuance of common stock in shelf offering, net of offering costs | -                         | 410,000      |
| Proceeds from stock option and warrant exercises                                | 25,000                    | 6,000        |
| Proceeds from the issuance of preferred stock                                   | -                         | 117,000      |
| Principal repayments on long term financing obligation                          | (24,000 )                 | (19,000 )    |
| Principal repayments on capital lease obligation                                | (18,000 )                 | (14,000 )    |
| Principal repayments on notes payable                                           | (53,000 )                 | (51,000 )    |
| Net borrowing on line of credit                                                 | 349,000                   | 380,000      |
| Net cash provided by financing activities                                       | 951,000                   | 829,000      |
| Net increase (decrease) in cash                                                 | 30,000                    | (164,000 )   |
| Cash at beginning of period                                                     | 1,084,000                 | 1,306,000    |
| Cash at end of period                                                           | \$1,114,000               | \$1,142,000  |
| Supplemental disclosures of cash flow information:                              |                           |              |
| Cash paid during the period for:                                                |                           |              |
| Interest                                                                        | \$283,000                 | \$256,000    |
| Non cash investing and financing activities:                                    |                           |              |
| Series B Preferred stock converted to common stock                              | \$39,000                  | \$381,000    |
| Dividends payable in common stock                                               | \$44,000                  | \$50,000     |
| Common stock issued in settlement of Series B preferred stock dividend          | \$2,000                   | \$2,000      |
| Property and equipment acquired through capital leases                          | -                         | \$64,000     |

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

REED'S, INC.  
NOTES TO CONDENSED FINANCIAL STATEMENTS  
Three and six months Ended June 30, 2011 and 2010 (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, 2011 and the results of operations and cash flows for the three and six months ended June 30, 2011 and 2010. The balance sheet as of December 31, 2010 is derived from the Company's audited financial statements.

In presenting the Company's consolidated statement of operations for the three and six months ended June 30, 2010, the Company previously presented \$314,000 and \$555,000, respectively, of delivery and handling expenses as part of cost of goods sold. In presenting the Company's consolidated statement of operations for the three and six months ended June 30, 2011, the Company has reclassified the delivery and handling expenses to operating expenses.

Certain information and footnote disclosures normally included in financial statements that have been prepared in accordance with generally accepted accounting principles 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, 2011.

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.

The results of operations for the three and six months ended June 30, 2011 are not necessarily indicative of the results of operations to be expected for the full fiscal year ending December 31, 2011.

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 (loss) per share is computed by dividing the net income (loss) 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, 2011 and 2010 the calculations of basic and diluted loss per share are the same because potential dilutive securities would have an anti-dilutive effect. The potentially dilutive securities consisted of the following as of:

June 30,                      June 30,

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|                          | 2011      | 2010      |
|--------------------------|-----------|-----------|
| Warrants                 | 2,394,370 | 2,009,028 |
| Series A Preferred Stock | 186,484   | 186,484   |
| Series B Preferred Stock | 573,062   | 668,353   |
| Options                  | 930,000   | 651,666   |
| Total                    | 4,083,916 | 3,515,531 |

#### Recent accounting pronouncements

In May 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-4, which amends the Fair Value Measurements Topic of the Accounting Standards Codification (ASC) to help achieve common fair value measurement and disclosure requirements in U.S. GAAP and IFRS. ASU No. 2011-4 does not require additional fair value measurements and is not intended to establish valuation standards or affect valuation practices outside of financial reporting. The ASU is effective for interim and annual periods beginning after December 15, 2011. The Company will adopt the ASU as required. The ASU will affect the Company's fair value disclosures, but will not affect the Company's results of operations, financial condition or liquidity.

In June 2011, the FASB issued ASU No. 2011-5, which amends the Comprehensive Income Topic of the ASC. The ASU eliminates the option to present the components of other comprehensive income as part of the statement of changes in shareholders' equity, and instead requires consecutive presentation of the statement of net income and other comprehensive income either in a continuous statement of comprehensive income or in two separate but consecutive statements. ASU No. 2011-5 is effective for interim and annual periods beginning after December 15, 2011. The Company will adopt the ASU as required. It will have no effect on the Company's results of operations, financial condition or liquidity.

Other recent accounting pronouncements issued by the FASB (including its Emerging Issues Task Force), the AICPA, and the Securities Exchange Commission (the "SEC") did not or 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, 2011.

During the three months ended June 30, 2011 and 2010, the Company had two customers, which accounted for approximately 30% and 10% of sales in 2011, and 32% and 10% of sales in 2010, respectively. During the six months ended June 30, 2011 and 2010, the Company had two customers, which accounted for approximately 30% and 12% of sales in 2011, and 32% and 12% of sales in 2010, respectively. No other customers accounted for more than 10% of sales in either year. As of June 30, 2011, the Company had accounts receivable due from a customer who comprised \$549,000 (26%) of its total accounts receivable and as of December 31, 2010, the Company had accounts receivable due from three customers who comprised \$199,000 (14%), \$197,000 (14%), and \$159,000 (11%), respectively, of its total accounts receivable.

#### 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.

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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, 2011 or December 31, 2010

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## 2. Inventory

Inventory consists of the following as of:

|                             | June 30,<br>2011 | December 31,<br>2010 |
|-----------------------------|------------------|----------------------|
| Raw Materials and packaging | \$ 2,729,000     | \$ 2,328,000         |
| Finished Goods              | 1,849,000        | 2,227,000            |
|                             | \$ 4,578,000     | \$ 4,555,000         |

## 3. Fixed Assets

Fixed assets are comprised of the following as of:

|                          | June 30,<br>2011 | December 31,<br>2010 |
|--------------------------|------------------|----------------------|
| Land                     | \$ 1,108,000     | \$ 1,108,000         |
| Building                 | 1,694,000        | 1,551,000            |
| Vehicles                 | 320,000          | 320,000              |
| Machinery and equipment  | 1,535,000        | 1,454,000            |
| Office equipment         | 400,000          | 395,000              |
|                          | 5,057,000        | 4,828,000            |
| Accumulated depreciation | (1,444,000)      | (1,178,000)          |
|                          | \$ 3,613,000     | \$ 3,650,000         |

Machinery and equipment at June 30, 2011 and December 31, 2010 includes equipment held under capital leases of \$226,000. Accumulated depreciation on equipment held under capital leases was \$76,000 and \$53,000 at June 30, 2011 and December 31, 2010, respectively.

## 4. Line of Credit

At June 30, 2011 and December 31, 2010, the aggregate amount outstanding under the line of credit agreement was \$2,387,000 and \$2,038,000 respectively, and the Company had approximately \$180,000 of availability on this line of credit at June 30, 2011. Interest accrues and is paid monthly on outstanding loans under the credit facility at a rate equal to 18% per annum. The line of credit is for \$3,000,000, based on 80% of eligible accounts receivable and 50% of eligible inventory, with a maximum inventory advance of \$1,500,000. The agreement renews in November 2011. The loan is secured by all of the business assets of the Company and is personally guaranteed by the principal shareholder and Chief Executive Officer.

## 5. Capital Lease Commitments

The Company leases equipment for its brewery operations with an aggregate value of \$226,000 under six non-cancelable capital leases. Most of the leases are personally guaranteed by the Company's Chief Executive Officer. The future minimum lease payments under the capital leases as of June 30, 2011 are as follows:

| Periods Ending June<br>30, |           |
|----------------------------|-----------|
| 2012                       | \$ 67,000 |
| 2013                       | 67,000    |



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|                                      |            |
|--------------------------------------|------------|
| 2014                                 | 67,000     |
| 2015                                 | 16,000     |
| Total minimum obligations            | 217,000    |
| Less: Amounts representing interest  | (50,000 )  |
| Present value of minimum obligations | 167,000    |
| Less: Current portion                | (43,000 )  |
| Non-current portion                  | \$ 124,000 |

## 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 three months ended June 30, 2011 and 2010 was \$13,000 in both years, and amortization of valuation discount during the six months ended June 30, 2011 and 2010 was \$25,000 in both years

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

|                                | June 30, 2011 | December 31,<br>2010 |
|--------------------------------|---------------|----------------------|
| Financing obligation           | \$ 2,975,000  | \$ 3,000,000         |
| Valuation discount             | (651,000 )    | (677,000 )           |
|                                | 2,324,000     | 2,323,000            |
| Less current portion           | (63,000 )     | (55,000 )            |
| Long term financing obligation | \$ 2,261,000  | \$ 2,268,000         |

## 7. Stockholders' Equity

### Preferred Stock

Dividends accrue quarterly on the Series B Convertible Preferred Stock outstanding at the end of the quarter. During the six months ended June 30, 2011, the Company accrued dividends of \$21,000. Dividends have been paid in common stock at the time of conversion of the Series B Convertible Preferred Stock into common stock. During the six months ended June 30, 2011, 3,900 shares of Series B Convertible Preferred Stock were converted into 27,300 shares of common stock, in accordance with the original certificate of designation, and \$2,000 of accrued dividends were paid on conversion, through the issuance of 1,326 shares of common stock. At June 30, 2011, the Company accrued a dividend for the Series A Convertible Preferred Stock of \$23,000, or \$0.50 per share, which shall be paid by the issuance of 11,451 shares of the Company's common stock.

### Common Stock

On February 3, 2011 the Company sold 304,880 shares of common stock at \$2.46 per share for \$750,000. In connection with the sale, the Company granted to the investors warrants to purchase 121,952 shares of common stock

for \$2.77 for five years. The Company paid an 8% placement agent fee of \$60,000. The Company received proceeds from the private placement, after deducting placement agent fees and offering expenses, of \$672,000. On March 25, 2011, a registration statement registering the common stock sold and the common stock underlying the accompanying warrants was declared effective by the Securities and Exchange Commission, in accordance with the registration rights agreement entered into between the Company and the investors.

During the six months ended June 30, 2011, the Company issued 34,112 shares of common stock at prices ranging from \$1.99 to \$2.69 per share with a value of \$77,000 for services rendered.

## 8. Stock Based Compensation

## Stock Options

During the six months ended June 30, 2011, the Company issued 130,000 options to employees at a weighted average exercise price of \$2.29 per share, the market price on the grant dates. Total stock-based compensation recognized on the Company's statement of operations for the three and six months ended June 30, 2011 was \$53,000 and \$103,000, respectively, as compared to 2010 expense of \$47,000 and \$104,000, respectively. As of June 30, 2011, the aggregate value of unvested options was \$313,000, which will vest over an average period of three years. There were no stock options exercised in the six months ended June 30, 2011. Stock options granted under our equity incentive plans vest over 2 to 3 years from the date of grant, 1/2 and 1/3 per year, respectively; and generally expire 5 years from the date of grant. We calculated the fair value of each option award on the date of grant using the Black-Scholes option pricing model. The aggregate fair value of the options granted during the six months ended June 30, 2011 was \$172,900. The following assumptions were utilized in valuing the options: strike price of \$2.25 to \$2.43; term of 3 years; volatility of 90.4% to 92.4%; expected dividends 0%; and a discount rate of 2.04% to 2.16%. The weighted average grant date fair value of options granted during the six months ended June 30, 2011 was \$1.33.

The following table summarizes stock option activity for the six months ended June 30, 2011:

|                                  | Shares    | Weighted-Average<br>Exercise Price | Weighted-Average<br>Remaining<br>Contractual<br>Terms (Years) | Aggregate<br>Intrinsic<br>Value |
|----------------------------------|-----------|------------------------------------|---------------------------------------------------------------|---------------------------------|
| Outstanding at December 31, 2010 | 840,000   | \$ 1.74                            |                                                               |                                 |
| Granted                          | 130,000   | 2.29                               |                                                               |                                 |
| Exercised                        | -         | -                                  |                                                               |                                 |
| Forfeited or expired             | (40,000 ) | 2.02                               |                                                               |                                 |
| Outstanding at June 30, 2011     | 930,000   | \$ 1.80                            | 3.1                                                           | \$595,000                       |
| Exercisable at June 30, 2011     | 516,666   | \$ 1.71                            | 2.5                                                           | \$510,000                       |

The aggregate intrinsic value was calculated as the difference between the market price and the exercise price of the Company's common stock, which was \$2.05 as of June 30, 2011.

The following table summarizes information about stock options at June 30, 2011:

| Range of<br>Exercise<br>Price | Options Outstanding at June 30, 2011 |                                                                    |                                          | Options Exercisable at June<br>30, 2011 |                                          |
|-------------------------------|--------------------------------------|--------------------------------------------------------------------|------------------------------------------|-----------------------------------------|------------------------------------------|
|                               | Number of<br>Shares<br>Outstanding   | Weighted<br>Average<br>Remaining<br>Contractual<br>Life<br>(years) | Weighted<br>Average<br>Exercise<br>Price | Number of<br>Shares<br>Exercisable      | Weighted<br>Average<br>Exercise<br>Price |
| \$0.01 -<br>\$1.99            | 525,000                              | 2.6                                                                | \$0.92                                   | 433,333                                 | \$0.87                                   |
| \$2.00 -<br>\$4.99            | 355,000                              | 4.1                                                                | \$2.30                                   | 33,333                                  | \$3.82                                   |
| -                             | -                                    | -                                                                  | -                                        | -                                       | -                                        |

|          |         |     |        |         |        |
|----------|---------|-----|--------|---------|--------|
| \$5.00 - |         |     |        |         |        |
| \$6.99   |         |     |        |         |        |
| \$7.00 - |         |     |        |         |        |
| \$8.50   | 50,000  | 0.9 | \$7.55 | 50,000  | \$7.55 |
|          | 930,000 |     |        | 516,666 |        |

Stock Warrants

On February 3, 2011, the Company granted warrants in connection with a placement of 304,880 shares of its common stock to purchase 121,952 shares of common stock for \$2.77 for a term of five years. In connection with the same placement, the Company also granted warrants to purchase 24,390 shares of common stock to a dealer-manager at a price of \$3.075 for five years. In February 2011, 11,000 warrants were exercised at a price of \$2.25 per share resulting in proceeds to the Company of \$25,000.

On April 8, 2011, the Company granted to a consultant 250,000 warrants to purchase common stock at a price of \$3.00 for five years. The warrants vest monthly over 24 months. During the six months ended June 30, 2011, 31,251 of such warrants vested, resulting in expense of \$26,000.

The following table summarizes stock warrant activity for the six months ended June 30, 2011:

|                                  | Shares    | Weighted-Average<br>Exercise Price | Weighted-Average<br>Remaining<br>Contractual<br>Terms (Years) | Aggregate<br>Intrinsic<br>Value |
|----------------------------------|-----------|------------------------------------|---------------------------------------------------------------|---------------------------------|
| Outstanding at December 31, 2010 | 2,009,028 | \$ 4.68                            |                                                               |                                 |
| Granted                          | 396,342   | \$ 2.93                            |                                                               |                                 |
| Exercised                        | (11,000 ) | \$ 2.25                            |                                                               |                                 |
| Forfeited or expired             | -         | -                                  |                                                               |                                 |
| Outstanding at June 30, 2011     | 2,394,370 | \$ 4.41                            | 2.3                                                           | \$ 490,000                      |
| Exercisable at June 30, 2011     | 1,951,230 | \$ 4.87                            | 2.0                                                           | \$ 350,000                      |

The aggregate intrinsic value was calculated as the difference between the market price and the exercise price of the Company's common stock, which was \$2.05 as of June 30, 2011.

#### 9. Subsequent Events

On July 18, 2011 the Company issued 5,663 shares of its common stock as payment for services valued at \$11,500. The shares were issued at a price of \$2.03 per share. On July 14, 2011, 98 shares of Series B Preferred Stock were exchanged for 736 shares of common stock. In July 2011, the Company entered into lease agreements for various equipment at a value of \$67,000 with monthly payments of \$1,680 through June 2016.

## 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 the three and six months ended June 30, 2011 reflect significant sales increases resulting from both price increases as well as volume increases in all major items sold. Cost increases on ingredients and packaging have generally leveled out from the rapid advances experienced in late 2010. The net result is that our margins are holding relatively steady in 2011 overall, from those in the prior year period. Sales of our new Virgil's ZERO line are gaining traction, as a result of promotional activities earlier in the year, with sales increases of approximately 45% during the six months ended June 30, 2011 over the prior period. As we proceed through the second half of 2011, we believe that we will continue to experience double digit growth in the sales of our branded business, as well as significant increases to our private label business which occurs largely in the fourth quarter. Our Los Angeles plant utilization and efficiency are starting to show improvements that will result in future cost savings and we are pressing hard to reduce other key components of our costs of goods sold. Despite our sales increases, we have not added to our administration and operations staffing and we believe that we will not need to add significant additional staffing in the foreseeable future.

### Results of Operations

#### Three months ended June 30, 2011 Compared to Three months ended June 30, 2010

##### Sales

Sales of \$6,191,000 for the three months ended June 30, 2011 represented an increase of 26% from \$4,905,000 in the prior year same period. Private label sales were \$569,000 during the three months, an increase of \$397,000 from the same period in 2010. Branded sales increased by 19% in the quarter, reflecting strong increases in all of our primary products. The number of grocery chains carrying our branded products is increasing and we are actively marketing to our existing customers with an improving effect on per store sales.

##### Cost of Tangible Goods Sold

Cost of tangible goods sold consists of the costs of raw materials and packaging utilized in the manufacture of products, co-packing fees, repacking fees, in-bound freight charges, as well as certain internal transfer costs. The total cost of \$3,762,000 for the three months ended June 30, 2011 decreased, as a percentage of sales, to 61% as compared to 62% of sales in the prior year. We have experienced increases in certain key ingredient costs, however; we have also made selective price increases to offset costs of ingredients and packaging.

##### 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 market 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 rather than added to the cost of finished goods. The increase in idle capacity expenses to \$493,000 in the three months ended June 30, 2011, from \$314,000 in the prior year, is primarily due to increases in payroll, workers compensation insurance and depreciation expense. The cost

trends for our plant are favorable, with decreases each month in overtime, with improved efficiencies in staffing and shift management.

#### Gross Profit

Our gross profit of \$1,936,000 in the three months ended June 30, 2011 represents an overall gross profit as a percentage of sales of 31%, as compared to 31% in the 2010 same period. Our gross margins on 12 ounce bottled beverages sold increased by approximately 3% in the three months ended June 30, 2011, as compared to the prior year. This improvement was offset by increases in the cost of goods sold – idle capacity as described above.



#### 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 costs increased to \$544,000 in the three months ended June 30, 2011 from \$360,000 in 2010. The increase is due to higher sales, increased freight costs and increased inventory costs.

#### 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 \$601,000 in the three months ended June 30, 2011 from \$538,000 in 2010. The \$63,000 increase is primarily due to increased compensation and travel costs of \$63,000.

We have recently increased our sales staff by several members in 2011, as compared to last year; with our overall sales costs as a percentage of revenues falling as we gain economies of scale.

#### 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 during the three months ended June 30, 2011 were \$676,000, approximately the same as the same period of 2010. Compensation costs increased by \$39,000, offset by decreases in facilities costs and professional consulting costs.

We believe that our existing executive and administrative staffing levels are sufficient to allow for moderate growth without the need to add personnel and related costs for the foreseeable future.

#### Loss from Operations

We generated income from operations of \$115,000 in the three months ended June 30, 2011, as compared to a loss of \$41,000 in the same period of 2010. The improvement of \$156,000 is primarily due to increased sales and margin contribution.

#### Interest Expense

Interest expense increased to \$170,000 in the three months ended June 30, 2011, compared to interest expense of \$123,000 in the same period of 2010. The increase is due to increased borrowing under a line of credit agreement with GemCap Lending I, LLC, secured primarily by our inventory and accounts receivable.

#### 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

| Three months ended June 30, |             |
|-----------------------------|-------------|
| 2011                        | 2010        |
| (unaudited)                 | (unaudited) |

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|                                       |              |               |
|---------------------------------------|--------------|---------------|
| Net loss                              | \$ (55,000 ) | \$ (164,000 ) |
| Modified EBITDA adjustments:          |              |               |
| Depreciation and amortization         | 165,000      | 156,000       |
| Interest expense                      | 170,000      | 123,000       |
| Stock option and warrant compensation | 80,000       | 47,000        |
| Other stock compensation for services | 35,000       | 48,000        |
| Total EBITDA adjustments              | 450,000      | 374,000       |
| Modified EBITDA (unaudited)           | \$ 395,000   | \$ 210,000    |

Six months ended June 30, 2011 Compared to Six months ended June 30, 2010

#### Sales

Sales of \$11,331,000 for the six months ended June 30, 2011 represented an increase of 27% from \$8,917,000 in the prior year same period. Private label sales were \$858,000 during the six months, an increase of \$550,000 from the same period in 2010. Branded sales increased by 24% in the six months ended June 30, 2011, from the prior year period, reflecting strong increases in all of our primary products. The number of grocery chains carrying our branded products is increasing and we are actively marketing to our existing customers with an improving effect on per store sales.

#### Cost of Tangible Goods Sold

Cost of tangible goods sold consists of the costs of raw materials and packaging utilized in the manufacture of products, co-packing fees, repacking fees, in-bound freight charges, as well as certain internal transfer costs. The total cost of \$7,083,000 for the six months ended June 30, 2011 increased, as a percentage of sales, to 63% as compared to 61% of sales in the prior year. We have experienced increases in certain key ingredient costs, however; we have also made selective price increases to offset costs of ingredients and packaging.

#### 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 market 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 rather than added to the cost of finished goods. The increase in idle capacity expenses to \$895,000 in the six months ended June 30, 2011, from \$555,000 in the prior year, is primarily due to increases in payroll, workers compensation insurance and depreciation expense. The cost trends for our plant are favorable, with decreases each month in overtime, with improved efficiencies in staffing and shift management.

#### Gross Profit

Our gross profit of \$3,353,000 in the six months ended June 30, 2011 represents an overall gross profit as a percentage of sales of 30%, as compared to 33% in the 2010 same period. Approximately 2% of this gross profit margin decrease is due to an increase in promotional programs during the quarter ended March 31, 2011 for certain retail customers and products, which is a deduction from sales. We had the opportunity to participate in a national promotion with a large chain, and we also opened up several markets with new mainstream DSD distributors. Our gross margins on 12 ounce bottled beverages increased by approximately 1% in the six months ended June 30, 2011, as compared to the prior year. This improvement was offset by increases in the cost of goods sold – idle capacity as described above.

#### 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 costs increased to \$932,000 in the six months ended June 30, 2011 from \$677,000 in 2010. The increase is due to higher sales, increased freight costs and increased inventory costs.

#### 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 \$1,181,000 in the six months ended June 30, 2011 from \$1,062,000 in 2010. The \$119,000 increase is primarily due to increased compensation and travel costs of \$140,000, offset partially by decreases in facilities related costs.

We have recently increased our sales staff by several members in 2011, as compared to last year; with our overall sales costs as a percentage of revenues falling as we gain economies of scale.

#### 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 during the six months ended June 30, 2011 were \$1,331,000, approximately the same as the same period of 2010. Compensation costs increased by \$31,000, offset by decreases in facilities costs and professional consulting costs.

We believe that our existing executive and administrative staffing levels are sufficient to allow for moderate growth without the need to add personnel and related costs for the foreseeable future.

#### Loss from Operations

Loss from operations of \$91,000 in the six months ended June 30, 2011, as compared to a loss of \$151,000 in the same period of 2010. The improvement of \$60,000 is primarily due to increased sales and margin contribution.

#### Interest Expense

Interest expense increased to \$329,000 in the six months ended June 30, 2011, compared to interest expense of \$272,000 in the same period of 2010. The increase is due to increased borrowing under a line of credit agreement with GemCap Lending I, LLC, secured primarily by our inventory and accounts receivable.

#### 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 June 30, |               |
|---------------------------------------|---------------------------|---------------|
|                                       | 2011                      | 2010          |
|                                       | (unaudited)               | (unaudited)   |
| Net loss                              | \$ (420,000 )             | \$ (423,000 ) |
| Modified EBITDA adjustments:          |                           |               |
| Depreciation and amortization         | 308,000                   | 305,000       |
| Interest expense                      | 329,000                   | 272,000       |
| Stock option and warrant compensation | 129,000                   | 104,000       |
| Other stock compensation for services | 77,000                    | 84,000        |
| Total EBITDA adjustments              | 843,000                   | 765,000       |
| Modified EBITDA (unaudited)           | \$ 423,000                | \$ 342,000    |

#### Liquidity and Capital Resources

As of June 30, 2011, we had stockholders equity of \$4,583,000 and we had working capital of \$2,297,000, compared to stockholders equity of \$4,142,000 and working capital of \$1,830,000 at December 31, 2010. Cash and cash equivalents were \$1,114,000 as of June 30, 2011, as compared to \$1,084,000 at December 31, 2010. The increase in our working capital of \$467,000 was primarily a result of our sale of our equity securities, offset by losses from operations, before depreciation and other non-cash expenses.

Our increase in cash and cash equivalents to \$1,114,000 at June 30, 2011 compared to \$1,084,000 at December 31, 2010 was primarily a result of cash used in operating activities, primarily for increases in accounts receivable and inventory prepayments that are related to our overall increases in ongoing revenues. Such cash used in operations was offset primarily by sales of equity securities. In addition to our cash position on June 30, 2011, we had availability

under our line of credit of approximately \$180,000.

On February 4, 2011, we sold 304,880 shares of our common stock and 121,952 warrants for \$750,000. We paid \$78,000 in expenses in connection with the transaction. The net proceeds are being used for working capital. We also gained \$25,000 through the exercise of warrants.

During the six months ended June 30, 2011, we invested \$229,000 in plant improvements. We are upgrading the facilities as well as adding new equipment to our production line that will increase our flexibility in product offerings and increase our plant performance.

Our senior revolver facility is for \$3,000,000, based on 80% of eligible accounts receivable and 50% of eligible inventory, with a maximum inventory advance of \$1,500,000. The line of credit bears interest of 18% per annum. At June 30, 2011, the outstanding line of credit was \$2,387,000, with \$180,000 available based on the collateral formula.

We believe that the Company currently has the necessary working capital to support existing operations through 2011. Our primary capital source will be cash flow from operations as we gain profitability in 2011. If our sales goals do not materialize as planned, we believe that the Company can become leaner and our costs can be managed to produce profitable 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 continue to 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.

Delivery and Handling Expenses - Delivery and handling costs that are incurred to move finished goods from our sales distribution centers to customer locations are included in delivery costs in our statements of income, as well as warehousing expenses after manufacture. Our customers do not pay us separately for shipping and handling costs related to finished goods.

Trademark License and Trademarks. We own trademarks that we consider material to our business. Three of our material trademarks are registered trademarks in the U.S. Patent and Trademark Office: Virgil's ®, Reed's Original Ginger Brew All-Natural Jamaican Style Ginger Ale ® and Tianfu China Natural Soda ®. Registrations for trademarks in the United States will last indefinitely as long as we continue to use and police the trademarks and renew filings with the applicable governmental offices. We have not been challenged in our right to use any of our material trademarks in the United States.

We account for these items in accordance with FASB guidance; we do not amortize indefinite-lived trademark licenses and trademarks.

In accordance with FASB guidance, we evaluate our non-amortizing trademark license and trademarks quarterly for impairment. We measure impairment by the amount that the carrying value exceeds the estimated fair value of the trademark license and trademarks. The fair value is calculated by reviewing net sales of the various beverages and applying industry multiples. Based on our quarterly impairment analysis the estimated fair values of trademark license and trademarks exceeded the carrying value and no impairments were identified during the six months ended June 30, 2011.

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 six months ended June 30, 2011.

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, 2011, 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, 2010.

#### Recent Accounting Pronouncements

In May 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-4, which amends the Fair Value Measurements Topic of the Accounting Standards Codification (ASC) to help achieve common fair value measurement and disclosure requirements in U.S. GAAP and IFRS. ASU No. 2011-4 does not require additional fair value measurements and is not intended to establish valuation standards or affect valuation practices outside of financial reporting. The ASU is effective for interim and annual periods beginning after December 15, 2011. The Company will adopt the ASU as required. The ASU will affect the Company's fair value disclosures, but will not affect the Company's results of operations, financial condition or liquidity.

In June 2011, the FASB issued ASU No. 2011-5, which amends the Comprehensive Income Topic of the ASC. The ASU eliminates the option to present the components of other comprehensive income as part of the statement of changes in shareholders' equity, and instead requires consecutive presentation of the statement of net income and other comprehensive income either in a continuous statement of comprehensive income or in two separate but consecutive statements. ASU No. 2011-5 is effective for interim and annual periods beginning after December 15, 2011. The Company will adopt the ASU as required. It will have no effect on the Company's results of operations, financial condition or liquidity.

Other recent accounting pronouncements issued by the FASB (including its Emerging Issues Task Force), the AICPA, and the Securities Exchange Commission (the "SEC") did not or are not believed by management to have a material impact on the Company's present or future consolidated 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, 2011.

### 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, 2011 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

During the three months ended June 30, 2011, the Company issued 16,617 shares of common stock for services at prices of \$1.99 to \$2.15 per share with a value of \$34,000. Such issuances are exempt from registration under Section 4(2) of the Securities Act of 1933, as amended, on the basis of each recipient's pre-existing relationship with the Company and the fact that no public offering was involved.

On April 8, 2011, the Company granted to a consultant 250,000 warrants to purchase common stock at a price of \$3.00 for five years. The warrants vest monthly over 24 months. During the three months ended June 30, 2011, 31,251 of such warrants vested, resulting in expense of \$26,000.

### Item 3. Defaults Upon Senior Securities

None

### Item 4. [REMOVED AND RESERVED]

### Item 5. Other Information

None

### Item 6. Exhibits

#### Exhibit No. Description

- |      |                                                                                                      |
|------|------------------------------------------------------------------------------------------------------|
| 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 Exhibit \*

101.SCH XBRL Exhibit \*

101.CAL XBRL Exhibit \*

101.DEF XBRL Exhibit \*

101.LAB XBRL Exhibit \*

101.PRE XBRL Exhibit \*

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\*filed herewith

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 11, 2011

/s/ Christopher J. Reed  
Christopher J. Reed  
President and Chief Executive Officer  
(Principal Executive Officer)

Date: August 11, 2011

/s/ James Linesch  
James Linesch  
Chief Financial Officer  
(Principal Financial Officer)