REED'S, INC.
Form 10-K
April 02, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF

THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2017

Commission File Number 000-32501

REED’S, INC.

(Exact name of registrant as specified in its charter)

Delaware	**35-2177773**
State or other jurisdiction of incorporation or organization	I.R.S. Employer Identification Number
13000 South Spring Street	
Los Angeles, California	**90061**
Address of principal executive offices	Zip Code

(310) 217-9400

Registrant's telephone number, including area code

Securities registered pursuant to Section 12(b) of the Act:

Title of Class	**Name of each exchange where registered**
Common Stock, $.0001 par value per share	**NYSE American**

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes [ ] No [X]

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes [ ] No [X]

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 [X] 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 [X] No [ ]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

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 definition of "large accelerated filer," "accelerated filer" and "small reporting company" in Rule 12b-2 of the Exchange Act.

Large Accelerated filer [ ] Accelerated filer [ ] Non-accelerated filer [ ] Smaller reporting company [X]

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates (excluding voting shares held by officers and directors) as of June 30, 2017 was $25,970,000.

24,619,591 common shares, $.001 par value, were outstanding on December 31, 2017.

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CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS AND INFORMATION

This Annual Report on Form 10-K (“Annual Report”), the other reports, statements, and information that we have previously filed or that we may subsequently file with the Securities and Exchange Commission (“SEC”) and public announcements that we have previously made or may subsequently make include, may include, incorporate by reference or may incorporate by reference certain statements that may be deemed to be forward-looking statements. The forward-looking statements included or incorporated by reference in this Annual Report and those reports, statements, information and announcements address activities, events or developments that Reed’s, Inc. (hereinafter referred to as “we,” “us,” “our” or “Reed’s”) expects or anticipates will or may occur in the future. Any statements in this document about expectations, beliefs, plans, objectives, assumptions or future events or performance are not historical facts and are forward-looking statements. These statements are often, but not always, made through the use of words or phrases such as “may,” “should,” “could,” “predict,” “potential,” “believe,” “will likely result,” “expect,” “will continue,” “a “seek,” “estimate,” “intend,” “plan,” “projection,” “would” and “outlook” and similar expressions. Accordingly, these statemen involve estimates, assumptions and uncertainties, which could cause actual results to differ materially from those expressed in them. Any forward-looking statements are qualified in their entirety by reference to the factors discussed throughout this document. All forward-looking statements concerning economic conditions, rates of growth, rates of income or values as may be included in this document are based on information available to us on the dates noted, and we assume no obligation to update any such forward-looking statements.

The risk factors referred to in this Annual Report could cause actual results or outcomes to differ materially from those expressed in any forward-looking statements made by us, and you should not place undue reliance on any such forward-looking statements. Any forward-looking statement speaks only as of the date on which it is made and we do not undertake any obligation to update any forward-looking statement or statements to reflect events or circumstances after the date on which such statement is made or to reflect the occurrence of unanticipated events. New factors emerge from time to time, and it is not possible for us to predict which will arise. In addition, we cannot assess the impact of each factor on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

Management cautions that these statements are qualified by their terms and/or important factors, many of which are outside of our control, involve a number of risks, uncertainties and other factors that could cause actual results and events to differ materially from the statements made, including, but not limited to, the following risk factors.

Our ability to generate sufficient cash flow to support capital expansion plans and general operating activities,

Decreased demand for our products resulting from changes in consumer preferences,

Competitive products and pricing pressures and our ability to gain or maintain its share of sales in the marketplace, The introduction of new products,

Our being subject to a broad range of evolving federal, state and local laws and regulations including those regarding the labeling and safety of food products, establishing ingredient designations and standards of identity for certain foods, environmental protections, as well as worker health and safety. Changes in these laws and regulations could have a material effect on the way in which we produce and market our products and could result in increased costs,

Changes in the cost and availability of raw materials and the ability to maintain our supply arrangements and relationships and procure timely and/or adequate production of all or any of our products,

Our ability to penetrate new markets and maintain or expand existing markets,

Maintaining existing relationships and expanding the distributor network of our products,

Maintaining the listing of our common stock on the NYSE American market or other national securities exchange.

The marketing efforts of distributors of our products, most of whom also distribute products that are competitive with our products,

Decisions by distributors, grocery chains, specialty chain stores, club stores and other customers to discontinue carrying all or any of our products that they are carrying at any time,

The availability and cost of capital to finance our working capital needs and growth plans,

The effectiveness of our advertising, marketing and promotional programs,

Changes in product category consumption,

Economic and political changes,

Consumer acceptance of new products, including taste test comparisons,

Possible recalls of our products,

Our ability to make suitable arrangements for the co-packing of any of our products, and

Our ability to find alternative co-packing and production facilities for our products if our Los Angeles production facility is unable to produce because of damage by a disaster.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance, or achievements.

PART I

Item 1. Business

Background

Reed’s Inc. (the “Company,” or “we,” or “us” throughout this report) is the owner and maker of the nation’s leading portfolio of handcrafted, natural beverages in the natural and specialty foods industry, selling to specialty gourmet, natural food, retail, and convenience stores and restaurants nationwide. The Company also sells through distributors to international markets. The Company’s two major core brands are Reed’s Ginger Beer and Virgil’s soda beverages. Reed’s Ginger Brews are unique in the beverage industry, being brewed, not manufactured, using fresh ginger, spices and fruits in a brewing process predating commercial soft drinks. Virgil’s sodas include award winning Root Beer and other soft drinks that are made using natural ingredients.

Historical Development

Reed's Original Ginger Brew was created in 1987 by Christopher J. Reed, our founder, and current Chief Innovation Officer. Our product was first introduced to the market in Southern California stores in 1989. By 1990, we began marketing our products through United Natural Foods Inc. (UNFI) and other natural food distributors and moved our production to a larger facility in Boulder, Colorado. The following year, the Company moved all production to a co-pack facility in Pennsylvania. Throughout the 1990's, we continued to develop and launch new Ginger Brew varieties. Reed's Ginger Brews reached broad placement in natural and gourmet foods stores nationwide through UNFI and other major specialty, natural and gourmet and mainstream food and beverage distributors.

In 1997, we began licensing the products of China Cola and eventually acquired the rights to the product in 2000. In 1999, we purchased the Virgil's Root Beer brand from the Crowley Beverage Company. In 2000, we moved into an 18,000-square foot warehouse property, the Brewery, in Los Angeles, California, to house our west coast production and warehouse facility. The Brewery also serves as our principal executive offices.

On December 12, 2006, we raised $8,000,000 through the sale of 2,000,000 shares of our common stock at an offering price of $4.00 per share in our initial public offering, trading on the OTC Bulletin board. Following the public offering, we expanded sales and operations dramatically, initially using a direct store delivery strategy in Southern California, along with other regional independent direct store distributors (DSD). The relationships with DSD's were supported by our sales staff.

In 2007, wed transferred our shares to NASDAQ and raised a net of $7,600,000 in a private placement. We refocused our sales strategy to eliminate company direct store delivery sales and to expand sales to DSD's and natural food distributors on a national level. We also started selling directly to supermarket grocery stores, which has become a significant portion of our business today.

We continually introduced new products and line extensions, such as our California Juice Company products in 2009, Virgil's diet line of ZERO beverages introduced in 2010, and Dr. Better and Light 55 Calories Extra Ginger Brew in 2011. We commenced offering private label products in 2010; and in 2012 we launched our Culture Club Kombucha line.

In 2013, our shares were transferred to the New York Stock Exchange, where we are currently trading.

In 2015, we launched Stronger Ginger Brew which contains 50% more fresh ginger than our best-selling Reed's Extra Ginger Brew.

In 2016, the board of directors brought on John Bello to serve as Chairman of the Board. Mr. Bello is the founder and former Chief Executive Officer of South Beach Beverage Company, the maker of nutritionally enhanced teas and juices marketed under the brand name SoBe. After growing the brand to $275 million in revenue over five years, he sold the company for $370 million to Pepsi. A 30-year veteran in the beverage industry, Mr. Bello is streamlining our business model and driving the Company to operate under an "asset-light" model and focus on becoming a premier sale and marketing driven organization.

In 2017, we continued the build out of the development of the first natural soda fountain products with trials in a large, national, fast, casual restaurant chain. The soda fountain versions of the popular natural sodas allow restaurants and other fountain concessions to buy the Company's products for significantly less than the full packaged bottled price and at competitive prices to other fountain products.

In 2017, under our new executive management team (see below), we began a complete operational review and developed a detailed action plan to capture performance improvements and drive core brand growth.

In 2017, the shareholders expanded the number of board appointed seats to allow for a more multi-dimensional board with strong business experience. We also brought on a new investor and raised financing through a number of transactions through the issuance of a convertible note, warrants, and a $14.0 million shareholder rights offering. Collectively, these transactions raised $19 million for the Company.

New Beginnings

In our efforts to transform operations and develop the Company into a premier sales and marketing organization, the board of directors brought on several seasoned industry experts to provide leadership and direction to the Company. In June 2017, the board appointed Val Stalowir to be the Company's new Chief Executive Officer. Mr. Stalowir is a 25-year veteran of the food and beverage industry and brings with him several years of global brand experience including Quaker Oats, Coca-Cola, and Yum! Brands and emerging brand experience including Boylan Bottling, Detour Bar, and Zola Acai. Mr. Stalowir has extensive experience in sales and marketing, new product development, and improving operational efficiency. He also has a proven track record of leading brand expansion into international markets and accessing private equity capital in the food and beverage sectors.

With the addition of Mr. Stalowir, the board appointed our founder, Chris Reed as Chief Innovation Officer in order to focus on the launch of a new portfolio of products and strengthen the Company's existing brand equity. The board's leadership restructuring also included the retention of Stefan Freeman then interim Chief Executive Officer, to be the Company's Chief Operating Officer. He brings with him over 25 years of beverage and consumer product industry having served in executive roles in Coca-Cola Refreshments, Dr. Pepper Snapple Group, and Pepsi-Cola Bottling Group.

At the September 2017 shareholder meeting, the shareholders authorized to increase the number of seats on the Board to nine and authorized an increase in common shares to 40,000,000 shares.

On March 24, 2018, the Company received a letter of intent from a party, partially owned by Chris Reed, one of the Company's current officers and directors, for the purchase of substantially all of the assets of the Los Angeles plant. It is anticipated the Board of Directors will approve the offer and the sale is anticipated to close during the summer of 2018.

We believe these changes to the board, the executive team and the operations will bring welcomed industry and professional strength to the Company which will transform our Company.

Industry Overview

We offer our portfolio of natural hand-crafted beverages in the natural and specialty foods industry as alternatives to the estimated $100 billion carbonated soft drinks (CSD) market nationwide. The Company's products are sold across the country and internationally to specialty gourmet, natural food stores, retail stores, convenience stores and restaurants. While we are a top-seller in natural food store markets, we also sell nationally to major grocery chains. The trend in grocery stores is to expand offerings of natural products. We believe as we restructure the Company and develop our sales and marketing functions, we will have the ability to scale and be capable of developing these direct customer relationships.

Carbonated Soft Drink Industry Overview

The CSD market continues to be a large category in the overall American consumer beverage industry. According to Nielsen data, eighty-eight percent of American households purchased CSD in 2016. While a very large market, the CSD category continues to experience overall volume declines accounting for 19.8% of stomach share in 2016 compared to 22.7% in 2011. On the other hand, the craft and natural soda category, comprising 1% of total soft drink sales, is growing at a rate of 16% annually.

Consumers continue to embrace ginger products. Nielsen's Jordan Rost stated recently in *Beverage Industry*, "Despite overall category declines, sales of ginger ale grew 9 percent in 2016 as more consumers focused on gut health and are likely opting for the functional and digestive health benefits of ginger-based soda. While many consumers clearly still want to indulge in soft drinks, they are turning to ginger ale as a way to impart some health benefits."

The biggest shift seen over the last decade is a redefinition of what it means to eat and drink healthfully. More consumers are opting for naturally healthful products touting organic and natural appeals. In addition, as the craft and natural soda segment is still underdeveloped at only 1% of the total CSD market, we believe there is significant potential to continue to market and sell our portfolio of branded products.

Consumer Trends Driving Growth for Our Products

In order to effectively sell and market our portfolio of beverages, we remain cognizant of the consumer trends in the marketplace driving the continued growth for ginger beer and craft sodas:

Better-for-You and Healthier Products: Consumers continue to gravitate toward natural products which are growing 10-15% a year and four to five times faster than their mainstream counterparts; consumers want simple, natural ingredients. They are also looking for beverages with function (e.g., the superfood ginger has health benefits).

Reducing Sugar: Consumers are moving away from high sugar beverages and artificially sweetened products.

Authentic and Distinct Brands: Broad, cross-generational products appeal to consumers. Boomers and Millennials gravitate to brands with an authentic story (‘retro’), unique liquid, and packaging.

Affordable Indulgence: Consumers are indulging themselves with affordable everyday premium refreshment beverages, 85% regular and 15% diet, with a slight male skew.

Trading up to Premium and Craft: There is a strong growth in the $500 million craft soda and premium mixer industry segments. Consumers are looking for small batch, handcrafted, higher quality, and authentic bold flavors.

The Craft Soda Category is Underdeveloped: The craft soda segment is underdeveloped relative to other super-premium food and beverage categories; it is currently less than 1% of the overall CSD category.

On-Premise: There is an opportunity to upsell to the on-premise market segment given the market’s desire for a beverage with a non-alcoholic, strong flavor alternative.

Demand for Premium Mixed Drinks: Leading the way in demand has been the Moscow Mule, but the Gin & Ginger and the Dark ‘n Stormy, both of which have ginger bases, have also been on the rise in popularity.

Our strategies will remain responsive to these consumer trends as we concentrate our efforts on developing the Company’s sales and marketing functions.

Our Products

We manufacture our hand-crafted natural beverages using premium natural ingredients. Our products are free of genetically modified organisms (GMO). Over the years, the Company has developed several product offerings. In 2017, we narrowed our focus to our core product flavor offerings of Reed’s Ginger Beer flavors and Virgil’s Craft Sodas. We may re-introduce at a later date our Kombucha and China Cola brands.

Reed’s Ginger Beers

Ginger ale is the oldest known soft drink. Before modern soft drink technology existed, non-alcoholic beverages were brewed at home directly from herbs, roots, spices, and fruits. These handcrafted brews were highly prized for their taste, tonic, and health-giving properties. Reed’s Ginger Beers are a revival of this lost art of home brewing sodas. We make them with care and attention to wholesomeness and quality, using the finest fresh herbs, roots, spices, and fruits.

We believe Reed’s Ginger Beers are unique in their kettle-brewed origin among all mass-marketed soft drinks. Reed’s Ginger Beers contain between 17 and 39 grams of fresh ginger in every 12-ounce bottle. Our products differ from commercial soft drinks in three characteristics: sweetening, carbonation, and coloring for greater adult appeal. We sweeten our products using pure cane sugar. Instead of using injected-based carbonation, we produce our carbonation naturally, through slower, beer-oriented techniques. This process produces smaller, longer lasting bubbles which do not dissipate rapidly when the bottle is opened. We do not add coloring. The color of our products comes naturally from herbs, fruits, spices, roots, and juices.

Since Reed’s Ginger Brews are pasteurized, they do not require or contain any preservatives. In contrast, modern commercial soft drinks are typically produced using natural and artificial flavor concentrates prepared by flavor laboratories, tap water, and highly refined sweeteners. Manufacturers make a centrally processed concentrate which lends itself to a wide variety of situations, waters, and filling systems. The final product is generally cold-filled and requires preservatives for stability. Added colors are either artificial, or if natural, they are often highly processed.

The Reed’s Ginger Brews line contain the following products:

Reed’s Original Ginger Brew was our first creation and is a Jamaican recipe for homemade ginger ale using 17 grams of fresh ginger root, lemon, lime, honey, raw cane sugar, pineapple, herbs and spices. Reed’s Original Ginger Brew is 20% fruit juice.

Reed’s Premium Ginger Brew is sweetened only with honey and pineapple juice. Reed’s Premium Ginger Brew is 20% fruit juice and contains 17 grams of fresh ginger root.

Reeds Extra Ginger Brew is the same recipe as Original Ginger Brew, but has 26 grams of fresh ginger root for a stronger bite.

Reeds Stronger Ginger Brew has 50% more ginger than the Extra Ginger Brew and has the highest ginger content of any of our beverage products.

Reed’s Raspberry Ginger Brew is brewed from 17 grams of fresh ginger root, raspberry juice, and lime. Reed’s Raspberry Ginger Brew is 20% raspberry juice.

Reed’s Light 55 Calories Extra Ginger Brew is a reduced calorie version of our top selling Reed’s Extra Ginger Brew, made possible by using Stevia. We use the same recipe of 26 grams of fresh ginger root, honey, pineapple, lemon and lime juices, and exotic spices.

Reed’s Natural Energy Elixir is an energy drink infused with all-natural ingredients designed to provide consumers with a healthy and natural boost to energy levels.

Virgil’s Root Beer

Virgil’s is a premium craft root beer made with natural ingredients. Our root beer contains filtered water, unbleached cane sugar, and spices sourced from around the world such as anise from Spain, licorice from France, bourbon vanilla from Madagascar, cinnamon from Sri Lanka, clove from Indonesia, wintergreen from China, sweet birch and molasses from the southern United States, nutmeg from Indonesia, pimento berry oil from Jamaica, balsam oil from Peru, and cassia oil from China. We purchase these ingredients from vendors who source these spices worldwide and gather them together at the brewing and bottling facilities. We combine these ingredients under strict specifications and finally heat-pasteurize all Virgil's sodas, to ensure quality. We sell Virgil's in 12-ounce bottles in both 4 packs and 12 pack boxes. The Virgil's soda line is also GMO free.

In addition to our Virgil's Root Beer, we also offer a Virgil's Cream Soda and Virgil's Black Cherry Cream Soda, Virgil's Orange Cream Soda, and a Virgil's ZERO line. In 2018our Virgil's ZERO line of 100% Stevia sweetened and zero calorie sodas will be replaced by our NEW Virgil's O Sugar line of craft sodas. This new natural line of Zero Sugar flavors includes Root Beer, Cola, Lemon-lime, Orange, Black Cherry, and Cream soda.

Other Products

We have other popular brands with limited distribution including our Flying Cauldron Butterscotch Beer and Sonoma Sparkler brand of sparkling juices designed to be celebratory drinks for holidays and special occasions.

Prior Product Innovations

We are experts in flavor and recipe development and have developed many innovative and award-winning products and line extensions. With the expansion of our management team of beverage industry professionals and the added Chief Innovation Officer position, we will continue to be at the forefront of developing flavor profiles and products.

While product innovation will remain a top priority, we have discontinued some drinks in response to various market conditions including changes in consumer preferences and price points in various markets.

These innovations which have sold well in the past, may be reintroduced to the marketplace in the future given favorable market conditions. These products include:

Reed's Ginger Brews: Reed's Spiced Apple Brew, Reed's Cherry Ginger Brew, and Reed's Nausea Relief.

Reed's Kombucha: all flavors.

Other Products: China Cola, certain private label products, and Reed's ice creams.

Our Primary Markets

We target a niche in the estimated $100 billion carbonated and non-carbonated soft drink markets in the U.S., Canada, and international markets. Our brands are generally regarded as premium and natural, with upscale packaging and are loosely defined as the artisanal (craft), premium bottled carbonated soft drink category.

During 2017, management began simplifying operations in order to focus the Company on becoming a premier sales and marketing organization. The new management team is currently assessing best strategies to augment our existing sales and marketing efforts by utilizing industry brokers and outside advertising firms.

We have an experienced and geographically diverse sales force promoting our products with senior sales representatives strategically placed in five regions across the country, supported by local Reeds sales staff. Our sales managers are responsible for all activities related to the sales, distribution, and marketing of our brands to our entire retail partner and distributor network in North America. The Company also employs an internal sales force and engages from time to time and in limited circumstances, independent sales brokers and outside representatives to promote our products.

We sell to well-known popular natural food and gourmet retailers, large grocery store chains, club stores, convenience and drug stores, liquor stores, industrial cafeterias (corporate feeders), and to on premise bars, gourmet restaurants, and delicatessens worldwide. We also sell our products and promotional merchandise directly to consumers via the Internet through our Company website, *www.reedsgingerbrew.com.*

Some of our key customers include:

Natural stores: Whole Foods Market, Sprouts Farmers Market, Natural Grocers, Earth Fare, and Fresh Thyme Famers Market

Gourmet & Specialty stores: Trader Joe's, Bristol Farms, The Fresh Market, and Central Market

Grocery store chains: Kroger, Safeway, Publix, Stop & Shop, H.E.B., and Wegmans

Club and Mass Stores: Costco Wholesale, Target, and Walmart

Liquor stores: BevMo!, Total Wine & More, and Spec's

Convenience & Drug stores: Circle K, Rite Aid, and CVS Pharmacy

Our Distribution Network

Our products are brought to market through direct-store-delivery (DSD), customer warehouse, and distributor networks. The distribution system used depends on customer needs, product characteristics, and local trade practices. Our products are brought to market through an extremely flexible and fluid hybrid distribution model.

Our product reaches the market in the following ways:

Direct to Natural & Specialty Wholesale Distributors

Our natural and specialty distributor partners operate a distribution network delivering thousands of SKUs of natural and gourmet products to thousands of small, independent, natural retail outlets around the U.S., along with national chain customers, both conventional and natural. This system of distribution allows our brands far reaching access to some of the most remote parts of North America.

Direct to Store Distribution (DSD) through alcoholic and non-alcoholic distributor network

Our independent distributor partners operate DSD systems which deliver primarily beverages, foods, and snacks directly to retail stores where the products are merchandised by their route sales and field sales employees. DSD enables us to merchandise with maximum visibility and appeal. DSD is especially well-suited to products frequently restocked and respond to in-store promotion and merchandising.

Direct to Store Warehouse Distribution

Some of our products are delivered from our manufacturing plants and warehouses directly to customer warehouses. Some retailers mandate we deliver directly to them, as it is more cost effective and allows them to pass savings along to their consumer. Other retailers may not mandate direct delivery, but they recommend and prefer it as they have the capability to self-distribute and can realize significant savings with direct delivery.

Wholesale Distribution

Our Wholesale Distributor network handles the wholesale shipments of our products. They have a warehouse, distribution center and ship Reed’s and Virgil’s products directly to the Retailer (or to customers who opt for drop shipping).

International Distribution

We presently export Reed’s and Virgil’s brands throughout international markets via US based exporters. Some markets are: Spain, Mexico, Puerto Rico, Canada, Philippines, U.K., Israel, South Africa, and Australia.

International sales to some areas of the world are cost prohibitive, except for some specialty sales, since our premium sodas are packed in glass, which drives substantial freight costs when shipping overseas. Despite these cost challenges, we believe there are good opportunities for expansion of sales in Canada, the Middle East, England, and Australia and we are increasing our marketing focus on these areas by adding freight friendly packages such as aluminum cans. We are open to exporting and co-packing internationally and expanding our brands into foreign markets, and we have held preliminary discussions with trading companies and import/export companies for the distribution of our products throughout Asia, Europe, Australia, and South America. We believe these areas are a natural fit for Reed’s ginger products, because of the importance of ginger in international markets, especially the Asian market, where ginger is a significant part of diet and nutrition.

We believe the strength of our brands, innovation, and marketing, coupled with the quality of our products and flexibility of our distribution network, allows us to compete effectively.

Agreements

We have entered into agreements with some of our distributors who commit us to “termination fees” if we terminate our agreements early or without cause. These agreements call for our customer to have the right to distribute our products to a defined type of retailer within a defined geographic region. As is customary in the beverage industry, if we should terminate the agreement or not automatically renew the agreement, we would be obligated to make certain payments to our customers. We are in constant review of our distribution agreements with our partners across North America.

Competition

The beverage industry is highly competitive. The principal areas of competition include pricing, packaging, development of new products and flavors, and marketing campaigns. Our products compete with a wide range of drinks produced by a relatively large number of manufacturers. Most of these brands have enjoyed broad, well-established national recognition for years, through well-funded ad and other branding campaigns. In addition, the companies manufacturing these products generally have greater financial, marketing, and distribution resources than we do. Competitors include the brands such as Henry Weinhard's, Thomas Kemper, Hansen's, Izze, and Boylan, and Jones Soda.

Important factors affecting our ability to compete successfully include the taste and flavor of products, trade and consumer promotions, rapid and effective development of new, unique cutting-edge products, attractive and different packaging, branded product advertising, and pricing. We also compete for distributors who will concentrate on marketing our products over those of our competitors, provide stable and reliable distribution, and secure adequate shelf space in retail outlets. Competitive pressures in the soft drink category could also cause our products to be unable to gain or to lose market share or we could experience price erosion.

Despite our products having a relatively high price for an artisanal premium beverage product, minimal mass media advertising, and a relatively small but growing presence in the mainstream market compared to many of our competitors, we believe our all-natural innovative beverage recipes, packaging, use of premium ingredients, and a trade secret brewing process provide us with a competitive advantage and our commitments to the highest quality standards and brand innovation are keys to our success.

Manufacture of Our Products

In 2017, management began concentrated efforts to work toward a business model to outsource our manufacturing processes and develop the operations into a premier sales and marketing company. Management began exploring the utilization of larger, efficient co-packers than the ones we use currently. While we explore these options, we continue to manufacture our product in three locations. Our Los Angeles facility known as "The Brewery," is located at our Company's headquarters, and there we produce certain soda and private label products. On March 24, 2018, the Company received a letter of intent from a party, partially owned by Chris Reed, one of the Company's current officers and directors, for the purchase of substantially all of the assets of the Los Angeles plant. It is anticipated the Board of Directors will approve the offer and the sale is anticipated to close during the summer of 2018. We also partner with two co-pack facilities which assemble our products and charge us a fee, generally by the case, for the products produced by them. These two facilities are in Indiana and Pennsylvania.

Raw Materials

Our products consist of two major raw materials, ingredients, and packaging. Generally, the raw materials used in our products are obtained from domestic and foreign suppliers and most of the materials have multiple, reliable suppliers. This provides a level of protection against a major supply constriction or calamity. Since our raw materials are common ingredients, and supply is easily accessible, we have no long-term contracts with our suppliers.

Substantially all of the raw materials used in the preparation, bottling and packaging of our products are purchased by us or by our contract packers in accordance with our specifications. Reed’s Crystallized Ginger is made to our specifications in Fiji. Reed’s Ginger Candy Chews are made and packed to our specifications in Indonesia.

A significant component of our product cost are the glass bottles used for our drinks. In December 2017, in efforts to restructure our supply chain and drive cost savings in the largest component of our raw material costs, we entered into a strategic partnership with a glass supplier, Owen-Illinois, who will serve as the Company’s exclusive glass supplier. Owen-Illinois will also provide their expertise in embossing and proprietary package design for the Company.

Production

In 2017, in our focused efforts to simplify operations, we streamlined our portfolio of over one hundred separate SKUs to focus on approximately 28 SKUs which comprise primarily two brands: Reeds and Virgil’s with twelve flavors. These two brands have two primary packaging configurations consisting of 24 6 by 4 pack cases and single 12 pack cases.

We also categorize our portfolio by non-core and discontinued SKU's containing multiple brands. The non-core SKU's are being evaluated and include such products as ginger candy, private label, and specialty packaging such as swing top lid beverages. The discontinued products category is defined as SKU's not in the Company's immediate production plans. Reed's may re-introduce these items as market conditions change or improve.

Management is constantly in the process of evaluating SKUs to maximize products with favorable results and make room for new inventions.

Warehousing and Distribution

Raw material handling and finished goods delivery costs also account for a significant portion of the Company's manufacturing and delivery processes. In December 2017, the Company entered into a strategic partnership with R.C. Moore as its primary logistics partner for North America. R.C. Moore, by utilizing their supply chain management expertise, transportation assets, and their beverage industry experience, will help the Company reduce logistics costs.

We follow a "fill as needed" manufacturing model to the best of our ability and have no significant order backlog.

New Product Development

While we are simplifying our business and streamlined dozens of SKUs in 2017 in order to further our primary objective of accelerating the growth of the Reed's and Virgil's core product offerings, we believe significant opportunity remains in the all-natural beverage space. Healthier alternatives will be the future for carbonated soft drinks. We will continue to drive product development in the all-natural, no and low sugar offerings in the "better for you" beverage categories. In addition, we believe there are powerful consumer trends that will help propel the growth of our brand portfolio including the increased consumption of ginger as a recognized superfood, the growing use of ginger beer in today's popular cocktail drinks, and consumers increased demand for higher quality, all-natural handcrafted beverages.

In 2017, with Chris Reed, the Company's founder and former Chief Executive Officer, appointed to the newly created position of Chief Innovation Officer and directing his full energies toward new offerings, we developed our first natural soda fountain products and continued a trial in a large national, casual, restaurant chain. We also continued the development of our compelling line of full flavor, all-natural, low calories sodas. These sodas contain only a fraction of the calories of traditional sugar-based sodas yet still have the full, robust taste of traditional sodas.

We believe as we continue to transform our business model, it will enhance our ability to be nimble and innovative, producing new products in a short period of time**.**

Proprietary Rights

We own trademarks we consider material to our business. Three of our material trademarks are registered trademarks in the U.S. Patent and Trademark Office: Reed’s Original Ginger Brew All-Natural Jamaican Style Ginger Ale ®, and Virgil’s ®. . 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.

In addition, we consider our finished product and concentrate formulae, which are not the subject of any patents, to be trade secrets. Our brewing process is a trade secret. This process can be used to brew flavors of beverages other than ginger ale and ginger beer, such as root beer, cream soda, cola, and other spice and fruit beverages. We have not sought any patents on our brewing processes because we would be required to disclose our brewing process in patent applications.

We generally use non-disclosure agreements with employees and distributors to protect our proprietary rights.

Regulation

The production, distribution and sale in the United States of many of our Company’s products are subject to the Federal Food, Drug, and Cosmetic Act, the Federal Trade Commission Act, the Lanham Act, state consumer protection laws, federal, state and local workplace health and safety laws, various federal, state and local environmental protection laws, and various other federal, state and local statutes and regulations applicable to the production, transportation, sale, safety, advertising, labeling and ingredients of such products. Outside the United States, the distribution and sale of our many products and related operations are also subject to numerous similar and other statutes and regulations.

A California law requires a specific warning appear on any product containing a component listed by the state as having been found to cause cancer or birth defects. The law exposes all food and beverage producers to the possibility of having to provide warnings on their products. This is because the law recognizes no generally applicable quantitative thresholds below which a warning is not required. Consequently, even trace amounts of listed components can expose affected products to the prospect of warning labels. Products containing listed substances occurring naturally or contributing to such products solely by a municipal water supply are generally exempt from the warning requirement. No Company beverages produced for sale in California are currently required to display warnings under this law. We are unable to predict whether a component found in a Company product might be added to the California list in the future, although the state has initiated a regulatory process in which caffeine and other natural occurring substances will be evaluated for listing. Furthermore, we are also unable to predict when or whether the increasing sensitivity of detection methodology may become applicable under this law and related regulations as they currently exist, or as they may be amended, might result in the detection of an infinitesimal quantity of a listed substance in a beverage of ours produced for sale in California.

Bottlers of our beverage products presently offer and use non-refillable, recyclable containers in the United States and various other markets around the world. Some of these bottlers also offer and use refillable containers, which are also recyclable. Legal requirements apply in various jurisdictions in the United States and overseas requiring deposits or certain taxes or fees be charged for the sale, marketing and use of certain non-refillable beverage containers. The precise requirements imposed by these measures vary. Other types of beverage container-related deposit, recycling, tax and/or product stewardship statutes and regulations also apply in various jurisdictions in the United States and overseas. We anticipate additional, similar legal requirements may be proposed or enacted in the future at local, state and federal levels, both in the United States and elsewhere.

All of our facilities and other operations in the United States are subject to various environmental protection statutes and regulations, including those relating to the use of water resources and the discharge of wastewater. Our policy is to comply with all such legal requirements. Compliance with these provisions has not had, and we do not expect such compliance to have, any material adverse effect on our capital expenditures, net income or competitive position.

Environmental Matters

Our primary cost environmental compliance activity is in recycling fees and redemption values. We are required to collect redemption values from our customers and remit those redemption values to the state, based upon the number of bottles of certain products sold in the state.

Our Employees

We have 52 full-time equivalent employees on our corporate staff down from 62 in the year ended December 31, 2017. The table below lists the departments. We employ additional people on a part-time basis as needed. We have never participated in a collective bargaining agreement. We believe relations with our employees are good.

	Number of FTE's		
Department	2017	2016	Change
General Management	4.7	4.0	0.7
Administrative Support	8.1	9.2	(1.1)
Research & Development	5.6	5.5	0.1
Sales	11.7	16.0	(4.3)
Production & Warehouse	22.3	27.7	(5.4)
Total	52.3	62.4	(10.1)

A full-time equivalent is based on 2,080 work hours in a calendar year. If an employee worked part-time, he or she would be a fraction of a a full-time equivalent.

Available Information

We are required to file annual, quarterly and current reports, proxy statements, and other information with the U.S. Securities and Exchange Commission (SEC). The public may read and copy any materials we file with the SEC at the SEC’s Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. Information on the operation of the Public Reference Room may be obtained by calling the SEC at 1-800-SEC-0330. In addition, the SEC maintains an Internet site containing reports, proxy and information statements, and other information regarding issuers filing electronically with the SEC at http://www.sec.gov.

Our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, proxy statements and amendments to those documents filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended (Exchange Act), are also available free of charge on our Internet site at http://www.reedsinc.com as soon as reasonably practicable after such reports are electronically filed with or furnished to the SEC.

Investors should note we currently announce material information to our investors and others using filings with the SEC, press releases, public conference calls, webcasts or our corporate website (www.reedsinc.com), including news and announcements regarding our financial performance, key personnel, our brands, and our business strategy. Information we post on our corporate website could be deemed material to investors. We encourage investors, the media, our customers, consumers, business partners, and others interested in us to review the information we post on these channels. We may from time to time update the list of channels we will use to communicate information deemed material and will post information about any such change on www.reedsinc.com. The information on our website is not, and shall not be deemed to be, a part hereof or incorporated into this or any of our other filings with the SEC.

Item 2. Property

We lease a facility of approximately 76,000 square feet, which serves as our principal executive offices, our West Coast Brewery and bottling plant and our Southern California warehouse facility. Approximately 30,000 square feet of the total space is leased under a long-term lease expiring in 2024.

Item 3. Legal Proceedings

From time to time, we are a party to claims and legal proceedings arising in the ordinary course of business. Our management evaluates our exposure to these claims and proceedings individually and in the aggregate and provides for potential losses on such litigation if the amount of the loss is estimable and the loss is probable.

Item 4. Mine Safety Disclosures

Not applicable.

PART II

Item 5. Market for Common Equity and Related Stockholder Matters

Our common stock is listed for trading on the NYSE American trading under the symbol "REED". The following is a summary of the high and low bid prices of our common stock on the NYSE American Capital Markets for the periods presented:

	Sales Price	
	High	Low
Year Ending December 31, 2016		
First Quarter	$5.46	$4.62
Second Quarter	4.85	2.37
Third Quarter	3.74	2.51
Fourth Quarter	4.25	3.86
Year Ending December 31, 2017		
First Quarter	$4.35	$3.65
Second Quarter	4.75	2.40
Third Quarter	2.55	1.55
Fourth Quarter	2.30	1.40

As of December 31, 2017, there were approximately 4,500 stockholders of record of the common stock (including only non-objecting beneficial owners of record) and 24,619,591 outstanding shares of common stock.

Registered and Unregistered Sales of Equity Securities

During the year ended December 31, 2017, we issued the following equity securities that were registered under the Securities Act:

Issued 58,065 shares of its common stock to certain members of the board of directors valued at $1.55 per share with an aggregate value of $90,000 for services rendered.

Issued 1,122,376 shares of its common stock at $1.50 per share with gross proceeds of $1,684,000 in connection with the exercise of investor warrants.

Issued 9,333,333 shares of its common stock at $1.50 per share with gross proceeds of $14,000,000 in connection with a Rights Offering.

Issued 117,647 shares of its common stock to a member of the board of directors valued at $1.70 per share with gross proceeds of $200,000.

Also during the year ended December 31, 2017, we issued the following equity securities that were unregistered under the Securities Act:

Issued 4,300 shares of its common stock to a related party valued at $2.20 per share with an aggregate value of $9,000 for services rendered.

Dividend Policy

We have never declared or paid dividends on our common stock. We currently intend to retain future earnings, if any, for use in our business, and, therefore, we do not anticipate declaring or paying any dividends in the foreseeable future. Payments of future dividends, if any, will be at the discretion of our board of directors after taking into account various factors, including the terms of our credit facility and our financial condition, operating results, current and anticipated cash needs, and plans for expansion.

We are obligated to pay a non-cumulative 5% dividend from lawfully available assets to the holders of our Series A preferred stock in additional shares of common stock at our discretion. In 2017 and 2016, we paid dividends on our Series A preferred stock in an aggregate of $5,000 and in 2017 and 2016, issued 1,640 and 1,504 shares of common stock in each year, respectively, and anticipate we will be obligated to issue at least these many shares annually to the holders of the Series A preferred stock so long as such shares are issued and outstanding.

Securities Authorized for Issuance Under Equity Compensation Plans

2007 Stock Option Plan, 2015 Incentive and Non-statutory and Stock Option Plan, and the 2017 Incentive Compensation plan

On October 8, 2007, our board of directors adopted the 2007 Stock Option Plan for 1,500,000 shares and the plan was approved by our stockholders on November 19, 2007. On December 30, 2015, the 2015 Incentive and Non-statutory Stock Option Plan for 500,000 shares was approved by our shareholders. Options issued and subsequently forfeited under the under the 2015 plan cannot be reissued. In 2017 the 2007 plan expired and no new options will be granted under the plan. On September 29, 2017, the 2017 Compensation Plan for 3,000,000 shares was approved by our shareholders. Options issued and forfeited under the 2017 plan contain an Evergreen provision and cannot be re-priced without shareholder approval.

The plans permit the grant of options and stock awards to our employees, directors and consultants. The options may constitute either “incentive stock options” within the meaning of Section 422 of the Internal Revenue Code or “non-qualified stock options”. The primary difference between “incentive stock options” and “non-qualified stock options” is that once an option is exercised, the stock received under an “incentive stock option” has the potential of being taxed at the more favorable long-term capital gains rate, while stock received by exercising a “non-qualified stock option” is taxed according to the ordinary income tax rate schedule.

The plans are currently administered by the board of directors. The plan administrator has full and final authority to select the individuals to receive options and to grant such options as well as a wide degree of flexibility in determining the terms and conditions of options, including vesting provisions.

The exercise price of an option granted under the plan cannot be less than 100% of the fair market value per share of common stock on the date of the grant of the option. The exercise price of an incentive stock option granted to a person owning more than 10% of the total combined voting power of the common stock must be at least 110% of the fair market value per share of common stock on the date of the grant. Options may not be granted under the plan on or after the tenth anniversary of the adoption of the plan. Incentive stock options granted to a person owning more than 10% of the combined voting power of the common stock cannot be exercisable for more than five years.

When an option is exercised, the purchase price of the underlying stock will be paid in cash, except that the plan administrator may permit the exercise price to be paid in any combination of cash, shares of stock having a fair market value equal to the exercise price, or as otherwise determined by the plan administrator.

If an optionee ceases to be an employee, director, or consultant with us, other than by reason of death, disability or retirement, all vested options must be exercised within three months following such event. However, if an optionee's employment or consulting relationship with us terminates for cause, or if a director of ours is removed for cause, all unexercised options will terminate immediately. If an optionee ceases to be an employee or director of, or a consultant to us, by reason of death, disability, or retirement, all vested options may be exercised within one year following such event or such shorter period as is otherwise provided in the related agreement.

For the 2015 plan, when a stock option expires or is terminated before it is exercised, the shares are canceled and cannot be reissued. For the 2017 plan, when a stock option expires or is terminated before it is exercised, the shares are not replenished. The option strike price cannot be re-priced without shareholder approval

No option can be granted under any plan after ten years following the earlier of the date the plan was adopted by the board of directors or the date the plan was approved by our stockholders.

Equity Compensation Plan

The following table provides information, as of December 31, 2017, with respect to equity securities authorized for issuance under compensation plans:

Plan Category	Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights (a)	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights (b)	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (excluding securities reflected in Column (a)
Equity compensation plans approved by security holders	4,048,500	$ 4.68	3,087,500
Equity compensation plans not approved by security holders	62,365	$ 1.55	-
TOTAL	4,110,865	$ 4.63	3,087,500

On January 10, 2018, pursuant to its employment agreement with Valentin Stalowir dated June 28, 2017, the Company’s board of directors granted to Mr. Stalowir 371,218 restricted stock units and options to purchase 371,218 shares of stock. The securities are to be issued pursuant to Reed’s 2017 Incentive Compensation Plan. The options will have an exercise price of $1.70. Other terms of the granted securities will be set by Reed’s compensation committee in compliance with the 2017 Incentive Compensation Plan.

Item 6. Selected Financial Data

As a smaller reporting company, Reed’s is not required to provide the information required by this Item 6.

Item 7. 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 Annual Report. This discussion and analysis may contain forward-looking statements based on assumptions about our future business. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including but not limited to those set forth under "Risk Factors" and elsewhere in this Annual Report.

Results of Operations

The following table sets forth key statistics for the years ended December 31, 2017 and 2016, respectively.

	Year Ended December 31, 2017	2016	Pct. Change
Gross sales	41,718,000	46,198,000	-10 %
Less: Promotional and other allowances	4,004,000	3,726,000	7 %
Net sales	$37,714,000	$42,472,000	-11 %
Cost of tangible goods sold	27,780,000	31,626,000	-12 %
As a percentage of:			
Gross sales	67 %	68 %	
Net sales	74 %	74 %	
Cost of goods sold – idle capacity	3,041,000	1,604,000	90 %
As a percentage of net sales	8 %	4 %	
Gross profit	6,893,000	9,242,000	-25 %
Gross profit margin as a percentage of net sales	18 %	22 %	

(a) Gross sales: Gross sales is used internally by management as an indicator of and to monitor operating performance, including sales performance of particular products, salesperson performance, product growth or declines and overall Company performance. The use of gross sales allows evaluation of sales performance before the effect of any promotional items, which can mask certain performance issues. We therefore believe that the presentation of gross sales provides a useful measure of our operating performance. Gross sales is not a measure that is recognized under Generally Accepted Accounting Principles "GAAP" and should not be considered as an alternative to net sales, which is determined in accordance with GAAP, and should not be used alone as an indicator of operating performance in place of net sales. Additionally, gross sales may not be comparable to similarly titled measures used by other companies, as gross sales have been defined by our internal reporting practices. In addition, gross sales may not be realized in the form of cash receipts as promotional payments and allowances may be deducted from payments received from certain customers.

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(b) Promotional and other allowances: Although the expenditures described in this line item are determined in accordance with GAAP and meet GAAP requirements, the disclosure thereof does not conform with GAAP presentation requirements. Additionally, our definition of promotional and other allowances may not be comparable to similar items presented by other companies. Promotional and other allowances primarily include consideration given to the Company's distributors or retail customers including, but not limited to the following: (i) reimbursements given to the Company's distributors for agreed portions of their promotional spend with retailers, including slotting, shelf space allowances and other fees for both new and existing products; (ii) the Company's agreed share of fees given to distributors and/or directly to retailers for in-store marketing and promotional activities; (iii) the Company's agreed share of slotting, shelf space allowances and other fees given directly to retailers; (iv) incentives given to the Company's distributors and/or retailers for achieving or exceeding certain predetermined sales goals; and (v) discounted or free products. The presentation of promotional and other allowances facilitates an evaluation of their impact on the determination of net sales and the spending levels incurred or correlated with such sales. Promotional and other allowances constitute a material portion of our marketing activities. The Company's promotional allowance programs with its numerous distributors and/or retailers are executed through separate agreements in the ordinary course of business. These agreements generally provide for one or more of the arrangements described above and are of varying durations, ranging from one week to one year.

(c) Cost of tangible goods sold: Cost of tangible goods sold consists of the costs of raw materials and packaging utilized in the manufacture of products, co-packing fees, repacking fees, in-bound freight charges, inventory adjustments, as well as certain internal transfer costs. Cost of tangible goods sold is used internally by management to measure the direct costs of goods sold, aside from unallocated plant costs. Cost of tangible goods sold is not a measure that is recognized under GAAP and should not be considered as an alternative to cost of goods sold, which is determined in accordance with GAAP, and should not be used alone as an indicator of operating performance in place of cost of goods sold.

(d) Cost of goods sold – idle capacity: Cost of goods sold – idle capacity consists of direct production costs in excess of charges allocated to our finished goods in production. Plant costs in excess of production allocations are expensed in the period incurred rather than added to the cost of finished goods produced. Plant costs include labor costs, production supplies, repairs and maintenance, and inventory write-off. Our charges for labor and overhead allocated to our finished goods are determined on a market cost basis, which is lower than our actual costs incurred. Cost goods sold – idle capacity is not a measure that is recognized under GAAP and should not be considered as an alternative to cost of goods sold, which is determined in accordance with GAAP, and should not be used alone as an indicator of operating performance in place of cost of goods sold.

Anticipated Sale of the Los Angeles Plant:

On March 24, 2018, the Company received a letter of intent from a party, partially owned by Chris Reed, one of the Company's current officers and directors, for the purchase of substantially all of the assets of the Los Angeles plant. It is anticipated the Board of Directors will approve the offer and the sale is anticipated to close during the summer of

2018. The letter of intent offers the Company $1,250,000 in cash for the LA plant buildings, equipment, and fixed assets. In addition, the Company will be relieved of the $1,472,000 long-term liability attached to the property. Based on the terms of the offer, the Company has recorded an impairment charge totaling $5,925,000, representing the difference between the offer terms and the net book value of the assets to be sold and the relief of the long-term liability.

Year ended December 31, 2017 Compared to Year ended December 31, 2016

Top line

Volume - During the first half of the year, the core brands continued to decline, reaching a year over year decline rate of 8.2%. The entire portfolio, that includes products that were impacted by our SKU rationalization, decreased at a greater pace, reaching a year over year decline rate of 16.3%. During the second half of the year, the volume decline slowed and was cut almost in half from 8.2% to 4.3% as compared to the same period in the prior year. The overall portfolio that included private label grew at a 1.9% improvement over prior year. For the year ended December 31, 2017, the core volume sequential trend, improved each quarter and is expected to improve into 2018.

Volume	**Q1**	**Q2**	**Q3**	**Q4**	**Total**
Reeds 12 ounce cases	293,133	294,336	293,532	249,228	1,109,733
Virgils 12 ounce cases	187,506	209,487	228,325	174,891	793,997
Core 12 ounce volume	480,639	503,823	521,857	424,119	1,903,730
Core Volume vs PY	-3.8 %	-8.2 %	-7.0 %	-4.3 %	-7.3 %
Total Volume vs PY	-13.8 %	-16.3 %	-12.4 %	1.9 %	-10.6 %

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Case Selling price - The Company initiated its first price increase for core products in over 6 years in August of 2017. Previously, the increase in selling price mix was driven by product offerings such as Kombucha and masked the lack of a price increases for our core premium products. The price increase took effect in mid-3rd quarter leading to a 4% growth in selling price per case year over year. The positive trend continued into the 4th quarter with a 6% growth in selling price per case year over year. The company expects this trend to continue through the first half of 2018 as the SKU rationalization improves the mix.

Sales price	**Q1**	**Q2**	**Q3**	**Q4**	**Total**
Core rev/case 2017	$17.86	$18.00	$18.32	$18.71	$18.14
Core rev/case 2016	$17.39	$17.66	$17.62	$17.64	$17.58
Core Beverage selling price vs PY	2.7 %	1.9 %	4.0 %	6.0 %	3.2 %

Case Cost of goods sold – As the Company turned its focus to core brands the Company began to realize a decline in cost of goods sold. By the 4th quarter, we had rolled back the 2017 costs of $11.33 per case to the prior year's average. The sequential trend in improvement that began in 2017 is expected to continue into 2018 as new supplier alliances are realized that include our new glass provider. Glass is our number one cost.

Cost of goods sold	**Q1**	**Q2**	**Q3**	**Q4**	**Total**
Core cogs/case 2017	$11.96	$11.83	$11.72	$11.33	$11.66
Core cogs/case 2016	$11.35	$11.26	$11.23	$11.58	$11.34
Core Beverage COGS vs PY	5.3 %	5.1 %	4.4 %	-2.2 %	2.8 %

Other Top Line Revenue and Costs - Consistent with historical accounting practices, discounts are not allocated to individual brands, flavors, or individual SKUs. Also consistent with historical accounting practices, total manufacturing costs, that is more than $2.00 for every case manufactured in Los Angeles, is expensed immediately rather than capitalized as part of inventory; these manufacturing costs are called idle plant costs – a non-GAAP measure. The chart below provides a reconciliation for years ended December 31 respectively. These additional costs on a percentage of gross sales as reported above and includes non-core activity.

Promotional costs – Total discounts during the year were $4,004,000 an increase of 1.5% based on a percentage of sales or $278,000 versus total discounts of $3,726,000 in the prior year. The increase of 1.5% is a direct reflection of lower volume.

Idle Plant – Idle Plant costs totaled $3,041,000 compared to $1,604,000 in the prior year. Idle plant costs as a percentage of sales grew 3.3% over the prior year. The increase is a direct reflection of not operating the LA Brewery to its full capacity in the first quarter of 2017, resulting in additional freight and handling expenses as the Company moved product from the east coast to our customers on the west coast.

Reserve adjustments - decreased 1.6% during the year versus the same period in the prior year as a percentage of sales and $32,000 in dollars. The decrease of 1.6% represented a 140% increase over the prior year and is a direct reflection of the reduction in inventory waste.

Top Line Reconciliation	2017	2016	Diff.	Pct.
Promotional costs as % of sales	-9.6 %	-8.1 %	-1.5%	19.0 %
Idle plant costs as % of sales	-7.3 %	-4.0 %	-3.3%	80.6 %
Total Other Top Line dilution	-16.9%	-12.1%	-4.8%	39.5 %
Gross profit above	34.7 %	34.4 %	0.3 %	0.9 %
Net Margin	17.8 %	22.3 %	-4.5%	-20.1 %
Reserve adjustments	0.5 %	-1.2 %	1.6 %	-139.9%
Reported margin	18.3 %	21.1 %	-2.9%	-13.6 %

Other	Q1	Q2	Q3	Q4	Total
Candy Gross Profit	$139,000	$75,000	$127,000	$152,000	$493,000
Sales Discounts	$1,059	$868	$1,178	$899	$4,004
Sales Discounts as a % of sales vs PY	37 %	3 %	-2 %	-1 %	7 %
Idle Plant	$788	$588	$799	$866	$3,041
Idle Plant as % of sales vs PY	233 %	5 %	439 %	-9 %	72 %

Top Line Summary - The transition from a manufacturing focused enterprise to a sales and marketing focused enterprise has begun. The sequential top line improvement reflects higher selling prices and lower COGS on an improving volume base. The LA plant cost structure continues to weigh on the top line margin. We believe that as the transition continues into 2018 all three key metrics of volume, price, and COGS will continue to improve sequentially.

<u>Operating Expenses</u>

Delivery and handling expense - increased 1.0% during the year versus the same period in the prior year and $40,000 in dollars. The increase of 1.0% was due to an increase in freight charges of $173,000 and additional labor related charges of $48,000 that were partially offset by a reduction in warehouse rentals of $181,000. As a percentage of sales, costs increased over the same period in the prior year by 13.7% to 10.4%. We believe that costs related to freight will decrease in 2018 to our historic norm of less than 10% of sales as production occurs closer to the customers and that cross-country shipping will decrease significantly.

Delivery and handling expense	**2017**	**2016**	**Diff**	**Change**
Total expenses	3,942	3,902	40	1.0 %
% of net sales	10.4 %	9.2 %	1.3 %	13.7 %
In dollars				
Freight	3,121	2,948	173	5.9 %

Labor	97	49	48	98.0	%
Warehouse	724	905	(181)	-20.1	%

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Selling and marketing expense declined 18.4% due to a reduction in staff, lower trade show related expenses, and lower sales support in terms of brokers. With the transition fully implemented, we expect the spending in this category to double in 2018 as open positions are filled, advertising expenses are incurred, and brokerage firms are utilized.

Selling and marketing expense	**2017**	**2016**	**Diff**	**Change**
Total expenses	3,021	3,701	(680)	-18.4 %
% of net sales	8.0 %	8.7 %	-0.7 %	-8.1 %
In dollars				
Sales Labor	1,595	2,014	(419)	-20.8 %
Sales Support	567	663	(96)	-14.5 %
Advertising	491	484	7	1.4 %
Sales Trade	368	540	(172)	-31.8 %

General and administrative expense increased 163.2% or $7.2MM largely due to impairment charges of $5,925,000 for equipment that was determined not be used by the Company for the originally intended purposes and for the anticipated sale of the Los Angeles plant. See previous discussion above of the sale of the plant anticipated to close in the summer of 2018. There were higher director fees for services, higher support services that included research and development costs, legal fees, I.T. related costs and higher costs indirectly related to the rights offering. We do not expect to incur further impairment costs and anticipate lower director expenses in 2018.

General and administrative expense	2017	2016	Diff	Change
Total expenses	11,679	4,438	7,241	163.2 %
% of net sales	31.0 %	10.4 %	20.6 %	197.8 %
In dollars				
Other (impairments)	5,925	484	5,441	1124.2%
G&A Labor	2,348	2,154	194	9.0 %
Director Services	1,165	214	952	445.5 %
G&A Support (rent, depreciation)	1,149	889	260	29.2 %
G&A Services (people)	711	479	232	48.5 %
Shareholder related	380	218	162	74.6 %

Financing expenses – The Company had distinct financing transactions during the year in addition to the reoccurring borrowing costs from prior years. For discussion purposes, the categories are interest, convertible note activity and warrant activity.

Interest – Interest paid in cash during the year increased due to new financing obtained in April 2017 and a full year of CAPEX interest charges of $161,000 plus immaterial changes in borrowing and fees for other loan types. Interest expense also includes the cost of the warrants issued in connection with the April financing, which is effectively considered a borrowing cost.

Convertible note activity - In April, the Company issued a convertible note with a face value of $3,400,000. In conjunction with the shareholder rights offering in December, this note was extinguished, and a new note was issued with substantially different terms. The interest, warrants, and notes are explained in detail in the footnotes to following financial statements.

Warrant activity - as noted in the second quarter of 2017, the Company recognized a gain from the change in the fair value of outstanding warrants of $3,275,000 that was partially offset by eliminating the liability terms in the third quarter of 2017 and by the subsequent exercise of some warrants outstanding at that time. The net adjustment of all warrant activity and the extinguishment of debt related the convertible note that flowed through the profit and loss statement was expense totaling $357,000.

Other	2017	2016	Diff	Change	
Interest expense	3,491	1,978	1,513	76.5	%
Financing costs and warrant modification	2,776	-	2,776	-	
Warrant liability and extinguishment of convertible note	357	232	125	53.9	%

Liquidity – In recognition of the need to financially restructure the Company, the shareholders authorized an additional 20,000,000 shares of common stock at 2017 annual meeting of shareholders. The authority to issue more equity in conjunction with the rights offering financing structure provided a mechanism for existing shareholders to maintain their equity interest in the financing that closed on December 18, 2017 and funded on December 28, 2017. The shareholders over subscribed to the offering and the Company raised $14,000,000 for purposes fully described in the rights offering prospectus dated December 12, 2017.

During the 4th quarter of 2017, all of the debt owed to PMC became due within one year on October 21, 2018. The Company will use the rights offering proceeds to facilitate an orderly transition to a sustainable financial structure with significantly reduced borrowing rates. In January 2018, the Company deployed capital to pay past due vendors, paid down the line of credit, and is holding cash for operations and final sale of the Los Angeles plant. See Liquidity and Capital Resources section following for detailed discussion.

Summary

We believe 2017 marked a turning point in the life of the Company. While sales and overall operating results did not outpace the prior year, 2017 is a year of new beginnings for Reed’s. With shareholder approval and financial support, the new leadership has turned the focus to the core products. The decisions made by the new leadership team have led to a sequential improvement quarter over quarter in volume, selling price, and cost of goods sold. These metrics will ensure Reed’s will maintain its leadership position in the healthy beverage and natural craft soda marketplace.

Modified EBITDA

In addition to our GAAP results, we present Adjusted EBITDA as a supplemental measure of our performance. However, Adjusted EBITDA is not a recognized measurement under GAAP and should not be considered as an alternative to net income, income from operations or any other performance measure derived in accordance with GAAP or as an alternative to cash flow from operating activities as a measure of liquidity. We define Adjusted EBITDA as net income (loss), plus depreciation and amortization, interest expense, reserve for replacement on fixed assets, impairment loss on brand names, stock-based compensation, and convertible note and warrant activity.

Management considers our core operating performance to be that which our managers can affect in any particular period through their management of the resources that affect our underlying revenue and profit generating operations that period. Non-GAAP adjustments to our results prepared in accordance with GAAP are itemized below. You are encouraged to evaluate these adjustments and the reasons we consider them appropriate for supplemental analysis. In evaluating Adjusted EBITDA, you should be aware that in the future we may incur expenses that are the same as or similar to some of the adjustments in this presentation. Our presentation of Adjusted EBITDA should not be construed as an inference that our future results will be unaffected by unusual or non-recurring items.

Set forth below is a reconciliation of Adjusted EBITDA to net loss for the years ended December 31, 2017 and 2016:

MODIFIED EBITDA SCHEDULE

	Years ended December 31,	
	2017	2016
	(unaudited)	(unaudited)
Net loss	$(18,373,000)	$(5,009,000)
Modified EBITDA adjustments:		
Depreciation and amortization	739,000	642,000
Interest expense	2,112,000	1,724,000
Stock option and warrant compensation	1,055,000	673,000
Impairment charges	5,925,000	484,000
Noncash charges related to our convertible note and warrants	4,324,000	232,000
Total EBITDA adjustments	$14,155,000	$3,755,000
Modified EBITDA	$(4,218,000)	$(1,254,000)

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Liquidity and Capital Resources

As of December 31, 2017, we had stockholder’s equity of $508,000 and working capital of $2,303,000, compared to stockholder’s deficit of $1,657,000 and working capital deficit of $1,563,000 at December 31, 2016. The increase in our working capital was primarily a result of shareholder rights offering in December 2017. The overall change in our shareholders’ equity was the result of the rights offering, offset by impairment charges taken on our plant and fixed assets in connection with our anticipated sale of the Los Angeles plant in the summer of 2018. See further discussion above and in the notes to the financial statements regarding the sale of the plant .

Our increase in cash and cash equivalents to $12,127,000 at December 31, 2017 compared to $451,000 at December 31, 2016, an increase of $11, 676,000 that was a result of $15,911,000 generated by financing activities less cash used for costs of plant improvements of $813,000 and use of cash for operations of $3,422,000.

For the year ended December 31, 2017, the Company recorded a net loss of $18,373,000 and utilized cash in operations of $3,422,000. During the year ended December 31, 2017, the company experienced significant financing shortages and engaged in three separate transactions to raise capital. The first transaction completed in April raised a net $3,083,000 by issuing a convertible note to Raptor/Harbor Reeds SPV LLC, the second transaction in July involved certain current warrant holders exercising their warrant holdings for $1,650,000 in exchange for other warrants and third and final transaction in December raised a net $13,087,000 from existing shareholders.

As of December 31, 2017, the Company had a cash balance of $12,127,000 and had available borrowing on our existing line of credit of $1,012,000. We estimate the Company currently has sufficient cash and liquidity to meet its anticipated working capital for the next twelve months. The Company’s secured working capital facility with $3.3 million of outstanding borrowings at December 31, 2017, will expire in October 2018, which we believe will be renewed or can be replaced. In addition, the Company’s bank notes (“Notes”), totaling $6.9 million also become due in October 2018. The Company believes it can successfully restructure its debt before the Notes mature. If not, the Company has sufficient cash on hand and borrowing capacity under its working capital facility to retire the Notes.

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

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

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

The accompanying financial statements have been prepared under the assumption that the Company will continue as a going concern. Such assumption contemplates the realization of assets and satisfaction of liabilities in the normal course of business.

As previously mentioned, the Company anticipates a closing of the sale of the Los Angeles plan to be completed in the summer 2018. These actions may lead to certain charges including, but not limited to additional cash-related expenses, non-cash impairment charges, discontinued operations and/or other costs in connection with exit and disposal activities. Such transactions will be recognized when appropriate and may require cash payments for obligations such as one-time employee involuntary termination benefits, lease and other contract termination costs, costs to close facilities, employee relocation costs and ongoing benefit arrangements.

The net of these charges and losses from operations may further decrease the shareholder equity and negatively impact the Company's continued listing criteria with the NYSE. Should we not meet the criteria, we believe the Company will be provided sufficient time by the NYSE to meet the criteria. There can be no assurance that we will be able to meet the listing criteria on acceptable terms with the NYSE. The Company will continue to evaluate its options and apprise shareholders should these events occur.

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 risk of loss transfers to our customers, and collection of the receivable is reasonably assured, which generally occurs when the product is shipped. 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.

Segments. The Company operates in one segment for the manufacture and distribution of our products. In accordance with the “Segment Reporting” Topic of the ASC, the Company’s chief operating decision maker has been identified as the Chief Executive Officer and President, who reviews operating results to make decisions about allocating resources and assessing performance for the entire Company. Existing guidance, which is based on a management approach to segment reporting, establishes requirements to report selected segment information quarterly and to report annually entity-wide disclosures about products and services, major customers, and the countries in which the entity holds material assets and reports revenue. All material operating units qualify for aggregation under “Segment Reporting” due to their similar customer base and similarities in: economic characteristics; nature of products and services; and procurement, manufacturing and distribution processes. Since the Company operates in one segment, all financial information required by “Segment Reporting” can be found in the accompanying consolidated financial statements

Long-Lived Assets. Management assesses the carrying value of property and equipment whenever events or changes in circumstances indicate the carrying value may not be recoverable. If there is indication of impairment, management prepares an estimate of future cash flows 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. For the year ended December 31, 2017, the Company recognized a $5,925,000 charge for impairments for its property and equipment in anticipation of the sale of the Los Angeles plant to be completed in the summer 2018. For the year ended December 31, 2016, the Company recognized a charge for impairments totaling $260,000 for obsolete equipment deemed no longer needed under the plans at that time for the Los Angeles plant completion.

Intangible assets are comprised of indefinite-lived brand names acquired and have been assigned an indefinite life as we currently anticipate that these brand names will contribute cash flows to the Company perpetually. These indefinite-lived intangible assets are not amortized but are assessed for impairment annually and evaluated annually to determine whether the indefinite useful life is appropriate. As part of our impairment test, we first assess qualitative factors to determine whether it is more likely than not the indefinite-lived intangible asset is impaired. If further testing is necessary, we compare the estimated fair value of our indefinite-lived intangible asset with its book value. If the carrying amount of the indefinite-lived intangible asset exceeds its fair value, as determined by its discounted cash flows, an impairment loss is recognized in an amount equal to that excess. For the year ended December 31, 2016, the Company recognized impairment charges related to its China Cola brand, totaling $224,000. No impairment charges were necessary during the year ended December 31, 2017.

Management believes 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. The Company periodically issues stock options and warrants to employees and non-employees in non-capital raising transactions for services and for financing costs. The Company accounts for stock option and warrant grants issued and vesting to employees based on the authoritative guidance provided by the Financial Accounting Standards Board (FASB) whereas the value of the award is measured on the date of grant and recognized as compensation on the straight-line basis over the vesting period. The Company accounts for stock option and warrant grants issued and vesting to non-employees in accordance with the authoritative guidance of the FASB whereas the value of the stock compensation is based upon 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 instruments is complete. Options granted to non-employees are revalued each reporting period to determine the amount to be recorded as an expense in the respective period. As the options vest, they are valued on each vesting date and an adjustment is recorded for the difference between the value already recorded and the then current value on the date of vesting. In certain circumstances where there are no future performance requirements by the non-employee, option grants are immediately vested and the total stock-based compensation charge is recorded in the period of the measurement date.

The fair value of the Company's stock option and warrant grants are estimated using the Black-Scholes-Merton Option Pricing model, which uses certain assumptions related to risk-free interest rates, expected volatility, expected life of the stock options or warrants, and future dividends. Compensation expense is recorded based upon the value derived from the Black-Scholes Option Pricing model, and based on actual experience. The assumptions used in the Black-Scholes-Merton Option Pricing model could materially affect compensation expense recorded in future periods.

We believe there have been no significant changes, during the year ended December 31, 2017, 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, 2017.

Recent Accounting Pronouncements

See Note 2 of the financial statements for a discussion of recent accounting pronouncements.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

As a smaller reporting company, Reed's is not required to provide the information required by this Item 7A.

Item 8. Financial Statements

Report of Independent Registered Public Accounting Firm

To the Board of Directors

Reeds, Inc.

Los Angeles, California

Opinion on the Financial Statements

We have audited the accompanying balance sheets of Reeds, Inc. (the “Company”) as of December 31, 2017 and 2016, the related statements of operations, stockholders’ equity (deficit), and cash flows for the years then ended, and the related notes (collectively referred to as the “financial statements”). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2017 and 2016, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Basis for Opinion

These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on the Company’s financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (“PCAOB”) and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. As part of our audits we are required to obtain an understanding of internal control over financial reporting but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control over financial reporting. Accordingly, we express no such opinion.

Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

Weinberg & Company, P.A.

We have served as the Company’s auditor since 2004.

Los Angeles, California

April 2, 2018

REED'S INC.

BALANCE SHEETS

DECEMBER 31, 2017 AND 2016

	December 31, 2017	December 31, 2016
ASSETS		
Current assets:		
Cash	$12,127,000	$451,000
Accounts receivable, net of allowance for doubtful accounts and returns and discounts of $601,000 and $256,000, respectively	2,691,000	2,485,000
Inventory, net of reserve for obsolescence of $509,000 and $115,000, respectively	5,931,000	6,885,000
Prepaid expenses and other current assets	199,000	500,000
Total Current Assets	20,948,000	10,321,000
Property and equipment, net of accumulated depreciation and impairment reserves of $9,339,000 and $4,863,000, respectively	353,000	7,726,000
Equipment held for sale, net	2,370,000	-
Intangible assets	805,000	805,000
Total assets	$24,476,000	$18,852,000
LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)		
Current Liabilities:		
Accounts payable	$7,480,000	$5,959,000
Accrued expenses	220,000	215,000
Advances from officers	277,000	-
Line of credit	3,301,000	4,384,000
Current portion of capital leases payable	198,000	183,000
Current portion of long term financing obligation	222,000	190,000
Current portion of bank notes	6,947,000	953,000
Total current liabilities	18,645,000	11,884,000
Capital leases payable, less current portion	236,000	438,000
Long term financing obligation, less current portion, net of discount of $714,000 and $825,000, respectively	1,250,000	1,363,000
Bank notes, less current portion	-	5,919,000
Convertible note to a related party	3,690,000	-
Warrant liability	36,000	775,000
Other long term liabilities	111,000	130,000
Total Liabilities	23,968,000	20,509,000
Stockholders' equity (deficit):		
	94,000	94,000

Series A Convertible Preferred stock, $10 par value, 500,000 shares authorized, 9,411 shares issued and outstanding		
Common stock, $.0001 par value, 40,000,000 shares authorized, 24,619,591 and 13,982,230 shares issued and outstanding, respectively	2,000	1,000
Common stock issuable, 400,000 shares payable	680,000	-
Additional paid in capital	49,833,000	29,971,000
Accumulated deficit	(50,101,000)	(31,723,000)
Total stockholders' equity (deficit)	508,000	(1,657,000)
Total liabilities and stockholders' equity (deficit)	$24,476,000	$18,852,000

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

REED'S, INC.

STATEMENTS OF OPERATIONS

For the Years Ended December 31, 2017 and 2016

	2017	2016
Net Sales	$37,714,000	$42,472,000
Cost of goods sold	30,821,000	33,230,000
Gross profit	6,893,000	9,242,000
Operating expenses:		
Delivery and handling expense	3,942,000	3,902,000
Selling and marketing expense	3,021,000	3,701,000
General and administrative expense	5,754,000	3,954,000
Impairment of assets	5,925,000	484,000
Total operating expenses	18,642,000	12,041,000
Loss from operations	(11,749,000)	(2,799,000)
Interest expense	(3,491,000)	(1,978,000)
Financing costs and warrant modification	(2,776,000)	-
Change in fair value of warrant liability	3,275,000	(232,000)
Extinguishment of convertible note	(3,632,000)	-
Net loss	(18,373,000)	(5,009,000)
Preferred Stock Dividends	(5,000)	(5,000)
Net loss attributable to common stockholders	$(18,378,000)	$(5,014,000)
Loss per share – basic and diluted	$(1.24)	$(0.37)
Weighted average number of shares outstanding – basic and diluted	14,775,828	13,619,930

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

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REED'S, INC.

STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (DEFICIT)

For the Years Ended December 31, 2017 and 2016

	Common Stock		Preferred Stock		Common Stock Issuable		Additional Paid In Capital	Accumulated Deficit	Total Stockholders' Equity (Deficit)
	Shares	Amount	Shares	Amount	Shares	Amount			
Balance, December 31, 2015	13,160,860	$1,000	9,411	$94,000	-	$-	$27,399,000	$(26,709,000)	$785,000
Fair value of common stock issued for services	4,228	-	-	-	-	-	15,000	-	15,000
Common shares issued upon exercise of warrants	16,260	-	-	-	-	-	45,000	-	45,000
Common shares issued upon exercise of options	76,966	-	-	-	-	-	71,000	-	71,000
Fair value of vested options		-	-	-	-	-	658,000	-	658,000
Common shares issued upon sale of securities	722,412	-	-	-	-	-	1,687,000	-	1,687,000
Fair value vesting of warrants issued as debt discount		-	-	-	-	-	91,000	-	91,000
Series A preferred stock dividend	1,504	-	-	-	-	-	5,000	(5,000)	-
Net Loss		-	-	-	-	-		(5,009,000)	(5,009,000)
Balance, December 31, 2016	13,982,230	1,000	9,411	94,000	-	-	29,971,000	(31,723,000)	(1,657,000)

Fair value of common stock issued for services	62,365	-	-	-	-	-	99,000	-	99,000
Common shares issued for cash	117,647	-	-	-	-	-	200,000	-	200,000
Common shares issued for cash, net of offering costs	9,333,333	1,000	-	-	-	-	12,886,000	-	12,887,000
Common shares issued upon exercise of warrants	1,122,376	-	-	-	-	-	1,650,000	-	1,650,000
Common stock issuable to the Board	-	-	-	-	400,000	680,000	-	-	680,000
Fair value of vesting of options to employees and directors	-	-	-	-	-	-	276,000	-	276,000
Premium related to the issuance of convertible note	-	-	-	-	-	-	1,423,000		1,423,000
Extinguishment of warrant liability	-	-	-	-	-	-	2,634,000	-	2,634,000
Fair value of warrants issued for financing costs	-	-	-	-	-	-	689,000	-	689,000
Series A preferred stock dividend	1,640	-	-	-	-	-	5,000	(5,000)	-
Net Loss	-	-	-	-	-	-		(18,373,000)	(18,373,000)
Balance, December 31, 2017	24,619,591	$2,000	9,411	$94,000	400,000	$680,000	$49,833,000	$(50,101,000)	$508,000

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

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REED’S, INC.

STATEMENTS OF CASH FLOWS

For the Years Ended December 31, 2017 and 2016

	2017	2016
Cash flows from operating activities:		
Net loss	$(18,373,000)	$(5,009,000)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	551,000	387,000
Amortization of debt discount	1,379,000	255,000
Fair value of vested stock options issued to employees	276,000	658,000
Common stock payable to the Board	680,000	-
Fair value of common stock issued for services	99,000	15,000
Fair value of warrants issued as financing costs	908,000	-
Cost of the modifications of warrants	1,868,000	-
(Decrease) increase in allowance for doubtful accounts	345,000	(100,000)
Increase in inventory reserve	394,000	
Increase in reserve for impairment of assets	5,925,000	484,000
Change in fair value of warrant liability	(3,275,000)	232,000
Loss on extinguishment of debt	3,632,000	-
Loss on sale of equipment	63,000	-
Accrued interest on convertible note	290,000	-
Changes in operating assets and liabilities:		
Accounts receivable	(551,000)	509,000
Inventory	560,000	1,089,000
Prepaid expenses and other assets	301,000	269,000
Accounts payable	1,521,000	(1,499,000)
Accrued expenses	34,000	17,000
Other long term liabilities	(49,000)	160,000
Net cash used in operating activities	(3,422,000)	(2,533,000)
Cash flows from investing activities:		
Purchase of property and equipment	(813,000)	(410,000)
Net cash used in investing activities	(813,000)	(410,000)
Cash flows from financing activities:		
Advances from officers, net	277,000	-
Proceeds from warrant exercises	1,650,000	116,000
Principal payments on capital expansion loan	(725,000)	(375,000)
Proceeds from sale of common stock	13,087,000	2,230,000
Proceeds from the issuance of convertible note	3,083,000	-
Principal repayments on long term financial obligation	(191,000)	(160,000)
Principal repayments on capital lease payable	(187,000)	(174,000)
Net repayments on line of credit	(1,083,000)	(59,000)
Net cash provided by financing activities	15,911,000	1,578,000

Net increase (decrease) in cash	11,676,000	(1,365,000)
Cash at beginning of period	451,000	1,816,000
Cash at end of period	$12,127,000	$451,000
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$1,806,000	$1,746,000
Non Cash Investing and Financing Activities		
Property and equipment acquired through capital expansion loan	$723,000	$2,442,000
Property and equipment acquired through capital lease obligations	-	$152,000
Reclass of property to equipment held for sale	$4,370,000	-
Fair value of note discount issued as a derivitive	$3,083,000	$91,000
Fair value of warrants granted as debt discount	-	$91,000
Dividends payable in common stock	$5,000	$5,000
Extinguishment of warrant liability	$2,634,000	-
Premium related to the issuance of convertible note	$1,423,000	-

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

REED’S, INC.

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2017 AND 2016

(1) Operations and Liquidity

A) Nature of Operations

Reed’s Inc. (the “Company”) is the owner and maker of a leading portfolio of handcrafted, natural beverages in the natural and specialty foods industry, selling to specialty gourmet, natural food, retail, and convenience stores and restaurants nationwide and internationally. The Company’s two major core brands are Reed’s Ginger Beer and Virgil’s soda beverages. Reed’s Ginger Brews are unique in the beverage industry, being brewed, not manufactured, using fresh ginger, spices and fruits in a brewing process predating commercial soft drinks. Virgil’s sodas include award winning Root Beer and other soft drinks that are made using natural ingredients.

B) Cash and Liquidity

The accompanying financial statements have been prepared under the assumption that the Company will continue as a going concern. Such assumption contemplates the realization of assets and satisfaction of liabilities in the normal course of business. For the year ended December 31, 2017 the Company recorded a net loss of $18,373,000 and utilized cash in operations of $3,422,000.

As of December 31, 2017, the Company had a cash balance of $12,127,000 and had available borrowing on our existing line of credit of $1,012,000. We estimate the Company currently has sufficient cash and liquidity to meet its anticipated working capital requirements for the next twelve months. The Company’s has a secured working capital facility with $3.3 million of outstanding borrowings at December 31, 2017, expiring in October 2018, which we believe will be renewed and or be replaced. In addition, the Company’s bank notes (“Notes”), totaling $6.9 million also become due in October 2018. The Company believes it can successfully restructure its debt before the Notes mature utilizing a combination of the cash on hand and or the cash realized from sale of the plant facility and other assets . Furthermore, the pending sale of the Company’s facility is expected to relieve the Company of its long term financial obligation.

Historically, we have financed our operations primarily through private sales of common stock, issuance of preferred stock, a line of credit from a financial institution, and cash generated from operations. We anticipate our primary capital source will be positive cash flow from operations. If our sales goals do not materialize as planned, we believe the Company can reduce its operating costs and achieve positive cash flow from operations. However, 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, or restructure our debt as planned, we may have insufficient working capital to maintain our operations as we presently intend to conduct them or to fund our expansion, marketing, and product development plans. There can be no assurance we will be able to obtain such financing on acceptable terms, or at all.

As previously mentioned, the Company anticipates a closing of the sale of the Los Angeles plan to be completed in the summer 2018. These actions may lead to certain charges including, but not limited to additional cash-related expenses, non-cash impairment charges, discontinued operations and/or other costs in connection with exit and disposal activities. Such transactions will be recognized when appropriate and may require cash payments for obligations such as one-time employee involuntary termination benefits, lease and other contract termination costs, costs to close facilities, employee relocation costs and ongoing benefit arrangements.

During the year ended December 31, 2017, the Company satisfied a listing deficiency with the NYSE. The listing criteria required the company to reach $6,000,000 in shareholder equity. During the year end review of reserves for bad debt, inventory obsolescence, impairment reserve on property and equipment, and contingent liabilities the Company recognized non-cash adjustments that took the company below the continued listing criteria. The Company will continue to work with the NYSE to explore all options to remain listed should the NYSE find the Company deficient.

(2) Significant Accounting Policies

A) Use of Estimates

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 and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Those estimates and assumptions include estimates for reserves of uncollectible accounts, inventory obsolescence, depreciable lives of property and equipment, analysis of impairments of recorded long-term assets and intangibles, realization of deferred tax assets, accruals for potential liabilities and assumptions made in valuing stock instruments issued for services.

B) Accounts Receivable

The Company evaluates the collectability of its trade accounts receivable based on a number of factors. In circumstances where the Company becomes aware of a specific customer’s inability to meet its financial obligations to the Company, a specific reserve for bad debts is estimated and recorded, which reduces the recognized receivable to the estimated amount the Company believes will ultimately be collected. In addition to specific customer identification of potential bad debts, bad debt charges are recorded based on the Company’s historical losses and an overall assessment of past due trade accounts receivable outstanding.

The allowance for doubtful accounts and returns and discounts is established through a provision reducing the carrying value of receivables. At December 31, 2017 and 2016, the allowance for doubtful accounts and returns and discounts was approximately $601,000 and $256,000, respectively.

C) Inventory

Inventory is 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.

D) Property and Equipment and Related Depreciation

Property and equipment is stated at cost. Expenditures for major renewals and improvements that extend the useful lives of property and equipment or increase production capacity are capitalized, and expenditures for repairs and maintenance are charged to expense as incurred. Depreciation is calculated using accelerated and straight-line methods over the estimated useful lives of the assets as follows:

Property and Equipment Type	Years of Depreciation
Building	39 years
Machinery and equipment	5-12 years
Vehicles	5 years
Office equipment	5-7 years

Management assesses the carrying value of property and equipment whenever events or changes in circumstances indicate that the carrying value may not be recoverable. If there is indication of impairment, management prepares an estimate of future cash flows 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. For the year ended December 31, 2016, the Company recognized a $260,000 charge for impairments for certain equipment considered obsolete since it would no longer be needed with the Los Angeles plant completion.

On March 24, 2018, the Company received a letter of intent from a party, partially owned by Chris Reed, one of the Company's officers and directors, for the purchase of substantially all of the assets of the Los Angeles plant. It is anticipated the Board of Directors will approve the offer and the sale will be completed in the summer of 2018. The letter of intent offers the Company $1,250,000 in cash for the LA plant buildings, equipment, and fixed assets. In addition, the Company will be relieved of the $1,400,000 long-term liability attached to the property. Based on the terms of the offer, the Company has recorded an impairment charge totaling $5,925,000, representing the difference between the offer terms and the net book value of the assets to be sold and the relief of the long-term liability.

In 2016, the Company established a reserve totaling $260,000 for obsolete equipment deemed no longer needed with the Los Angeles plant completion.

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E) Intangible Assets and Impairment Policy

Intangible assets are comprised of indefinite-lived brand names acquired and have been assigned an indefinite life as we currently anticipate these brand names will contribute cash flows to the Company perpetually. These indefinite-lived intangible assets are not amortized but are assessed for impairment annually and evaluated annually to determine whether the indefinite useful life is appropriate. As part of our impairment test, we first assess qualitative factors to determine whether it is more likely than not the indefinite-lived intangible asset is impaired. If further testing is necessary, we compare the estimated fair value of our indefinite-lived intangible asset with its book value. If the carrying amount of the indefinite-lived intangible asset exceeds its fair value, as determined by its discounted cash flows, an impairment loss is recognized in an amount equal to that excess. For the year ended December 31, 2016, the Company recognized an impairment charge of $224,000 for the China Cola brand. There were no impairment charges incurred during the year ended December 31, 2017.

F) Concentrations

The Company’s cash balances on deposit with banks are guaranteed by the Federal Deposit Insurance Corporation up to $250,000 at December 31, 2017. The Company may be exposed to risk for the amounts of funds held in bank accounts more than 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 more than the guarantee during the years ended December 31, 2017 and 2016.

During the year ended December 31, 2017, the Company had two customers who accounted for approximately 23% and 16% of its sales, respectively; and during the year ended December 31, 2016, the Company had two customers who accounted for approximately 22% and 12% of its sales, respectively. No other customer accounted for more than 10% of sales in either year.

As of December 31, 2017, the Company had accounts receivable due from two customers who had balances totaling $823,000 and $450,000, respectively, representing 25% and 14% of total accounts receivable, respectively; and as of December 31, 2016, the Company had accounts receivable due from one customer who comprised $719,000 (25%) of its total accounts receivable. No other customer accounted for more than 10% of accounts receivable in either year.

During the year ended December 31, 2017, the Company had utilized three separate co-pack packers for most its production and bottling of beverage products in the Eastern United States. Although there are other packers and the Company has outfitted our own brewery and bottling plant, a change in packers may cause a delay in the production process, which could ultimately affect operating results.

During the years ended December 31, 2017 and 2016, the Company had one vendor which accounted for approximately 20% and 26%, respectively of its total purchases. At December 31, 2017, the Company had accounts payable due to one vendor who comprised 20% of its total accounts payable. At December 31, 2016, the Company had accounts payable due to two vendors who comprised 13% and 10% of its total accounts payable. No other account was more than 10% of the balance of accounts payable in either year.

G) 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 carrying amounts of financial assets and liabilities, such as cash and cash equivalents, accounts receivable, short-term bank loans, accounts payable, notes payable and other payables, approximate their fair values because of the short maturity of these instruments. The carrying values of capital lease obligations, convertible note, and long-term financing obligations approximate their fair values since the interest rates on these obligations are based on prevailing market interest rates. The fair value of the warrant liability was estimated using Level 2 inputs to estimate the liability at December 31, 2017 and 2016 totaling $36,000 and of $775,000, respectively.

H) Cost of Goods Sold

Cost of goods sold is comprised of the costs of raw materials and packaging utilized in the manufacture of products, co-packing fees, repacking fees, in-bound freight charges, as well as certain internal transfer costs. Additionally, cost of goods sold consists of direct production costs in excess of charges allocated to finished goods in production. Plant costs include labor costs, production supplies, repairs and maintenance, direct inventory write-off charges and adjustments to the inventory reserve. Charges for labor and overhead allocated to finished goods are determined on a market cost basis, which may be lower than the actual costs incurred. Plant costs in excess of production allocations are expensed in the period incurred rather than added to the cost of finished goods produced. Expenses not related to the production of our products are classified as operating expenses.

I) Delivery and Handling Expense

Shipping and handling costs are comprised of purchasing and receiving costs, inspection costs, warehousing costs, transfer freight costs, and other costs associated with product distribution after manufacture and are included as part of operating expenses.

J) Income Taxes

The Company uses an asset and liability approach for financial accounting and reporting for income taxes that allows recognition and measurement of deferred tax assets based upon the likelihood of realization of tax benefits in future years. Under the asset and liability approach, deferred taxes are provided for the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. A valuation allowance is provided for deferred tax assets if it is more likely than not these items will either expire before the Company is able to realize their benefits, or that future deductibility is uncertain. The Company's policy is to recognize interest and/or penalties related to income tax matters in income tax expense.

K) Revenue Recognition

Revenue is recognized on the sale of a product when the risk of loss transfers to our customers, and collection of the receivable is reasonably assured, which generally occurs when the product is shipped. 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 accounts for certain sales incentives for customers, including slotting fees, as a reduction of gross sales. These sales incentives for the years ended December 31, 2017 and 2016 were approximately $4,004,000 and $3,726,000, respectively.

L)Net Loss Per Share

Basic earnings (loss) per share is computed by dividing the net income (loss) applicable to Common Stockholders 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 Stockholders 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 if their effect is antidilutive.

For the years ended December 31, 2017 and 2016, 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:

	December 31, 2017	December 31, 2016
Convertible note	2,266,667	-
Warrants	7,325,282	803,909
Series A Preferred Stock	37,644	37,644
Options	677,500	1,048,500
Total	10,307,093	1,890,053

M)Advertising Costs

Advertising costs are expensed as incurred and are included in selling expense in the amount of $491,000 and $254,000, for the years ended December 31, 2017 and 2016, respectively.

N)Stock Compensation Expense

The Company periodically issues stock options and warrants to employees and non-employees in non-capital raising transactions for services and for financing costs. The Company accounts for stock option and warrant grants issued and vesting to employees based on the authoritative guidance provided by the Financial Accounting Standards Board (FASB) whereas the value of the award is measured on the date of grant and recognized as compensation expense on the straight-line basis over the vesting period. The Company accounts for stock option and warrant grants issued and vesting to non-employees in accordance with the authoritative guidance of the FASB whereas the value of the stock compensation is based upon 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 instruments is complete. Options granted to non-employees are revalued each reporting period to determine the amount to be recorded as an expense in the respective period. As the options vest, they are valued on each vesting date and an adjustment is recorded for the difference between the value already recorded and the then current value on the date of vesting. In certain circumstances where there are no future performance requirements by the non-employee, option grants are immediately vested and the total stock-based compensation charge is recorded in the period of the measurement date.

The fair value of the Company’s stock option and warrant grants are estimated using the Black-Scholes-Merton Option Pricing model, which uses certain assumptions related to risk-free interest rates, expected volatility, expected life of the stock options or warrants, and future dividends. Compensation expense is recorded based upon the value derived from the Black-Scholes-Merton Option Pricing model and based on actual experience. The assumptions used in the Black-Scholes-Merton Option Pricing model could materially affect compensation expense recorded in future periods.

O) Reclassification

In presenting the Company's Statement of Operations for the year ended December 31, 2016, the Company previously included a $260,000 charge for obsolete equipment in cost of goods sold and also included $254,000 of the amortization of a debt discount with respect to certain warrants in general and administrative expenses. In presenting the Company's Statement of Operations for the years ended December 31, 2017 and 2016, the Company has reclassified the charge for the obsolete equipment to Impairment of assets and the amortization of the debt discount in interest expense.

P) Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers. ASU 2014-09 is a comprehensive revenue recognition standard that will supersede nearly all existing revenue recognition guidance under current U.S. GAAP and replace it with a principle-based approach for determining revenue recognition. Under ASU 2014-09, revenue is recognized when a customer obtains control of promised goods or services and is recognized in an amount that reflects the consideration which the entity expects to receive in exchange for those goods or services. In addition, the standard requires disclosure of the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The FASB has recently issued ASU 2016-08, ASU 2016-10, ASU 2016-11, ASU 2016-12, and ASU 2016-20 all of which clarify certain implementation guidance within ASU 2014-09. ASU 2014-09 is effective for interim and annual periods beginning after December 15, 2017. The standard can be adopted either retrospectively to each prior reporting period presented (full retrospective method), or retrospectively with the cumulative effect of initially applying the guidance recognized at the date of initial application (the cumulative catch-up transition method). The Company is currently in the process of analyzing the information necessary to determine the impact of adopting this new guidance on its financial position, results of operations, and cash flows but does not believe the adoption of this standard will have a material effect, if any. The Company will adopt the provisions of this statement in the first quarter of fiscal 2018.

In February 2016, the FASB issued ASU No. 2016-02, Leases. ASU 2016-02 requires a lessee to record a right of use asset and a corresponding lease liability on the balance sheet for all leases with terms longer than 12 months. ASU 2016-02 is effective for all interim and annual reporting periods beginning after December 15, 2018. Early adoption is permitted. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest period presented in the financial statements. The Company is currently in the process of analyzing the information necessary to determine the impact of adopting this new guidance on its financial position, results of operations, and cash flows. The Company will adopt the provisions of this statement in the first quarter of fiscal 2019 and believes that the adoption of this pronouncement will not have a material effect if any.

In July 2017, the FASB issued ASU No. 2017-11, "Earnings Per Share (Topic 260); Distinguishing Liabilities from Equity (Topic 480); Derivatives and Hedging (Topic 815): (Part I) Accounting for Certain Financial Instruments with Down Round Features; (Part II) Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception" ("ASU 2017-11"). ASU 2017-11 allows companies to exclude a down round feature when determining whether a financial instrument (or embedded conversion feature) is considered indexed to the entity's own stock. As a result, financial instruments (or embedded conversion features) with down round features may no longer be required to be accounted for as derivative liabilities. A company will recognize the value of a down round feature only when it is triggered, and the strike price has been adjusted downward. For equity-classified freestanding financial instruments, an entity will treat the value of the effect of the down round as a dividend and a reduction of income available to common shareholders in computing basic earnings per share. For convertible instruments with embedded conversion features containing down round provisions, entities will recognize the value of the down round as a beneficial conversion discount to be amortized to earnings. ASU 2017-11 is effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted. The guidance in ASU 2017-11 can be applied using a full or modified retrospective approach. The adoption of ASU 2017-11 is not expected to have a material impact on the Company's financial position, results of operations, and cash flows.

Other recent accounting pronouncements issued by the FASB, including its Emerging Issues Task Force, the American Institute of Certified Public Accountants, and the Securities and Exchange Commission did not or are not believed by management to have a material impact on the Company's present or future consolidated financial statements.

(3) Inventory

Inventory is valued at the lower of cost (first-in, first-out) or market, and is comprised of the following:

	December 31, 2017	December 31, 2016
Raw Materials and Packaging	$2,670,000	$3,874,000
Finished Goods	3,261,000	3,011,000
Total	$5,931,000	$6,885,000

The Company has prepaid for glass raw materials at year end which will not be used until the following year. Total prepaid inventory at December 31, 2017 and 2016, totaled $40,000 and $294,000, respectively. The Company has recorded an obsolescence reserve for potentially slow moving and obsolete inventory. The reserve at December 31, 2017 and 2016, totaled $509,000 and $115,000, respectively.

(4) Property and Equipment

Property and equipment is comprised of the following:

	December 31, 2017	December 31, 2016
Land	$1,107,000	$1,107,000
Building	2,360,000	1,875,000
Vehicles	568,000	600,000
Machinery and equipment	4,924,000	3,696,000
Equipment under capital leases	226,000	226,000
Office equipment	507,000	475,000
Construction In Progress	-	4,610,000
Book value	9,692,000	12,589,000
Accumulated depreciation	(5,414,000)	(4,603,000)

Impairment reserve	(3,925,000)	(260,000)
Net book value	$353,000	$7,726,000

On March 24, 2018, the Company received a letter of intent from a party, partially owned by Chris Reed, one of the Company’s current officers and directors, for the purchase of substantially all of the assets of the Los Angeles plant. It is anticipated the Board of Directors will approve the offer and the sale will be completed in the summer of 2018. The letter of intent offers the Company $1,250,000 in cash for the LA plant buildings, equipment, and fixed assets. In addition, the Company will be relieved of the $1,400,000 long-term liability attached to the property. Based on the terms of the offer, the Company has recorded an impairment charge totaling $5,925,000, representing the difference between the offer terms and the net book value of the assets to be sold and the relief of the long-term liability.

In 2016, the Company established a reserve totaling $260,000 for obsolete equipment deemed no longer needed with the Los Angeles plant completion.

Depreciation expense for the years ended December 31, 2017 and 2016 totaled $551,000 and $387,000, respectively.

Accumulated depreciation on equipment held under capital leases totaled $414,000 and $226,000 as of December 31, 2017, and 2016, respectively. (See *Note 7 Capital Leases Payable*).

Equipment held for sale consists of the following:

	December 31, 2017	December 31, 2016
Equipment held for sale	$4,370,000	$ -
Reserve	(2,000,000)	-
Net book value	$2,370,000	$ -

In 2017, the Company agreed to pre-pay the CAPEX Loan (See *Note 6 Line of Credit and Bank Notes*) by at least $300,000 from the proceeds of the sale of idle equipment, when the sale should occur. In January 2018, equipment with no book value was sold for $312,000 and the CAPEX Loan was repaid for this amount.

(5) Intangible Assets

Intangible assets consist of trademarks for the Company's brand names:

	December 31, 2017	December 31, 2016
Virgil's	$576,000	$576,000
Sonoma Sparkler	229,000	229,000
Brand names	$805,000	$805,000

Virgil's and Sonoma Sparkler brand names are deemed to have indefinite lives and are not amortized, but are tested for impairment annually. For the year ended December 31, 2016, the Company recognized an impairment charge, completely writing off its China Cola Brand, totaling $224,000. No impairment charge was incurred for the year ended December 31, 2017.

(6) Line of Credit and Bank Notes

The Company has a Loan and Security Agreement with PMC Financial Services Group, LLC ("PMC") that provides a $6,000,000 revolving line of credit, a $3,000,000 term loan and a Capital Expansion loan up to $4,700,000. The loans are secured by substantially all the assets of the Company and were due on January 1, 2019. As a condition to PMC's approval of the transaction described in *Note 9 Convertible Note to a Related Party*, and the Purchaser's subordinated security interest, on April 21, 2017, the Company and PMC entered into Amendment Number Fifteen to Amended and Restated Loan and Security Agreement changing the Revolving Line of Credit Maturity Date, Term Loan Maturity Date, Cap Ex Loan Maturity Date and Term Loan B Maturity Date from January 1, 2019, to October 21, 2018.

The Line of Credit and Bank Notes are as follows:

Revolving Line of Credit - The agreement provides a $6,000,000 revolving line of credit that was expanded by an additional $630,000 to accommodate prepaid inventory. At December 31, 2017 and 2016, the aggregate amount outstanding under the line of credit was $3,301,000 and $4,384,000, respectively.

There is a monthly management fee of .45% of the average monthly loan balance.

The revolving line of credit is based on 85% of accounts receivable and 60% of eligible inventory and is secured by substantially all of the Company's assets. As of December 31, 2017, the Company had $1,012,000 of borrowing availability under the line of credit agreement. The line of credit matures on October 21, 2018 and is not subject to pre-payment penalty.

Bank Notes - Bank notes consist of the following as of December 31, 2017 and 2016:

	December 31, 2017	December 31, 2016
Term Loans	$3,000,000	$3,000,000
CAPEX loan	3,947,000	3,950,000
Valuation discount	-	(78,000)
Net	6,947,000	6,872,000
Current portion	(6,947,000)	(953,000)
Long term portion	$-	$5,919,000

Term Loans: In connection with the Loan and Security Agreement with PMC, the Company entered into two Term Loans of $1,500,000 each, for an aggregate borrowing of $3,000,000. The term loans are secured by all of the unencumbered assets of the Company and are due October 21, 2018. The annual interest rate on the loans are discussed below. As of December 31, 2017, and 2016, the amount outstanding was $3,000,000 and $3,000,000 respectively.

Capital Expansion ("CAPEX") Loan: In connection with the Loan and Security Agreement with PMC, the Company entered into a Capital expansion loan which, after amendment, allows for total borrowings of $4,700,000. The loans are secured by all of the property and equipment purchased under the loan. The interest rate on the CAPEX loan is the prime rate plus 5.75% (9.5% at December 31, 2017). The entire CAPEX loan is due October 21, 2018. At December 31, 2017 and 2016, the balance on the CAPEX loan was $3,947,000 and $3,950,000 respectively, and as of December 31, 2017, the Company had no further borrowing availability.

In 2017, the Company agreed to pre-pay the CAPEX Loan by at least $300,000 from the proceeds of the sale of idle equipment, when the sale should occur. In January 2018, $312,000 of equipment was sold and the CAPEX Loan was repaid for this amount.

Valuation Discount (Issuance of Warrants upon Amendments): In prior years, the Company issued 225,000 warrants to PMC in connection with the restructuring of the notes. The aggregate value of the warrants was valued at $179,000 using the Black Scholes Merton option pricing model and was recorded as a valuation discount and has been amortized over the term loans. On December 7, 2016, the Company agreed to reprice the exercise price of 175,000 common stock purchase warrants granted. The incremental value of the PMC warrants before and after the modification of $38,000 is being amortized over the remaining term of the loans. As of December 31, 2016, the unamortized balance of the loans was $78,000. During the year ended 2017, the remaining unamortized balance was fully amortized.

Interest Rates

Notwithstanding the other borrowing terms above, if Excess Borrowing Availability under the $6 million Revolving line of credit remains more than $1,500,000 at all times during the preceding month (currently the Company has no further Borrowing Availability) the additional interest rate for all loans will be eliminated. The following chart summarizes borrowing rates for the loans as of December 31, 2017:

Description	Base Interest Rate	Increase in Prime	Current Original rate	Additional Interest	Current rate
Line of Credit (Prime Plus)	3.60 %	1.25 %	4.85 %	3.00 %	7.85 %
Term A	9.00 %	1.25 %	10.25 %	3.00 %	13.25 %
Term B	11.60 %	1.25 %	12.85 %	3.00 %	15.85 %
CAPEX Loan	9.00 %	1.25 %	10.25 %	3.00 %	13.25 %

There is a .45% monthly monitoring fee for the line of credit. When added to current rate, the current annual rate on the line of credit is approximately 13.25%.

(7) Capital Leases Payable

The Company leases equipment for its brewery operations with an aggregate value of $944,000 under nine non-cancelable capital leases. Monthly payments range from $341 to $10,441 per month, including interest, at interest rates ranging from 6.51% to 17.31% per annum. The Company’s total payment obligation for the leases aggregates $19,000 per month at December 31, 2017. The leases expire at various dates through 2021.

Future minimum lease payments under capital leases are as follows:

Years Ending December 31,	
2018	$227,000
2019	188,000
2020	59,000
2021	2,000
Total payments	$476,000
Less: Amount representing interest	(42,000)
Present value of net minimum lease payments	$434,000
Less: Current portion	(198,000)
Non-current portion	$236,000

(8) Long Term Financing Obligation

Long term financing obligation is comprised of the following:

	December 31,	
	2017	2016
Financing obligation	$2,186,000	$2,378,000
Valuation discount	(714,000)	(825,000)
Net long term financing obligation	$1,472,000	$1,553,000
Less current portion	(222,000)	(190,000)
Long term financing obligation	$1,250,000	$1,363,000

On June 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, were originally recorded as a financing obligation in the amount of $3,056,000. Monthly payments under the financing agreement of approximately $35,000 are recorded as interest expense and a reduction in the financing obligation at an implicit rate of 9.9%. The financing obligation was personally guaranteed up to a limit of $150,000 by former Chief Executive Officer and current Chief Innovation Officer, Christopher J. Reed.

In connection with the financing obligation and subsequent amendments, the Company issued an aggregate of 600,000 warrants to purchase its common stock. The 600,000 warrants were valued at an aggregate amount of $1,336,000 and were recorded as a valuation discount at the date of issuance, and are being amortized over 15 years, the term of the purchase option. The balance of the unamortized valuation discount at December 31, 2017 and 2016 was $714,000 and $825,000, respectively. Amortization of valuation discount was $110,000 for each of the years ended December 31, 2017 and 2016.

The aggregate amount due under the financing obligation at December 31, 2017 and 2016 was $2,186,000 and $2,378,000, respectively. Aggregate future obligations under the financing obligation are as follows:

Year	Amount
2018	222,000
2019	259,000
2020	299,000
2021	344,000
2022	395,000
Thereafter	667,000
Total	$2,186,000

(9) Convertible Note to a Related Party

The Convertible Note to a Related Party consists of the following:

	December 31,	
	2017	2016
12% Convertible Note Payable	$3,400,000	$ -
Accrued Interest	290,000	-
Convertible Note Payable, Net	$3,690,000	$ -

On April 21, 2017 ("Closing Date"), pursuant to a Securities Purchase Agreement ("Purchase Agreement"), the Company sold and issued a secured, convertible, subordinated, non-redeemable note in the principal amount of $3,400,000 ("Note") and a warrant to purchase 1,416,667 shares of common stock ("Warrant Shares") to Raptor/Harbor Reeds SPV LLC ("Purchaser"). Raptor/Harbor Reeds owns 27.64% of the Company's common stock at December 31, 2017. The Note bears interest at a rate of 12% per annum, compounded monthly on a 360-day year/ 30-day month basis. The Note is secured by a second priority security interest in the Company's assets, which is subordinate to the first priority security interest of PMC Financial Services Group, LLC ("PMC"). The Note matures on the two-year anniversary of the Closing date and may not be prepaid. After 180 days, the Note may be converted, at any time and from time to time, into 1,133,333 shares of common stock of the Company ("Conversion Shares"). Wunderlich Securities, the Company's placement agent, received a fee of $160,000 for placement agency services. In addition, the Company incurred other direct costs of $157,000 resulting in net proceeds to the Company of $3,083,000.

The Warrant Shares will expire on the fifth (5th) anniversary of the Closing Date and have an exercise price equal to $4.00. The Warrant Shares will not be exercisable until 180 days after the Closing date. The Note and Warrant contain customary anti-dilution provisions and the Conversion Shares and Warrant Shares are subject to a registration rights agreement. The investor was granted a right to participate in future financing transactions of the Company for a term of two years. In addition, the warrants issued to the investor included a fundamental transaction provision, and, as such, were accounted for as warrant liability. Upon their issuance, the fair value of these warrants was determined to be $3,302,000 using the Black-Scholes-Merton option pricing model (see Note 10 for further discussion of warrant liability). In accordance with the current accounting guidance $3,083,000 of this amount was recorded as a valuation discount, and the excess of the fair value of the warrant liability at the issuance date over the amount allocated to valuation discount of $219,000 was accounted for as a financing cost. As such, the Company recognized a debt discount at the dates of issuance in the aggregate amount of $3,400,000 related to the fair value of the warrant liability of $3,083,000 and cash offering costs of $317,000. The debt discount is to be amortized over the term of the note. Amortization of the note discount through December 12, 2017 was $1,191,000 and the unamortized debt discount at that date was $2,209,000.

On April 19, 2017, three accredited investors that are party to the Securities Purchase Agreement dated May 26, 2016 and hold participation rights in the Company's financing transactions agreed to waive their participation rights with regard to the April 21, 2017 financing. In consideration, these investors' participation rights, expiring in May 2017, were extended for a period of two years. In addition, the Company increased the terms of their outstanding warrants by one year and reduced the exercise price from $4.25 to $3.00, The incremental change in their fair value of $187,000 was accounted for as an increase in the fair value of the warrant liabilities as of the date of modification and recorded as a cost of warrant modification. In addition, the Company also issued five-year warrants to purchase an aggregate of 210,111 shares of common stock at the exercise price of $3.00 to these investors. The newly issued warrants contain customary anti-dilution provisions and included a fundamental transaction provision and were accounted for as warrant liability. As such, the fair value of the new warrants of $571,000 was accounted for as a warrant liability and a financing cost at the issue date. Fair value was determined using the Black-Scholes-Merton option pricing model.

On July 13, 2017, the Company entered into warrant exercise agreements with the investors to reprice the warrants to purchase 1,416,667 related to the Purchase Agreement and the 210,111 shares of our common stock discussed above.

On December 12, 2017, in connection with the reduction of the offering price in the Rights Offering (Note 11) to $1.50, the Company entered into an amendment to the Note further reducing the conversion price of the Note to $1.50. The Company analyzed whether the modifications of the conversion price of the Note would require application of the provisions of ASC Topic 470-50, Accounting for Modification [or Exchange] of Convertible Debt Instruments ("ASC 470-50"). Based on the Company's analysis, the Company determined that such modification resulted in a change of more than 10% of the fair value of the Note, and as such, accounted for the transaction as an extinguishment. Extinguishment accounting requires the removal of old liability at carrying value and the establishment of the new note at fair value. The Company retained an independent third-party valuation firm to calculate for the fair value of the new note using discounted cash flow and Black Scholes methods and determined the fair value to be $4,823,000. As such, the original Note of $3,400,000 and corresponding unamortized discount of $2,209,000 was eliminated. Simultaneously, the new Note of $3,400,000 was recorded and a corresponding premium of $1,423,000, representing the excess of the fair value over the face value of the Note, was recorded to additional paid in capital in capital. The loss realized in connection with the extinguishment of the Note totaled $3,632,000 and is reflected in the accompanying Statement of Operations.

(10) Warrant Liability

Various stock sales made by the Company to finance operations have been accompanied by the issuance of warrants. Some of these warrant agreements contain fundamental transaction provisions which may give rise to an obligation of the Company to pay cash to the warrant holders. For accounting purposes, in accordance with *ASC 480, Distinguishing Liabilities from Equity*, those warrants with fundamental transaction terms are accounted for as liabilities given the terms may give rise to an obligation of the Company to the warrant holders. These liabilities are measured at fair value at each reporting period and the change in the fair value is recognized in earnings in the accompanying Statements of Operations.

The fair value of the warrant liability was determined at the following reporting, issuance, and modification dates using the Black-Scholes-Merton option pricing model and the following assumptions:

	As of December 31, 2016 (1)		Upon Issuance April 21, 2017 (2)		Upon Modification April 21, 2017 (3)		Upon Modification July 13, 2017 (4)		As of December 31, 2017 (5)	
Stock Price	$4.10		$4.75		$ 4.75		$2.35		$ 1.55	
Risk free interest rate	1.58	%	1.51	%	1.51	%	1.65	%	1.74	%
Expected Volitility	54.71	%	49.33	%	49.33	%	53.75	%	56.06	%
Expected life in years	4.42		5.00		5.00		4.77 to 4.89		3.42	
Expected dividend yield	0	%	0	%	0	%	0	%	0	%
Number of Warrants	418,909		1,626,778		280,147		1,906,925		138,762	
Fair Value of Warrants	$775,000		$3,873,000		$ 187,000		$1,109,000		$36,000	

(1) Warrant valuation on December 31, 2016 for 418,909 warrants containing fundamental transaction provisions.

(2) On April 21, 2017 and April 19, 2017, the Company granted warrants to purchase 1,416,667 shares and 210,111 shares, respectively, of the Company's common stock in connection with the Company's issuance of the Convertible Note. The warrants included fundamental transaction provisions resulting in the total fair value of $3,873,000 to be classified as an increase to the warrant liability. On July 13, 2017, these warrants were repriced as discussed below.

(3) On April 19, 2017, three accredited investors that are party to the Securities Purchase Agreement dated May 26, 2016 and hold participation rights in the Company's financing transactions agreed to waive their participation rights with regard to the April 21, 2017 financing. In consideration, these investors' participation rights, expiring in May 2017, were extended for a period of two years. In addition, on April 21, 2017, the Company increased the terms of their outstanding 280,147 warrants by one year and reduced the exercise price from $4.25 to $3.00, The incremental change in their fair value of $187,000 on the modification date was reported as an increase to the warrant liability.

(4) On July 13, 2017, the Company entered into warrant exercise agreements with certain investors holding participation rights in our financing transactions to reprice warrants to purchase 1,906,925 shares of our common stock. The warrants' exercise prices were lowered from $3 and $4 per share to $1.50 per share, and the incremental cost before and after the modification of the warrants resulted in an incremental charge of $1,109,000. The warrants were also changed to modify language pertaining to a "fundamental transaction," eliminating the need to classify the warrants as a warrant liability.

Upon modification, the investors exercised warrants into 1,122,376 shares of common stock at the repriced $1.50 per share resulting in proceeds to the Company of $1,650,000. The fair value of the warrant liability for these warrants at the date of exercise was $1,601,000 and was reclassified from the warrant liability to additional paid in capital. At the same date, the Company and the holders of the remaining warrants agreed to modify the language of the fundamental transaction clause for the remaining 784,549 investor warrants, where the definition became dependent on obtaining board approval, thus eliminating the need for the liability classification of warrants. Accordingly, the fair value of these warrants totaling $1,033,000 was reclassified from the warrant liability to additional paid in capital.

(5) Warrant valuation on December 31, 2017 for 138,762 warrants containing fundamental transaction provisions. The change in the fair value of the warrant liability was $3,275,000 and $232,000 for the years ended December 31, 2017 and 2016, respectively.

The risk-free interest rate used in the calculations was based on rates established by the Federal Reserve Bank. The Company uses the historical volatility of its common stock to estimate the expected volatility. The expected life of the warrants was determined by the remaining contractual life of the warrant instrument. The expected dividend yield was determined to be zero since the Company has not paid dividends to its common stockholders in the past and does not expect to pay dividends to its common stockholders in the future.

(11) Stockholders' Equity

Series A Convertible Preferred Stock - Series A Preferred stock consists of $10 par value, 500,000 shares authorized, 5% non-cumulative, participating, preferred stock. As of December 31, 2017, and 2016, there were 9,411 shares outstanding, with a liquidation preference of $10.00 per share. Each share of Series A Preferred stock can be converted into four shares of the Company's common stock.

The Series A Preferred shares have a 5% pro-rata annual non-cumulative dividend. The dividend can be paid in cash or, in the sole and absolute discretion of our board of directors, in shares of common stock based on its then fair market value. The Company cannot declare or pay any dividend on shares of our securities ranking junior to the preferred stock until the holders of the preferred stock have received the full non-cumulative dividend to which they are entitled. In addition, the holders of the preferred stock are entitled to receive pro rata distributions of dividends on an “as converted” basis with the holders of our common stock.

In the event of any liquidation, dissolution or winding up of the Company, or if there is a change of control event (as defined in the Certificate of Designations of Series A Preferred Stock), then, subject to the rights of the holders of our more senior securities, if any, the holders of Series A preferred stock are entitled to receive, prior to the holders of any junior securities, $10.00 per share plus all accrued and unpaid dividends. Thereafter, all remaining assets shall be distributed pro rata among all security holders. Since June 30, 2008, the Company has the right, but not the obligation, to redeem all or any portion of the Series A preferred stock by paying the holders thereof the sum of the original purchase price per share, which was $10.00, plus all accrued and unpaid dividends.

The Series A preferred stock may be converted, at the option of the holder, at any time after issuance and prior to the date such stock is redeemed, into four shares of common stock, subject to adjustment in the event of stock splits, reverse stock splits, stock dividends, recapitalization, reclassification, and similar transactions. The Company is obligated to reserve authorized but unissued shares of common stock enough such shares to affect the conversion of all outstanding shares of Series A preferred stock.

Except as provided by law, the holders of our Series A preferred stock do not have the right to vote on any matters, including, without limitation, the election of directors. However, so long as any shares of Series A preferred stock are outstanding, the Company shall not, without first obtaining the approval of at least a majority of the holders of the Series A preferred stock, authorize or issue any equity security having a preference over the Series A preferred stock with respect to dividends, liquidation, redemption or voting, including any other security convertible into or exercisable for any equity security other than any senior preferred stock.

The Company accrued and paid a $5,000 dividend payable to the preferred shareholders, which the board of directors elected to pay through the issuance of 1,640 shares and 1,504 shares of its common stock, respectively during the years ended December 31, 2017 and 2016. No shares of Series A preferred stock were converted into common stock in 2017 and 2016.

Common Stock - Common stock consists of $.0001 par value, 40,000,000 shares authorized, and 24,619,591 shares and 13,982,230 shares outstanding as of December 31, 2017 and 2016, respectively.

Common Stock Issued in Connection with the Rights Offering – In December 2017, in the Rights Offering, the Company offered the distribution of rights to purchase up to $14 million of units, each unit consisting of one share of the Company’s common stock, par value $0.001 per share and one-half warrant to purchase common stock. Pursuant to the Rights Offering, the Company sold an aggregate of 9,333,333 units consisting of 9,333,333 shares of common stock and warrants to purchase 4,666,666 shares of common stock, with each warrant exercisable for one share of common stock at an exercise price of $2.025 per share. The net proceeds to the Company was $12,887,000 after deducting all offering costs and dealer-manager fees and expenses.

On December 6, 2017, the Company entered into a definitive backstop commitment agreement (“Backstop Agreement”) with Raptor/ Harbor Reeds SPV LLC (“Raptor”) whereby Raptor agreed to purchase from the Company a minimum of $6 million of unregistered units not subscribed in the Rights Offering in a private placement, subject to customary terms and conditions. Raptor had the right to exercise its basic subscription right and over-subscription privilege as a rights holder in the Rights Offering (subject to pro-ration) but had no obligation to do so.

As compensation for the backstop commitment and subject to the closing of the Rights Offering, the Company issued to Raptor, five-year warrants to purchase a minimum of 750,000 shares of the Company's common stock. Based on the completion of the Rights Offering because the offering was oversubscribed, Raptor did not purchase any unregistered units in a private placement under the provisions of the Backstop Agreement. In connection with the offering, the Company also agreed to register the shares of common stock underlying the units (including shares of common stock underlying the warrants contained in the units) and shares of common stock underlying the backstop warrants. The Company registered the shares in February 2018.

Common Stock Issued Pursuant to a Dealer-Manager Agreement in the Rights Offering - On December 6, 2017, the Company entered into a dealer-manager agreement ("DM Agreement") with Maxim Group LLC ("Maxim") in connection with the Rights Offering.

In connection with the DM Agreement, the Company agreed to pay to Maxim as the dealer-manager, a cash fee equal to: (i) 7% of the gross proceeds received by the Company directly from exercises of the subscription rights, other than from exercises by our officers and directors or Raptor /Harbor Reed's SPV LLC ("Raptor"), (ii) 4% of the gross proceeds received from certain investors having prior existing relationships with the Company, and (iii) 2% of the gross proceeds received by the Company from the backstop commitment, as described below, or from Raptor's exercise of the subscription rights. The Company paid Maxim $830,000 for it DM agreement and an additional $75,000 for expenses for a total of $905,000.

Additionally, the Company has granted to Maxim the right of participation to act as book runner or co-manager with at least 25.0% of the economics for any and all future equity, equity-linked or debt (excluding commercial bank debt) offerings undertaken during such period by the Company or any of the Company's subsidiaries or successor entities until December 11, 2018.

The Company has agreed to indemnify Maxim and its respective affiliates against certain liabilities arising under the Securities Act of 1933, as amended. Maxim's participation in the offering is subject to customary conditions contained in the DM Agreement, including the receipt by Maxim of an opinion of the Company's counsel. Maxim and its affiliates may also provide to the Company from time to time in the future, in the ordinary course of their business, certain financial advisory, investment banking and other services for which Maxim will be entitled to receive fees.

Common Stock Issued in Connection with the Sale of Shares - In 2017, the Company sold 117,647 shares of its common stock to a member of the board of directions valued at $1.70 per share with total proceeds $200,000.

In connection with the exercise of investor warrants, the Company issued 1,122,376 shares of its common stock at $1.50 per share with gross proceeds of $1,650,000.

In 2016, the Company entered into a securities purchase agreement with institutional investors in a private financing transaction for the issuance and sale of 692,412 shares of the Company's common stock and warrants to purchase 346,206 shares of common stock. The Company also sold 30,000 shares of its common stock to certain officers of the Company at $3.90 per share with total proceeds of $117,000. The net proceeds to the Company from the sale of the shares totaled $1,687,000 after deducting underwriting discounts, commissions and offering expenses.

Common Stock Issued for Services - During the year ended December 31, 2017, the Company issued 58,065 shares of its common stock to certain members of the board of directors valued at $1.55 per share with an aggregate value of $90,000 for services rendered. The Company also issued 4,300 shares of its common stock to a related party valued at $2.20 per share with an aggregate value of $9,000 for services rendered.

During the year ended December 31, 2016, the Company issued 4,228 shares of common stock for consulting services valued at an aggregate value of $15,000 for services rendered.

Common Stock Issuable – On January 10, 2018, the Company issued to the independent members of its board of directors issued 400,000 shares of common stock valued at $1.70 per share totaling $680,000 for services provided in 2017. These shares have been reflected as Common Stock Issuable at December 31, 2017 in the accompanying Statement of Stockholders' Equity.

(12) Stock Options and Warrants

Stock Options – During the year, the Company had three equity plans in place to incentivize performance by employees, directors, and consultants: The 2007 Stock Option Plan, the 2015 Incentive and Non-Statutory Stock Option Plan, and in 2017 the Company adopted the 2017 Incentive Compensation Plan (the "Plans"). In 2017, the 2007 plan expired. No new options will be granted under the 2007 plan. The options under the 2015 and 2017 Plans shall be granted from time to time by the Board of Directors. Individuals eligible to receive options include employees of the Company, consultants to the Company and directors of the Company. The options shall have a fixed price, which will not be less than 100% of the fair market value per share on the grant date. The total number of options authorized is 500,000 and 3,000,000, respectively for the Plans.

Stock option activity consists of the following:

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Terms (Years)	Aggregate Intrinsic Value
Outstanding at December 31, 2015	980,000	$ 3.96		