REEDS INC
Form 10KSB/A
July 27, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-KSB/A

(X) ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the annual period ended December 31, 2005

Commission file number: 333-120451

REED'S INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

13000 South Spring St.
Los Angeles, Ca. 90061

(Address of principal executive offices) (Zip Code)

(310) 217-9400

(Registrant's telephone number, including area code)

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 ( )

There were 5,042,197 shares of the registrant's common stock outstanding as of December 31, 2005.

FORWARD LOOKING STATEMENTS

Some of the statements made in this report, constitute forward-looking statements.

In some cases, you can identify forward-looking statements by terminology such as "may," "will," "should," "could," "expects "plans," "anticipates," "believes," "estimates," "predicts," "potential," or "continue" or the negative of such terms or other comparable terminology.

Forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance, or achievements to be materially different from any future results, levels of activity, performance, or achievement expressed or implied by such forward-looking statements.

Management cautions that these statements are qualified by their terms and/or important factors, many of which are outside the control of the Company, 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:

- The Company's 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 the Company's ability to gain or maintain its share of sales in the marketplace;
- The introduction of new products;
- The Company's 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 the Company produces and markets its 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 the Company's products;
- The Company's ability to penetrate new markets and maintain or expand existing markets;

· Maintaining existing relationships and expanding the distributor network of the Company’s products;

· The marketing efforts of distributors of the Company’s products, most of whom also distribute products that are competitive with the Company’s products;

· Decisions by distributors, grocery chains, specialty chain stores, club stores and other customers to discontinue carrying all or any of the Company’s products;

· Decisions by distributors, grocery chains, specialty chain stores, club stores and other customers to discontinue carrying all or any of the Company’s products that they are carrying at any time;

· The availability and cost of capital to finance the Company’s working capital needs and growth plans;

· The Effectiveness of the Company’s 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 the Company’s products; and

· The Company’s ability to make suitable arrangements for the co-packing of any of its products.

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: <u>Description of Business.</u>

We were founded in 1989 and are a corporation.

We are a growing developer, manufacturer, marketer, and seller of New Age beverages, as well as candies and ice creams. "New Age Beverages" is a category that includes natural soda, fruit juices and fruit drinks, ready-to-drink teas, sports drinks and water. We currently offer 14 beverages, 2 candies, and 3 ice creams.

We sell the majority of our products primarily in upscale gourmet and natural food stores and supermarket chains in the United States and, to a lesser degree, in Canada. Historically, most of our beverages were sold in the natural food industry.

Our current business strategy is to maintain a firm marketing focus in the natural food marketplace while building a national direct sales and distribution force to take our proven products into mainstream market and distribution channels.

At this time, we produce our carbonated beverages at two facilities. Our Brewery in Los Angeles, producing certain soda products for the western half of the United States and we have a contract with The Lion Brewery, Inc., a packing, or co-pack, facility in Pennsylvania to supply us with product we don't produce in our Los Angeles Brewery. Our Ginger Juice Brews are co-packed for us in Northern California. Our ice creams are co-packed for us at a dairy in upstate New York.

We have a national network of natural and specialty food distributors in the United States and Canada. We also have mainstream beverage distributors in select markets. In Southern California, we have our own direct distribution in addition to other local distributors. We currently rely upon one retailer for between 10-15% of our aggregate gross revenues. If we were to lose this retailer, our operations would be materially effected. We currently rely on one wholesaler for approximately 39% of our aggregate gross revenue. Management believes the loss of this wholesaler will not have a material impact on its business as alternative distribution channels are available to the Company.

We currently maintain two separate sales organizations, one of which handles natural food sales and the other of which handles mainstream sales. Both sales forces consist of sales managers and sales representatives. The natural food sales force works mainly in the natural and gourmet food stores serviced by the natural and gourmet distributors. Representatives are responsible for the accounts in their territory and they stay on a focused schedule of visits to maintain store and distributor relationships. In the future, we intend to integrate both our distributions and sales forces.

We compete for distributors, shelf space, and customers primarily with other New Age beverage companies including: SoBe (owned by Pepsi), Snapple, Mistic, IBC and Stewart's (owned by Cadbury Schweppes), Henry Weinhard (owned by Phillip Morris), Arizona, Hansen's, Knudsen & Sons, Jones Sodas, A&W Root Beer, Blue Sky, Natural Brews

Several of our competitors and potential competitors have financial resources greater than ours, and Pepsi, Cadbury Schweppes, and Phillip Morris have substantially greater financial resources than ours. These greater resources permit our competitors to implement extensive advertising and promotional programs, which we have not been, and may not be, able to match. As competitors enter the field, our market share may fail to increase or may decrease despite our efforts to continue to produce superior products with higher quality ingredients and a brewing process that we believe remains a trade secret.

Competitors in the soft drink industry include bottlers and distributors of nationally advertised and marketed products as well as chain store and private label soft drinks. The principal methods of competition include brand recognition, price and price promotion, retail space management, service to the retail trade, new product introductions, packaging changes, distribution methods, and advertising.

We depend upon an uninterrupted supply of ginger and certain other ingredients, a significant portion of which we obtain overseas, principally from China and Brazil. We obtain almost all of our crystallized ginger from Fiji and our Ginger Chews from Indonesia. Any decrease in the supply of these ingredients or increase in the prices of these ingredients as a result of any adverse weather conditions, pests, crop disease, interruptions of shipment or political considerations, among other reasons, could substantially increase our costs and adversely affect our financial performance.

The Company currently owns trademarks for the Reed's brand of products, the Virgil's brand of products and the China Cola products.

The company's research and development activities are not a material expense to the business.

The Company's primary cost of environmental compliance is in recycling fees, which approximated $37,000 in 2005.

We have 30 full time employees and employ additional people on a part-time basis as needed.

ITEM 2: Description of Property

In December 2000, we purchased an 18,000 square foot warehouse, the Brewery, at 13000 South Spring Street, Los Angeles, California 90061, in an unincorporated area of Los Angeles County near downtown Los Angeles. This facility serves as our principal executive offices, our West Coast bottling plant, and our Southern California warehouse facility. Most of the Company's assets provide security, in the form of liens or mortgagees, for the debt agreements the Company has in place as of December 31, 2005.

ITEM 3: Legal Proceeding

On January 20 th , 2006, Consac Industries, Inc. (dba Long Life Teas and Long Life Beverages) filed a lawsuit in the United States District Court for the Central District of California against Reed's Inc. and Christopher Reed, Case No. CV06-0376. The complaint asserts claims for negligence, breach of contract, breach of warranty, and breach of express indemnity relating to Reed's, Inc.'s manufacture of approximately 13,000 cases of "Prism Green Tea Soda" for Consac. Consac contends that we negligently manufactured the soda resulting in at least one personal injury. Consac seeks $2.6 million in damages, plus interest and attorneys fees. We contend that Consac was responsible for the soda's condition by providing a defective formula which had not been adequately tested. Management has filed a motion to dismiss. We believe that we will successfully defend Consac's claims and the case is without merit. Some of the allegations made against the company are covered by insurance and some allegations are not covered by insurance. While there is no assurance, we believe that the Consac litigation will have no material adverse effect upon our operations.

On January 26, 2006 we filed a post-effective amendment with the Securities and Exchange Commission for this offering. We have recently been advised that sales of securities in the amount of up to 189,760 shares may have been completed without the Securities and Exchange Commission declaring this January 26, 2006 amendment effective. We are currently considering the possibility of offering to all the investors in these 189,760 shares the alternative of either reaffirming their investment or requesting a refund of the amount of their investment. The maximum amount of the refund is approximately $759,000. Management will develop a plan to effect such a refund in the event it proceeds with such an offer. It is possible that such a refund would materially and adversely effect the Company's financial position.

ITEM 4: Submission of Matters to a Vote of Security Holders

No matters were submitted to a vote of the securities holders during the fourth quarter of the 2005 fiscal year.

PART II

ITEM 5: Market for Common Equity Related Stockholder Matters and Small Business Issuer Purchases of Equity Securities

We issued 262,500 shares of unregistered securities during the 2005 fiscal year, as a result of warrant exercise We did not repurchase any of our securities during the 2005 fiscal year. Our shares of common stock do not trade on any market and the Company does not facilitate the purchase or sale of stock between private parties. The Company is conducting an initial public offering at a price of $4.00 per share of common stock. During the two years ending December 31, 2005, the only sale of common stock by the Company is in connection with its current initial public offering. Management has no knowledge of the per share value of any shares which may have be sold between private parties. We currently have approximately 198 shareholders. The Company has not declared a dividend on its common stock in the two years ended December 31, 2005. Common stock dividends can not be declared or paid until preferred stock holders have received the full non-commutative dividend to which they are entitled.. Management has no intent to declare a common stock dividend in the year ending December 31, 2006.

ITEM 6: Management Discussion and Analysis or Plan of Operation

You should read the following discussion and analysis in conjunction with our financial statements and related notes included elsewhere in this prospectus. Except for historical information, the following discussion and analysis contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995.

Overview

We develop, manufacture, market, and sell “alternative” or “New Age” beverages and assorted foods. We currently manufacture, market and sell six unique product lines:

- Reed’s Ginger Brews
- Virgil’s Root Beer and Cream Sodas
- China Colas
- Reed’s Ginger Juice Brews
- Reed’s Ginger Candies
- Reed’s Ginger Ice Creams

We currently distribute and sell our products through a network of natural, gourmet, and independent distributors, as well as through our growing in-house direct sales and distribution team, throughout the United States and, to a lesser extent, in Canada. In 2003, we implemented direct sales to several large national retail accounts. These accounted for approximately 19% of our gross sales in 2003 and approximately 22% of our gross sales in 2004 and 16% in 2005. In addition, in 2003 we created our own distribution system in southern California. This accounted for approximately 1% of our gross sales in 2003 and approximately 4% of our gross sales in 2004 and 8% in 2005. The following table shows a breakdown of net sales with respect to the distribution channel.

Distribution Channel	Direct sales to large retailers	%	Our local direct distribution	%	Natural, Gourmet and Mainstream distributors	%	Total
2003	$1,286,365	19	$90,121	1	$5,405,290	80	$6,781,776
2004	1,983,598	22	395,601	4	6,599,166	74	8,978,365
2005	1,536,896	16	751,999	8	7,181,390	76	9,470,285

New products, or SKUs, that we launched in 2003 include a 5-liter "party keg" version of our Virgil's Root Beer and Virgil's Cream Soda in 12-ounce long neck bottles. Both of these high-margin items continued to contribute to growth of our sales for 2003, 2004 and 2005. In 2004, we launched the 750 ml size bottles of our Reed's Spiced Apple Brew and the Cream Soda 5-liter party keg. These were followed up in 2005 with the launch of Reed's Original and Reed's Extra Ginger Brew in the new 750ml size. These new launches have been successful and these products continue to be part of our product mix.

In 2003, we expanded our marketing from our historical focus on natural and gourmet foods to include more mainstream markets. These efforts included selling our products directly to large retail accounts, primarily Costco, BJ Wholesale, and Cost Plus World Markets. In addition, through our current North American natural and gourmet distributors, we have focused sales to the natural food section of mainstream supermarket chains. This has resulted in our products now being sold in Safeway, Kroger's and numerous other national supermarket chains. Our local distribution in southern California is placing our products directly into accounts locally, including Ralph's, Bristol Farms, and many independent accounts. These efforts continue to be a part of our sales expansion.

We gauge the financial success of our company by a number of different parameters. Because our industry typically values companies on a top-line basis, one of our main company goals is to increase net sales. We continue to increase net sales each year. Net sales have increased from $6.2 million in 2001 to $6.4 million in 2002 to $6.8 million in 2003. In 2004 sales grew to $9.0 million and $9.5 million in 2005. We believe that the increase in net sales comes from three sources: successes in our new local distribution, increases in our core business and our new direct sales to large retailers.

Almost as important as increasing our net sales are increasing our gross margins. We continue to work to reduce costs related to production of our products. In 2002, we purchased and outfitted a West Coast production facility, the Brewery, in part to help reduce both production costs and freight costs associated with our West Coast sales. Gross profits declined after the construction of the Brewery. Gross margins decreased from 24.8% in 2002 to 19.5% in 2003. We believe that the inefficiencies commensurate with a start-up period for the Brewery have been a principal cause of the decline of our gross margins in 2003. Gross margins recovered to 20.9% in 2004, we believe that this increase in gross margin is because of the Brewery attaining greater functionality and efficiencies. In 2005, fuel prices, as a result of the hurricane Katrina, put downward pressure on our margins due to increased freight expenses and increased glass and production costs both of which are sensitive to fuel costs. In addition, the brewery on the west coast is running at 40% of capacity. The main reason for the underutilization is that management is trying to solve problems associated with the flavor of the ginger brew products produced at the west coast facility. Management is committed to selling a high quality, great tasting product. Since the east coast co-packer is producing such a product, management has elected to continue to sell that product on the west coast, even though it negatively impacts Company gross margins. As the Brewery continues to become more fully operational, we believe that we will see greater margin improvements due to freight and production savings. We expect to have the Brewery fully functional by the end of 2006. The following table shows the progress of production at the Brewery and the savings being generated:

Year	Cases of candy produced at new brewery	Candy production savings ($)	Cases of beverages produced at new brewery	Freight savings beverages ($)	Total savings ($)
2002	0	$ 0	0	$ 0	$ 0
2003	33,514	$ 33,514	16,835	$ 22,390	$ 55,904
2004	31,278	$ 31,278	113,816	$ 151,372	$ 182,650
2005	39,058	$ 39,058	229,094	$ 304,688	$ 343,746

In addition, through the Brewery, we have increased our capability to offer specialty beverage packaging options not typically available in the marketplace, such as our new 5-liter party keg line and our new 750 ml. champagne bottle line. We also intend to manage general and administrative and selling expenses, in order to improve our profitability.

Trends, Risks, Challenges, Opportunities That May or Are Currently Affecting Our Business

Our main challenges, trends, risks, and opportunities that could affect or are affecting our financial results include but are not limited to:

Fuel Prices - As oil prices continue to rise, our freight rates, which run at approximately 8% of net sales, have been increasing. We currently see freight rates increasing by an additional 5% to 10% in the near term. On the other hand, we expect that the Brewery will counter this trend, at least in part, by reducing our need for cross-country freight services.

Low Carbohydrate Diets and Obesity - Consumers have been demanding lower carbohydrate products. This trend did not seem to affect our sales growth in 2005. We are watching this trend closely and have started developing low-carbohydrate versions of some of our beverages.

Distribution Consolidation - The trend towards continued consolidation of the beverage distribution industry through mergers and acquisitions has inspired us to start our own direct distribution locally in southern California and to go to large national retailers. Consolidation among natural foods industry distributors has not had an affect on our sales. However, this consolidation may limit the distributor options outside natural foods to service mass-market food accounts.

Consumer Demanding More Natural Foods - The rapid growth of the natural foods industry has been fueled by the growing consumer awareness of the potential health problems due to the consumption of chemicals in the diet. Consumers are reading ingredient labels and choosing products based on them. We design products with these consumer concerns in mind. We feel this trend toward more natural products is one of the main trends behind our growth. Recently, this trend in drinks has not only shifted to products using natural ingredients, but also to products with added ingredients possessing a perceived positive function like vitamins, herbs and other nutrients. Our products are designed with this consumer demand in mind also.

Supermarket and Natural Food Stores - More and more supermarkets, in order to compete with the growing natural food industry, have started including natural food sections. As a result of this trend, our products are now available in supermarkets throughout the United States. Supermarkets can require that we spend more advertising money and they sometimes require slotting fees. We continue to work to keep these fees reasonable. Slotting fees in the natural food section of the supermarket are generally not as expensive as in other areas of the store. See the “Business” section regarding supermarket marketing.

Beverage Packaging Changes - Beverage packaging has continued to innovate. There is an increase in the sophistication with respect to beverage packaging design. While we feel that our current core brands still compete on the level of packaging, we continue to experiment with new and novel packaging designs such as the 5-liter party keg and 750 ml champagne style bottles. We have further plans for other innovative packaging designs. See the "Business" section for new product developments.

Cash Flow Requirements - Growth of our company will depend on the availability of additional capital infusions. We have a financial history of losses and are dependent on non-banking sources of capital, which tend to be more expensive and charge higher interest rates. Any increase in costs of goods will further increase losses and will further tighten cash reserves.

Packaging or Raw Material Price Increases - An increase in packaging or raw materials has caused our margins to suffer and has negatively impacted our cash flow and income. We continue to search for packaging and production alternatives to reduce our cost of goods.

***Interest Rates* -** The Company is negatively impacted in an increasing interest rate environment, such as the current environment. Management believes the IPO will provide capital sufficient for the Company to reduce its debt level and allow the Company to lower its incremental borrowing costs.

Results of Operations:

Twelve Months Ended December 31, 2005 Compared to Twelve Months Ended December 31, 2004

Net sales increased by $491,920, or 5.5%, from $8,978,365 in 2004 to $9,470,285 in 2005. Sales were affected by a number of trends from 2004 to 2005. In 2004, we had a number of sales of the new Virgil's 5 liter party keg that did not reoccur in 2005. These one time sales were to large club store customers. Sales of these 5 liter party kegs dropped by $427,000 from $1,002,000 in 2004 to $575,000 in 2005. Sales of the new Virgil's Cream soda increased from $139,000 in 2004 to $667,000 in 2005. Ice cream sales dropped from $196,000 in 2004 to $145,000 in 2005. Candy sales increased from $699,000 in 2004 to $822,000 in 2005. The core Reed's Ginger Brew item increased from $3,681,000 in 2004 to $4,103,000 in 2005. Virgil's Root Beer 12 ounce bottles increased from $1,591,000 in 2004 to $2,091,000 in 2005. We had other offsets such as our co-packing sales of private labels from our west coast facility that dropped by $210,000. In summary, our core brands Reed's Ginger Brews and Virgil's Root Beer lines continue to increase in sales. These increases are being offset by reduced co-packing sales, ice cream sales and juice sales and the reduced Virgil Root Beer 5 liter party keg sales. We expect to continue this trend with a few exceptions. We expect to turn around the ice cream sales or at least stabilize them. We also expect to increase our sales of the 5 liter party keg. We do not believe this product will continue its trend down since a core customer base is being established and it is meeting with ongoing success and year after year orders in these accounts. With the completion of the companies current IPO, we expect to increase the sales force and therefore experience increased sales of the core product lines for 2006. Due to the decreased margins, we have raised prices effective February 1, 2006 and we anticipate that sales will initially be slower but expect a recovery in the second quarter of 2006. We are launching the new Virgil's Black Cherry Cream in May 2006 and expect it to add to 2006 sales.

In 2004, we incurred $400,323 of promotional expenses due to deals offered by our sales force in the sale of our products. This represented about 4.3% of gross sales. In 2005, they were similar at $291,755 and about 2.9% of gross sales. These deals are accounted for as a direct reduction of sales. These percentage rates are in line with our historical rates and we do not anticipate them changing significantly. These promotional expenses are monitored and kept in a certain range.

As a percentage of net sales, gross profit decreased from 20.9% in 2004 to 18.2% in 2005. This decrease was due to increases in higher freight costs due to increased fuel costs (0.6%), increased depreciation (0.3%) and increased packaging costs due to glass costs increasing due to fuel costs increases (1.7%). To offset the reduced margins, effective February 1, 2006 we have increased prices in a number of the companies product lines. We expect margins to increase for 2006 due to this. This price increase averaged approximately 7% across the board.

General and Administrative and Selling expenses increased by $213,958 or 11.5% from $1,866,511, in 2004 to $2,080,469 in 2005 and increased as a percentage of net sales from 20.8% in 2004 to 22.0% in 2005. The increase in expenses was primarily due to increased sales wages due to a larger sales force (2.7%), more commissions due to increased number of outside sales brokers (1.0%), increased sales fuel costs (1.6%), increased fuel expenses for plant heating requirements (1.5%) and increased accounting costs due to the extra costs associated with being an SEC reporting company (1.7%). We do expect to increase the selling expenses upon the completion of the current IPO as we gear up the sales force for further expansion into the mainstream. We anticipate a lead time until these new sales people are generating enough additional revenue to support their additional expenses. We anticipate that General and Administrative expenses should remain relatively constant for 2006.

Legal Defense costs for 2004 were $80,156. These expenses were incurred for a lawsuit brought against us by a consultant alleging funds due him from us. We mounted a successful defense in this action. We filed a post trial motion for attorney fees and costs and were awarded $64,895. The case went to appeal which generated an additional expense of $36,558 in 2005. We won the appeal and are seeking additional damages. In 2006, we expect to spend approximately the same amount of legal expenses as 2005.

Interest expense was $309,504 in 2005, compared to interest expense of $255,032 in 2004. We had slightly higher interest expense in 2005 due to increased borrowing on our receivable line of credit with our lender, BACC. In 2006, we expect that the IPO will reduce our need for debt financing and allow the Company to obtain more favorable borrowing rates, thus offsetting the rise in the Prime Rate, and therefore interest expense should decrease.

Liquidity and Capital Resources

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.

As of December 31, 2005, we had a working capital deficit of $1,594,758, compared to a working capital deficit of $684,647 as of December 31, 2004. This increase in our working capital deficit was primarily attributable to increases in accounts payable and our line of credit These increases were required due to the loss the Company incurred in 2005 and costs incurred for the IPO.

We used $214,667 in investing activities for the twelve months ended December 31, 2005, primarily for the purchase of equipment for our West Coast Brewery and a loan made to a director before we became public. The purchase of equipment was for the 5 liter party keg filler. This piece of equipment reduces the labor costs by over 75% in the manufacture of the party kegs.

Cash flow provided from financing activities was $242,533 for the twelve months ended December 31, 2005 and was the result of increased borrowing on our line of credit, principal borrowing on long term debt, used primarily to purchase manufacturing equipment to improve the west coast production facility and vehicles, and cash from the sale of stock from the company’s IPO, offset by principal payments of debt payments for deferred offering expenses associated with the Company’s IPO.

Management recognizes the operating losses and costs incurred in the Company’s initial public offering have negatively impacted liquidity. Management plans to continue to have available a line of credit to provide short term liquidity and plans to continue its efforts regarding the IPO currently effective. Management believes the combination of these two items, will provide the liquidity the Company needs for 2006. In addition, the price increases Management instituted should lead to increased margins and a decrease in loss from operations, thus improving the Company’s liquidity needs. Management also recognizes there may be a potential securities law violation, which may require the Company to refund a maximum of approximately $759,000 relating to the issuance of shares of our common stock in 2006. In the event no further sales of the offering occur and in the event the Company is required to refund the entire $759,000, Management believes it will be able to refund that amount and provide working capital to the Company sufficient for the Company to conduct operations during the 2006 fiscal year.

Critical Accounting Policies

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 summarizes our most significant accounting and reporting policies and practices:

Trademark License and Trademarks. Trademark license and trademarks primarily represent the costs we pay for exclusive ownership of the Reed's® trademark in connection with the manufacture, sale and distribution of beverages and water and non-beverage products. We also own the Virgil's® trademark and the China Cola® trademark. In addition, we own a number of other trademarks in the United States as well as in a number of countries around the world. We account for these items in accordance with SFAS No. 142, "Goodwill and Other Intangible Assets." Under the provisions of SFAS No. 142, we do not amortize indefinite-lived trademark licenses and trademarks.

In accordance with SFAS No. 142, we evaluate our non-amortizing trademark license and trademarks quarterly for impairment. We measure impairment by the amount that the carrying value exceeds the estimated fair value of the trademark license and trademarks. The fair value is calculated by reviewing net sales of the various beverages and applying industry multiples. Based on our quarterly impairment analysis the estimated fair values of trademark license and trademarks exceeded the carrying value and no impairments were identified during the years ended December 31, 2005 or 2004.

Long-Lived Assets. Our management regularly reviews property, equipment and other long-lived assets, including identifiable amortizing intangibles, for possible impairment. This review occurs quarterly or more frequently if events or changes in circumstances indicate the carrying amount of the asset may not be recoverable. If there is indication of impairment of property and equipment or amortizable intangible assets, then management prepares an estimate of future cash flows (undiscounted and without interest charges) expected to result from the use of the asset and its eventual disposition. If these cash flows are less than the carrying amount of the asset, an impairment loss is recognized to write down the asset to its estimated fair value. The fair value is estimated at the present value of the future cash flows discounted at a rate commensurate with management's estimates of the business risks. Quarterly, or earlier, if there is indication of impairment of identified intangible assets not subject to amortization, management compares the estimated fair value with the carrying amount of the asset. An impairment loss is recognized to write down the intangible asset to its fair value if it is less than the carrying amount. Preparation of estimated expected future cash flows is inherently subjective and is based on management's best estimate of assumptions concerning expected future conditions. No impairments were identified during the years ended December 31, 2005 or 2004.

Management believes that the accounting estimate related to impairment of our long lived assets, including our trademark license and trademarks, is a "critical accounting estimate" because: (1) it is highly susceptible to change from period to period because it requires management to estimate fair value, which is based on assumptions about cash flows and discount rates; and (2) the impact that recognizing an impairment would have on the assets reported on our consolidated 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.

Advertising. We account for advertising production costs by expensing such production costs the first time the related advertising is run.

Accounts Receivable. We evaluate the collectibility 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.

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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.

Income Taxes. Current income tax expense is the amount of income taxes expected to be payable for the current year. A deferred income tax asset or liability is established for the expected future consequences of temporary differences in the financial reporting and tax bases of assets and liabilities. We consider future taxable income and ongoing, prudent, and feasible tax planning strategies, in assessing the value of our deferred tax assets. If our management determines that it is more likely than not that these assets will not be realized, we will reduce the value of these assets to their expected realizable value, thereby decreasing net income. Evaluating the value of these assets is necessarily based on our management's judgment. If our management subsequently determined that the deferred tax assets, which had been written down, would be realized in the future, the value of the deferred tax assets would be increased, thereby increasing net income in the period when that determination was made.

Recent Accounting Pronouncements

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs, an amendment of ARB No. 43, Chapter 4." The amendments made by Statement 151 clarify that abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current period charges and require the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. The guidance is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. Earlier application is permitted for inventory costs incurred during fiscal years beginning after November 23, 2004. The Company has evaluated the impact of the adoption of SFAS 151, and does not believe the impact will be significant to the Company's overall results of operations or financial position.

In December 2004, the FASB issued SFAS No.153, "Exchanges of Non-monetary Assets, an amendment of APB Opinion No. 29, Accounting for Non-monetary Transactions." The amendments made by Statement 153 are based on the principle that exchanges of non-monetary assets should be measured based on the fair value of the assets exchanged. Further, the amendments eliminate the narrow exception for non-monetary exchanges of similar productive assets and replace it with a broader exception for exchanges of non-monetary assets that do not have commercial substance. Previously, Opinion 29 required that the accounting for an exchange of a productive asset for a similar productive asset or an equivalent interest in the same or similar productive asset should be based on the recorded amount of the asset relinquished. Opinion 29 provided an exception to its basic measurement principle (fair value) for exchanges of similar productive assets. The Board believes that exception required that some non-monetary exchanges, although commercially substantive, be recorded on a carryover basis. By focusing the exception on exchanges that lack commercial substance, the Board believes this Statement produces financial reporting that more faithfully represents the economics of the transactions. The Statement is effective for non-monetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. Earlier application is permitted for non-monetary asset exchanges occurring in fiscal periods beginning after the date of issuance. The provisions of this Statement shall be applied prospectively. The Company has evaluated the impact of the adoption of SFAS 152, and does not believe the impact will be significant to the Company's overall results of operations or financial position.

In December 2004, the FASB issued SFAS No.123 (revised 2004), "Share-Based Payment." Statement 123(R) will provide investors and other users of financial statements with more complete and neutral financial information by requiring that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the fair value of the equity or liability instruments issued. Statement 123(R) covers a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. Statement 123(R) replaces FASB Statement No. 123, “Accounting for Stock-Based Compensation”, and supersedes APB Opinion No. 25, “Accounting for Stock Issued to Employees.” Statement 123, as originally issued in 1995, established as preferable a fair-value-based method of accounting for share-based payment transactions with employees. However, that Statement permitted entities the option of continuing to apply the guidance in Opinion 25, as long as the footnotes to financial statements disclosed what net income would have been had the preferable fair-value-based method been used. Public entities (other than those filing as small business issuers) will be required to apply Statement 123(R) as of the first interim or annual reporting period that begins after June 15, 2005. The Company has evaluated the impact of the adoption of SFAS 123(R), and does not believe the impact will be significant to the Company’s overall results of operations or financial position. All options issued prior to December 31, 2005 vested immediately, and therefore, there is no associated unamortized compensation that will be recorded in future periods relating to these options.

In May 2005 the FASB issued SFAS Number 154, “Accounting Changes and Error Corrections”. This SFAS provides guidance on accounting for and reporting of accounting changes and error corrections. The Company has evaluated the impact of SFAS 154 and does not believe the impact will be significant to the Company’s overall results of operations or financial position.

We do not believe that the adoption of the above recent pronouncements will have a material effect on our consolidated financial position or results of operations.

Inflation

Although management expects that our operations will be influenced by general economic conditions, we do not believe that inflation has a material effect on our results of operations.

Principal Commitments:

At December 31, 2005, the Company did not have any material commitments for capital expenditures. The Company's principal commitments for the next five fiscal years consisted of contractual commitments as summarized below. The summary shown below assumes that the Company will repay it lines of credit in full without renewals.

	Payments Due by Year					
Contractual cash obligations	**Total**	**2006**	**2007**	**2008**	**2009**	**2010**
Lines of credit	$ 1,445,953	$ 1,445,953	$ -0-	$ -0-	$ -0-	$ -0-
Long -term debt	580,794	169,381	111,321	102,654	87,348	38,090
Operating lease obligations	94,479	58,433	20,968	10,905	4,173	-0-
Total contractual cash Obligations	$ 5,644,978	$ 1,933,813	$ 1,168,870	$ 1,232,707	$ 884,183	$ 425,405

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ITEM 7: FINANCIAL STATEMENTS

We have audited the accompanying balance sheet of Reed’s, Inc. as of December 31, 2005 and the related statements of operations, changes in stockholders’ equity and cash flows for the years ended December 31, 2005 and 2004. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly in all material respects, the financial position of Reed’s, Inc. as of December 31, 2005 and the results of its operations and its cash flows for the years ended December 31, 2005 and 2004 in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. However, the Company incurred a loss of $825,955 and used $42,610 of cash in operating activities during the year ended December 31, 2005, and had a working capital deficiency of $1,594,758 as of December 31, 2005. These factors, among others, as discussed in Note 1 to the financial statements, raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 1. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ WEINBERG & COMPANY, P.A.

Weinberg & Company, P.A.

Los Angeles, California
April 7, 2006

REED'S, INC.
BALANCE SHEET
As of December 31, 2005

ASSETS		
Cash	$	27,744
Inventory		1,208,019
Trade accounts receivable, net of allowance for doubtful accounts and returns and discounts of $70,000		534,906
Other receivables		10,563
Prepaid expenses		74,279
Total Current Assets		1,855,511
Property and equipment, net of accumulated depreciation of $508,136		1,885,354
OTHER ASSETS		
Brand names		800,201
Other intangibles, net of accumulated amortization of $3,723		14,891
Deferred stock offering costs		356,238
Total Other Assets		1,171,330
TOTAL ASSETS	$	4,912,195
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	$	1,644,491
Lines of credit		1,445,953
Current portion of long term debt		169,381
Accrued interest		136,240
Accrued expenses		54,204
Total Current Liabilities		3,450,269
Loans payable, related party		252,358
Long term debt, less current portion		1,060,573
Total Liabilities		4,763,200
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY		
Preferred stock, $10.00 par value, 500,000 shares authorized, 58,940 shares issued and outstanding, liquidation preference of $10.00, per share		589,402
Common stock, $.0001 par value, 11,500,000 shares authorized, 5,042,197 shares issued and outstanding		503
Common stock to be issued (7,367 shares)		29,470
Additional paid in capital		2,788,683
Accumulated deficit		(3,259,063)
Total stockholders' equity		148,995

TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$	4,912,195

The accompanying notes are an integral part of these financial statements

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REED'S, INC.
STATEMENTS OF OPERATIONS
For the Years Ended December 31, 2005 and 2004

	Year Ended December 31, 2005		Year Ended December 31, 2004	
SALES	$	9,470,285	$	8,978,365
COST OF SALES		7,745,499		7,103,037
GROSS PROFIT		1,724,786		1,875,328
OPERATING EXPENSES				
Selling		1,124,705		791,975
General & Administrative		955,764		1,074,536
Legal Fees		36,558		80,156
Provision for amounts due from director		124,210		0
		2,241,237		1,946,667
LOSS FROM OPERATIONS		(516,451)		(71,339)
OTHER EXPENSES				
Interest Expense		(309,504)		(255,032)
Loss on extinguishment of debt		(—)		(153,000)
		(309,504)		(408,032)
NET LOSS		(825,955)		(479,371)
Preferred Stock Dividend		(29,470)		—
Net Loss Attributable to Common Stockholders	$	(855,425)	$	(479,371)
NET LOSS PER SHARE AVAILABLE TO COMMON STOCKHOLDERS — BASIC AND DILUTED	$	(0.18)	$	(0.10)
WEIGHTED AVERAGE SHARES OUTSTANDING, Basic and Fully Diluted		4,885,151		4,726,091

The accompanying notes are an integral part of these financial statements

REED'S, INC.
STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
For the Years Ended December 31, 2005 and 2004

	Common Stock				Preferred Stock			
	Shares	**Amount**	**Common Stock to be Issued**	**Additional Paid In Capital**	**Shares**	**Amount**	**Accumulated Deficit**	**Total**
Balance, January 1, 2004	4,726,091	$ 472	$ —	$ 2,429,824	—	$ —	$ (1,723,627)	$ 706,669
Issuance of preferred stock	—	—	—	—	33,440	334,400	—	334,400
Conversion of debt to preferred stock	—	—	—	—	25,500	255,002	—	255,002
Recognition of beneficial conversion feature on issuance of preferred stock	—	—	—	353,640	—	—	(200,640)	153,000
Net loss for year ended 2004	—	—	—	—	—	—	(479,371)	(479,371)
Balance, December 31, 2004	4,726,091	472	—	2,783,464	58,940	589,402	(2,403,638)	969,700
Exercise of warrants	262,500	26		5,224	—	—	—	5,250
Preferred Stock Dividend	—	—	29,470		—	—	(29,470)	—
Common stock issued for cash	53,606	5	—	196,570	—	—	—	196,575
Deferred stock offering costs charged to additional paid in capital	—	—	—	(196,575)	—	—	—	(196,575)
	—	—	—	—	—	—	(825,955)	(825,955)

Net loss for year ended December 31, 2005													
Balance December 31, 2005	5,042,197	$	503	$	29,470	$	2,788,683	58,940	$	589,402	$	(3,259,063)	$ 148,995

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, 2005 and 2004

	Year Ended December 31 , 2005		2004	
CASH FLOWS FROM OPERATING ACTIVITIES				
Net Loss	$	(825,955)	$	(479,371)
Adjustments to reconcile net loss to net cash used in operating activities:				
Depreciation and amortization		118,517		97,329
Loss on extinguishment of debt		—		153,000
Provision for amounts due from director		124,210		—
(Increase) decrease in operating assets and increase (decrease) in operating liabilities:				
Accounts receivable		262,708		(231,557)
Inventory		93,006		(3,665)
Prepaid expenses		(68,627)		11,730
Other receivables		(7,400)		7,589
Accounts payable		232,367		233,447
Accrued expenses		2,655		(9,755)
Accrued interest		25,909		45,233
Net cash used in operating activities		(42,610)		(176,020)
CASH FLOWS FROM INVESTING ACTIVITIES:				
Purchase of property and equipment		(181,654)		(204,147)
Due from director		(33,013)		(44,040)
Net cash used in investing activities		(214,667)		(248,187)
CASH FLOWS FROM FINANCING ACTIVITIES:				
Deferred offering costs		(332,858)		(219,955)
Principal payments on debt		(263,815)		(208,852)
Proceeds from issuance of common stock		196,575		—
Proceeds received from issuance of preferred stock		—		334,400
Proceeds from borrowings on debt		295,900		208,464
Net borrowings on lines of credit		367,731		339,708
Payments on debt to related parties		(21,000)		—
Net cash provided by financing activities		242,533		453,765
NET INCREASE (DECREASE) IN CASH		(14,744)		29,558
CASH — Beginning of year		42,488		12,930
CASH — End of year	$	27,744	$	42,488
Supplemental Disclosures of Cash Flow Information				
Cash paid during the period for:				
Interest	$	283,595	$	227,669
Taxes	$	—	$	—
Noncash Investing and Financing Activities				
Notes payable converted to preferred stock	$	—	$	224,000
Accrued interest converted to preferred stock		—		31,002
Beneficial conversion feature		—		353,640
Common Stock issued in settlement of accrued interest on related party debt upon exercise of warrants		5,250		—

Common Stock to be issued in settlement of preferred stock dividend (7,367 shares)	29,470	—
Conversion of a line of credit to a term loan	50,000	—

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

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REED’S, INC.
NOTES TO FINANCIAL STATEMENTS

(1) Operations and Summary of Significant Accounting Policies

A) Nature of Operations

Reed’s, Inc. (the “Company”) was organized under the laws of the state of Florida in January 1991. In 2001, the Company changed its name from Original Beverage Corporation to Reed’s, Inc. and changed its state of incorporation from Florida to Delaware. The Company is engaged primarily in the business of developing, manufacturing and marketing natural non-alcoholic beverages, as well as candies and ice creams. The Company currently offers 14 beverages, two candies, and three ice creams.

The Company sells its products primarily in upscale gourmet and natural food stores and supermarket chains in the United States and, to a lesser degree, in Canada.

B) Going Concern

The accompanying financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, which contemplate continuation of the Company as a going concern. However, the Company had a net loss of $825,955 and utilized cash of $42,610 in operating activities during the year ended December 31, 2005, and had a working capital deficiency of $1,564,758 at December 31, 2005. In addition, the Company may have committed a violation of securities law which may require the rescission of common stock issued in 2006 in the aggregate of approximately $759,000, see Note 14. These factors raise substantial doubt about the Company's ability to continue as a going concern. The financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts, or amounts and classification of liabilities that might result from this uncertainty. The Company is conducting an initial public offering of its stock. The maximum amount of common stock to be sold is 2,000,000 shares at $4.00. Management has received interest enough in the offering which leads it to believe the maximum amount of the offering will be sold. The Company has received approximately $975,076 from the offering, see Note 14. In the event no further sales of the offering occur and in the event the Company is required to refund the entire $759,000, management believes it will be able to refund that amount and provide working capital to the Company sufficient for the Company to conduct operations during the 2006 fiscal year.

C) 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.

D) Accounts Receivable

The Company evaluates the collectibility 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 for returns and discounts charged against sales. Receivables are charged off against the allowance when payments are received or products returned. The allowance for doubtful accounts and returns and discounts as of December 31, 2005 was $70,000.

E) Property and Equipment and Related Depreciation

Property and equipment is stated at cost. 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	7-12 years
Computer	3-5 years
Automobile	5 years
Office equipment	7 years

REED’S, INC.
NOTES TO FINANCIAL STATEMENTS — (Continued)

Management regularly reviews property, equipment and other long-lived assets for possible impairment. This review occurs quarterly, or more frequently if events or changes in circumstances indicate the carrying amount of the asset may not be recoverable. If there is indication of impairment, management prepares an estimate of future cash flows (undiscounted and without interest charges) expected to result from the use of the asset and its eventual disposition. If these cash flows are less than the carrying amount of the asset, an impairment loss is recognized to write down the asset to its estimated fair value. Management believes that the accounting estimate related to impairment of its property and equipment 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 are expected to continue to do so.

F) Intangible Assets

The Company records intangible assets in accordance with Statement of Financial Accounting Standard (SFAS) Number 142, “Goodwill and Other Intangible Assets.” Goodwill and other intangible assets deemed to have indefinite lives are not subject to annual amortization. The Company reviews, at least quarterly, its investment in brand names and other intangible assets for impairment and if impairment is deemed to have occurred the impairment is charged to expense. Intangible assets which have finite lives are amortized on a straight line basis over their remaining useful life; they are also subject to annual impairment reviews. See Note 4.

Management applies the impairment tests contained in SFAS number 142 to determine if an impairment has occurred. Accordingly, management compares the carrying value of the asset to its fair value in determining the amount of the impairment. No impairments were identified for the years ended December 31, 2005 and 2004.

Management believes that the accounting estimate related to impairment of its intangible assets, 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 are expected to continue to do so.

G) Concentrations

The Company’s cash balances on deposit with banks are guaranteed by the Federal Deposit Insurance Corporation up to $100,000. The Company may be exposed to risk for the amounts of funds held in one bank in excess of the insurance limit. In assessing the risk, the Company’s policy is to maintain cash balances with high quality financial institutions. The Company had cash balances in excess of the $100,000 guarantee during the year ended December 31, 2005.

During the years ended December 31, 2005 and 2004 the Company’s had two customers, which accounted for approximately 39% and 15% and 39% and 14% of sales, respectively . No other customer accounted for more than 10% of sales in either year. As of December 31, 2005, the Company had approximately $181,580 and $38,000, respectively, of accounts receivable due from these customers.

REED'S, INC.
NOTES TO FINANCIAL STATEMENTS — (Continued)

The Company currently relies on a single contract packer for a majority of its production and bottling of beverage products. The Company has different packers for their non-beverage products. Although there are other packers and the Company is in the process of outfitting their own brewery and bottling plant, a change in packers may cause a delay in the production process, which could ultimately affect operating results.

H) Fair Value of Financial Instruments

The carrying amount of the Company's financial instruments including cash, accounts and other receivables, accounts payable, accrued interest and accrued expenses approximate their fair value as of December 31, 2005 due to their short maturities. The carrying amount of lines of credit, loans payable, related party and long term debt approximate fair value because the related effective interest rates on these instruments approximate the rates currently available to the Company.

I) Cost of sales

The Company , with one exception, classifies shipping and handling costs of the sale of its products as a component of cost of sales. The one exception regards shipping and handling costs associated with local sales and local distribution. Since these activities are integrated, those costs are combined and are included as selling expenses in the year ended 2005 and general and administrative expenses in the year ended 2004. For the years ended December 31, 2005 and 2004 those costs were approximately $88,000 and $63,000, respectively.

In addition, the Company classifies purchasing and receiving costs, inspection costs, warehousing costs, freight costs, internal transfer costs and other costs associated with product distribution as costs of sales. Certain of these costs become a component of the inventory cost and are expensed to costs of sales when the product to which the cost has been allocated is sold.

Expenses not related to the production of our products are classified as operating expenses.

J) Income Taxes

Current income tax expense is the amount of income taxes expected to be payable for the current year. A deferred income tax asset or liability is established for the expected future consequences of temporary differences in the financial reporting and tax bases of assets and liabilities. The Company considers future taxable income and ongoing, prudent and feasible tax planning strategies, in assessing the value of its deferred tax assets. If the Company determines that it is more likely than not that these assets will not be realized, the Company will reduce the value of these assets to their expected realizable value, thereby decreasing net income. Evaluating the value of these assets is necessarily based on the Company's judgment. If the Company subsequently determined that the deferred tax assets, which had been written down, would be realized in the future, the value of the deferred tax assets would be increased, thereby increasing net income in the period when that determination was made.

K) Deferred Stock Offering Costs

The Company capitalizes costs incurred related to an initial public offering and future issuance of common stock until such time as the stock is issued, or the stock offering is abandoned by the Company. These costs include attorney's fees, accountant's fees, SEC filing fees, state filing fees, and other specific incremental costs directly related to the initial public offering and related issuance of common stock. At December 31, 2005, deferred offering costs were $356,238. The offering associated with these costs is continuing. As proceeds are received from the offering the deferred offering costs are charged to additional paid in capital. During the year ended December 31, 2005, $196,575 of deferred offering costs where charged to additional paid in capital. No such charge was made to additional paid in capital during 2004, as the offering had not commenced until 2005.

REED'S, INC.
NOTES TO FINANCIAL STATEMENTS — (Continued)

L) Stock Options

Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" (SFAS No. 123), establishes a fair value method of accounting for stock-based compensation plans and for transactions in which an entity acquires goods or services from non-employees in exchange for equity instruments. SFAS No. 123 also encourages, but does not require, companies to record compensation cost for stock-based employee compensation. SFAS No. 123 was amended by SFAS No. 148, which now requires companies to disclose in interim financial statements the pro forma effect on net income (loss) and net income (loss) per common share of the estimated fair market value of stock options or warrants issued to employees. The Company has chosen to continue to account for stock-based compensation issued to employees utilizing the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees", with pro forma disclosures of net income (loss) as if the fair value method had been applied. Accordingly, compensation cost for stock options is measured as the excess, if any, of the fair market price of the Company's stock at the date of grant over the amount an employee must pay to acquire the stock.

For the year ended December 31, 2005, 218,500 options were issued that immediately vested. The pro forma disclosure related to the issuance and vesting of these options is as follows:

Net loss as reported	$	(825,955)
Stock based compensation		(530,955)