JONES SODA CO
Form 10-Q
November 10, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the Quarterly Period Ended September 30, 2008

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the Transition Period From __________ to __________

Commission File Number 0-28820

Jones Soda Co.

(Exact name of registrant as specified in its charter)

Washington	**91-1696175**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**
234 9th Avenue North	
Seattle, Washington	**98109**
(Address of principal executive offices)	**(Zip Code)**

(206) 624-3357

(Registrant s Telephone Number, Including Area Code)

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

Indicate by check 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 for such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x 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 x	Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

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

As of November 5, 2008, the issuer had 26,369,321 shares of common stock outstanding.

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JONES SODA CO.

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EXPLANATORY NOTE

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

In addition, unless otherwise indicated or the context otherwise requires, all references in this Quarterly Report to *Jones Soda* and *Jones Pure Cane Soda* refer to our premium soda sold under the trademarked brand name *Jones Soda Co*.

CAUTIONARY NOTICE REGARDING FORWARD LOOKING STATEMENTS

We desire to take advantage of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. This Quarterly Report on Form 10-Q and the documents incorporated herein by reference contain a number of forward-looking statements that reflect management s current views and expectations with respect to our business, strategies, products, future results and events and financial performance. All statements made in this Report other than statements of historical fact, including statements that address operating performance, events or developments that management expects or anticipates will or may occur in the future, including statements related to distributor channels, volume growth, revenues, profitability, new products, adequacy of funds from operations, statements expressing general optimism about future operating results and non-historical information, are forward looking statements. In particular, words such as believe, expect, intend, anticipate, estimate, may, will, should, plan, predict, could, future, target, variations of such words, and similar expressions identify forward statements, but are not the exclusive means of identifying such statements and their absence does not mean that the statement is not forward-looking.

Readers should not place undue reliance on these forward-looking statements, which are based on management s current expectations and projections about future events, are not guarantees of future performance, are subject to risks, uncertainties and assumptions and apply only as of the date of this Report. Our actual results, performance or achievements could differ materially from historical results as well as the results expressed in, anticipated or implied by these forward-looking statements. In particular, our operating results may fluctuate due to a number of factors, including, but not limited to, the following:

- Our ability to successfully refocus our business plan on our core products;

- Our ability to implement our business plan in the current global economic crisis, which could adversely affect demand for our products and make it more difficult for us to secure additional financing, if necessary;

- Our inability to generate sufficient cash flow from operations, or to obtain funds through additional financing, to support our business plan, which may force us to delay, curtail or eliminate some or all of our product development, marketing or distribution programs or to pursue various other strategies to secure additional financing, which may include, without limitation, public or private offerings of debt or equity securities, joint ventures with one or more strategic partners and other strategic alternatives;

- Our inability to create and maintain brand name recognition and acceptance of our products, which are critical to our success in our competitive, brand-conscious industry;

- Our inability to continue developing new products to satisfy our consumers changing preferences;

- Litigation or legal proceedings (including pending securities class actions), which could expose us to significant liabilities and damage our reputation;

The inability of our exclusive manufacturer and distributor (National Beverage Corp.) of Jones Soda 8-ounce and 12-ounce cans and 1-liter PET bottles and Jones Energy in 16-ounce cans in the grocery and mass merchant channel to perform adequately, which would impair our ability to gain market acceptance in the CSD industry;

Our ability to establish long-term agreements with our distributors and our ability to attract and maintain key distributors;

Our ability to carefully manage our inventory levels and to predict the timing and amount of our sales;

Our ability to establish and maintain distribution arrangements directly with retailers and national retail accounts, on which our business plan and future growth are dependent in part;

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Our ability to successfully implement our carbonated soft drink (CSD) strategy, on which our business plan and future growth are dependent to a significant extent;

Our ability to realize the benefits expected from our sponsorship agreements, to which we have dedicated, and expect to continue to dedicate, significant resources;

Our ability to realize the benefits expected from various trade promotion and marketing expenditures;

Our reliance on third-party packers of our products, which could make management of our marketing and distribution efforts inefficient or unprofitable;

Our ability to secure a continuous supply and availability of raw materials;

Our ability to source our flavors on acceptable terms from our key flavor suppliers;

Our ability to maintain brand image and product quality and the risk that we may suffer other product issues such as product recalls;

Our ability to attract and retain key personnel, which would directly affect our efficiency and results of operations;

Our ability to effectively manage our growth and resources in order to execute on our business plan;

Our inability to protect our trademarks, patent and trade secrets, which may prevent us from successfully marketing our products and competing effectively;

Our inability to remediate a material weakness in our internal control over financial reporting, which could adversely impact our ability to report accurate financial results in a timely manner;

Our inability to build and sustain proper information technology infrastructure;

Our ability to comply with the many regulations to which our business is subject;

Our ability to compete successfully against much larger, well-funded established companies currently operating in the beverage industry; and

Our inability to sustain compliance with the continued listing requirements of The Nasdaq Capital Market, including the $1 minimum bid price requirement, which could result in delisting of our common stock and adversely affect its market price and liquidity.

For a discussion of some of the additional factors that may affect our business, results and prospects, see Item 1A. RISK FACTORS in our Annual Report on Form 10-K for the year ended December 31, 2007 filed with the Securities and Exchange Commission on March 17, 2008. Readers are also urged to carefully review and consider the various disclosures made by us in this Report and in our other reports we file with the Securities and Exchange Commission, including our periodic reports on Forms 10-Q and 8-K. Except as required by law, we undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS
JONES SODA CO. AND SUBSIDIARIES

Condensed Consolidated Balance Sheets

September 30, 2008 with comparative figures for December 31, 2007

	September 30, 2008 (Unaudited)	December 31, 2007
Assets		
Current assets:		
Cash and cash equivalents	$ 15,648,002	$ 17,857,805
Short-term investments		9,935,400
Total cash and short-term investments	15,648,002	27,793,205
Accounts receivable	4,670,854	4,474,559
Taxes receivable	98,681	
Inventory (note 3)	6,823,288	5,745,888
Prepaid expenses	762,441	822,620
	28,003,266	38,836,272
Deferred income tax asset (note 8)	117,850	117,850
Capital assets	1,217,288	1,078,916
Other assets	1,364,072	1,418,516
Intangible assets	148,009	173,040
	$ 30,850,485	$ 41,624,594
Liabilities and Shareholders Equity		
Current liabilities:		
Accounts payable and accrued liabilities	$ 7,362,634	$ 6,993,226
Current portion of capital lease obligations	150,190	156,847
Taxes payable		203,379
	7,512,824	7,353,452
Capital lease obligations, less current portion	360,459	474,226
Long term liabilities - Other (note 5)	306,382	
	666,841	474,226
Commitments and contingencies (note 9)		
Shareholders equity (note 7)		
Common stock:		
Authorized: 100,000,000 common stock, no par value		
Issued and outstanding: 26,368,881 and 26,251,183 shares, respectively.	43,956,476	43,855,928
Additional paid-in capital	4,632,086	3,990,711
Accumulated other comprehensive income	107,752	129,471
Deficit	(26,025,494)	(14,179,194)
	22,670,820	33,796,916

	$ 30,850,485	$ 41,624,594

See accompanying notes to interim condensed consolidated financial statements.

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JONES SODA CO. AND SUBSIDIARIES

Condensed Consolidated Statements of Operations

(Unaudited)

Three months and nine months ended September 30, 2008 and 2007

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Net Revenue	$ 8,684,265	$ 11,737,462	$ 29,787,150	$ 33,932,419
Cost of goods sold	7,718,309	8,374,986	23,918,235	22,770,207
Gross profit	965,956	3,362,476	5,868,915	11,162,212
Licensing revenue	43,063	87,082	151,564	280,824
	1,009,019	3,449,558	6,020,479	11,443,036
Operating expenses (1) :				
Promotion and selling	3,481,317	4,276,215	9,967,081	10,103,523
General and administrative	2,723,937	1,842,969	7,808,724	4,940,776
	6,205,254	6,119,184	17,775,805	15,044,299
Loss before interest income and income taxes	(5,196,235)	(2,669,626)	(11,755,326)	(3,601,263)
Interest\other income, net:	66,034	492,359	300,873	1,349,715
Loss before income tax	(5,130,201)	(2,177,267)	(11,454,453)	(2,251,548)
Income tax benefit (expense) (note 8)				
Current	(118,436)	(139,221)	(358,103)	(286,081)
Deferred	(11,248)	793,012	(33,744)	1,113,192
	(129,684)	653,791	(391,847)	827,111
Loss for the period	$ (5,259,885)	$ (1,523,476)	$ (11,846,300)	$ (1,424,437)
Loss per share, basic and diluted	$ (0.20)	$ (0.06)	$ (0.45)	$ (0.05)
Weighted average number of common stock, basic and diluted	26,354,177	26,136,560	26,324,270	25,902,076

(1) Includes non-cash stock-based compensation as follows (note 7):

Promotion and selling	$ 105,481	$ 160,400	$ 222,140	$ 359,488
General and administrative	$ 237,669	$ 234,600	$ 450,904	$ 568,830

See accompanying notes to interim condensed consolidated financial statements.

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JONES SODA CO. AND SUBSIDIARIES

Condensed Consolidated Statements of Shareholders Equity and Comprehensive Loss

Nine months ended September 30, 2008 (Unaudited)

	Common Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Shareholders Deficit	Total Equity
	Share	Amount				
Balance, January 1, 2008	26,251,183	$ 43,855,928	$ 3,990,711	$ 129,471	$ (14,179,194)	$ 33,796,916
Loss for the period					(11,846,300)	(11,846,300)
Proceeds from employee equity incentive plans	117,698	68,879				68,879
Exercise of stock options		31,669	(31,669)			
Stock-based compensation			673,044			673,044
Other comprehensive losses, unrealized losses on available-for-sale short-term investments				(21,719)		(21,719)
Balance, September 30, 2008	26,368,881	$ 43,956,476	$ 4,632,086	$ 107,752	$ (26,025,494)	$ 22,670,820

See accompanying notes to interim condensed consolidated financial statements.

JONES SODA CO. AND SUBSIDIARIES

Condensed Consolidated Statements of Cash Flows

(Unaudited)

Nine months ended September 30, 2008 and 2007

	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Operating activities:		
Loss for the period	$ (11,846,300)	$ (1,424,437)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	531,368	670,106
Deferred income tax		(1,113,192)
Stock-based compensation expense	673,045	928,318
Cash provided/used by changes in operating assets and liabilities:		
Accounts receivable	(196,295)	(28,817)
Taxes receivable	(98,681)	(162,438)
Inventory	(1,077,400)	(978,678)
Prepaid expenses	60,179	(992,807)
Taxes payable	(203,379)	(150,141)
Accounts payable and accrued liabilities	335,255	599,438
Long term liabilities other	277,921	
Net cash used in operating activities	(11,544,287)	(2,652,648)
Investing activities:		
Purchase of capital assets	(325,194)	(441,415)
Purchase of other assets	(202,458)	
Sales of short-term investments-net	9,913,681	6,690,848
Net cash from investing activities	9,386,029	6,249,433
Financing activities:		
Net repayment of capital lease obligations	(120,424)	(84,272)
Proceeds from exercise of options	68,879	1,318,033
Net cash from (used in) financing activities	(51,545)	1,233,761
Net increase (decrease) in cash and cash equivalents	(2,209,803)	4,830,546
Cash and cash equivalents, beginning of period	17,857,805	13,905,870
Cash and cash equivalents, end of period	$ 15,648,002	$ 18,736,416
Supplemental disclosure of non-cash financing activities:		
Assets acquired under capital lease	$	$ 672,737
Cash paid (received) during year for:		
Interest	$ (429,874)	$ (1,288,741)
Income taxes	$ 326,894	$ 591,463

See accompanying notes to interim condensed consolidated financial statements.

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JONES SODA CO. AND SUBSIDIARIES

Notes to Interim Condensed Consolidated Financial Statements

Nine months ended September 30, 2008 and 2007 (Unaudited)

1. Nature and continuance of operations:

Jones Soda Co. develops, produces, markets, licenses and distributes premium beverages and related products. Our primary product lines include the brands Jones Pure Cane Soda®, a premium soda; Jones 24C , an enhanced water beverage; Jones Organics , a ready to drink organic tea; Jones Energy , a high energy drink; WhoopAss Energy Drink®, a high energy drink; and Jones Naturals®, a noncarbonated juice and tea drink. We are a Washington corporation and our corporate offices are located at 234 9th Avenue North, Seattle, Washington. We have three operating subsidiaries, Jones Soda Co. (USA) Inc., Jones Soda (Canada) Inc., and myjones.com, Inc., as well as one nonoperating subsidiary, Whoopass USA Inc.

On October 6, 2008, we implemented a reduction in workforce that reduced our staff by approximately 38%. After this reduction, our total headcount was 68. The workforce reduction was implemented in an effort to reduce ongoing operating expenses and improve our overall efficiency. Severance and termination benefits to the affected employees are not expected to be material to our financial results for the fourth quarter of 2008.

On November 5, 2008, our $15 million line of credit with KeyBank National Association was terminated after discussions that were initiated by KeyBank given the current economic climate and our financial condition and operating results. We considered different borrowing alternatives with KeyBank but these alternatives would not offer us a net borrowing position on the line. As a result, we elected not to pursue such alternatives. We remained in compliance with all covenants through the termination date. We are examining other financing options, including asset based lending solutions, to replace the KeyBank facility, although there can be no assurance that we will secure a replacement facility on acceptable terms, if at all.

We believe that our cash and cash equivalents, and net cash provided by operations will be sufficient to meet our anticipated cash needs for working capital and capital expenditures through the end of fiscal 2009. This will depend on our ability to effectively manage our costs and to generate sufficient cash flow from operations, which will depend to a significant extent on our ability to meet our revenue expectations. To achieve this, we are focusing our 2009 business plan on our higher-margin core products, including our Jones Soda glass bottle and 24C business, new higher-margin product introductions in 2009, and further cost reductions, and we intend to continually monitor and adjust our business plan as necessary to respond to developments in our business, our markets and the broader economy. A revenue shortfall could deplete our limited financial resources or cause us to take additional actions to manage our costs.

If we are unable to generate sufficient cash flow from operations to cover our working capital and capital expenditure requirements, we may need to obtain funds through additional financing, which may not be available to us on acceptable terms, if at all.

2. Significant accounting policies:

(a) Basis of presentation:

These unaudited interim condensed consolidated financial statements have been prepared using generally accepted accounting principles in the United States of America (GAAP) and United States Securities and Exchange Commission (SEC) rules and regulations applicable to interim financial reporting. The accompanying unaudited interim condensed consolidated financial statements are prepared in accordance with GAAP but do not include all information and footnotes required by GAAP for annual financial statements. However, in the opinion of management, all adjustments (which consist only of normal recurring adjustments) necessary for a fair presentation of the results of operations for the relevant periods have been made. Results for the interim period are not necessarily indicative of the results to be expected for the full fiscal year or for any other interim period. These financial statements should be read in conjunction with the summary of accounting policies and the notes to the consolidated financial statements for the year ended December 31, 2007, as amended by note 2(d) below, included in our annual report on Form 10-K.

The condensed consolidated financial statements include the accounts of our company and our wholly-owned subsidiaries. Intercompany accounts and transactions have been eliminated on consolidation.

(b) Use of estimates:

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

(c) Seasonality:

Our sales are seasonal and we experience significant fluctuations in quarterly results as a result of many factors. We generate a substantial percentage of our revenues during the warm weather months of April through September. Timing of customer purchases will vary each year and sales can be expected to shift from one quarter to another. As a result, management believes that period-to-period comparisons of results of operations are not necessarily meaningful and should not be relied upon as any indication of future performance or results expected for the fiscal year.

(d) Recently issued accounting pronouncements:

Effective January 1, 2008 we adopted FASB issued FAS No. 157 entitled Fair Value Measurements (FAS No. 157). This statement clarifies the definition of fair value to provide greater consistency and clarity on existing accounting pronouncements that require fair value measurements, provides a framework for using fair value to measure assets and liabilities and expands disclosures about fair value measurements. FAS No. 157 was required to be applied for fiscal years beginning after November 15, 2007 and interim periods within that year, but FASB Staff Position 157-2 defers the effective date of FAS No. 157 to fiscal years beginning on or after November 15, 2008 for all non-financial assets and non-financial liabilities, except those that are recognized and disclosed at fair value on a recurring basis. The adoption of FAS No. 157 had no significant impact on our consolidated financial statements. In accordance with FASB Staff Position (FSP FAS) 157-2, Effective Date of FASB Statement No. 157, the Company has deferred application of SFAS No. 157 until fiscal year 2009, in relation to nonrecurring nonfinancial assets and nonfinancial liabilities including goodwill impairment testing, asset retirement obligations, long-lived asset impairments and exit and disposal activities. Effective January 1, 2008 we adopted SFAS No. 159 entitled The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 (FAS No. 159). FAS No. 159 permits companies to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value and establishes presentation and disclosure requirements. Unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings. FAS No. 159 is effective for fiscal years beginning after November 15, 2007. The adoption of FAS No. 159 had no significant impact on our consolidated financial statements.

In December 2007, the FASB ratified the EITF s Consensus for Issue No. 07-1, Accounting for Collaborative Arrangements (EITF 07-1), which defines collaborative arrangements and establishes reporting requirements for transactions between participants in a collaborative arrangement and between participants in the arrangement and third parties. EITF 07-1 will become effective beginning with our first quarter of 2009. We are currently evaluating the impact, if any, of this standard on our Consolidated Financial Statements.

In May 2008, the FASB issued SFAS No. 162, The Hierarchy of General Accepted Accounting Principles. This statement documents the hierarchy of the various sources of accounting principles and the framework for selecting the principles used in preparing financial statements. This statement shall be effective 60 days following the Securities and Exchange Commission s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles. SFAS No. 162 will not have a material impact on our consolidated financial statements.

In October 2008, the FASB issued Staff Position No.157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active (FSP 157-3). FSP 157-3 clarifies the application of SFAS 157, which the Company adopted as of January 1, 2008, in cases where a market is not active. The Company has considered the guidance provided by FSP 157-3 in its determination of estimated fair values as of September 30, 2008, and the impact was not material.

3. Inventory:

Inventories consist of raw materials and finished goods and are stated at the lower of cost and estimated net realizable value and include adjustments for estimated obsolescence. The provisions for obsolete inventory are based on current market value of inventories. Cost is determined principally using actual cost on a first-in first-out basis. A significant

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change in demand for certain products as compared to forecasted amounts may result in the recording of additional provisions for obsolete inventory. Provisions for obsolete inventory are recorded as cost of goods sold.

	September 30, 2008	December 31, 2007
Finished goods	$ 4,869,118	$ 3,797,884
Raw materials	1,954,170	1,948,004
	$ 6,823,288	$ 5,745,888

4. Segmented information and export sales:

We have one operating segment, with operations during the first nine months of 2008 primarily in the United States and Canada. During the nine-month period ended September 30, 2008, sales in the United States were approximately $24,655,000 (2007 $29,132,000), sales in Canada were approximately $4,717,000 (2007 $4,422,000), and sales to other countries totaled approximately $415,000 (2007 $378,000). During the three months ended September 30, 2008, sales in the United States were approximately $6,745,000 (2007 - $9,695,000), sales in Canada were approximately $1,768,000 (2007 - $1,939,000) and other countries $170,000 (2007 - $104,000). Sales have been assigned to geographic locations based on the location of customers.

During the nine-month period ended September 30, 2008, revenues from one customer represented $5,910,000 or 19.8% (2007 $5,038,000 or 14.8%) of total revenue. During the three-month period ended September 30, 2008, revenues from one customer represented $882,000 or 10.1% (2007 - $1,800,000 or 15.3%) of total revenue.

5. Long term liabilities:

Long term liabilities include certain amounts related to our sponsorship agreement with the Seattle Seahawks, non-identifiable benefits and deferred gains on the sale and leaseback of certain equipment.

Sponsorship agreement with the Seattle Seahawks	$ 277,921
Deferred gain of sale/leaseback of equipment	28,461
	$ 306,382

6. Loss per share:

The computation for basic and diluted loss per share is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Loss for the period	$ (5,259,885)	$ (1,523,476)	$ (11,846,300)	$ (1,424,437)
Weighted average number of common stock outstanding:				
Basic	26,354,177	26,136,560	26,324,270	25,902,076
Dilutive stock options				

Diluted	26,354,177	26,136,560	26,324,270	25,902,076
Loss per share:				
Basic	$ (0.20)	$ (0.06)	$ (0.45)	$ (0.05)
Diluted	$ (0.20)	$ (0.06)	$ (0.45)	$ (0.05)

As of September 30, 2008, due to the net loss for the period all outstanding equity options are anti-dilutive.

7. Stock-based compensation:

In 1996, we adopted a stock option plan (the 1996 Plan) that provides for the issuance of incentive and nonqualified stock options to officers, directors, employees and consultants. In addition, in 2002 we adopted a second stock option plan for the issuance of incentive and nonqualified stock options to officers, directors, employees and consultants (the 2002 Plan). (The 1996 Plan and 2002 Plan are collectively referred to as the Plans.) On May 18, 2006, at the annual shareholders meeting, the shareholders approved an amendment to the 2002 Plan to increase the total number of

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shares of common stock authorized for issuance during the life of the plan from an aggregate 3,750,000 shares to 4,500,000 shares. The 1996 Plan terminated by its terms on June 18, 2006 and no additional options may be granted thereunder. There are no options outstanding under the 1996 plan. On May 31, 2007, at the annual shareholders meeting, the shareholders approved another amendment to the 2002 Plan to permit awards of restricted stock and the 2002 Plan was renamed as the 2002 Stock Option and Restricted Stock Plan.

Under the terms of our 2002 Plan, our Board of Directors may grant options or restricted stock to employees, officers, directors and consultants. The plan provides for granting of options or restricted stock at the fair market value of our stock at the grant date. Historically, options generally vested over a period of eighteen months, with the first 25% vesting at the date of grant and the balance vesting in equal amounts every six months thereafter. Effective during the quarter ended September 30, 2006, we changed the vesting schedule for our prospective stock option grants, to vest over a period of forty-two months, with the first 1/7th vesting six months from the grant date and the balance vesting in equal amounts every six months thereafter. We determine the term of each option at the time it is granted. Historically, options granted generally have a five- or ten-year term.

(a) Stock options:

A summary of our stock option activity is as follows:

	Outstanding Options	
	Number of Shares	Average Exercise Price
Balance at December 31, 2007	1,072,736	$ 8.91
Options granted	658,250	3.43
Options exercised	(87,500)	.79
Options cancelled	(366,968)	9.83
Balance at September 30, 2008	1,276,518	$ 6.37
Exercisable, September 30, 2008	735,043	$ 6.64
Vested and expected to vest	1,740,046	$ 4.68

(b) Non-vested shares:

During the nine months ended September 30, 2008, the Board of Directors granted 66,850 shares of restricted stock to certain employees and directors under our revised 2002 Stock Option and Restricted Stock Plan, which was approved by our shareholders in May 2007. No monetary payment is required from the employees or directors upon receipt of the restricted stock awards. The shares of restricted stock vest over a period of forty-two months in equal amounts every six months. At September 30, 2008, the restricted stock had an aggregate intrinsic value of approximately $-0-.

A summary of our restricted stock activity is as follows:

	Restricted Shares	Weighted Grant Date Fair Value	Weighted Average Contractual Life
Unvested restricted stock at December 31, 2007	129,500	$ 10.12	3.28 yrs
Granted	66,850	3.30	
Vested	(30,680)	8.84	
Stock Cancelled	(75,085)	2.89	
Balance at September 30, 2008	90,585	$ 6.55	2.61 yrs

(c) Stock-based compensation expense:

We account for stock-based compensation in accordance with Financial Accounting Standards Board (FASB) Statement No. 123(R), *Share-Based Payment* (FAS 123R), using the fair-value based method. Stock-based compensation expense is recognized using the straight-line attribution method over the employees requisite service period.

The following table summarizes the stock-based compensation expense by type of awards:

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	Three Months Ended September 30, 2008	2007	Nine Months Ended September 30, 2008	2007
Stock options	$ 208,231	$ 335,505	$ 571,828	$ 868,318
Restricted stock	134,919	59,495	101,217	60,000
	$ 343,150	$ 395,000	$ 673,045	$ 928,318

Shares of restricted stock are valued at the grant date market price of the underlying securities, and the compensation expense is recognized on a straight-line basis over the forty-two month vesting period based on the estimated number of awards expected to vest.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model employing the following key assumptions. Expected stock price volatilities are based upon the historical volatility of our daily stock closing prices over a period equal to the expected life of each option grant. The risk-free interest rate was selected based on yields from Government Bond yields with a term equal to the expected term of the options being valued. Expected term of the option is based on historical employee stock option exercise behavior, the vesting terms of the respective option and a contractual life of five to ten years. Our stock price volatility and option lives involve management s best estimates at that time, and both of these metrics impact the fair value of the option calculated under the Black-Scholes methodology and, ultimately, the expense that will be recognized over the requisite service period.

We employ the following key weighted average assumptions in determining the fair value of stock options, using the Black-Scholes option pricing model:

	Three Months Ended September 30, 2008	2007	Nine Months Ended September 30, 2008	2007
Expected dividend yield				
Expected stock price volatility		55.0%	71.1%	55.0%
Risk-free interest rate		4.9%	2.7%	4.9%
Expected term (in years)		2.75	4.5	2.75
Weighted-average grant date fair-value	$	$ 4.88	$ 1.97	$ 4.88

SFAS 123R also requires that we recognize compensation expense for only the portion of stock options or restricted stock that is expected to vest. Therefore, we apply estimated forfeiture rates that are derived from historical employee termination behavior. If the actual number of forfeitures differs from those estimated by management, additional adjustments to stock- based compensation expense may be required in future periods. During the quarter ended June 30, 2008, as a result of the departure of certain employees and directors, we increased our estimated forfeiture rate from 11% to a range of 13% to 85.7% on outstanding stock options and restricted stock. We also cancelled 12,857 unvested shares of restricted stock for one of our directors. At September 30, 2008, the unrecognized compensation expense related to stock options and unvested restricted stock was $1,838,000 and $677,000, respectively, which are to be recognized over weighted-average periods of 2.43 years and 2.61 years, respectively.

8. Income Taxes:

We account for income taxes in accordance with SFAS 109, Accounting for Income Taxes, which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements which differ from our tax returns.

The determination of our provision of income taxes and valuation allowances requires significant judgment, the use of estimates, and the interpretation and application of complex tax laws. To the extent management believes it is more likely than not that we will not be able to utilize some or all of our deferred tax assets prior to their expiration, we are required to establish valuation allowances against that portion of deferred tax assets. We analyze the valuation allowances on our deferred taxes on a quarterly basis.

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9. Commitments and contingencies
Commitments

	Payments Due by Period				
(Dollars in Thousands)	**Total**	**Less than 1 Year**	**Years 2 - 3**	**Years 4 - 5**	**More than 5 Years**
Purchase Obligations and Capital Expenditure Commitments	$ 25,373	$ 4,360	$ 14,721	$ 4,227	$ 2,064

During the nine months ended September 30, 2008 we had commitments aggregating approximately $25,373,000, excluding our operating and capital lease obligations, which represent commitments made by us to various suppliers of raw materials and finished goods; commitments to co-packers for production equipment; commitments under our Sponsorship Agreements with the Seattle Seahawks and the New Jersey Nets in exchange for exclusive beverage rights for certain soft drinks at Qwest Field and the proposed new arena in Brooklyn, New York, as well as signage, advertising and other promotional benefits to enhance our brand awareness; and commitments under our supply agreement relating to PHARMA GABA to purchase raw materials through the end of the term of the agreement in July 2010. These obligations vary in terms and commit us to payments from 2008 to 2014.

Legal proceedings

On September 4, 2007, a putative class action complaint was filed against us, our then serving chief executive officer, and our then serving chief financial officer in the U.S. District Court for the Western District of Washington, alleging claims under Section 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended, and Rule 10b-5 promulgated thereunder. The case is entitled Saltzman v. Jones Soda Company, et al., Case No. 07-CV-1366-RSL, and purports to be brought on behalf of a class of purchasers of our common stock during the period March 9, 2007, to August 2, 2007. Six substantially similar complaints subsequently were filed in the same court, some of which alleged claims on behalf of a class of purchasers of our common stock during the period November 1, 2006, to August 2, 2007. Some of the subsequently filed complaints added as defendants certain current and former directors and another former officer of the Company. The complaints generally alleged violations of federal securities laws based on, among other things, false and misleading statements and omissions about our financial results and business prospects. The complaints sought unspecified damages, interest, attorneys fees, costs, and expenses. On October 26, 2007, these seven lawsuits were consolidated as a single action entitled In re Jones Soda Company Securities Litigation, Case No. 07-cv-1366-RSL. On March 5, 2008, the Court appointed Robert Burrell lead plaintiff in the consolidated securities case. On May 5, 2008, the lead plaintiff filed a First Amended Consolidated Complaint, which purports to allege claims on behalf of a class of purchasers of our common stock during the period of January 10, 2007, to May 1, 2008, against the Company and Peter van Stolk, our former Chief Executive Officer, former Chairman of the Board, and current director. The First Amended Consolidated Complaint generally alleges violations of federal securities laws based on, among other things, false and misleading statements and omissions about our agreements with retailers, allocation of resources, and business prospects. Defendants filed a motion to dismiss the amended complaint on July 7, 2008. The motion has now been fully briefed and was submitted for consideration in early October 2008. The Court has not yet scheduled a hearing date for oral argument on the motion to dismiss.

In addition, on September 5, 2007, a shareholder derivative action was filed in the Superior Court for King County, Washington, allegedly on behalf of and for the benefit of the Company, against certain of our current officers and current and former directors. The case is entitled Cramer v. van Stolk, et al., Case No. 07-2-29187-3 SEA (Cramer Action). The Company also was named as a nominal defendant. Four other shareholders filed substantially similar derivative actions. Two of these actions were filed in the Superior Court for King County, Washington. One of these two Superior Court actions has been voluntarily dismissed and the other has been consolidated with the Cramer Action under the caption In re Jones Soda Co. Derivative Litigation, Lead Case No. 07-2-31254-4 SEA. On April 28, 2008, plaintiffs in the consolidated action filed an amended complaint based on the same basic allegations of fact as in the federal securities class actions and alleging, among other things, that certain of our current and former officers and directors breached their fiduciary duties to the Company and were unjustly enriched in connection with the public disclosures that are the subject of the federal securities class actions. On May 2, 2008, the Court signed a stipulation and order staying the proceedings in the consolidated Cramer Action until all motions to dismiss in the consolidated federal securities class action have been adjudicated.

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The two remaining shareholder derivative actions were filed in the U.S. District Court for the Western District of Washington. On April 10, 2008, the Court presiding over the federal derivative cases consolidated them under the caption Sexton v. Van Stolk, et al., Case No. 07-1782RSL (Sexton Action), and appointed Bryan P. Sexton lead plaintiff. The Court also established a case schedule, which, among other things, sets the close of fact discovery as January 4, 2009, and sets a trial date of May 4, 2009. The actions comprising the consolidated Sexton Action are based on the same basic allegations of fact as in the securities class actions filed in the U.S. District Court for the Western District of Washington and the Cramer Action, filed in the Superior Court for King County. The actions comprising the Sexton Action allege, among other things, that certain of our current and former directors and officers breached their fiduciary duties to the Company and were unjustly enriched in connection with the public disclosures that are the subject of the federal securities class actions. The complaints seek unspecified damages, restitution, disgorgement of profits, equitable and injunctive relief, attorneys fees, costs, and expenses. On June 3, 2008, the parties filed a joint motion to stay the Sexton Action until all motions to dismiss in the federal securities class action have been adjudicated. On June 5, 2008, the Court granted the motion and stayed the Sexton action.

The Cramer Action and Sexton Action are derivative in nature and do not seek monetary damages from the Company. However, the Company may be required, throughout the pendency of the action, to advance payment of legal fees and costs incurred by the defendants and the litigation may result in significant obligations for payment of defense costs and indemnification, which could be material.

On August 27, 2008, Advanced Business Strategies filed a Complaint for Damages against us in the Circuit Court for the State of Oregon for breach of contract and breach of implied covenant of good faith and fair dealing, seeking damages in excess of $1.1 million. Advanced Business Strategies has alleged that we improperly terminated their agreement to provide us with certain sales and marketing services. On October 1, 2008, we filed a Notice of Removal from the State Court to the United States District Court, District of Oregon. Our answer to the claims was filed on October 8, 2008; we asserted that Advanced Business Strategies is in breach of the agreement and has failed to mitigate its alleged damages. We expect this litigation will go to trial in late 2009 or early 2010.

We are unable to predict the outcome of these cases. An adverse court determination in any of these actions against us could result in significant liability and could have a material adverse effect on our business, results of operations or financial condition, subject to the limits of our insurance policies.

We are involved in various other claims and legal actions arising in the ordinary course of business, including proceedings involving product liability claims and other employee claims, and tort and other general liability claims, for which we carry insurance, as well as trademark, copyright, and related claims and legal actions. In the opinion of our management, the ultimate disposition of these matters will not have a material adverse effect on our consolidated financial position, results of operations or liquidity.

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

You should read the following discussion and analysis in conjunction with our unaudited consolidated financial statements and related notes included elsewhere in this Report and the 2007 audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K, which was filed with the Securities and Exchange Commission on March 17, 2008.

This Quarterly Report on Form 10-Q and the documents incorporated herein by reference contain forward-looking statements. These statements relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terminology such as believe, expect, intend, anticipate, estimate, may, will, should, plan, predict, could, future, target, variations of such words, and similar expressions. These statements are only predictions. Actual events or results may differ materially. In evaluating these statements, you should specifically consider various factors, including the risks outlined at the beginning of this report under Cautionary Notice Regarding Forward-Looking Statements and in Item 1A of our most recent Annual Report on Form 10-K filed with the Securities and Exchange Commission. These factors may cause our actual results to differ materially from any forward-looking statements. Except as required by law, we undertake no obligation to publicly release any revisions to these forward-looking statements that may be made to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

Overview

We develop, produce, market and distribute New Age or Premium beverages. We currently produce, market and distribute six beverage brands:

- *Jones Pure Cane Soda* , a premium soda;
- *Jones 24C* , an enhanced water beverage;
- *Jones Organics* , a ready-to-drink organic tea;
- *Jones Energy* , a citrus energy drink;
- *WhoopAss Energy Drink®*, a citrus energy drink; and
- *Jones Naturals®*, a non-carbonated juice & tea.

We currently sell and distribute our products throughout the United States, Canada and Australia through our network of independent distributors (our Direct Store Delivery channel, or DSD) and our national retail accounts (our Direct To Retail channel, or DTR), as well as through licensing and distribution arrangements.

In 2007, we entered the carbonated soft drink market (CSD) with the introduction of 12-ounce cans of Jones Pure Cane Soda, which are manufactured and distributed by National Beverage Corp. in grocery and mass merchant channels in the U.S. pursuant to an exclusive agreement we entered into with National Beverage in September 2006. Through this arrangement, we identify and secure various national and regional retailers across the United States for our premium carbonated 12-ounce soft drinks and 16-ounce energy drink products, and we are responsible for all sales efforts, marketing, advertising and promotion. Using concentrate supplied by Jones, National Beverage both manufactures and sells on an exclusive basis the products directly to retailers. National Beverage is responsible for the manufacturing, delivery and invoicing of the sales of our products in this channel.

With respect to our DSD channel, we have focused our sales and marketing resources on the expansion and penetration of our products through our independent distributor network in our core markets consisting of the Northwest, Southwest and Midwest U.S. and Western Canada, as well as targeted expansion into our less penetrated markets consisting of the Northeast and Southeast U.S. and Eastern Canada.

We launched our DTR business strategy in 2003 as a complementary channel of distribution to our DSD channel. Through these programs, we negotiate directly with national retailers, primarily food service-based businesses, to carry our products, serviced through the retailer s appointed distribution system. Our DTR channel customers include, but are not limited to, Barnes & Noble, Panera Bread Company, Target Corporation, Cost Plus, Ruby Tuesday, SuperValu, Inc., Alaska Airlines and Sam s Club.

Critical Accounting Estimates and Policies