

REEDS INC  
Form 10-Q  
November 09, 2010

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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 September 30, 2010

☐ 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 35-2177773  
(State of incorporation) (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 ☐

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

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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 10,400,247 shares of Common Stock outstanding as of November 5, 2010.

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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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## TABLE OF CONTENTS

|                                |                                                                                                                       |    |
|--------------------------------|-----------------------------------------------------------------------------------------------------------------------|----|
| PART I - FINANCIAL INFORMATION |                                                                                                                       | 1  |
| Item 1.                        | Condensed Financial Statements                                                                                        | 1  |
|                                | Condensed Balance Sheets - September 30, 2010 (unaudited) and December 31, 2009                                       | 1  |
|                                | Condensed Statements of Operations for the three and nine month periods ended September 30, 2010 and 2009 (unaudited) | 2  |
|                                | Condensed Statement of Changes in Stockholders' Equity for the nine month period ended September 30, 2010 (unaudited) | 3  |
|                                | Condensed Statements of Cash Flows for the nine month periods ended September 30, 2010 and 2009 (unaudited)           | 4  |
|                                | Notes to Condensed Financial Statements (unaudited)                                                                   | 5  |
| Item 2.                        | Management's Discussion and Analysis of Financial Condition and Results of Operations                                 | 11 |
| Item 3.                        | Quantitative and Qualitative Disclosures About Market Risk                                                            | 17 |
| Item 4.                        | Controls and Procedures                                                                                               | 17 |
| PART II - OTHER INFORMATION    |                                                                                                                       | 17 |
| Item 1.                        | Legal Proceedings                                                                                                     | 17 |
| Item 1A.                       | Risk Factors                                                                                                          | 17 |
| Item 2.                        | Unregistered Sales of Equity Securities and Use of Proceeds                                                           | 17 |
| Item 3.                        | Defaults Upon Senior Securities                                                                                       | 17 |
| Item 4.                        | Removed and Reserved                                                                                                  | 17 |
| Item 5.                        | Other Information                                                                                                     | 17 |

|            |          |    |
|------------|----------|----|
| Item 6.    | Exhibits | 18 |
| Signatures |          | 19 |

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## Part I – FINANCIAL INFORMATION

## Item 1. Financial Statements

## REED'S, INC.

## CONDENSED BALANCE SHEETS

|                                                                                                                                     | September<br>30, 2010 | December<br>31, 2009 |
|-------------------------------------------------------------------------------------------------------------------------------------|-----------------------|----------------------|
|                                                                                                                                     | (unaudited)           |                      |
| <b>ASSETS</b>                                                                                                                       |                       |                      |
| Current assets:                                                                                                                     |                       |                      |
| Cash                                                                                                                                | \$958,000             | \$1,306,000          |
| Inventory                                                                                                                           | 3,957,000             | 2,884,000            |
| Trade accounts receivable, net of allowance for doubtful accounts and returns and discounts of \$105,000 and \$90,000, respectively | 1,473,000             | 866,000              |
| Prepaid Inventory                                                                                                                   | 491,000               | 3,000                |
| Prepaid expenses and other current assets                                                                                           | 134,000               | 96,000               |
| Total Current Assets                                                                                                                | 7,013,000             | 5,155,000            |
| Property and equipment, net of accumulated depreciation of \$1,062,000 and \$727,000, respectively                                  |                       |                      |
|                                                                                                                                     | 3,693,000             | 3,655,000            |
| Brand names                                                                                                                         | 1,029,000             | 1,029,000            |
| Deferred financing fees, net of amortization of \$102,000 and \$10,000, respectively                                                | 39,000                | 131,000              |
| Total assets                                                                                                                        | \$11,774,000          | \$9,970,000          |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                                                                         |                       |                      |
| Current Liabilities:                                                                                                                |                       |                      |
| Accounts payable                                                                                                                    | \$2,643,000           | \$954,000            |
| Accrued expenses                                                                                                                    | 129,000               | 127,000              |
| Dividends payable                                                                                                                   | 36,000                | -                    |
| Recycling fees payable                                                                                                              | 359,000               | 456,000              |
| Line of credit                                                                                                                      | 1,518,000             | 1,415,000            |
| Current portion of long term financing obligation                                                                                   | 51,000                | 40,000               |
| Current portion of capital leases payable                                                                                           | 38,000                | 24,000               |
| Current portion of note payable                                                                                                     | 97,000                | 102,000              |
| Total current liabilities                                                                                                           | 4,871,000             | 3,118,000            |
| Long term financing obligation, less current portion, net of discount of \$689,000 and \$726,000, respectively                      |                       |                      |
|                                                                                                                                     | 2,271,000             | 2,274,000            |
| Capital leases payable, less current portion                                                                                        | 157,000               | 130,000              |
| Note payable, less current portion                                                                                                  | -                     | 71,000               |
| Total liabilities                                                                                                                   | 7,299,000             | 5,593,000            |
| 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              |

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|                                                                                                                                                 |               |              |
|-------------------------------------------------------------------------------------------------------------------------------------------------|---------------|--------------|
| Series B Convertible Preferred stock, \$10 par value, 500,000 shares authorized, 91,442 and 120,820 shares issued and outstanding, respectively | 914,000       | 1,208,000    |
| Common stock, \$.0001 par value, 19,500,000 shares authorized, 10,353,884 and 9,606,127 shares issued and outstanding, respectively             | 1,000         | 1,000        |
| Additional paid in capital                                                                                                                      | 21,478,000    | 20,203,000   |
| Accumulated deficit                                                                                                                             | (18,384,000)  | (17,501,000) |
| Total stockholders' equity                                                                                                                      | 4,475,000     | 4,377,000    |
| Total liabilities and stockholders' equity                                                                                                      | \$ 11,774,000 | \$ 9,970,000 |

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

REED'S, INC.

## CONDENSED STATEMENTS OF OPERATIONS

For the Three and Nine Months Ended September 30, 2010 and 2009

(Unaudited)

|                                                                    | Three months ended<br>September 30, |              | Nine months ended<br>September 30, |                |
|--------------------------------------------------------------------|-------------------------------------|--------------|------------------------------------|----------------|
|                                                                    | 2010                                | 2009         | 2010                               | 2009           |
| Sales                                                              | \$5,428,000                         | \$4,027,000  | \$14,345,000                       | \$11,658,000   |
| Cost of sales                                                      | 4,365,000                           | 3,038,000    | 11,047,000                         | 8,722,000      |
| Gross profit                                                       | 1,063,000                           | 989,000      | 3,298,000                          | 2,936,000      |
| Operating expenses:                                                |                                     |              |                                    |                |
| Selling and marketing expense                                      | 570,000                             | 646,000      | 1,632,000                          | 1,853,000      |
| General and administrative expense                                 | 742,000                             | 623,000      | 2,066,000                          | 1,896,000      |
| Impairment of assets                                               | -                                   | -            | -                                  | 641,000        |
| Total operating expenses                                           | 1,312,000                           | 1,269,000    | 3,698,000                          | 4,390,000      |
| Loss from operations                                               | (249,000 )                          | (280,000 )   | (400,000 )                         | (1,454,000 )   |
| Interest expense                                                   | (149,000 )                          | (122,000 )   | (421,000 )                         | (319,000 )     |
| Net loss                                                           | (398,000 )                          | (402,000 )   | (821,000 )                         | (1,773,000 )   |
| Preferred stock dividend                                           | (12,000 )                           | -            | (62,000 )                          | (23,000 )      |
| Net loss attributable to common stockholders                       | \$(410,000 )                        | \$(402,000 ) | \$(883,000 )                       | \$(1,796,000 ) |
| Loss per share available to common stockholders, basic and diluted | \$(0.04 )                           | \$(0.04 )    | \$(0.09 )                          | \$(0.20 )      |
| Weighted average number of shares outstanding - basic and diluted  | 10,298,739                          | 9,215,171    | 10,117,906                         | 9,125,887      |

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



REED'S, INC.

## CONDENSED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY

For the Nine Months ended September 30, 2010

(unaudited)

|                                                                 | Common Stock |          | Series A Preferred Stock |            | Series B Preferred Stock |              | Additional      | Accumulated    | Total                |
|-----------------------------------------------------------------|--------------|----------|--------------------------|------------|--------------------------|--------------|-----------------|----------------|----------------------|
|                                                                 | Shares       | Amount   | Shares                   | Amount     | Shares                   | Amount       | Paid-In Capital | Deficit        | Stockholders' Equity |
| Balance, December 31, 2009                                      | 9,606,127    | \$ 1,000 | 46,621                   | \$ 466,000 | 120,820                  | \$ 1,208,000 | \$ 20,203,000   | \$(17,501,000) | \$ 4,377,000         |
| Fair Value of common stock issued for bonus and services        | 153,830      | -        | -                        | -          | -                        | -            | 261,000         | -              | 261,000              |
| Common stock issued upon conversion of Series B preferred stock | 295,106      | -        | -                        | -          | (42,158 )                | (422,000 )   | 422,000         | -              | -                    |
| Sale of common stock in shelf offering                          | 277,359      | -        | -                        | -          | -                        | -            | 432,000         | -              | 432,000              |
| Sale of Series B preferred stock, net of offering costs         | -            | -        | -                        | -          | 12,780                   | 128,000      | (11,000 )       | -              | 117,000              |
| Exercise of stock options                                       | 8,333        | -        | -                        | -          | -                        | -            | 6,000           | -              | 6,000                |
| Fair value vesting of options issued to employees               | -            | -        | -                        | -          | -                        | -            | 139,000         | -              | 139,000              |
| Series B preferred stock dividend                               | -            | -        | -                        | -          | -                        | -            | -               | (39,000 )      | (39,000)             |
| Common stock paid for Series B preferred stock dividend         | 1,918        | -        | -                        | -          | -                        | -            | 3,000           | -              | 3,000                |
| Common stock paid for Series A preferred stock dividend         | 11,211       | -        | -                        | -          | -                        | -            | 23,000          | (23,000 )      | -                    |
| Net loss                                                        | -            | -        | -                        | -          | -                        | -            | -               | (821,000 )     | (821,000)            |
| Balance, September 30, 2010                                     | 10,353,884   | \$ 1,000 | 46,621                   | \$ 466,000 | 91,442                   | \$ 914,000   | \$ 21,478,000   | \$(18,384,000) | \$ 4,475,000         |

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

## REED'S, INC.

## CONDENSED STATEMENTS OF CASH FLOWS

For the Nine Months Ended September 30, 2010 and 2009

(Unaudited)

|                                                                                 | Nine Months Ended<br>September 30, |                |
|---------------------------------------------------------------------------------|------------------------------------|----------------|
|                                                                                 | 2010                               | 2009           |
| Cash flows from operating activities:                                           |                                    |                |
| Net loss                                                                        | \$(821,000 )                       | \$(1,773,000 ) |
| Adjustments to reconcile net loss to net cash used in operating activities:     |                                    |                |
| Depreciation and amortization                                                   | 465,000                            | 324,000        |
| Fair value of stock options issued to employees                                 | 139,000                            | 360,000        |
| Fair value of common stock issued for services and bonus                        | 261,000                            | 247,000        |
| Increase in allowance for doubtful accounts                                     | 15,000                             | -              |
| Impairment loss on assets                                                       | -                                  | 641,000        |
| Changes in assets and liabilities:                                              |                                    |                |
| Accounts receivable                                                             | (622,000 )                         | (478,000 )     |
| Inventory                                                                       | (1,073,000 )                       | (339,000 )     |
| Prepaid inventory and expenses and other current assets                         | (526,000 )                         | (158,000 )     |
| Accounts payable                                                                | 1,689,000                          | (237,000 )     |
| Accrued interest                                                                | 2,000                              | 25,000         |
| Recycling fees payable                                                          | (97,000 )                          | 66,000         |
| Net cash used in operating activities                                           | (568,000 )                         | (1,322,000 )   |
| Cash flows from investing activities:                                           |                                    |                |
| Purchase of property and equipment                                              | (310,000 )                         | (240,000 )     |
| Net cash used in investing activities                                           | (310,000 )                         | (240,000 )     |
| Cash flows from financing activities:                                           |                                    |                |
| Proceeds from issuance of common stock in shelf offering, net of offering costs | 432,000                            | 150,000        |
| Proceeds from stock option exercise                                             | 6,000                              | -              |
| Proceeds from the issuance of Series B preferred stock, net of offering costs   | 117,000                            | -              |
| Principal repayments on long term financing obligation                          | (30,000 )                          | (8,000 )       |
| Proceeds received from long term financing obligation                           | -                                  | 3,056,000      |
| Principal payments on long term debt                                            | -                                  | (1,763,000 )   |
| Principal repayments on capital lease obligations                               | (22,000 )                          | (4,000 )       |
| Principal repayments on notes payable                                           | (76,000 )                          | -              |
| Net borrowing on line of credit                                                 | 103,000                            | 93,000         |
| Payments for offering costs                                                     | -                                  | (115,000 )     |
| Net cash provided by (used in) financing activities                             | 530,000                            | (1,409,000 )   |
| Net decrease in cash                                                            | (348,000 )                         | (153,000 )     |
| Cash at beginning of period                                                     | 1,306,000                          | 229,000        |
| Cash at end of period                                                           | \$958,000                          | \$76,000       |
| Supplemental disclosures of cash flow information:                              |                                    |                |
| Cash paid during the period for:                                                |                                    |                |
| Interest                                                                        | \$405,000                          | \$293,000      |
| Non cash investing and financing activities:                                    |                                    |                |
| Series B preferred stock converted to common stock                              | \$422,000                          | \$5,000        |
| Fair value warrants granted for deferred financing fees                         | \$-                                | \$653,000      |

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|                                                                                     |          |           |
|-------------------------------------------------------------------------------------|----------|-----------|
| Series B preferred stock dividend payable in common stock                           | \$39,000 | \$-       |
| Common stock issued in settlement of Series A and Series B preferred stock dividend | \$26,000 | \$23,000  |
| Property and equipment acquired through capital leases                              | \$63,000 | \$163,000 |

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

REED'S, INC.

## NOTES TO CONDENSED FINANCIAL STATEMENTS

Three and Nine Months Ended September 30, 2010 and 2009 (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 September 30, 2010 and the results of operations and cash flows for the three and nine months ended September 30, 2010 and 2009. The balance sheet as of December 31, 2009 is derived from the Company's audited financial statements.

Certain information and footnote disclosures normally included in financial statements that have been prepared in accordance with 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 30, 2010.

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.

The results of operations for the three and nine months ended September 30, 2010 are not necessarily indicative of the results of operations to be expected for the full fiscal year ending December 31, 2010.

### 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 nine months ended September 30, 2010 and 2009 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:

|                          | September 30,<br>2010 | September 30,<br>2009 |
|--------------------------|-----------------------|-----------------------|
| Warrants                 | 2,009,028             | 2,208,236             |
| Series A Preferred Stock | 186,484               | 186,484               |
| Series B Preferred Stock | 640,094               | -                     |
| Options                  | 780,000               | 720,000               |
| Total                    | 3,615,606             | 3,114,720             |

## Recent Accounting Pronouncements

In April 2010, the Financial Accounting Standards Board (FASB) issued new accounting guidance in applying the milestone method of revenue recognition to research or development arrangements. Under this guidance management may recognize revenue contingent upon the achievement of a milestone in its entirety, in the period in which the milestone is achieved, only if the milestone meets all the criteria within the guidance to be considered substantive. This standard is effective on a prospective basis for research and development milestones achieved in fiscal years, beginning on or after June 15, 2010. Early adoption is permitted; however, adoption of this guidance as of a date other than January 1, 2011 will require the Company to apply this guidance retrospectively effective as of January 1, 2010 and will require disclosure of the effect of this guidance as applied to all previously reported interim periods in the fiscal year of adoption. As the Company plans to implement this standard prospectively, the effect of this guidance will be limited to future transactions. The Company does not expect adoption of this standard to have a material impact on its financial position or results of operations as it has no material research and development arrangements which will be accounted for under the milestone method.

In January 2010, the FASB issued new accounting guidance which requires new disclosures regarding transfers in and out of Level 1 and Level 2 fair value measurements, as well as requiring presentation on a gross basis of information about purchases, sales, issuances and settlements in Level 3 fair value measurements. The guidance also clarifies existing disclosures regarding level of disaggregation, inputs and valuation techniques. The new guidance is effective for interim and annual reporting periods beginning after December 15, 2009. Disclosures about purchases, sales, issuances and settlements in the roll forward of activity in Level 3 fair value measurements are effective for fiscal years beginning after December 15, 2010. As this guidance requires only additional disclosure, there should be no impact on the financial statements of the Company upon adoption.

In October 2009, a new accounting consensus was issued for multiple-deliverable revenue arrangements. This consensus amends existing revenue recognition accounting standards. This consensus provides accounting principles and application guidance on whether multiple deliverables exist, how the arrangement should be separated and the consideration allocated. This guidance eliminates the requirement to establish the fair value of undelivered products and services and instead provides for separate revenue recognition based upon management's estimate of the selling price for an undelivered item when there is no other means to determine the fair value of that undelivered item. Previously the existing accounting consensus required that the fair value of the undelivered item be the price of the item either sold in a separate transaction between unrelated third parties or the price charged for each item when the item is sold separately by the vendor. Under the existing accounting consensus, if the fair value of all of the elements in the arrangement was not determinable, then revenue was deferred until all of the items were delivered or fair value was determined. This new approach is effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. The Company is in the process of evaluating whether the adoption of this standard will have a material effect on its financial position, results of operations or cash flows.

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 nine months ended September 30, 2010.

During the three months ended September 30, 2010 and 2009, the Company had two customers, which accounted for approximately 13% and 30% of sales in 2010, and 14% and 34% of sales in 2009, respectively. During the nine months ended September 30, 2010 and 2009, the Company had two customers, which accounted for approximately 12% and 32% of sales in 2010, and 17% and 32% of sales in 2009, respectively. No other customers accounted for more than 10% of sales in either year. As of September 30, 2010 and December 31, 2009, the Company had approximately \$113,000 (7%) and \$369,000 (23%); and \$134,000 (14%) and \$147,000 (15%), respectively, of accounts receivable from these customers.

#### Fair Value of Financial Instruments

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

financial assets:

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

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

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

The Company had no such assets or liabilities recorded to be valued on the basis above at September 30, 2010 or December 31, 2009.



## 2. Inventory

Inventory consists of the following as of:

|                             | September 30,<br>2010 | December 31,<br>2009 |
|-----------------------------|-----------------------|----------------------|
| Raw Materials and packaging | \$ 1,924,000          | \$ 1,337,000         |
| Finished Goods              | 2,033,000             | 1,547,000            |
|                             | \$ 3,957,000          | \$ 2,884,000         |

## 3. Fixed Assets

Fixed assets are comprised of the following as of:

|                          | September 30,<br>2010 | December 31,<br>2009 |
|--------------------------|-----------------------|----------------------|
| Land                     | \$ 1,108,000          | \$ 1,108,000         |
| Building                 | 1,522,000             | 1,393,000            |
| Vehicles                 | 320,000               | 320,000              |
| Machinery and equipment  | 1,412,000             | 1,169,000            |
| Office equipment         | 393,000               | 392,000              |
|                          | 4,755,000             | 4,382,000            |
| Accumulated depreciation | (1,062,000 )          | (727,000 )           |
|                          | \$ 3,693,000          | \$ 3,655,000         |

Machinery and equipment at September 30, 2010 and December 31, 2009 includes equipment held under capital leases of \$226,000 and \$163,000, respectively. Accumulated depreciation on equipment held under capital leases was \$43,000 and \$13,000 at September 30, 2010 and December 31, 2009, respectively.

## 4. Line of Credit

At September 30, 2010 and December 31, 2009, the aggregate amount outstanding under the line of credit was \$1,518,000 and \$1,415,000 respectively, and the Company had approximately \$187,000 of availability on this line of credit at September 30, 2010. 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 terminates November 2010, and as of July 18, 2010 the Company is no longer subject to an early termination fee if the loan is terminated before November 2010. 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 September 30, 2010 are as follows:



Periods Ending September 30,

|                                      |    |           |
|--------------------------------------|----|-----------|
| 2011                                 | \$ | 67,000    |
| 2012                                 |    | 67,000    |
| 2013                                 |    | 67,000    |
| 2014                                 |    | 59,000    |
| 2015                                 |    | 7,000     |
| Total minimum obligations            |    | 267,000   |
| Less: Amounts representing interest  |    | (72,000 ) |
| Present value of minimum obligations |    | 195,000   |
| Less: Current portion                |    | (38,000 ) |
| Non-current portion                  | \$ | 157,000   |

#### 6. Long-term Financing Obligation

On September 15, 2009, the Company closed escrow on the sale of its 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 and nine months ended September 30, 2010 was \$13,000 and \$38,000, respectively. Amortization during the three and nine months ended September 30, 2009 was \$13,000.

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

|                                | September 30,<br>2010 | December 31,<br>2009 |
|--------------------------------|-----------------------|----------------------|
| Financing obligation           | \$ 3,011,000          | \$ 3,040,000         |
| Valuation discount             | (689,000 )            | (726,000 )           |
|                                | 2,322,000             | 2,314,000            |
| Less current portion           | (51,000 )             | (40,000 )            |
| Long term financing obligation | \$ 2,271,000          | \$ 2,274,000         |

#### 7. Stockholders' Equity

##### Preferred Stock

On June 30, 2010, the Company accrued dividends payable in common stock on its Series A Convertible Preferred Stock in the amount of \$23,000. Such dividend was paid during the three months ended September 30, 2010, through the issuance of 11,211 shares of common stock.

On February 5, 2010, the Company completed a standby offering of 12,780 shares of its Series B Convertible Preferred Stock at \$10.00 per share, for gross proceeds of \$127,800. In connection with the offering, the Company also issued warrants to purchase 3,575 shares of common stock at \$1.79 per share for five years. The Company paid legal and broker fees of approximately \$11,000 in connection with the offering, resulting in net proceeds to the Company of \$117,000.

Dividends accrue quarterly on the Series B Convertible Preferred shares outstanding at the end of the quarter. During the three and nine months ended September 30, 2010, the Company accrued dividends of \$12,000 and \$39,000, respectively. Dividends have been paid in common stock at the time of conversion of the Series B Convertible Preferred Stock into common stock. During the nine months ended September 30, 2010, 42,158 shares of Series B Convertible Preferred Stock were converted into 295,106 shares of common stock, in accordance with the original certificate of designation, and \$3,000 of accrued dividends were paid on conversion, through the issuance of 1,918 shares of common stock.

## Common Stock

On February 18, 2010, the Company sold an aggregate of 277,359 shares of common stock at a price of \$1.70 per share for gross proceeds of \$472,000. Investors were also issued warrants to purchase 83,208 shares of common stock, in connection with the transaction. The warrants are exercisable at a price of \$2.10 per share for a period of five years commencing nine months from the closing date of the offering. In connection with the sale, the Company paid direct costs of approximately \$40,000. The Company received proceeds, after deducting offering expenses, of approximately \$432,000.

During the nine months ended September 30, 2010, the Company issued 72,826 shares of common stock at prices ranging from \$1.62 to \$2.30 per share with a value of \$135,000 for services rendered and 81,004 shares of common stock at stock prices ranging from \$1.32 to \$2.12 per share with a value of \$126,000 to employees as a bonus.

## 8. Stock Based Compensation

### Stock Options

During the nine months ended September 30, 2010, the Company issued 135,000 options to employees at exercise prices between \$1.79 and \$2.02 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 nine months ended September 30, 2010 was \$35,000 and \$139,000, respectively, as compared to 2009 expense of \$91,000 and \$360,000 respectively. As of September 30, 2010, the aggregate value of unvested options was \$251,000, which will vest over an average period of three years. There were 8,333 stock options exercised at a price of \$0.75 per share resulting in proceeds to the Company of \$6,000 in the nine months ended September 30, 2010. 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 following table summarizes stock option activity for the nine months ended September 30, 2010:

|                                  | Shares   | Weighted-Average<br>Exercise Price | Weighted-Average<br>Remaining<br>Contractual<br>Terms (Years) | Aggregate<br>Intrinsic<br>Value |
|----------------------------------|----------|------------------------------------|---------------------------------------------------------------|---------------------------------|
| Outstanding at December 31, 2009 | 690,000  | \$ 1.74                            |                                                               |                                 |
| Granted                          | 135,000  | 2.02                               |                                                               |                                 |
| Exercised                        | (8,333 ) | 0.75                               |                                                               |                                 |

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|                                   |           |         |      |           |  |
|-----------------------------------|-----------|---------|------|-----------|--|
| Forfeited or expired              | (36,667 ) | 0.75    |      |           |  |
| Outstanding at September 30, 2010 | 780,000   | \$ 1.84 | 2.65 | \$539,000 |  |
| Exercisable at September 30, 2010 | 395,000   | \$ 2.34 | 2.0  | \$291,000 |  |

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 \$1.95 as of September 30, 2010.

The following table summarizes information about stock options at September 30, 2010:

| Range of Exercise Price | Options Outstanding at September 30, 2010 |                                                     |                                 | Options Exercisable at September 30, 2010 |                                 |
|-------------------------|-------------------------------------------|-----------------------------------------------------|---------------------------------|-------------------------------------------|---------------------------------|
|                         | Number of Shares Outstanding              | Weighted Average Remaining Contractual Life (years) | Weighted Average Exercise Price | Number of Shares Exercisable              | Weighted Average Exercise Price |
| 0.01 - \$1.99           | 525,000                                   | 2.5                                                 | \$0.93                          | 265,000                                   | \$0.87                          |
| 2.00 - \$4.99           | 205,000                                   | 3.2                                                 | \$2.80                          | 80,000                                    | \$4.00                          |
| 5.00 - \$6.99           | -                                         | -                                                   | -                               | -                                         | -                               |
| 7.00 - \$8.50           | 50,000                                    | 1.68                                                | \$7.55                          | 50,000                                    | \$7.55                          |
|                         | 780,000                                   |                                                     |                                 | 395,000                                   |                                 |

#### Stock Warrants

On February 9, 2010, the Company granted warrants to purchase 3,575 shares of common stock to a dealer-manager in connection with the placement of its Series B Convertible Preferred Stock. The warrants are exercisable for five years at \$1.79. On February 22, 2010, the Company granted warrants to purchase 83,208 shares of common stock to investors who purchased 277,359 shares of its common stock. The warrants are exercisable for five years at a price of \$2.10.

The following table summarizes stock warrant activity for the nine months ended September 30, 2010:

|                                   | Shares    | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Terms (Years) | Aggregate Intrinsic Value |
|-----------------------------------|-----------|---------------------------------|------------------------------------------------------|---------------------------|
| Outstanding at December 31, 2009  | 1,991,690 | \$ 4.70                         |                                                      |                           |
| Granted                           | 86,783    | \$ 2.09                         |                                                      |                           |
| Exercised                         | —         | —                               |                                                      |                           |
| Forfeited or expired              | (69,445 ) | \$ 1.80                         |                                                      |                           |
| Outstanding at September 30, 2010 | 2,009,028 | \$ 4.68                         | 2.6                                                  | \$426,000                 |
| Exercisable at September 30, 2010 | 1,809,028 | \$ 5.05                         | 2.6                                                  | \$306,000                 |

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 \$1.95 as of September 30, 2010.

#### 9. Related Party Transactions

On February 2, 2009, the Company issued 52,420 shares of its common stock, at the market value, to two brothers of Christopher Reed, Chief Executive Officer of the Company, in satisfaction of \$65,000 due under an agreement for the distribution of its products internationally. On April 23, 2009, the Company repriced 200,000 warrants granted in

connection with this distribution agreement, to \$1.35, the market value on that date. The warrants will be valued and a corresponding expense will be recorded upon the attainment of the sales goals identified when the warrants were granted.

10. Subsequent Events

During October 2010, 5,676 shares of Series B Convertible Preferred Stock were converted into 41,208 shares of common stock, in accordance with the terms. On October 12, 2010, 5,155 shares were issued at the market price of \$1.94 per share for services in the amount of \$10,000.



## 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

We continue to experience significant increases in sales of our branded products in 2010, and we anticipate that those increases will continue for the balance of the year. Our third fiscal quarter included our first significant private label sales and the fourth quarter will reflect further growth in this category. Our gross margin on sales of branded products was consistent, while our overall gross margin was adversely impacted by initial lower-margin private label sales and one-time costs associated with the start up of this business segment. We are taking measures to improve the margins on private label sales, especially on 2011 contract terms. During the fourth fiscal quarter, our new diet line will contribute to our Virgil's brand revenues. We are currently setting promotion and pricing plans for 2011, and we believe that margin improvement will be significant on all of our products sold.

## Results of Operations

The following table sets forth key statistics for the three and nine months ended September 30, 2010 and 2009, respectively.

|                                                  | Three Months Ended<br>September 30, |             | Percentage<br>Change<br>10 vs. 09 | Nine Months Ended<br>September 30, |              | Percentage<br>Change<br>10 vs. 09 |
|--------------------------------------------------|-------------------------------------|-------------|-----------------------------------|------------------------------------|--------------|-----------------------------------|
|                                                  | 2010                                | 2009        |                                   | 2010                               | 2009         |                                   |
| Total net sales                                  | \$5,428,000                         | \$4,027,000 | 35%                               | \$14,345,000                       | \$11,658,000 | 23%                               |
| Net sales comprised of:                          |                                     |             |                                   |                                    |              |                                   |
| Sales branded products                           | 4,887,000                           | 4,027,000   | 21%                               | 13,497,000                         | 11,658,000   | 16%                               |
| Sales of private label products                  | 541,000                             | -           | 100%                              | 848,000                            | -            | 100%                              |
| Cost of sales:                                   |                                     |             |                                   |                                    |              |                                   |
| Costs of products sold                           | 4,040,000                           | 2,758,000   | 46%                               | 10,059,000                         | 7,954,000    | 26%                               |
| Overhead costs of sales                          | 325,000                             | 280,000     | 16%                               | 988,000                            | 768,000      | 29%                               |
| Total cost of sales                              | 4,365,000                           | 3,038,000   | 44%                               | 11,047,000                         | 8,722,000    | 27%                               |
| Gross profit                                     | 1,063,000                           | 989,000     | 7%                                | 3,298,000                          | 2,936,000    | 12%                               |
| Gross profit margin as a percentage of net sales | 20%                                 | 25%         |                                   | 23%                                | 25%          |                                   |
| Operating expenses:                              |                                     |             |                                   |                                    |              |                                   |
| Selling and marketing expense                    | 570,000                             | 646,000     | (12%)                             | 1,632,000                          | 1,853,000    | (12%)                             |
| General and administrative expense               | 742,000                             | 623,000     | 19%                               | 2,066,000                          | 1,896,000    | 9%                                |
| Impairment of assets                             | -                                   | -           |                                   | -                                  | 641,000      |                                   |
| Total operating expenses                         | 1,312,000                           | 1,269,000   | 3%                                | 3,698,000                          | 4,390,000    | (16%)                             |

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|                      |              |              |       |              |                |       |
|----------------------|--------------|--------------|-------|--------------|----------------|-------|
| Loss from operations | (249,000 )   | (280,000 )   | (11%) | (400,000 )   | (1,454,000 )   | (72%) |
| Interest expense     | (149,000 )   | (122,000 )   | 22%   | (421,000 )   | (319,000 )     | 32%   |
| Net loss             | \$(398,000 ) | \$(402,000 ) | -     | \$(821,000 ) | \$(1,773,000 ) | (54%) |

Three months ended September 30, 2010 Compared to Three months ended September 30, 2009

#### Sales

Sales of \$5,428,000 for the three months ended September 30, 2010 represented an increase of 35% or \$1,401,000, as compared to the prior year same period. Sales of private label products accounted for approximately \$541,000 of this increase, which were not a part of the prior year sales. Sales from branded products increased over 20% during the quarter, from the 2009 same quarter. The number of grocery chains carrying our branded and private label products is increasing and we are actively marketing to our existing customers with an improving effect on per store sales.

#### Cost of Goods Sold

Cost of goods sold consists primarily of the costs of our ingredients, packaging, production and freight. Our cost of goods sold of \$4,365,000 for the three months ended September 30, 2010 represents an increase of \$1,327,000 as compared to the 2009 same period. We have experienced increases in certain ingredient costs which have been partially offset by decreases in glass and other costs. Our unabsorbed overhead production costs increased by approximately \$45,000 or 16% from the same 2009 period. Freight delivery costs increased by approximately \$150,000, or 67% from the prior year.

#### Gross Profit

Our gross profit increased to \$1,063,000 in the three months ended September 30, 2010, from \$989,000 in 2009, an increase of \$74,000 or 7%. The overall gross profit as a percentage of sales decreased to 20% in 2010, from 25% in 2009. The gross profit from our initial private label contracts was nominal, reflecting certain start-up production costs and higher ingredient costs. Ongoing margins from private label sales are anticipated to contribute to gross profit in the fourth quarter and improve further in 2011, as contract terms improve. Our average gross profit percentage on the sales of our branded products, including primarily our Reed's and Virgil's brands, is approximately the same during the three months ended September 30, 2010 as compared to 2009, with nominal erosion of margins experienced in certain items due primarily to ingredient cost increases.

#### 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 decreased to \$570,000 in the three months ended September 30, 2010 from \$646,000 in 2009. The decrease is primarily due to a decrease in advertising promotion and trade shows of \$97,000 and a decrease stock option expense of \$38,000; offset by an increase in compensation and travel costs of \$42,000 and an increase in facilities related costs of \$17,000.

We have recently increased our direct marketing capabilities, while continuing to maintain our senior sales staff that is focused on sales in significant grocery chains nationwide. The trend in grocery stores is to offer more natural products. Our sales force is leveraging our strong position in natural food grocery stores throughout the nation, to establish new relationships with mainstream grocery stores.

#### General and Administrative Expenses

General and administrative expenses consist primarily of the cost of executive, administrative, and finance personnel, as well as professional fees. General and administrative expenses increased to \$742,000 during the three months ended September 30, 2010 from \$623,000 in the same period of 2009. The overall increase of \$119,000 in 2010 is primarily due to an increase in compensation costs of \$49,000, an increase in amortization expense of \$38,000, and an

increase in facilities-related costs of \$25,000; offset by a decrease in stock option expense of \$18,000.

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

Our loss from operations decreased to \$249,000 in the three months ended September 30, 2010 from \$280,000 in the same period of 2009. The improvement is a direct result of increased sales.

#### Interest Expense

Interest expense increased to \$149,000 in the three months ended September 30, 2010, compared to interest expense of \$122,000 in the same period of 2009. The increase is due to the increase in long-term debt, as a result of our financing obligation; and increased borrowing under a line of credit agreement with GemCap Lending I, LLC, secured primarily by our inventory and accounts receivable.

Nine months ended September 30, 2010 Compared to Nine months ended September 30, 2009

#### Sales

Sales of \$14,345,000 for the nine months ended September 30, 2010 represented an increase of 23% or \$2,687,000, as compared to the prior year same period. Sales of private label products accounted for approximately \$848,000 of this increase, which were not a part of the prior year sales. Sales from branded products increased over 16% during the nine month period, from the 2009 same period.

#### Cost of Goods Sold

Cost of goods sold consists primarily of the costs of our ingredients, packaging, production and freight. Our cost of goods sold of \$11,047,000 for the nine months ended September 30, 2010 represents an increase of \$2,325,000 as compared to the 2009 same period. We have experienced increases in certain ingredient costs which have been partially offset by decreases in glass and other costs. Our unabsorbed overhead productions costs increased by approximately \$220,000 or 29% from the same 2009 period. Freight delivery costs increased by approximately \$250,000, or 40% from the prior year.

#### Gross Profit

Our gross profit increased to \$3,298,000 in the nine months ended September 30, 2010, from \$2,936,000 in 2009, an increase of \$362,000 or 12%. The overall gross profit as a percentage of sales decreased to 23% in 2010, from 25% in 2009. The gross profit from our initial private label contracts was nominal, reflecting certain start-up production costs and higher ingredient costs. Our average gross profit percentage on the sales of our branded products, including primarily our Reed's and Virgil's brands, is approximately the same during the nine months ended September 30, 2010 as compared to 2009, with nominal erosion of margins experienced in certain items due primarily to ingredient cost increases.

#### 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 decreased to \$1,632,000 in the nine months ended September 30, 2010 from \$1,853,000 in 2009, a decrease of \$221,000 or 12%. The decrease is primarily due to a decrease stock option expense of \$200,000 and a decrease in advertising and trade show costs of \$106,000; offset by an increase in facilities related costs of \$44,000 and an increase in compensation related expenses of \$41,000.

#### General and Administrative Expenses

General and administrative expense consists primarily of the cost of executive, administrative, and finance personnel, as well as professional fees. General and administrative expenses increased to \$2,066,000 during the nine months ended September 30, 2010 from \$1,896,000 in the same period of 2009. The overall increase of \$170,000 in 2010 is primarily due to an increase in compensation costs of \$128,000, an increase in Depreciation and amortization of \$49,000, and an increase in facilities-related costs of \$15,000; partially offset by a decrease in stock option expense of \$22,000.

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

Our loss from operations decreased to \$400,000 in the nine months ended September 30, 2010 from \$1,454,000 in the same period of 2009. The improvement is a direct result of increased sales and an impairment loss in the 2009 period of \$641,000 which did not reoccur in 2010.

#### Interest Expense

Interest expense increased to \$421,000 in the nine months ended September 30, 2010, compared to interest expense of \$319,000 in the same period of 2009. The increase is due to the increase in long-term debt, as a result of our financing obligation; and increased borrowing under a line of credit agreement with GemCap Lending I, LLC, secured primarily by our inventory and accounts receivable.

## Liquidity and Capital Resources

As of September 30, 2010, we had stockholders equity of \$4,475,000 and we had working capital of \$2,142,000, compared to stockholders equity of \$4,377,000 and working capital of \$2,037,000 at December 31, 2009. Cash and cash equivalents were \$958,000 as of September 30, 2010, as compared to \$1,306,000 at December 31, 2009. This increase in our working capital of \$105,000 was primarily a result of sales of our equity securities. In addition to our cash position on September 30, 2010, we had availability under our line of credit of approximately \$187,000.

Our decrease in cash and cash equivalents to \$958,000 at September 30, 2010 compared to \$1,306,000 at December 31, 2009 was primarily a result of cash used in operating activities, primarily for increases in accounts receivable and inventory that are related to our overall increases in ongoing revenues. Such cash used in operations was offset by net draw-downs on our line of credit and sales of equity securities.

We believe that the Company currently has the necessary working capital to support existing operations through September 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.

Net cash used in operations during 2010 was \$568,000 compared with \$1,322,000 used in operations during the same period in 2009. Cash used in operations during 2010 was primarily due to the net loss in period and to an increase in accounts receivable, inventory and prepaid raw materials costs, as we prepare for higher levels of continuing sales.

Net cash used in investing activities of \$310,000 during 2010 compared with \$240,000 during 2009 is primarily the result of equipment purchases in both years.

Net cash provided by financing activities of \$530,000 during 2010 was primarily due to proceeds from the sale of our common and preferred stock in the aggregate amount of \$549,000, net of offering costs, and to net draws on the revolving line of credit of \$103,000; offset by debt repayments of \$128,000. On February 5, 2010, the Company completed a standby offering of 12,780 shares of its Series B Preferred Stock at \$10.00 per share, for gross proceeds of \$127,800. The Company paid legal and broker fees of approximately \$11,000 in connection with the offering. On February 18, 2010, the Company sold an aggregate of 277,359 shares of common stock at a price of \$1.70 per share for gross proceeds of \$472,000. In connection with the sale, the Company paid legal and broker fees of approximately \$40,000.

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 September 30, 2010, the outstanding line of credit was \$1,518,000, with \$187,000 available based on the collateral formula.

Our operating losses have negatively impacted our liquidity and we are continuing to work on decreasing operating losses, while focusing on increasing net sales. We believe that our current cash position and line of credit availability will be sufficient to enable us to meet our cash needs throughout 2011. We believe that if the need arises we can raise money through the equity markets.

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.

**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 intend to obtain international registration of certain trademarks in foreign jurisdictions.

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 nine months ended September 30, 2010.

**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 nine months ended September 30, 2010.

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. We adopted FASB guidance effective January 1, 2006, and are using the modified prospective method in which compensation cost is recognized beginning with the effective date (a) for all share-based payments granted after the effective date and (b) for all awards granted to employees prior to the effective date that remain unvested on the effective date. We account for stock option and warrant grants issued and vesting to non-employees in accordance with accounting guidance 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 nine month period ended September 30, 2010, 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, 2009.

#### Recent Accounting Pronouncements

In April 2010, the Financial Accounting Standards Board (FASB) issued new accounting guidance in applying the milestone method of revenue recognition to research or development arrangements. Under this guidance management may recognize revenue contingent upon the achievement of a milestone in its entirety, in the period in which the milestone is achieved, only if the milestone meets all the criteria within the guidance to be considered substantive. This standard is effective on a prospective basis for research and development milestones achieved in fiscal years, beginning on or after June 15, 2010. Early adoption is permitted; however, adoption of this guidance as of a date other than January 1, 2011 will require the Company to apply this guidance retrospectively effective as of January 1, 2010 and will require disclosure of the effect of this guidance as applied to all previously reported interim periods in the fiscal year of adoption. As the Company plans to implement this standard prospectively, the effect of this guidance will be limited to future transactions. The Company does not expect adoption of this standard to have a material impact on its financial position or results of operations as it has no material research and development arrangements which will be accounted for under the milestone method.

In January 2010, the FASB issued new accounting guidance which requires new disclosures regarding transfers in and out of Level 1 and Level 2 fair value measurements, as well as requiring presentation on a gross basis of information about purchases, sales, issuances and settlements in Level 3 fair value measurements. The guidance also clarifies existing disclosures regarding level of disaggregation, inputs and valuation techniques. The new guidance is effective for interim and annual reporting periods beginning after December 15, 2009. Disclosures about purchases, sales, issuances and settlements in the roll forward of activity in Level 3 fair value measurements are effective for fiscal years beginning after December 15, 2010. As this guidance requires only additional disclosure, there should be no impact on the financial statements of the Company upon adoption.

In October 2009, a new accounting consensus was issued for multiple-deliverable revenue arrangements. This consensus amends existing revenue recognition accounting standards. This consensus provides accounting principles and application guidance on whether multiple deliverables exist, how the arrangement should be separated and the consideration allocated. This guidance eliminates the requirement to establish the fair value of undelivered products and services and instead provides for separate revenue recognition based upon management's estimate of the selling price for an undelivered item when there is no other means to determine the fair value of that undelivered item. Previously the existing accounting consensus required that the fair value of the undelivered item be the price of the item either sold in a separate transaction between unrelated third parties or the price charged for each item when the item is sold separately by the vendor. Under the existing accounting consensus, if the fair value of all of the elements in the arrangement was not determinable, then revenue was deferred until all of the items were delivered or fair value was determined. This new approach is effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. The Company is in the process of evaluating whether the adoption of this standard will have a material effect on its financial position, results of operations or cash flows.

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.

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 September 30, 2010.

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 September 30, 2010 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 September 30, 2010, the Company issued 16,306 shares of common stock for services at prices of \$1.78 and \$2.10 per share with a value of \$31,000 and 13,440 shares of common stock at \$1.86 per share with a value of \$25,000 to an employee as a bonus. Such transactions 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.

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.* |

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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: November 9, 2010

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

Date: November 9, 2010

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