DNA BRANDS INC
Form 10-Q
November 19, 2012

U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

Form 10-Q

Quarterly Report Under the Securities Exchange Act of 1934

For Quarter Ended: September 30, 2012

DNA BRANDS, INC.
(Exact name of small business issuer as specified in its charter)

Colorado	000-53086	26-0394476
(State or other jurisdiction of incorporation)	(Commission File Number)	(IRS Employer ID No.)

544 NW 77th Street Boca Raton, Florida, 33487
(Address of principal executive offices)

(954) 970-3826
(Issuer's Telephone Number)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes þ 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.

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

The number of shares of the registrant’s only class of common stock issued and outstanding as of November 15, 2012 was 57,896,866 shares.

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

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DNA BRANDS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2012 (unaudited)	December 31, 2011
ASSETS		
Current assets		
Cash and cash equivalents	$ —	$ —
Accounts receivable, net	32,184	86,410
Inventory	90,470	179,363
Loans receivable from related party	—	18,247
Prepaid expenses and other current assets	290,645	31,647
Total current assets	413,299	315,667
Property and equipment, net	22,580	31,624
Other assets	27,272	25,199
Total assets	$ 463,151	$ 372,490
LIABILITIES AND STOCKHOLDERS' DEFICIT		
Current liabilities		
Bank overdrafts	$ 853	$ 19,157
Accounts payable	568,269	702,301
Accrued liabilities	1,595,561	1,355,576
Loans payable, other	—	3,178
Loans payable to officers	1,414,641	1,303,388
Convertible debentures, net of discount, current portion	113,956	—
Embedded conversion option liabilities	118,691	—
Total current liabilities	3,811,971	3,383,600
Convertible debentures, net of discounts	667,605	566,045
Total liabilities	4,479,576	3,949,645
Commitments and contingencies	—	—
Stockholders' deficit		
Preferred stock, $0.001 par value, 10,000,000 authorized, none issued and outstanding, respectively	—	—
Common stock, $0.001 par value, 100,000,000 authorized, 56,470,776 and 45,425,135 issued and outstanding as of September 30, 2012 and December 31, 2011, respectively	56,471	45,425
Additional paid-in capital	20,342,927	17,809,281
Accumulated deficit	(24,415,823)	(21,431,861)
Total stockholders' deficit	(4,016,425)	(3,577,155)
Total liabilities and stockholders' deficit	$ 463,151	$ 372,490

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

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DNA BRANDS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)
FOR THE THREE AND NINE MONTH PERIODS ENDED SEPTEMBER 30, 2012 AND 2011

	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Sales	$ 28,142	$ 467,337	$ 200,953	$ 1,155,415
Cost of goods sold	18,239	251,637	118,269	694,341
Gross margin	9,903	215,700	82,684	461,074
Operating expenses				
Compensation and benefits	302,203	409,329	1,051,624	1,324,885
Depreciation expense	2,368	4,016	9,044	14,887
General and administrative expenses	164,709	259,717	557,434	731,287
Professional and outside services	174,164	97,994	630,577	546,125
Selling and marketing expenses	(72,583)	263,320	108,061	807,976
Total operating expenses	570,861	1,034,376	2,356,740	3,425,160
Loss from operations	(560,958)	(818,676)	(2,274,056)	(2,964,086)
Other income (expense)				
Gain on embedded conversion option liabilities	92,122	—	92,122	—
Interest expense	(116,909)	(52,564)	(802,028)	(86,955)
Total other expense	(24,787)	(52,564)	(709,906)	(86,955)
Loss before income taxes	(585,745)	(871,240)	(2,983,962)	(3,051,041)
Income taxes	—	—	—	—
Net loss	$ (585,745)	$ (871,240)	$ (2,983,962)	$ (3,051,041)
Loss per share:				
Basic and diluted	$ (0.01)	$ (0.02)	$ (0.06)	$ (0.08)
Weighted average number of common shares outstanding:				
Basic and diluted	50,392,491	38,377,193	48,197,391	36,522,413

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

DNA BRANDS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
FOR THE NINE MONTH PERIODS ENDED SEPTEMBER 30, 2012 AND 2011

	2012	2011
Cash flows from operating activities:		
Net loss	$ (2,983,962)	$ (3,051,041)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation expense	9,044	14,887
Loss on disposal of fixed assets	—	3,014
Gain on embedded conversion option liabilities	(92,122)	—
Non-cash interest expense related to discount on convertible debentures	707,231	29,690
Provision for doubtful accounts	36,474	7,723
Common stock and common stock warrants issued in exchange for services	706,628	720,475
Common stock issued as employee compensation	310,000	391,500
Changes in operating assets and liabilities:		
Accounts receivable	35,999	(299,136)
Inventory	88,893	(123,411)
Prepaid expenses and other current assets	(258,998)	(160,013)
Other assets	(2,073)	—
Bank overdraft	(18,304)	—
Accounts payable	(134,032)	172,113
Accrued expenses	239,985	(165,924)
Net cash used in operating activities	(1,355,237)	(2,460,123)
Cash flows from investing activities:		
Proceeds from the sale of property and equipment	—	250
Net advances to related party	—	(12,213)
Net cash used in investing activities	—	(11,963)
Cash flows from financing activities:		
Net proceeds from (repayments on) loans payable to officers	636,203	(94,312)
Net repayments on loans payable	(3,178)	(9,674)
Net proceeds from the issuance of convertible debentures	357,668	900,000
Net proceeds from the issuance of convertible, preferred stock	6,000	1,106,750
Net proceeds from the issuance of common stock	205,624	499,025
Net proceeds from the exercise of common stock warrants	152,920	—
Net cash provided by financing activities	1,355,237	2,401,789
Net change in cash and cash equivalents	—	(70,297)
Cash and cash equivalents at beginning of period	—	74,604
Cash and cash equivalents at end of period	$ —	$ 4,307
Supplemental disclosures:		
Interest paid	$ 94,354	$ 57,265
Supplemental disclosures of non-cash investing and financing activities:		
Conversion of loans payable to officers into convertible debentures	$ 524,950	$ —

Conversion of convertible debentures into common stock	$	524,950	$	—
Discounts on convertible debentures	$	324,443	$	397,000

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

DNA Brands, Inc.
Notes to Condensed Consolidated Financial Statements

1. Organization and Summary of Significant Accounting Policies

DNA Brands, Inc. (hereinafter referred to as “the Company” or “DNA”) produces, markets and sells a proprietary line of four carbonated blends of DNA Energy Drinks® and other related products. Additionally, through its wholly-owned subsidiary Grass Roots Beverage Company Inc. ("Grass Roots") the Company distributes DNA energy drinks and other related products.

The Company was incorporated in the State of Colorado on May 23, 2007 under the name Famous Products, Inc. Prior to July 6, 2010, the Company was a holding company operating as a promotion and advertising company.

Effective July 6, 2010, the Company executed agreements to acquire all of the remaining assets, liabilities and contract rights of DNA Beverage Corporation (“DNA Beverage”) of Boca Raton, Florida, and 100% of the common stock of DNA Beverage’s wholly-owned subsidiary Grass Roots Beverage Company, Inc. (“Grass Roots”) in exchange for the issuance of 31,250,000 shares of the Company’s common stock. This share issuance represented approximately 94.6% of the Company’s outstanding stock. The historical financial statements of the Company are those of DNA Beverage and of the consolidated entity. All DNA Beverage share amounts presented, including weighted average shares outstanding and shares outstanding, have been adjusted to reflect the conversion ratio of .729277794. As a result of this transaction, the Company changed its name to DNA Brands, Inc.

On November 9, 2010, the Company changed its fiscal year end from October 31 to December 31.

The Company’s current business commenced in May 2006 in the State of Florida under the name Grass Roots Beverage Company, Inc. Initial operations of Grass Roots included the development of energy drinks, sampling and other marketing efforts and initial distribution of its energy drinks in the State of Florida. The Company began selling its energy drink in the State of Florida in 2007.

Basis of Presentation

The accompanying unaudited financial statements have been prepared in accordance with generally accepted accounting principles applicable to interim financial information and the requirements of Form 10-Q and Article 10 of Regulation S-X of the SEC. Accordingly, they do not include all of the information and disclosures required by accounting principles generally accepted in the United States of America for complete financial statements. Interim results are not necessarily indicative of results for a full year. In the opinion of management, all adjustments considered necessary for a fair presentation of the financial position and the results of operations and cash flows for the interim periods have been included.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary Grass Roots. All significant intercompany balances and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

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Revenue Recognition

The Company derives revenues from the sale of carbonated energy drinks and meat snacks. Revenue is recognized when all of the following elements are satisfied: (i) there are no uncertainties regarding customer acceptance; (ii) there is persuasive evidence that an agreement exists; (iii) delivery has occurred; (iv) legal title to the products has transferred to the customer; (v) the sales price is fixed or determinable; and (vi) collectability is reasonably assured.

Shipping and Handling Costs

Shipping and handling costs related to the movement of finished goods from manufacturing locations to sales distribution centers are included in cost of goods sold on the Company's consolidated statements of operations. Shipping and handling costs incurred to move finished goods from the Company's sales distribution centers to its customer locations are also included in cost of goods sold on its consolidated statements of operations. The Company's customers do not pay separately for shipping and handling costs.

Fair Value of Financial Instruments

The Company's financial instruments consist mainly of cash and cash equivalents, accounts receivable, loans receivable from related party, accounts payable, accrued expenses, loans payable, and convertible debentures. The carrying values of the financial instruments approximate their fair value due to the short-term nature of these instruments. The fair values of the loans payable and convertible debentures have interest rates that approximate market rates.

We follow accounting guidance for financial and non-financial assets and liabilities. This standard defines fair value, provides guidance for measuring fair value and requires certain disclosures. This standard does not require any new fair value measurements, but rather applies to all other accounting pronouncements that require or permit fair value measurements. This guidance does not apply to measurements related to share-based payments. This guidance discusses valuation techniques, such as the market approach (comparable market prices), the income approach (present value of future income or cash flow), and the cost approach (cost to replace the service capacity of an asset or replacement cost). The guidance utilizes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The following is a brief description of those three levels:

Level 1: Observable inputs such as quoted prices (unadjusted) in active markets for identical assets or liabilities.

Level 2: Inputs, other than quoted prices, which are observable either directly or indirectly. These include quoted prices for similar assets or liabilities in active markets and quoted prices for identical or similar assets or liabilities in markets that are not active.

Level 3: Unobservable inputs in which little or no market data exists, therefore developed using estimates and assumptions developed by us, which reflect those that a market participant would use.

We currently measure and report derivative liabilities at fair value. The fair value of derivative liabilities is measured using the Black-Scholes option pricing method.

Cash and Cash Equivalents

The Company considers all highly liquid investments with a maturity of three months or less at the date of purchase to be cash equivalents. Cash and cash equivalents are stated at cost and consist solely of bank deposits. The carrying amount of cash and cash equivalents approximates fair value.

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Accounts Receivable and Allowance for Doubtful Accounts

The Company bills its customers after its products are shipped. The Company bases its allowance for doubtful accounts on estimates of the creditworthiness of customers, analysis of delinquent accounts, payment histories of its customers and judgment with respect to the current economic conditions. The Company generally does not require collateral. The Company believes the allowances are sufficient to cover uncollectible accounts. The Company reviews its accounts receivable aging on a regular basis for past due accounts, and writes off any uncollectible amounts against the allowance.

Inventory

Inventory is stated at the lower of cost or market. Cost is primarily determined by using the average cost method that approximates the First-In, First-Out (FIFO) method of accounting for inventory. Inventory consists of raw materials as well as finished goods held for sale. The Company's management monitors the inventory for excess and obsolete items and makes necessary valuation adjustments when required.

Property and Equipment

Property and equipment is recorded at cost less accumulated depreciation. Replacements, maintenance and repairs which do not improve or extend the lives of the respective assets are charged to expense as incurred. Depreciation is computed using the straight-line method over the estimated useful lives of the assets as follows:

Equipment	5 Years
Furniture and fixtures	5 Years
Vehicles	5 Years

Impairment of Long-Lived Assets

Long-lived assets are reviewed for impairment when events or changes in circumstances indicate the book value of the assets may not be recoverable. In accordance with Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 360-10-35-15 Impairment or Disposal of Long-Lived Assets recoverability is measured by comparing the book value of the asset to the future net undiscounted cash flows expected to be generated by the asset.

No events or changes in circumstances have been identified which would impact the recoverability of the Company's long-lived assets reported at September 30, 2012 and December 31, 2011.

Derivative Instruments

The Company does not enter into derivative contracts for purposes of risk management or speculation. However, from time to time, the Company enters into contracts, namely convertible notes payable, that are not considered derivative financial instruments in their entirety, but that include embedded derivative features.

In accordance with FASB ASC 815-15, Embedded Derivatives, and guidance provided by the SEC Staff, the Company accounts for these embedded features as a derivative liability or equity at fair value.

The recognition of the fair value of the derivative instrument at the date of issuance is applied first to the debt proceeds. The excess fair value, if any, over the proceeds from a debt instrument, is recognized immediately in the statement of operations as expense. The value of derivatives associated with a debt instrument is recognized at inception as a discount to the debt instrument and amortized to interest expense over the life of the debt instrument. A determination is made upon settlement, exchange, or modification of the debt instruments to determine if a gain or loss on the extinguishment has been incurred based on the terms of the settlement, exchange, or modification and on the value allocated to the debt instrument at such date.

The Company evaluates its convertible debt, options, warrants or other contracts to determine if those contracts or embedded components of those contracts qualify as derivatives to be separately accounted for. The result of this accounting treatment is that under certain circumstances the fair value of the derivative is marked-to-market each balance sheet date and recorded as a liability. In the event that the fair value is recorded as a liability, the change in fair value is recorded in the statement of operations as other income or expense. Upon conversion or exercise of a derivative instrument, the instrument is marked to fair value at the conversion date and then that fair value is reclassified to equity. Equity instruments that are initially classified as equity and become subject to reclassification under this accounting standard are reclassified as a liability at the fair value of the instrument on the reclassification date.

Stock-Based Compensation

The Company applies FASB ASC 718, Compensation – Stock Compensation, which requires the measurement and recognition of non-cash compensation expense for all share-based payment awards made to employees and directors. The Company records common stock issued for services or for liability extinguishments at the closing market price for the date in which obligation for payment of services is incurred.

Stock compensation arrangements with non-employee service providers are accounted for in accordance with FASB ASC 505-50 Equity-Based Payments to Non-Employees, using a fair value approach. The compensation costs of these arrangements are subject to re-measurement over the vesting terms as earned.

Stock Purchase Warrants

The Company has issued warrants to purchase shares of its common stock. Warrants have been accounted for as equity in accordance with FASB ASC 480, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, Distinguishing Liabilities from Equity.

Income Taxes

Income taxes are accounted for under the asset and liability method as stipulated by FASB ASC 740. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. Under FASB ASC 740, the effect on deferred tax assets and liabilities or a change in tax rate is recognized in income in the period that includes the enactment date. Deferred tax assets are reduced to estimated amounts to be realized by the use of a valuation allowance. A valuation allowance is applied when in management's view it is more likely than not (50%) that such deferred tax will not be utilized.

The Company follows the provisions of the FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109. FASB Statement No. 109 has been codified in FASB ASC 740. FASB

ASC 740 contains a two-step approach to recognizing and measuring uncertain tax positions accounted for in accordance with ASC 740. This first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount which is more than 50% likely of being realized upon ultimate settlement. The Company considers many factors when evaluating and estimating its tax positions and tax benefits, which may require periodic adjustments and which may not accurately anticipate actual outcomes. FASB ASC 740 did not result in any adjustment to the Company's provision for income taxes.

Earnings (Loss) Per Share

The Company computes basic earnings (loss) per share using the weighted average number of shares of common stock outstanding during the period.

2. Going Concern

The accompanying financial statements have been prepared on a going concern basis which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business as they become due.

During the nine month period ended September 30, 2012, the Company recorded a net loss of $2,983,962 and had negative cash flows of $1,355,237 from its operating activities. At September 30, 2012, the Company had a working capital deficit of $3,398,672 and a stockholders’ deficit of $4,016,425. The Company has relied, in large part, upon debt and equity financing to fund its operations. These matters collectively raise a substantial doubt about the Company’s ability to continue as a going concern.

The ability of the Company to continue as a going concern is dependent on management's plans, which includes implementation of its business plan and continuing to raise funds through debt or equity raises. The Company will likely continue to rely upon related-party debt or equity financing in order to ensure the continuing existence of the business. Additionally the Company is working on generating new sales from additional retail outlets, distribution centers or through sponsorship agreements; and allocating sufficient resources to continue with advertising and marketing efforts.

The financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result if the Company is unable to operate as a going concern.

3. Accounts Receivable

The following table sets forth the composition of the Company’s accounts receivable at September 30, 2012 and December 31, 2011:

	September 30, 2012 (unaudited)	December 31, 2011
Accounts receivable	$ 35,001	$ 135,246
Less: Allowance for doubtful accounts	(2,817)	(48,836)
Accounts receivable, net	$ 32,184	$ 86,410

Bad debt expense related to the Company’s trade accounts receivable for nine month periods ended September 30, 2012 and 2011 was $36,474 and $7,723, respectively.

4. Inventory

The following table sets forth the composition of the Company’s inventory at September 30, 2012 and December 31, 2011:

	September 30, 2012 (unaudited)	December 31, 2011
Raw materials	$ 38,192	$ 37,228
Finished goods	52,278	142,135
Total inventory	$ 90,470	$ 179,363

5. Prepaid Expenses and Other Assets

The following table sets forth the composition of the Company's prepaid expenses and other assets at September 30, 2012 and December 31, 2011:

	September 30, 2012 (unaudited)	December 31, 2011
Short-term security deposit	$ 10,000	$ 10,000
Employee and other advances	61,819	46,846
Prepaid expenses	246,098	—
Total prepaid expenses and other assets	317,917	56,846
Less: Non-current portion	(27,272)	(25,199)
Prepaid expenses and other current assets	$ 290,645	$ 31,647

6. Property and Equipment, Net

The following table sets forth the composition of the Company's property and equipment at September 30, 2012 and December 31, 2011:

	September 30, 2012 (unaudited)	December 31, 2011
Equipment	$ 18,690	$ 18,690
Furniture and fixtures	9,156	9,156
Vehicles	75,907	75,907
Accumulated depreciation	(81,173)	(72,129)
Total property and equipment, net	$ 22,580	$ 31,624

Depreciation expense for the nine month periods ended September 30, 2012 and 2011 was $9,044 and $14,887, respectively. In March 2011, the Company disposed of one of its vehicles. As a result of the transaction, the Company received cash proceeds of $250 and recorded a loss of $3,014.

7. Accrued Liabilities

The following table sets forth the composition of the Company's accrued liabilities at September 30, 2012 and December 31, 2011:

	September 30, 2012 (unaudited)	December 31, 2011
Salaries and bonuses	$ 934,085	$ 767,798
Payroll taxes and penalties	606,350	559,420
Interest expense on convertible debentures	33,625	7,932
Professional services	12,500	20,426
Other	9,001	—
Total accrued liabilities	$ 1,595,561	$ 1,355,576

Salaries and bonuses represent amounts due to officers and employees. Due to the Company's shortage of liquidity, its two principal executive officers have deferred cash payment of their salaries since 2008. As of September 30, 2012, the Company's officers were owed $757,500 as a result of their deferrals and its employees were owed $176,585 for amounts earned and accrued in the normal course of business.

As of September 30, 2012 and December 31, 2011, accrued payroll taxes and penalties represented the unpaid portion of employer and employee payroll taxes totaling $471,140 and $446,460, respectively. The Company has estimated potential penalties associated with these unpaid amounts to be $135,210 and $112,960 for each of these periods, respectively. The Company has engaged the services of a professional experienced in payroll tax matters to assist it develop a plan for repayment and future compliance deemed acceptable to the Internal Revenue Service. In March 2012, the Company made a payment of $50,000 against its payroll tax liabilities.

8. Loans Payable - Other

Loans payable were comprised of a third party financing arrangement for the Company’s vehicles utilized for the transport of the Company’s products. The original term of the loans was five years, bearing interest at a rate of 9.3%. At September 30, 2012, all borrowed principal amounts on these loans had been repaid.

9. Convertible Debentures, Net of Discounts

A summary of the issuances of all convertible notes during the nine month period ended September 30, 2012 is as follows:

Issue Date	Interest Rate	Face Value	Original Due Date	Conversion Rate of Face Value to Common Shares