

JONES SODA CO  
Form 10-Q  
November 10, 2008  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

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

OR

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

Commission File Number 0-28820

**Jones Soda Co.**

(Exact name of registrant as specified in its charter)

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**Washington**  
(State or other jurisdiction of  
incorporation or organization)  
  
**234 9th Avenue North**  
  
**Seattle, Washington**  
(Address of principal executive offices)

**91-1696175**  
(I.R.S. Employer  
Identification Number)

**98109**  
(Zip Code)

**(206) 624-3357**

(Registrant's Telephone Number, Including Area Code)

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

Indicate by check whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file for such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check One):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
(Do not check if a smaller reporting company)

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

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

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**JONES SODA CO.**

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**EXPLANATORY NOTE**

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

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

**CAUTIONARY NOTICE REGARDING FORWARD LOOKING STATEMENTS**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Our inability to build and sustain proper information technology infrastructure;

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

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

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

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

**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS  
JONES SODA CO. AND SUBSIDIARIES**

Condensed Consolidated Balance Sheets

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

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



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\$ 30,850,485      \$ 41,624,594

See accompanying notes to interim condensed consolidated financial statements.

**Table of Contents****JONES SODA CO. AND SUBSIDIARIES**

## Condensed Consolidated Statements of Operations

(Unaudited)

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

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

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

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

See accompanying notes to interim condensed consolidated financial statements.

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**JONES SODA CO. AND SUBSIDIARIES**

Condensed Consolidated Statements of Shareholders' Equity and Comprehensive Loss

Nine months ended September 30, 2008 (Unaudited)

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

See accompanying notes to interim condensed consolidated financial statements.

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## Condensed Consolidated Statements of Cash Flows

(Unaudited)

Nine months ended September 30, 2008 and 2007

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

See accompanying notes to interim condensed consolidated financial statements.

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**JONES SODA CO. AND SUBSIDIARIES**

**Notes to Interim Condensed Consolidated Financial Statements**

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

**1. Nature and continuance of operations:**

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

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

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

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

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

**2. Significant accounting policies:**

(a) Basis of presentation:

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

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

(b) Use of estimates:

The preparation of the condensed consolidated financial statements requires management to make a number of estimates and assumptions relating to the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported

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amounts of revenue and expenses during the reporting period. Significant items subject to such estimates and assumptions include, but are not limited to, inventory valuation, depreciable lives of capital assets, valuation of other assets and intangible assets, valuation allowances for receivables, trade promotion liabilities, stock-based compensation expense, valuation allowances for deferred income tax assets and contingencies. Actual results could differ from those estimates.

**(c) Seasonality:**

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

**(d) Recently issued accounting pronouncements:**

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

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

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

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

**3. Inventory:**

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





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

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

**4. Segmented information and export sales:**

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

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

**5. Long term liabilities:**

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

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

**6. Loss per share:**

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

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

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

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

### 7. Stock-based compensation:

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

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

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

(a) Stock options:

A summary of our stock option activity is as follows:

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

(b) Non-vested shares:

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

A summary of our restricted stock activity is as follows:

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

(c) Stock-based compensation expense:

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

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

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

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

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

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

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

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

**8. Income Taxes:**

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

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

**Table of Contents****9. Commitments and contingencies****Commitments**

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

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

**Legal proceedings**

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

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

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

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

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

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

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

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

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

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

**Overview**

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

*Jones Pure Cane Soda*, a premium soda;

*Jones 24C*, an enhanced water beverage;

*Jones Organics*, a ready-to-drink organic tea;

*Jones Energy*, a citrus energy drink;

*WhoopAss Energy Drink*<sup>®</sup>, a citrus energy drink; and

*Jones Naturals*<sup>®</sup>, a non-carbonated juice & tea.

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

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

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



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

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**Table of Contents****Critical Accounting Estimates and Policies**

The discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates including, but not limited to, those affecting revenues, the allowance for doubtful accounts, the salability of inventory and the useful lives of tangible and intangible assets, valuation allowances for receivables, trade promotions, stock-based compensation expense, valuation allowances for deferred income taxes and liabilities and contingencies. The brief discussion below is intended to highlight some of the judgments and uncertainties that can impact the application of these policies and the specific dollar amounts reported on our financial statements. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form our basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions, or if management made different judgments or utilized different estimates. Many of our estimates or judgments are based on anticipated future events or performance, and as such are forward-looking in nature, and are subject to many risks and uncertainties, including those discussed below and elsewhere in this Report. We do not undertake any obligation to update or revise this discussion to reflect any future events or circumstances.

We have identified below some of our accounting policies that we consider critical to our business operations and the understanding of our results of operations. This is not a complete list of all of our accounting policies, and there may be other accounting policies that are significant to us. For a detailed discussion on the application of these and our other accounting policies, see Note 2 to the Consolidated Financial Statements included in this Report and the summary of accounting policies and notes to the financial statements included in our annual report on Form 10-K for the year ended December 31, 2007.

*Revenue Recognition*

We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable and collectability is reasonably assured.

With respect to our DSD and DTR channels, our products are sold on various terms for cash or credit. Our credit terms, which are established in accordance with local and industry practices, typically require payment within 30 days of delivery. We recognize revenue upon receipt of our products by our distributors and retail customers in accordance with written sales terms, net of provisions for discounts and allowances. All sales to distributors and customers are final sales and we have a no return policy; however, in limited instances, due to product quality issues, we may take back product.

With respect to our CSD channel, we recognize revenue from the sale of concentrate to National Beverage Corp. on a gross basis and recognize revenue upon receipt of concentrate by National Beverage. The selling price and terms of sale of concentrate to National Beverage are determined in accordance with our manufacturing and distribution agreement with them. Our credit terms from the sale of concentrate typically require payment within 30 days of delivery. All sales of concentrate to National Beverage are final sales and we have a no return policy with them, however, in limited instances, due to product quality or other custom package commitments, we may take back product.

Licensing revenue is recorded when we receive a sale confirmation from the third party.

We pay for slotting fees or similar arrangements in accordance with Emerging Issues Task Force ( EITF ) Issue No. 01-9, Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products). Generally, this incentive is recognized as a reduction in revenue at the later of the date on which the related revenue is recognized or a commitment is made. If we receive a benefit from any such incentives over a period of time and we meet certain criteria, such as retailer performance, recoverability and enforceability, such incentives are recorded as an asset and are amortized as a reduction of revenue over the term of the arrangement. Typically, we amortize slotting fees over a period not exceeding 12 months subject to recoverability consideration. We evaluate the recoverability of any deferred slotting fees on a quarterly basis.

Cash consideration and promotion allowances (including slotting fees) that we pay to customers or distributors are accounted for as a reduction of revenue when expensed or amortized in our statements of operations. For the nine-month

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period ended September 30, 2008, our revenue was reduced by approximately \$4,309,000 (2007-\$1,653,000), primarily on account of promotion allowances, slotting fees and cash considerations.

We entered into a Sponsorship Agreement with Football Northwest LLC (d/b/a Seattle Seahawks) and First & Goal, Inc. on May 22, 2007 and with Brooklyn Arena LLC and New Jersey Nets Basketball, LLC on November 8, 2007, both of which provide us with the exclusive beverage rights for certain soft drinks as well as signage, advertising and other promotional benefits to enhance our brand awareness. We have allocated amounts under the agreements to the identifiable benefits including signage, advertising and other promotional benefits based on their fair value and are recognizing such costs in promotion and selling expenses based on our existing policy for such expenses.

### *Allowance for Doubtful Accounts; Bad Debt Reserve*

We routinely estimate the collectability of our accounts receivable. We analyze accounts receivable, historical bad debts, customer concentrations, customer credit-worthiness, current economic trends and changes in our customer payment terms when evaluating the adequacy of the allowance for doubtful accounts. In general, we have historically and continue today to provide an allowance for doubtful accounts equal to 100% of any unpaid balance outstanding greater than 90 days since invoice, unless considered collectible. We believe that in general bad debt reserves for other companies in the beverage industry represent approximately 2% of total sales. Historically, our bad debt reserves have been less than 1% of total sales. Bad debt expense is classified within general and administrative expenses in our Consolidated Statements of Operations. In light of current economic conditions, we increased our allowance for doubtful accounts by \$100,000 or 72% in the third quarter of 2008.

Additionally, if we receive notice of a disputed receivable balance, we accrue such additional amount as we determine is reflective of the risk of noncollection. In considering the amount of bad debt allowance we rely heavily on our history of no material write-offs and on the fact that our revenue is not dependent on one or a few customers, but is spread among a number of customers. However, as noted above, we will change our estimates as we assess the effect the downturn in the economy may have on collections if we see a greater concentration of our receivables from fewer customers. In such events, we may be required to record additional charges to cover this exposure. Material differences may result in the amount and timing of our bad debt expenses for any period if we made different judgments or utilized different estimates.

### *Inventory*

We hold raw materials and finished goods inventories, which are manufactured and procured based on our sales forecasts. We value inventory at the lower of cost or estimated net realizable value, and include adjustments for estimated obsolescence, on a first in-first out basis. These valuations are subject to customer acceptance, planned and actual product changes, demand for the particular products, and our estimates of future realizable values based on these forecasted demands. We regularly review inventory detail to determine whether a write-down is necessary. We consider various factors in making this determination, including recent sales history and predicted trends, industry market conditions and general economic conditions. The amount and timing of write-downs for any period could change if we make different judgments or use different estimates. We also determine whether an allowance for obsolescence is required on products that are over 12 months from production date. During the nine months ended September 30, 2008, we increased inventory obsolescence provisions for discontinued raw material and finished goods. At September 30, 2008 we had an inventory obsolescence provision of approximately \$950,000 (\$565,000 at December 31, 2007).

### *Deferred Income Taxes*

The determination of our provision for income taxes requires significant judgment, the use of estimates, and the interpretation and application of complex tax laws. To the extent management believes it is more likely than not that we will not be able to utilize some or all of our deferred taxes prior to their expiration, we are required to establish valuation allowances against that portion of deferred tax assets. The determination of required valuation allowances involves significant management judgment and is based upon our best estimate of anticipated taxable profits in various jurisdictions with which the deferred tax assets are associated. Changes in expectations could result in significant adjustments to the valuation allowances and material changes to our provision for income taxes.

During the fourth quarter of fiscal 2007, we concluded that it was appropriate to record a charge of approximately \$5,483,000 to establish a full valuation allowance against the tax benefits arising from losses in our U.S. operations. As of December 31, 2007, we had incurred cumulative losses in recent years with respect to our U.S. operations. We incurred additional losses in our U.S. operations during the first half of 2008 and increased our cumulative losses in our U.S.



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operations. In accordance with the relevant accounting guidance, we considered future projections of U.S. pretax income as a material factor in our analysis of the realizability of our net U.S. deferred tax assets. Nonetheless, it was difficult to overcome the cumulative losses and, thus, we continue to establish a full valuation allowance against our net U.S. deferred tax assets. This is due to the fact that the relevant accounting guidance puts more weight on the negative objective evidence of cumulative losses in recent years than the positive subjective evidence of future projections of pretax income. We analyze the realizability of our deferred tax assets on a quarterly basis, but reasonably expect to continue to record a full valuation allowance on future U.S. tax benefits until we sustain an appropriate level of taxable income through improved U.S. operations and tax planning strategies. No valuation allowance was recorded for deferred tax assets recorded in the Canadian subsidiary, as this subsidiary remains profitable.

We adopted the provisions of Financial Accounting Standards Board Interpretation No. 48 ( FIN 48 ) on January 1, 2007. The adoption of FIN 48 did not impact the consolidated financial condition, results of operations or cash flows. We believe that we have appropriate support for the income tax positions taken and to be taken on our tax returns and that our accruals for tax liabilities are adequate for all open years based on an assessment of many factors including past experience and interpretations of tax law applied to the facts of each matter. Therefore, no reserves for uncertain income tax positions have been recorded for the nine months ended September 30, 2008 pursuant to FIN 48.

*Contingencies*

We are subject to the possibility of losses from various contingencies. See Part II: Item 1. Legal Proceedings. Considerable judgment is necessary to estimate the probability and amount of loss from such contingencies. An accrual is made when it is probable that a liability has been incurred or an asset has been impaired and the amount of loss can be reasonably estimated. We accrue a liability and charge to operations for estimated costs of adjudication or settlement and unasserted claims existing as of the balance sheet date.

As of September 30, 2008, no loss contingencies have been accrued for any lawsuits to which we are a party, as we are unable to predict the outcome of these cases. An adverse court determination in any of these actions against us could result in significant liability and could have a material adverse effect on our business, results of operations or financial condition, subject to the limits of our insurance policies.

*Stock-based Compensation*

We adopted Statement of Financial Accounting Standards No. 123R, Share-Based Payment (SFAS 123R), using the modified prospective transition method in 2006. Under this method, stock-based compensation expense is recognized using the fair-value based method for all awards granted on or after the date of adoption. We have adopted the Black-Scholes option pricing model to estimate fair value of each option grant. Determining the fair value of share-based awards at the grant date requires judgment. In addition, judgment is also required in estimating the amount of share-based awards that are expected to be forfeited. If actual results differ significantly from these estimates, our stock-based compensation expense and results of operations could be materially impacted. During the quarter ended June 30, 2008, as a result of the departure of certain employees and directors, we increased our estimated forfeiture rate from 11% to a range of 13% to 85.7% on outstanding stock options and restricted stock.

During the six months ended June 30, 2008, the Board of Directors granted restricted stock awards for 66,850 shares and stock option awards for 658,250 shares under our 2002 Stock Option and Restricted Stock Plan, which was approved by our shareholders in May 2007. Under the fair value recognition provision of SFAS 123R, share-based compensation cost for stock awards is measured at the grant date based on the fair value of the award and is recognized as expense over the requisite service period. No grants were made in the quarter ended September 30, 2008.

We amortize stock-based compensation for both stock option grants and restricted stock awards, in most instances, over a period of 42 months, with the first 1/7th vesting six months from the grant date and the balance vesting in equal amounts every six months thereafter.

**Table of Contents****Results of Operations for the Three and Nine months Ended September 30, 2008***Revenue*

<i>(Dollars in Thousands)</i>	Three Months Ended September 30,			Nine Months Ended September 30,		
	2008	2007	Change	2008	2007	Change
Gross Revenue (1)	\$ 9,730	\$ 13,047	-25.4%	\$ 34,096	\$ 35,585	-4.2%
Less: Promotion allowances and slotting fees (2)	(1,046)	(1,310)	-20.2%	(4,309)	(1,653)	160.7%
<b>Net Revenue</b>	<b>\$ 8,684</b>	<b>\$ 11,737</b>	<b>-26.0%</b>	<b>\$ 29,787</b>	<b>\$ 33,932</b>	<b>-12.2%</b>

- (1) Gross revenue, which excludes the impact of slotting fees and promotional allowances, is a non-GAAP financial measure. The most directly comparable GAAP measure is net revenues. Under GAAP, slotting fees and promotional allowances are recorded as a reduction of revenue in calculating net revenues. Gross revenue is used by management to monitor operating performance, including in comparison to prior years, as it allows evaluation of sales performance before the effects of any slotting fees and promotional items. We believe that the presentation of gross revenues provides useful information to investors because it allows a more comprehensive presentation of the Company's operating performance. However, gross revenues should not be used alone as an indicator of operating performance in place of net revenues. Gross revenues may not be realized in the form of cash receipts as slotting fees and promotional payments and allowances may be deducted from payments received from customers. This table reconciles gross revenues to net revenues.
- (2) 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, the presentation of promotional allowances and slotting fees may not be comparable to similar items presented by other companies. The presentation of promotional allowances and slotting fees facilitates an evaluation of the impact thereof on the determination of net revenues and illustrates the spending levels incurred to secure such sales.

For the three months ended September 30, 2008, net revenues were \$8,684,000, a decrease of \$3,053,000, or 26.0%, from \$11,737,000 in net revenues for the three months ended September 30, 2007. The decrease in net revenues over the same period of the prior year was primarily attributable to a decrease in DTR channel sales, with the loss of certain Jones Soda business at Wal-Mart and lower Sam's Club business versus the prior year, as well as lower DSD channel sales. The decrease in net revenues in the DTR channel during the quarter ended September 30, 2008, was somewhat offset by gains from our agreement as the exclusive supplier of canned soda to Alaska Airlines. Revenues in our DSD channel decreased compared to the same three-month period of the prior year, primarily due to lower shipments of Jones Soda in the Midwest and Northeast, with some of this decrease offset by increases in shipments to Eastern Canada. Additionally, revenue in the third quarter of 2007 included sales of 16-ounce single-serve cans for which there were no comparable sales in 2008, as we discontinued this product. Increased case sales in Eastern Canada are due to new product placement arrangements with Loblaw's, a Canadian grocery store chain. We believe the decline in sales of our 12-ounce bottles in the Midwest during 2008 may be attributable to the introduction of 12-ounce cans in those regions. Our Eastern region was negatively impacted by the termination of a seasonal sales program at BJ's Wholesale, which was in place in 2007.

For the three-month period ended September 30, 2008, our gross revenue was reduced by \$1,046,000 due to promotion allowances, compared to a reduction on account of promotion allowances of \$1,310,000 in the comparable three-month period in 2007. The decrease in promotion allowances in the third quarter of 2008 compared to the same period of 2007 was the result of lower sales, as promotion allowances are generated by sales.

For the nine months ended September 30, 2008, net revenues were approximately \$29,787,000, a decrease of \$4,145,000, or 12.2%, over the approximately \$33,932,000 in net revenues for the nine months ended September 30, 2007. The decrease in net revenues over the same period of the prior year was primarily attributable to an increase in promotion allowances and slotting fees in the first two quarters of 2008. The decrease in net revenues over the same period of the prior year was also attributable to decreased revenue in our DSD channel and decreased sales of concentrate to National Beverage Corp (all as discussed below).

Revenues in our DSD channel decreased in the first nine months of 2008 compared to the same period of the prior year, primarily due to lower shipments of Jones Soda glass bottles, and no sales of 16 ounce cans, which had contributed to sales in 2007. We believe the decrease in case

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sales in the DSD channel in the first three quarters of 2008 was also due to the reduction or loss of distribution points at some key retailers (including Speedway, Fred Meyer and Alberstons) due to slow sales and the introduction of our 12-ounce cans (which we believe had a negative impact on sales of our Jones Soda

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glass bottles). These decreased case sales were partially offset by increased shipments to Canada, our 24C launch late in 2007, which contributed to 2008 sales, and the addition of new retailers and the implementation of new retailer programs.

Revenue in our DTR channel in the first nine months of 2008 held steady compared to the same period of the prior year. Primary contributors to DTR revenue in 2008 are Alaska Airlines and Sam's Club. We were selected by Sam's Club as a Volume Producing Items (VPI) partner for 2008, under which we expected to have opportunities for enhanced in-store placement and promotions. This selection positively impacted our sales to Sam's Club in the first and second quarters of 2008, as we commenced shipments under this program. However, during the second and third quarters of 2008, Sam's Club reduced the number of stores carrying Jones Soda under the VPI program. As a result, our sales to Sam's Club under the VPI program have had a lesser than planned positive impact in the third quarter of 2008. Our status as a VPI partner does not guarantee any minimum sales levels and could be terminated or further limited at any time, so there can be no assurance regarding the level of revenue that we will generate under this program. Alaska Airlines and Sam's Club's sales helped offset reduced revenue from Wal-Mart. Wal-Mart has discontinued carrying Jones Soda 12-ounce bottles (although it continues to carry the 12-ounce can), which negatively impacted revenue in the DTR channel during the second and third quarters of 2008.

Our concentrate sales to National Beverage decreased in the third quarter and first nine months of 2008 over the comparable periods in 2007. New concentrate shipments in the second quarter of 2008 relating to our national launch of Jones Cola and Jones Lemon Lime, which were in addition to shipments of our traditional flavors, were strong. However, concentrate sales in the first and third quarters of 2008 were lower, due to existing inventory levels, than in the same periods of 2007 when we launched our Jones cans nationwide. In the future, we expect National Beverage to order concentrate for various flavors based on its production needs and inventory levels, as they already have sufficient inventory of most of our traditional and new flavors for current orders and will only re-order based on demand.

For the nine-month period ended September 30, 2008, our gross revenue was reduced by \$4,309,000 on account of promotion allowances and slotting fees, compared to promotion allowances and slotting fees of \$1,653,000 in the comparable nine-month period in 2007. We incurred increased promotion allowances and slotting fees primarily in the CSD channel and, to a lesser extent, the DSD channel, in the first two quarters of 2008 to activate placement and promotions related to additional distribution of our CSD business along with specific new distribution points of 24C in the U.S. and Jones Soda glass bottles in Canada.

Case sales

Historically, we have reported our sales volume of unit cases of finished products sold by us through our DTR and DSD channels. Starting in 2008, we are also reporting for informational purposes sales volume of unit cases of Jones-branded finished products sold by National Beverage (through the CSD channel) to various retailers. This does not change our revenue recognition policy. These are finished goods bearing our trademarks where we provide marketing support and from the sale of which we derive economic benefit. We believe that this measurement, together with finished product sales to our DTR and DSD channels, provides another indication of the strength of our brand and acceptance of our products in the marketplace.

Consolidated case sales of finished products to retailers and distributors through our DSD and DTR channels for the nine months ended September 30, 2008, expressed as 288-ounce equivalent cases, were 2,416,000. This is a decrease of 17,000 cases, or 0.7%, over total comparable case sales for the same period in 2007. During the first nine months of 2008, total case sales of Jones-branded finished products sold directly by National Beverage to retailers in the CSD channel were 1,864,000, a decrease of 16.3%, compared to 2,226,000 for the same period in 2007. This decrease was primarily attributable to the loss of our business at Winco in the first quarter of 2008 (which accounted for sales of approximately 214,000 cases in the nine months ended September 2007), and a decrease of approximately 607,000 cases at Wal-Mart compared to the same period of the prior year due to its discontinuation of carrying the Jones Soda 12-ounce bottles.

We also intend to continue to report consolidated case sales of concentrate to National Beverage. Concentrate case sales represents the amount of concentrate sold by us to National Beverage. We recognize revenue from these sales upon receipt of the concentrate by National Beverage in accordance with our revenue recognition policy. Case sales of concentrate to National Beverage and total cases of finished products sold by National Beverage to retailers (which are discussed above) are not necessarily equivalent during any given period. Factors such as seasonality, National Beverage inventory practices, timing of price increases, new product introductions, retailer demand and changes in product mix can



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impact unit case volume and concentrate sales and can create differences between sales of concentrate by us and sales of finished products to retailers by National Beverage.

Consolidated case sales of concentrate to National Beverage for the nine months ended September 30, 2008, expressed as 288-ounce equivalent cases, were approximately 1,366,000. This is a decrease of 1,211,000 cases, or 47.0%, over total case sales for the comparable nine-month period in 2007, resulting primarily from our increased shipments to National Beverage in 2007 due to the introduction of new flavors and the fact that we did not ship any significant amount of concentrate to National Beverage in the first and third quarters of 2008, as discussed above.

**288-ounce equivalent case sales by Jones Soda**

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2008	2007	Change	2008	2007	Change
Finished products case sales to DTR and DSD channels	712,308	890,368	-20.0%	2,416,203	2,433,000	-0.7%
Concentrate case sales to National Beverage	314,702	676,697	-53.5%	1,365,781	2,577,116	-47.0%

**288-ounce equivalent case sales by National Beverage**

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2008	2007	Change	2008	2007	Change
Jones branded finished products case sales by National Beverage	690,494	910,605	-24.2%	1,864,395	2,226,315	-16.3%

*Gross Profit*

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2008	2007	Change	2008	2007	Change
<i>(Dollars in Thousands)</i>						
Gross profit	\$ 966	\$ 3,362	-71.3%	\$ 5,869	\$ 11,162	-47.4%
Percentage of Revenue	11.1%	28.6%		19.7%	32.9%	

For the three-month period ended September 30, 2008, gross profit decreased by approximately \$2,397,000, or 71.3%, over the approximately \$3,362,000 in gross profit for the three-month period ended September 30, 2007. For the three-month period ended September 30, 2008, gross profit as a percentage of revenue decreased to 11.1% from 28.6% for the comparable period in 2007. The decrease in gross profit for the quarter was primarily attributable to lower sales of Jones Soda products (as discussed above) recorded in the quarter, along with an increase in the provision for inventory obsolescence by \$626,000 for aged inventory.

For the nine-month period ended September 30, 2008, gross profit decreased by approximately \$5,293,000 or 47.4% over the \$11,162,000 in gross profit for the nine-month period ended September 30, 2007. For the nine-month period ended September 30, 2008, gross profit as a percentage of revenue decreased to 19.7% from 32.9% for the comparable period in 2007. The decrease in gross profit is primarily attributable to lower sales of Jones Soda products, increased promotion allowances recorded in the first two quarters (as discussed above), and overall increased freight costs caused by the volatility in the commodity markets and the shutdown of our St. Louis co-packer, which in turn resulted in longer shipping distances to our customers in the Midwest and Southeast.

*Licensing Revenue*

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2008	2007	Change	2008	2007	Change
<i>(Dollars in Thousands)</i>						
Licensing revenue	\$ 43	\$ 87	-50.5%	\$ 152	\$ 281	-45.9%

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Licensing revenue during the third quarter of 2008 consisted primarily of our exclusive licensing arrangements with Big Sky Brands for Jones Soda Flavor Booster Hard Candy. For the three-month period ended September 30, 2008, we received royalty payments of approximately \$43,000, a decrease of 50.5% compared to \$87,000 earned in the same period of 2007. For the nine-month period ended September 30, 2008, we received royalty payments of approximately \$152,000, a decrease of 45.9% compared to \$281,000 earned in the same period of 2007. We believe licensing revenue was down due to the negative impact on sales resulting from the economic downturn.

*Total Operating Expenses*

<i>(Dollars in Thousands)</i>	<b>Three Months Ended September 30,</b>			<b>Nine Months Ended September 30,</b>		
	<b>2008</b>	<b>2007</b>	<b>Change</b>	<b>2008</b>	<b>2007</b>	<b>Change</b>
Promotion and selling	\$ 3,481	\$ 4,276	-18.6%	\$ 9,967	\$ 10,103	-1.3%
General and administrative	2,724	1,843	47.8%	7,809	4,940	58.1%
<b>Total operating expenses</b>	<b>\$ 6,205</b>	<b>\$ 6,119</b>	<b>1.4%</b>	<b>\$ 17,776</b>	<b>\$ 15,044</b>	<b>18.2%</b>
Percentage of revenue	71.5%	52.1%		59.7%	44.3%	

Total operating expenses for the three-month period ended September 30, 2008 were \$6,205,000, an increase of \$86,000, or 1.4%, over operating expenses of \$6,119,000 for the three-month period ended September 30, 2007. For the three-month period ended September 30, 2008, total operating expenses as a percentage of revenue increased to 71.5% from 52.1% over the comparable period in 2007. The increase in total operating expenses was primarily attributable to an increase in costs related to employee compensation, offset by a decrease in selling expenses.

Total operating expenses for the nine-month period ended September 30, 2008 were \$17,776,000, an increase of \$2,732,000 or 18.2% over operating expenses of \$15,044,000 for the nine-month period ended September 30, 2007. For the nine-month period ended September 30, 2008, total operating expenses as a percentage of revenue increased to 59.7% from 44.3% over the comparable period in 2007. The increase in total operating expenses was primarily attributable to an increase in costs related to employee compensation, marketing expenses, and legal and accounting fees. These increases were offset by a reduction in stock compensation expense resulting from a change in estimate as a result of the departure of employees and directors during the second quarter of 2008.

Changes in promotion and selling and general and administrative expenses are explained in greater detail below.

*Promotion and selling expenses*

<i>(Dollars in Thousands)</i>	<b>Three Months Ended September 30,</b>			<b>Nine Months Ended September 30,</b>		
	<b>2008</b>	<b>2007</b>	<b>Change</b>	<b>2008</b>	<b>2007</b>	<b>Change</b>
Promotion and selling	\$ 3,481	\$ 4,276	-18.6%	\$ 9,967	\$ 10,103	-1.3%
Percentage of revenue	40.1%	36.4%		33.5%	29.8%	

Promotion and selling expenses for the three months ended September 30, 2008 were \$3,481,000, representing a decrease of \$795,000 over promotion and selling expenses of \$4,276,000 for the three-month period ended September 30, 2007. Promotion and selling expenses as a percentage of revenue increased to 40.1% for the three-month period ended September 30, 2008 from 36.4% over the comparable period in 2007. The decrease in total promotion and selling expenses was primarily attributable to a consolidation of our sales management team, offset somewhat by additional brand building expenses incurred during the quarter and the continuation of our model market initiative, which includes deep regional market sales support, in three selected regions.

Promotion and selling expenses for the nine months ended September 30, 2008 were \$9,967,000, a decrease of \$136,000 over promotion and selling expenses of \$10,103,000 for the nine-month period ended September 30, 2007. Promotion and selling expenses as a percentage of revenue increased to 33.5% for the nine-month period ended September 30, 2008 from 29.8% over the comparable period in 2007. This decrease in promotion and selling expenses is due to a reduction in trade spending offset by increased spending on marketing campaigns. Also, salaries were up as a result of having 64 employees in sales and marketing at September 30, 2008 versus 45 employees at September 30, 2007.

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Our sales salaries for the nine-month period increased due to an increase in the number of sales positions, as well as the introduction of new regional sales representatives for our model market initiative. On October 6, 2008, we reduced our sales and marketing staff by 48% to 33 employees. This decrease in sales workforce is expected to lower our promotion and selling expenses going forward. See discussion under Subsequent Events in this report for a description of this reduction in force.

*General and Administrative Expenses*

<i>(Dollars in Thousands)</i>	Three Months Ended September 30,			Nine Months Ended September 30,		
	2008	2007	Change	2008	2007	Change
General and administrative	\$ 2,724	\$ 1,843	47.8%	\$ 7,809	\$ 4,940	58.1%
Percentage of revenue	31.4%	15.7%		26.2%	14.6%	

General and administrative expenses for the three-month period ended September 30, 2008 were \$2,724,000, representing an increase of \$881,000, or 47.8%, compared to \$1,843,000 for the three-month period ended September 30, 2007. General and administrative expenses as a percentage of revenue increased to 31.4% for the three months ended September 30, 2008 from 15.7% for the comparable period in 2007. The increase in general and administrative expenses was due to an increase in administrative salaries and benefits (due primarily to additional compensation paid to our Chief Executive Officer and our Chief Operating Officer and to increased headcount in the Operations and Finance departments, as well as transition payments to previous executives).

General and administrative expenses for the nine-month period ended September 30, 2008 were \$7,809,000, an increase of \$2,869,000, or 58.1%, compared to \$4,940,000 for the nine-month period ended September 30, 2007. General and administrative expenses as a percentage of revenue increased to 26.2% for the nine-months ended September 30, 2008 from 14.6% for the comparable period in 2007. The increase in general and administrative expenses was due to an increase in legal fees (primarily related to our ongoing securities litigation and to executive transition matters), accounting fees, insurance expenses (primarily related to higher premiums) and administrative salaries and benefits (due primarily to additional compensation paid to our Chief Executive Officer and our Chief Operating Officer and to increased headcount in the Operations and Finance departments, as well as transition payments to previous executives).

*Interest/Other income, net*

For the three-month period ended September 30, 2008, interest/other income was approximately \$66,000 compared to interest/other income of approximately \$492,000 in same period in 2007. The decrease in interest income/other income was due to lower levels of cash and short-term investments and lower levels of effective interest rates compared to the same period in 2007.

For the nine months ended September 30, 2008, interest income was approximately \$301,000, compared to interest income of approximately \$1,350,000 in the same period in 2007. The decrease in interest income/other income was due to decreased interest income due to lower levels of cash and short-term investments and lower levels of effective interest rates compared to the same period in 2007.

*Income taxes*

Provision for income taxes for the three and nine months ended September 30, 2008 were approximately \$130,000 and \$392,000, respectively. This compares to a tax benefit of approximately \$654,000 and \$827,000 for the same comparable periods in 2007.

The tax provision for the three and nine months ended September 30, 2008 relates to the tax provision on income from our Canadian operations, as this subsidiary's income remains fully taxable. No tax benefit is recorded for the loss in our U.S. operations as we have recorded a full valuation allowance on our U.S. net deferred tax assets. We expect to continue to record a full valuation allowance on our U.S. net deferred tax assets until we sustain an appropriate level of taxable income through improved U.S. operations.

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Our effective tax rate is based on recurring factors, including the forecasted mix of income before taxes in various jurisdictions, estimated permanent differences and the recording of a full valuation allowance on our U.S. net deferred tax assets.

### *Net Loss*

Net loss for the three and nine months ended September 30, 2008 was approximately \$5,260,000 and \$11,846,000, respectively. This compares to net loss of approximately \$1,523,000 and \$1,424,000, respectively, for the three and nine months ended September 30, 2007. The increase in net loss for the comparable periods was due to lower sales of Jones Soda products, increased promotion allowances in the DTR, DSD and CSD channels, provisions for discontinued inventory, increased freight costs, increased salaries incurred in sales and administration, and increased marketing expenses, legal fees and accounting fees. Each of these factors is discussed in greater detail above.

### **Liquidity and Capital Resources**

We have accumulated a deficit of approximately \$26,025,000 as of September 30, 2008, an increase of approximately \$11,846,000 from the same period in 2007. This increase is due to net losses from operations that we have incurred in each of the last four fiscal quarters. During these periods, we have used a significant amount of our cash resources to fund our net losses and working capital requirements.

Cash, cash-equivalents and short-term investments were approximately \$15,648,000 as of September 30, 2008, compared to approximately \$27,793,000 as of December 31, 2007. Net cash used in operating activities was approximately \$11,544,000 for the nine-month period ended September 30, 2008, primarily due to our loss from operations and an increase in working capital items such as inventory and accounts receivable. The increase in inventory is due to seasonal buildup of inventory. Investing activities provided approximately \$9,386,000 for the nine-month period ended September 30, 2008, primarily due to the sale of short-term investments. Net cash used in financing activities was approximately \$52,000 for the nine-month period ended September 30, 2008, and consisted of repayment of capital lease obligations offset by proceeds from the exercise of stock options. As of September 30, 2008, we had working capital of approximately \$20,490,000, compared to working capital of approximately \$31,483,000 as of December 31, 2007. This decrease in working capital was primarily due to net cash used in operating activities of approximately \$11,544,000, as noted above.

We believe that our cash and cash equivalents, and net cash provided by operations will be sufficient to meet our anticipated cash needs for working capital and capital expenditures through the end of fiscal 2009. This will depend on our ability to effectively manage our costs and to generate sufficient cash flow from operations, which will depend to a significant extent on our ability to meet our revenue expectations. To achieve this, we are focusing our 2009 business plan on our higher-margin core products, including our Jones Soda glass bottle and 24C business, new higher-margin product introductions in 2009, and further cost reductions, and we intend to continually monitor and adjust our business plan as necessary to respond to developments in our business, our markets and the broader economy. In addition, we have taken action in the fourth quarter of 2008 to reduce our costs by implementing a reduction in our workforce of approximately 38%, which we project will save an estimated \$2.6 million in expenses on an annualized basis. A revenue shortfall could deplete our limited financial resources or cause us to take additional actions to manage our costs.

If we are unable to generate sufficient cash flow from operations to cover our working capital and capital expenditure requirements, we may need to obtain funds through additional financing, which may not be available to us on acceptable terms, if at all. In this regard, as described below under Part II, Item 5 of this report, our \$15 million line of credit with KeyBank National Association was terminated on November 5, 2008, so we no longer have this facility available to us to fund any cash flow shortfalls. We are examining other financing alternatives, including asset based lending solutions, to replace the KeyBank facility. However, there can be no assurance that we will secure a replacement facility on acceptable terms, if at all, particularly in light of the current economic climate and our financial condition and results of operations. Accordingly, in addition to our efforts to secure a replacement credit facility, we intend to explore various strategies to secure any necessary additional financing, which may include, without limitation, public or private offerings of debt or equity securities, joint ventures with one or more strategic partners and other strategic alternatives. There can be no assurance that our efforts in this regard will result in any agreements or transactions. In addition, any issuance of additional

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equity or equity-related securities will dilute the ownership interest of existing shareholders and our issuance of debt securities could increase the risk or perceived risk of an investment in our company.

If we are unable to generate sufficient cash flow from operations, or to obtain funds through additional financing, our operations could be severely limited and we may not be able to implement our business plan in a timely manner or at all. In that case, we may be forced to delay, curtail or eliminate some or all of our product development, marketing or distribution programs or other aspects of our operations. Any of these measures could materially adversely affect our business, results of operations and financial position.

Accounts receivable increased from December 31, 2007 to September 30, 2008 from approximately \$4,475,000 to approximately \$4,671,000. This increase was due to a seasonal increase in shipments taking place during the third quarter. Accounts payable increased from December 31, 2007 to September 30, 2008 from approximately \$6,993,000 to approximately \$7,363,000. This increase was due primarily to outstanding GST taxes and severance payments.

Various class action lawsuits and derivative suits have been filed against us and certain directors and officers as of September 30, 2008. We are unable to predict the outcome of these cases. An adverse court determination in any of these actions against us could result in significant liability and could have a material adverse effect on our business, results of operations or financial condition, subject to the limits of our insurance policies.

**Contractual Obligations and Off-Balance Sheet Arrangements**

Our commitments as of September 30, 2008 with respect to known contractual obligations were as follows:

Contractual obligations	Total	Payments Due by Period			More than 5 years
		Less than 1 year	2-3 years	4-5 years	
Capital lease obligations	\$ 510,649	\$ 150,190	\$ 264,877	\$ 95,581	\$
Operating lease obligations	498,740	165,230	333,510		
Purchase obligations	25,360,873	4,348,141	14,721,292	4,227,350	2,064,091
Capital expenditure commitments	12,100	12,100			
<b>TOTAL</b>	<b>\$ 26,382,362</b>	<b>\$ 4,675,661</b>	<b>\$ 15,319,679</b>	<b>\$ 4,322,931</b>	<b>\$ 2,064,091</b>

Our purchase obligations include commitments under our sponsorship agreements with the Seattle Seahawks and the New Jersey Nets, which represent almost half of our total purchase obligations. Our purchase obligations also include commitments under our supply agreement relating to PHARMA GABA to purchase an additional approximately \$1.5 million of raw materials during the fourth quarter of 2008 and to use our commercially reasonable best efforts to purchase an additional \$8.4 million of raw materials through the end of the term of the agreement in July 2010. We are required to purchase approximately \$3.4 million of raw materials between August 1, 2008 and July 31, 2009, not including the \$1.5 million referred to above, in order to maintain the exclusivity of our rights to PHARMA GABA in the United States, Mexico and Canada for the duration of the supply agreement. Our purchase obligations also include commitments made by us to various suppliers of raw materials and finished goods.

All commitments vary in terms and commit us to payments from 2008 to 2014.

We have no off-balance sheet arrangements.

**Seasonality**

As is typical in the beverage industry, our sales are seasonal. In a typical year, approximately 60% of our sales by volume occur from April to September and approximately 40% occur from October to March. As a result, our working capital requirements and cash flow vary substantially throughout the year. Consumer demand for our products is also affected by weather conditions. Cool, wet spring or summer weather could result in decreased sales of our beverages and could have an adverse effect on our results of operations. Management believes that the demand for our products will continue to reflect such seasonal consumption patterns. In addition, our operating results are highly dependent upon the



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performance of our independent distributors and retailers, as well as competition in the industry and general economic conditions.

Due to these and other factors, our results of operations have fluctuated from period to period. As a result, management believes that period-to-period comparisons of results of operations are not necessarily meaningful and should not be relied upon as any indication of future performance. While we look to expand our distribution network and increase market penetration, such seasonality may not be easily discernible from results of operations. Due to all of the foregoing factors, our operating results in a particular quarter may fail to meet market expectations.

### **Subsequent Events**

On October 6, 2008, the Company implemented a reduction in workforce that reduced the Company's staff by approximately 38%. After this reduction, the Company's total headcount was 68. The workforce reduction was implemented in an effort to reduce ongoing operating expenses and improve the Company's overall efficiency. Severance and termination benefits to the affected employees are not expected to be material to the Company's financial results for the fourth quarter of 2008. The Company projects that the reduction in workforce will save an estimated \$2.6 million in expenses on an annualized basis.

On November 5, 2008, our \$15 million line of credit with KeyBank National Association was terminated after discussions that were initiated by KeyBank given the current economic climate and our financial condition and operating results. We considered different borrowing alternatives with KeyBank but these alternatives would not offer us a net borrowing position on the line. As a result, we elected not to pursue such alternatives. We remained in compliance with all covenants through the termination date. As discussed in the Liquidity and Capital Resources section in Part I, Item 2 of this report, we are examining other financing options, including asset based lending solutions, to replace the KeyBank facility, although there can be no assurance that we will secure a replacement facility on acceptable terms, if at all.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

In the normal course of our business, our financial position is routinely subject to a variety of risks. The principal market risks (i.e., the risk of loss arising from adverse changes in market rates and prices) to which we are exposed are fluctuations in energy and commodity prices affecting the cost of raw materials (including, but not limited to, increases in the price of aluminum for cans, resin for PET plastic bottles, as well as cane sugar), and the limited availability of certain raw materials and co-packer capacity. We are also subject to market risks with respect to the cost of commodities because our ability to recover increased costs through higher pricing is limited by the competitive environment in which we operate. In addition, we are subject to interest rate risk to the extent we maintain an investment portfolio for our cash, and to foreign exchange risk due to our sales and co-packing operations in Canada. We are also subject to other risks associated with the business environment in which we operate, including the collectability of accounts receivable and obsolescence of inventory due to changes in market conditions or new product initiatives. We believe that our exposure to these risks as of September 30, 2008 is not material.

We do not use derivative financial instruments to protect ourselves from fluctuations in interest rates or foreign currency fluctuations, and do not hedge against fluctuations in commodity prices. We do not use hedging agreements or alternative instruments to manage the risks associated with securing sufficient ingredients or raw materials, including, but not limited to, cans, PET plastic bottles, glass, labels, pure cane sugar or packaging arrangements, or protecting against shortages of raw materials.

With respect to foreign currency risk, the functional currency for substantially all of our operations is the U.S. dollar. However, we held aggregate cash and operating assets in Canadian dollars valued at approximately U.S. \$800,000 as of September 30, 2008.

At September 30, 2008, the majority of our debt consisted of fixed rate debt under our capital leases. During the nine months ended September 30, 2008, we did not make any draws on our line of credit.

### **ITEM 4. CONTROLS AND PROCEDURES**

#### **Disclosure Control and Procedures**

Under the supervision and with the participation of the Company's management, including our Chief Executive Officer and our Chief Financial Officer, the Company has evaluated the effectiveness of its disclosure controls and





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procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) as of September 30, 2008, the end of the period covered by this report. Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that these disclosure controls and procedures were not effective as of September 30, 2008. The basis for this determination was that, as discussed below, we have identified a material weakness in our internal control over financial reporting, which we view as an integral part of our disclosure controls and procedures. This material weakness is briefly described below and is described in detail in our Management's Report on Internal Control Over Financial Reporting that is included in our Form 10-K for the year ended December 31, 2007, which was filed with the Securities and Exchange Commission on March 17, 2008. As of September 30, 2008, we had not fully remediated this weakness.

### **The Remediation Plan and Changes in Internal Control over Financial Reporting**

As discussed above, we identified the following material weakness in our internal control over financial reporting as of December 31, 2007: The Company has limited accounting personnel with sufficient expertise, accounting knowledge and training in generally accepted accounting principles and financial reporting requirements. Specifically, we lack sufficient personnel to anticipate, identify, resolve and review complex accounting issues and to complete a timely review of the financial statements. Although we have not fully remediated this material weakness as of September 30, 2008, we have made, and will continue to make, improvements to our policies, procedures, systems and staff who have significant roles in internal control to address the internal control deficiencies identified by us and our independent registered public accounting firm. We have initiated the following remediation steps to address the material weakness described above:

In the third quarter of 2008, we hired a new Chief Financial Officer.

We also hired in the first quarter of 2008 an experienced Manager of SEC and GAAP reporting to support and prepare all SEC financial filings, as well as a Manager of Legal Affairs to support all contract analysis and SEC compliance filings.

We will continue to add additional accounting and finance staff with the commensurate knowledge, experience, and training necessary to complement the current staff in the financial reporting functions, in addition to the staff hired in the first three quarters of 2008.

We will continue to focus on improving the skill sets of our accounting and finance staff through education and training.

We have previously engaged qualified professional consultants where we did not have sufficient internal resources, with management reviewing both the inputs and outputs of the services provided. We will continue to seek employees for our accounting and finance staff with appropriate expertise and, as necessary, will continue to engage qualified professional consultants to supplement our accounting and finance staff.

Except for the items noted above, there have been no other changes in our internal control over financial reporting during the quarter ended September 30, 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **PART II. OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

On September 4, 2007, a putative class action complaint was filed against us, our then serving chief executive officer, and our then serving chief financial officer in the U.S. District Court for the Western District of Washington, alleging claims under Section 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended, and Rule 10b-5 promulgated thereunder. The case is entitled *Saltzman v. Jones Soda Company, et al.*, Case No. 07-CV-1366-RSL, and purports to be brought on behalf of a class of purchasers of our common stock during the period March 9, 2007, to August 2, 2007. Six substantially similar complaints subsequently were filed in the same court, some of which alleged claims on behalf of a class of purchasers of our common stock during the period November 1, 2006, to August 2, 2007. Some of the subsequently filed complaints added as defendants certain current and former directors and another former officer of the Company. The complaints generally alleged violations of federal securities laws based on, among other things, false and misleading statements and omissions about our financial

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results and business prospects. The complaints sought unspecified damages, interest, attorneys' fees, costs, and expenses. On October 26, 2007, these seven lawsuits were consolidated as a single

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action entitled *In re Jones Soda Company Securities Litigation*, Case No. 07-cv-1366-RSL. On March 5, 2008, the Court appointed Robert Burrell lead plaintiff in the consolidated securities case. On May 5, 2008, the lead plaintiff filed a First Amended Consolidated Complaint, which purports to allege claims on behalf of a class of purchasers of our common stock during the period of January 10, 2007, to May 1, 2008, against the Company and Peter van Stolk, our former Chief Executive Officer, former Chairman of the Board, and current director. The First Amended Consolidated Complaint generally alleges violations of federal securities laws based on, among other things, false and misleading statements and omissions about our agreements with retailers, allocation of resources, and business prospects. Defendants filed a motion to dismiss the amended complaint on July 7, 2008. The motion has now been fully briefed and was submitted for consideration in early October 2008. The Court has not yet scheduled a hearing date for oral argument on the motion to dismiss.

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

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

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

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

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

We are involved in various other claims and legal actions arising in the ordinary course of business, including proceedings involving product liability claims and other employee claims, and tort and other general liability claims, for which we carry insurance, as well as trademark, copyright, and related claims and legal actions. In the opinion of our

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management, the ultimate disposition of these matters will not have a material adverse effect on our consolidated financial position, results of operations or liquidity.

**ITEM 1A. RISK FACTORS**

Except for the risk factors set forth below, there have been no material changes that we are aware of from the risk factors set forth in Part I, Item 1A in our Annual Report on Form 10-K for the year ended December 31, 2007 filed with the Securities and Exchange Commission on March 17, 2008.

***We may have to reduce or cease operations if we are unable to meet our funding requirements.***

We have incurred a net loss from operations in each of the first three fiscal quarters of 2008 and have used a significant amount of our cash resources during this period to fund our net losses and working capital and capital expenditure requirements. As of September 30, 2008, we had cash, cash-equivalents and short-term investment of approximately \$15.6 million, compared to approximately \$27.8 million as of December 31, 2007. Our success in the future will depend on our ability to effectively manage our costs and to generate sufficient cash flow from operations, or to obtain funds through additional financing, to implement our business plan. To achieve this, we are focusing our 2009 business plan on our higher-margin core products, including our Jones Soda glass bottle and 24C business, new higher-margin product introductions in 2009, and further cost reductions, and we intend to continually monitor and adjust our business plan as necessary to respond to developments in our business, our markets and the broader economy. There can be no assurance, however, that we will be able to successfully execute on our business plan or that we will be able to generate the level of revenue that we expect or that is necessary to generate the cash flow from operations that we will require. Moreover, there can be no assurance that we will be successful in our efforts to further reduce our costs or that we will realize the expected cost savings from any actions we take.

With respect to additional financing sources, as noted below under Part II, Item 5 of this report, on November 5, 2008, our \$15 million line of credit with KeyBank National Association was terminated. Accordingly, we no longer have this facility available to us to fund any cash shortfall. Although we never drew on this facility, we may have financing requirements in the future and there can be no assurance that additional debt or equity financing will be available to us on acceptable terms, particularly in light of our financial condition, results of operations and the current economic climate.

If we are unable to generate sufficient cash flow from operations, or to obtain funds through additional financing, our operations could be severely limited and we may not be able to implement our business plan in a timely manner or at all. In that case, we may be forced to delay, curtail or eliminate some or all of our product development, marketing or distribution programs or other aspects of our operations. For example, on October 6, 2008, we implemented a reduction in workforce that reduced our staff by approximately 38%, reducing our sales and marketing resources. In addition, we may have to pursue various other strategies to secure additional financing, which may include, without limitation, public or private offerings of debt or equity securities, joint ventures with one or more strategic partners and other strategic alternatives. There can be no assurance that our efforts in this regard will result in any agreements or transactions. In addition, any issuance of additional equity or equity-related securities will dilute the ownership interest of existing shareholders and our issuance of debt securities could increase the risk or perceived risk of an investment in the Company. Our inability to generate sufficient cash flow from operations, or to obtain funds through additional financing, could have a materially adverse impact on our financial conditions and results of operations.

***The recent disruptions in the overall economy and the financial markets may adversely impact our business and results of operations.***

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The beverage industry can be affected by macro economic factors, including changes in national, regional, and local economic conditions, employment levels and consumer spending patterns. The recent disruptions in the overall economy and financial markets could reduce consumer confidence in the economy and negatively affect consumers' willingness to purchase our products. Moreover, current economic conditions may adversely affect the ability of our distributors to obtain the credit necessary to fund their working capital needs, which could negatively impact their ability or desire to continue to purchase products from us in the same frequencies and volumes as they have done in the past. There can be no assurances that government responses to the disruptions in the financial markets will restore consumer confidence, stabilize the markets or increase liquidity and the availability of credit. If the current economic conditions persist, sales of our products could be adversely affected, which could have a material adverse impact on our operating results and financial condition.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

The following table contains information for shares repurchased during the third quarter of 2008.

Fiscal period	Total number of shares purchased (1)	Average price paid per share (1)	Total number of shares purchased as part of publicly announced plans or programs	Approximate dollar value of shares that may yet be purchased under the plans or programs (in \$ 000)
July 1 to July 31, 2008		\$		\$
August 1 to August 31, 2008	2,663	\$ 2.38		
September 1 to September 30, 2008(2)	3,282	\$ 1.75		
<b>Total</b>	<b>5,945</b>	<b>\$ 2.06</b>		<b>\$</b>

- (1) The number of shares reported above as purchased are attributable to shares withheld by the Company as payment for withholding taxes due in connection with the vesting of restricted stock awards issued under the Jones Soda Co. 2002 Stock Option and Restricted Stock Plan. The average price paid per share reflects the average market value per share of the shares withheld for tax purposes.
- (2) The following shares were repurchased during the first quarter of 2008 for the same purposes as is described in footnote (1) above.

Fiscal period	Total number of shares purchased	Average price paid per share
January 1 to January 30, 2008		\$
February 1 to February 29, 2008	2,568	\$ 5.90
March 1 to March 31, 2008		\$
<b>Total</b>	<b>2,568</b>	<b>\$ 5.90</b>

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**ITEM 5. OTHER INFORMATION**

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

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**ITEM 6. EXHIBITS**

- 10.1\* Employment Offer Letter between Michael R. O'Brien and Jones Soda Co., dated August 15, 2008 (Previously filed with, and incorporated herein by reference to, Exhibit 10.1 to our current report on Form 8-K, filed on August 18, 2008; File No. 000-28820)
- 10.2\* Separation Agreement and Release between Hassan Natha and Jones Soda Co., dated August 18, 2008. (Filed herewith.)
- 31.1 Section 302 Certification of CEO - Stephen C. Jones, Chief Executive Officer (Filed herewith.)
- 31.2 Section 302 Certification of CFO - Michael R. O'Brien, Chief Financial Officer (Filed herewith.)
- 32.1 Section 906 Certification of CEO - Stephen C. Jones, Chief Executive Officer of Jones Soda Co., pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Filed herewith.)
- 32.2 Section 906 Certification of CFO - Michael R. O'Brien, Chief Financial Officer of Jones Soda Co., pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Filed herewith.)

\* Management contract or compensatory plan or arrangement.

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**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

November 10, 2008

JONES SODA CO.

By: /s/ Stephen C. Jones  
Stephen C. Jones  
Chief Executive Officer  
(principal executive officer)

By: /s/ Michael R. O'Brien  
Michael R. O'Brien  
Chief Financial Officer  
(principal financial and accounting officer)