AMAZON COM INC
Form 4
February 19, 2014

FORM 4

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

OMB APPROVAL

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STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

(Print or Type Responses)

1. Name and Address of Reporting Person [*]
Reynolds Shelley

(Last) (First) (Middle)

P.O. BOX 81226

(Street)

SEATTLE, WA 98108-1226

(City) (State) (Zip)

2. Issuer Name **and** Ticker or Trading Symbol
AMAZON COM INC [AMZN]

3. Date of Earliest Transaction (Month/Day/Year)
02/15/2014

4. If Amendment, Date Original Filed(Month/Day/Year)

5. Relationship of Reporting Person(s) to Issuer

(Check all applicable)

_____ Director _____ 10% Owner
__X__ Officer (give title below) _____ Other (specify below)
Vice President

6. Individual or Joint/Group Filing(Check Applicable Line)
_X_ Form filed by One Reporting Person
___ Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1.Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	Amount	(A) or (D)	Price			
Common Stock, par value $.01 per share	02/15/2014		M		442	A	$ 0	6,431	D	
Common Stock, par value $.01 per share	02/15/2014		M		962	A	$ 0	7,393	D	
Common Stock, par	02/18/2014		S [(1)]		5	D	$ 349.44	7,388	D	

value $.01 per share									
Common Stock, par value $.01 per share	02/18/2014		S (1)	200	D	$ 350.48 (2)	7,188	D	
Common Stock, par value $.01 per share	02/18/2014		S (1)	400	D	$ 351.93 (3)	6,788	D	
Common Stock, par value $.01 per share	02/18/2014		S (1)	399	D	$ 352.7226 (4)	6,389	D	
Common Stock, par value $.01 per share	02/18/2014		S (1)	300	D	$ 353.8533 (5)	6,089	D	
Common Stock, par value $.01 per share	02/18/2014		S (1)	100	D	$ 355.08	5,989	D	
Common Stock, par value $.01 per share							132.043	I	Held by the reporting person's Amazon.com 401(k) plan account

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

Persons who respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB control number.

SEC 1474 (9-02)

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(*e.g.*, puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)	5. Number of Derivative Securities	6. Date Exercisable and Expiration Date (Month/Day/Year)	7. Title and Amount of Underlying Securities (Instr. 3 and 4)

Derivative Security				Code	V	Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5) (A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares
Restricted Stock Unit Award	$ 0 (6)	02/15/2014		M			442	05/15/2010 (7)	02/15/2014	Common Stock, par value $.01 per share	442
Restricted Stock Unit Award	$ 0 (6)	02/15/2014		M			962	05/15/2012 (8)	02/15/2014	Common Stock, par value $.01 per share	962

Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
Reynolds Shelley P.O. BOX 81226 SEATTLE, WA 98108-1226			Vice President	

Signatures

/s/ by Michael D. Deal as attorney-in-fact for Shelley Reynolds, Vice President	02/19/2014
**Signature of Reporting Person	Date

Explanation of Responses:

* If the form is filed by more than one reporting person, *see* Instruction 4(b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

(1) This transaction was effected pursuant to a Rule 10b5-1 trading plan adopted by the reporting person.

(2) Represents the weighted average sale price. The highest price at which shares were sold was $350.51 and the lowest price at which shares were sold was $350.45.

(3) Represents the weighted average sale price. The highest price at which shares were sold was $352.38 and the lowest price at which shares were sold was $351.60.

(4) Represents the weighted average sale price. The highest price at which shares were sold was $352.77 and the lowest price at which shares were sold was $352.69.

(5) Represents the weighted average sale price. The highest price at which shares were sold was $354.03 and the lowest price at which shares were sold was $353.76.

(6) Converts into Common Stock on a one-for-one basis.

(7) This award vested based upon the following vesting schedule and the satisfaction of certain business criteria intended to qualify the award as tax-deductible compensation under Section 162(m) of the Internal Revenue Code: 158 shares on each of May 15, 2010, August 15, 2010, and November 15, 2010; 157 shares on February 15, 2011; 339 shares on each of May 15, 2011 and August 15, 2011; 338 shares on each of November 15, 2011 and February 15, 2012; 556 shares on each of May 15, 2012, August 15, 2012, and November 15, 2012; 555 shares on February 15, 2013; and 442 shares on each of May 15, 2013, August 15, 2013, November 15, 2013, and February 15, 2014.

(8) This award vested based upon the following vesting schedule and the satisfaction of certain business criteria intended to qualify the award as tax-deductible compensation under Section 162(m) of the Internal Revenue Code: 1,312 shares on each of May 15, 2012, August 15, 2012, and November 15, 2012; 1,313 shares on February 15, 2013; 963 shares on each of May 15, 2013, August 15, 2013, and November 15, 2013; and 962 shares on February 15, 2014.

Remarks:

REMARKS:

The reporting person undertakes to provide, upon request by the staff of the SEC, the issuer, or a security holder of the issuer,

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, *see* Instruction 6 for procedure.

Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number. round: transparent"> Our Products segment sells water dispensers that are designed to dispense Primo and other dispenser-compatible bottled water. Our Products sales are primarily generated through major U.S. retailers. Our water dispensers are sold primarily through a direct-import model, where we recognize revenues for the sale of the water dispensers when title is transferred to our retailer customers. We support retail sell-through with limited domestic inventory.

We evaluate the financial results of these segments focusing primarily on segment net sales and segment income (loss) from operations before depreciation and amortization (segment income (loss) from operations). We utilize segment net sales and segment income (loss) from operations because we believe they provide useful information for effectively allocating our resources between business segments, evaluating the health of our business segments based on metrics that management can actively influence and gauging our investments and our ability to service, incur or pay down debt.

Operating segments that do not meet quantitative thresholds for segment reporting are included in Other.

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Cost of sales for Exchange consists of costs for bottling and related packaging materials and distribution costs for our bottled water. Cost of sales for Products consists of contract manufacturing, freight, duties and warehousing costs of our water dispensers.

Selling, general and administrative expenses for both segments consist primarily of personnel costs for sales, marketing, operations support and customer service, as well as other supporting costs for operating each segment.

Expenses not specifically related to operating segments are shown separately as Corporate. Corporate expenses are comprised mainly of compensation and other related expenses for corporate support, information systems, and human resources and administration. Corporate expenses also include certain professional fees and expenses and compensation of our Board of Directors.

Recent Transactions

In December 2009, we completed the divestiture of our former subsidiary, Prima Bottled Water, Inc. (Prima), by distributing the stock in Prima to our existing stockholders on a pro rata basis based upon each such stockholder s proportionate ownership of our common stock, Series A preferred stock and Series C preferred stock on an as-converted basis. The assets, liabilities and results of operations of Prima are accounted for as discontinued operations. For 2007, 2008 and 2009, we recognized losses from discontinued operations of $1.9 million, $5.7 million and $3.7 million, respectively. For the six months ended June 30, 2009 and 2010, we recognized losses from discontinued operations of $0.4 million and $0, respectively.

On June 1, 2010 we entered into an asset purchase with Culligan to purchase the Culligan Refill Business. See Culligan Refill Acquisition on page 84 for a more detailed description of this transaction.

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Results of Operations

The following table sets forth our results of operations for the periods indicated:

	Years Ended December 31,			Six Months Ended June 30,	
	2007	2008	2009	2009	2010
				(Unaudited)	
			(In thousands)		
Consolidated statements of operations data:					
Net sales	$ 13,453	$ 34,647	$ 46,981	$ 24,500	$ 21,002
Operating costs and expenses:					
Cost of sales	11,969	30,776	38,771	20,368	16,672
Selling, general and administrative expenses	10,353	13,791	9,922	5,041	5,814
Depreciation and amortization	3,366	3,618	4,205	2,078	2,010
Total operating costs and expenses	25,688	48,185	52,898	27,487	24,496
Loss from operations	(12,235)	(13,538)	(5,917)	(2,987)	(3,494)
Interest (expense) and other income, net	65	(70)	(2,257)	(1,037)	(1,464)
Loss from continuing operations before income taxes	(12,170)	(13,608)	(8,174)	(4,024)	(4,958)
Provision for income taxes					
Loss from continuing operations	(12,170)	(13,608)	(8,174)	(4,024)	(4,958)
Loss from discontinued operations, net of income taxes	(1,904)	(5,738)	(3,650)	(357)	
Net loss	(14,074)	(19,346)	(11,824)	(4,381)	(4,958)
Preferred dividends and beneficial conversion charge	(2,147)	(19,875)	(3,042)	(1,521)	(1,164)
Net loss attributable to common stockholders	$ (16,221)	$ (39,221)	$ (14,866)	$ (5,902)	$ (6,122)

The following table sets forth our results of operations expressed as a percentage of net sales for the periods indicated:

	Years Ended December 31,			Six Months Ended June 30,	
	2007	2008	2009	2009	2010
				(Unaudited)	
Consolidated statements of operations data:					

Net sales	100.0%	100.0%	100.0%	100.0%	100.0%
Operating costs and expenses:					
Cost of sales	89.0	88.8	82.5	83.1	79.4
Selling, general and administrative expenses	77.0	39.8	21.1	20.6	27.6
Depreciation and amortization	25.0	10.5	9.0	8.5	9.6
Total operating costs and expenses	191.0	139.1	112.6	112.2	116.6
Loss from operations	(91.0)	(39.1)	(12.6)	(12.2)	(16.6)
Interest (expense) and other income, net	0.5	(0.2)	(4.8)	(4.2)	(7.0)
Loss from continuing operations before income taxes	(90.5)	(39.3)	(17.4)	(16.4)	(23.6)
Provision for income taxes					
Loss from continuing operations	(90.5)	(39.3)	(17.4)	(16.4)	(23.6)
Loss from discontinued operations, net of income taxes	(14.1)	(16.5)	(7.8)	(1.5)	
Net loss	(104.6)%	(55.8)%	(25.2)%	(17.9)%	(23.6)%

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The following table sets forth our segment net sales and segment income (loss) from operations presented on a segment basis and reconciled to our consolidated loss from operations.

	Years Ended December 31,			Six Months Ended June 30,	
	2007	2008	2009	2009	2010
				(Unaudited)	
	(In thousands)				
Segment Net Sales					
Exchange	$ 10,875	$ 19,237	$ 22,638	$ 11,121	$ 12,022
Products	949	13,758	22,824	12,642	8,177
Other	1,818	1,874	1,611	820	811
Inter-company elimination	(189)	(222)	(92)	(83)	(8)
Total net sales	$ 13,453	$ 34,647	$ 46,981	$ 24,500	$ 21,002
Segment Income (Loss) from Operations					
Exchange	$ (2,834)	$ (1,267)	$ 3,374	$ 1,517	$ 1,733
Products	(631)	(1,447)	(272)	60	26
Other	(175)	(116)	(34)	(30)	62
Inter-company elimination		(13)	9	5	(5)
Corporate	(5,229)	(7,077)	(4,789)	(2,461)	(3,300)
Depreciation and amortization	(3,366)	(3,618)	(4,205)	(2,078)	(2,010)
Loss from operations	$ (12,235)	$ (13,538)	$ (5,917)	$ (2,987)	$ (3,494)

Six Months Ended June 30, 2010 Compared to Six Months Ended June 30, 2009

Net Sales. Net sales for the six months ended June 30, 2010 decreased $3.5 million or 14.3% to $21.0 million from $24.5 million for the six months ended June 30, 2009. The decrease in sales for the six months ended June 30, 2010 resulted primarily from a 35.3% decrease in Products sales offset by an 8.1% increase in Exchange sales.

Exchange. Exchange net sales increased $0.9 million or 8.1% to $12.0 million, representing 57.2% of our total net sales, for the six months ended June 30, 2010. The increase for the six months ended June 30, 2010 compared to the same period in 2009 was the result of a 10.7% increase in water bottle units sold to approximately 2.1 million. The increase in units sold was driven by an 8.1% increase in selling locations to approximately 7,200 at June 30, 2010 as well as an increase in same store units of 4.0% for the six months ended June 30, 2010. The average price per unit decreased 2.4% for the six months ended June 30, 2010 compared to the same period in 2009. The decrease is a result of a shift in mix of transactions to 73.2% exchange transactions and 26.8% non-exchange transactions for the six months ended June 30, 2010 compared to 69.0% exchange transactions and 31.0% non-exchange transactions for the six months ended June 30, 2009. The shift in the mix of transactions is due to the increase in the overall number of repeat consumers utilizing our three- and five-gallon bottled water exchange service. This shift in mix is also impacted by the number of new locations added during the period. Locations in new markets generally have a higher percentage of non-exchange transactions as we introduce our service to new consumers. We recognize approximately twice as much revenue on non-exchange transactions as we do on exchange transactions as a result of the discount provided to consumers for the return of an empty three- or five-gallon bottle in exchange for the purchase of a new three- or five-gallon bottle of purified water. Adding new locations at which our water bottle exchange service is offered is important to our strategy of penetrating more homes with our water dispensers as expanded locations and increased water bottle availability enhance the convenience of our service to consumers.

Products. Products net sales decreased $4.5 million or 35.3% to $8.2 million, representing 38.9% of our total net sales, for the six months ended June 30, 2010. Dispenser sales decreased approximately 45,000 units or 24.6% to approximately 138,000 units for the six months ended June 30, 2010. We believe our water dispenser sales at retail to consumers increased substantially in units and revenues during 2010 based on sales data from our retail partners despite our reduced sales to retailers as we believe retailers are managing their inventory levels in anticipation of a new product line in the fourth quarter of 2010. In addition, our 2009 sales of water dispensers benefited from many of our retail customers building their inventory levels.

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Gross Margin. Our overall gross margin, defined as net sales less cost of sales, as a percentage of net sales increased to 20.6% for the six months ended June 30, 2010 from 16.9% for the six months ended June 30, 2009.

Exchange. Gross margin as a percentage of net sales in our Exchange segment increased to 26.9% for the six months ended June 30, 2010 from 25.4% for the six months ended June 30, 2009. This increase is due primarily to benefits from the improvements in our supply chain, which were completed in 2009. We anticipate that gross margins will continue to see improvements as we realize the full benefits of these improvements. These benefits could be offset slightly if fuel prices continue to increase and effect freight cost negatively.

Products. Gross margin as a percentage of net sales in our Products segment increased to 7.4% for the six months ended June 30, 2010 from 6.8% for the six months ended June 30, 2009. This increase is due primarily to the mix of dispensers sold during 2010 as compared to 2009. Our strategy is to sell our water dispensers at minimal operating profit in order to increase home penetration, which we believe will lead to increased recurring revenue, higher margin Exchange sales.

Selling, General and Administrative Expenses. Selling, general and administrative expenses increased $0.8 million or 15.3% to $5.8 million for the six months ended June 30, 2010. As a percentage of net sales, selling, general and administrative expenses increased to 27.6% for the six months ended June 30, 2010 from 20.6% for the six months ended June 30, 2009. The increase in selling, general and administrative expenses is primarily from increased salaries and related payroll costs associated with additional employees, professional and other expenses of approximately $0.3 million associated with the acquisition of Culligan Store Solutions, LLC and the increase in non-cash stock compensation of $0.1 million.

Exchange. Selling, general and administrative expenses of our Exchange segment increased $0.2 million or 14.3% to $1.5 million for six months ended June 30, 2010. Selling, general and administrative expenses as a percentage of Exchange segment net sales was 12.5% for the six months ended June 30, 2010 compared to 11.8% for the six months ended June 30, 2009. The increase resulted primarily from increased salaries and related payroll expenses from employees added in business development.

Products. Selling, general and administrative expenses of our Products segment decreased $0.2 million or 27.5% to $0.6 million for the six months ended June 30, 2010. This decrease is primarily the result of reduced advertising and marketing expenses in 2010 as compared to 2009. Selling, general and administrative expenses as a percentage of Products segment net sales increased to 7.1% for the six months ended June 30, 2010 from 6.3% for the six months ended June 30, 2009. The increase as a percentage of Products segment net sales is a result of the 35.3% decrease in Product net sales.

Other. Other selling, general and administrative expenses, which include our Other segment and Corporate, increased $0.8 million or 27.5% to $3.7 million for the six months ended June 30, 2010. Selling, general and administrative expenses as a percentage of consolidated net sales increased to 17.8% for the six months ended June 30, 2010 from 12.0% for the six months ended June 30, 2009. The increase resulted primarily from an increase in salaries and related payroll costs associated with the additional employees, professional and other expenses of approximately $0.3 million associated with the acquisition of Culligan Store Solutions, LLC and the increase in non-cash stock compensation of $0.1 million. In connection with the acquisition of Culligan Store Solutions, LLC we will incur a transaction fee of $1.5 million along with other legal and professional fees related to the acquisition that will be expensed when they are incurred. In addition, we expect to incur approximately $1.0 million annually in additional costs as a public company related to compliance, reporting and insurance.

Depreciation and Amortization. Depreciation and amortization decreased 3.3% to $2.0 million for the six months ended June 30, 2010.

Interest (Expense) and Other Income, Net. Net interest expense increased to $1.5 million for the six months ended June 30, 2010 from $1.0 million for the six months ended June 30, 2009. The increase is a result of an increase in the use of debt to fund business operations as well as the higher interest rate on our 2011 Notes.

Preferred Dividends and Beneficial Conversion Charge. Dividends on our Series B preferred stock decreased $0.4 million to $1.2 million for the six months ended June 30, 2010. In January 2009, we offered holders of our Series B preferred stock the option to suspend their current cash dividend payment of 10% in exchange for a

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dividend accrual of 15% for 2009. In January 2010, the dividend accrual was reduced to 10% with no cash dividend until the Series B preferred stock is redeemed. Cash dividends paid on our Series B preferred stock were $0.2 million and $0.8 million for the six months ended June 30, 2010 and 2009, respectively. At June 30, 2010, the accrued and unpaid dividends on our Series B preferred stock is $3.3 million, which is included in accrued expenses and other current liabilities in the consolidated balance sheet. In July 2010, we agreed to modify the terms of common stock warrants for the aggregate purchase of 716 shares of common stock, originally issued to the purchasers of the Series B preferred stock and Series C preferred stock, to remove a provision that accelerated the termination of the warrants exercise period upon the consummation of an IPO. The warrants will now expire on the date such warrants would have otherwise expired absent an IPO. At the time of the modification a charge of approximately $2.3 million will be recorded to additional paid in capital with no effect on total stockholders equity, but will increase the net loss attributable to common stockholders in the third quarter of 2010. In October 2010, we agreed to reduce the exercise price of the warrants issued to the holders of the Series C convertible preferred stock from $20.66 to $13.04. At the time of modification, a charge of approximately $0.2 million will be recorded to additional paid in capital with no effect on stockholders equity but will increase the net loss attributable to common stockholders in the fourth quarter of 2010.

Year Ended December 31, 2009 Compared to Year Ended December 31, 2008

Net Sales. Net sales for 2009 increased $12.3 million or 35.6% to $47.0 million from $34.6 million in 2008. The increase in sales resulted primarily from a 65.9% increase in Products sales and a 17.7% increase in Exchange sales.

Exchange. Exchange net sales increased $3.4 million or 17.7% to $22.6 million in 2009, representing 48.2% of our total net sales in 2009. The increase was due to an increase in water bottle units sold of approximately 0.6 million units or 19.8% to 3.9 million units sold in 2009. The increase in units sold was driven by a same store sales increase of 7.9% as well as an 8.3% increase in selling locations to approximately 7,000 at December 31, 2009. We believe the increase in same store sales is primarily a result of two factors: first, the increase in water dispenser sales results in an increasing number of consumers of three- and five-gallon bottled water and second, as more consumers become aware of and participate in our exchange program at a particular selling location, the number of water bottle units sold at that location typically increases over comparable prior periods. During 2009, we added approximately 600 selling locations as a result of both adding new retail customers and increased penetration with our existing retail customers. The average price per unit decreased 1.7% in 2009 compared to 2008 as a result of a shift in mix of transactions to 70.9% exchange and 29.1% non-exchange transactions in 2009 compared to 63.2% exchange and 36.8% non-exchange transactions in 2008. The shift in the mix of transactions is due to the increase in the overall number of repeat consumers utilizing our three- and five-gallon bottled water exchange service compared to the number of consumers that are new to our service. We anticipate the shift in mix towards a higher percentage of exchange transactions to continue as the overall number of consumers utilizing our exchange program continues to grow. We recognize approximately twice as much revenue on non-exchange transactions as we do on exchange transactions as a result of the discount provided to consumers for the return of an empty three- or five-gallon bottle in exchange for the purchase of a new three- or five-gallon bottle of purified water. Adding new locations at which our water bottle exchange service is offered is important to our strategy of penetrating more homes with our water dispensers as expanded locations and increased water bottle availability enhance the convenience of our service to consumers.

Products. Products net sales increased $9.1 million or 65.9% to $22.8 million in 2009, representing 48.6% of our total net sales in 2009. Dispenser sales increased 95,000 units or 53% to approximately 272,000 units in 2009. The increase in sales and units in 2009 is primarily a result of a greater than 100% increase in the number of retail locations offering our dispensers to approximately 5,500 at December 31, 2009. The difference in growth rates in net sales compared to the number of retail locations at which our water dispensers are offered is the result of retail locations being added during the course of the year which did not sell our water dispensers during the entire twelve-month period. As a result, during a period in which we experience rapid growth in the number of retail locations at which our water dispensers are offered, there is a delay before the full effect of these additional retail locations is reflected in our net sales. In addition, we successfully launched several new water dispenser models which accounted for approximately 48% of the total units sold in 2009. We anticipate continuing to introduce and offer

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new water dispenser models. Water dispenser home penetration is critical to the success of our strategy of increasing sales of our complementary recurring-revenue bottled water exchange service.

Gross Margin. Our overall gross margin, defined as net sales less cost of sales, as a percentage of net sales increased to 17.5% for 2009 from 11.2% for 2008.

Exchange. Gross margin as a percentage of net sales in our Exchange segment increased to 26.6% for 2009 from 15.2% in 2008 due primarily to decreased freight costs as a result of the addition of bottling and distribution capabilities during 2008 for which we received a full-year benefit in 2009. With these additions we believe we have sufficient bottling and distribution capabilities to service our continued growth. We anticipate slight improvements in gross margin for our Exchange segment for 2010 as we further benefit from improvements in our supply chain and realize efficiencies from our business model in which many of our variable costs are fixed.

Products. Gross margin as a percentage of net sales in our Products segment improved to 5.6% for 2009 from 0.5% in 2008 due primarily to improved pricing from retailers. Our strategy is to sell our water dispensers at minimal operating profit in order to increase home penetration, which we believe will lead to increased recurring-revenue, higher margin Exchange sales.

Selling, General and Administrative Expenses. Selling, general and administrative expenses for 2009 decreased $3.9 million or 28.1% to $9.9 million from $13.8 million and, as a percentage of net sales, decreased to 21.1% for 2009 from 39.8% for 2008.

Exchange. Selling, general and administrative expenses of our Exchange segment decreased $1.5 million or 36.8% to $2.6 million from $4.2 million and as a percentage of Exchange segment net sales decreased to 11.7% in 2009 from 21.8% in 2008. The decrease is due to lower employee-related costs as a result of a reduction in headcount of seven employees as well as reduced levels of consulting fees and related travel and benefit costs resulting in approximately $1.0 million of the overall reduction of selling, general and administrative expenses. The additional personnel resources were related to our efforts in 2008 to expand our supply chain with more bottling and distribution capacity. During 2009 we were able to reduce these personnel resources when our supply chain reached what we believe to be an appropriate size. We were able to significantly grow our Exchange segment net sales and gross margins in 2009 despite the reduction in selling, general and administrative expenses.

Products. Selling, general and administrative expenses of our Products segment decreased as a percentage of Products segment net sales to 6.8% in 2009 from 11.1% in 2008. Our Products segment was able to significantly increase sales without the need for additional headcount or selling, general and administrative costs.

Other. Other selling, general and administrative expenses for 2009, which includes our Other segment and Corporate, decreased $2.4 million or 29.1% to $5.7 million from $8.1 million, and as a percent of consolidated net sales decreased to 12.2% for 2009 from 23.3% in 2008. The decrease is primarily due to lower employee-related costs as a result of a reduction in headcount of nine employees as well as reduced levels of consulting fees and related travel and benefit costs resulting in about $1.6 million of the overall reduction of selling, general and administrative expenses. The additional resources were related to our efforts in 2008 to expand our information system and financial infrastructure as well as our efforts to establish new business segments. While we do not expect to incur significant additional costs connected with the growth of our businesses in 2010, we do expect to incur about $1.0 million in additional costs as a public company related to compliance, reporting and insurance.

Depreciation and Amortization. Depreciation and amortization increased $0.6 million or 16.2% to $4.2 million in 2009 from $3.6 million in 2008. The increase is the result of a full year of depreciation on the $8.3 million of capital expenditures in 2008.

Interest (Expense) and Other Income, Net. Net interest expense for 2009 increased to $2.3 million from $70,000 in 2008 as a result of increased use of debt to fund business operations. We expect the proceeds from this offering to repay debt and lower future interest cost relative to that experienced during 2009.

Preferred Dividends and Beneficial Conversion Charge. Dividends on our Series B preferred stock increased $0.7 million to $3.0 million in 2009 from $2.3 million in 2008. In January 2009, we offered holders of our Series B preferred stock the option to suspend their current cash dividend payment of 10% in exchange for a dividend accrual of 15% for 2009. Cash dividends paid on our Series B preferred stock during 2009 and 2008 were $1.3 million and

$2.3 million, respectively. At December 31, 2009 and 2008 the accrued and unpaid dividends on our Series B preferred stock were $2.4 million and $0.6 million, respectively, which is included in accrued expenses and other current liabilities in the consolidated balance sheet. Our Series C preferred stock is convertible into common stock at a ratio of 1:0.184, which was based upon a formula taking into account sales for 2008, compared to the original conversion ratio of 1:0.096. The change in the conversion resulted in a $17.6 million beneficial conversion or deemed dividend on the Series C preferred stock for 2008, which is included in the $19.9 million preferred dividends and beneficial conversion charge in 2008.

Year Ended December 31, 2008 Compared to Year Ended December 31, 2007

Net Sales. Net sales for 2008 increased $21.2 million or 157.5% to $34.6 million from $13.5 million in 2007. The increase in net sales resulted primarily from a 1,349.7% increase in Products sales and a 76.9% increase in Exchange sales.

Exchange. Exchange net sales increased $8.3 million to $19.2 million in 2008, representing 55.5% of our total net sales in 2008. The increase was due to an increase in water bottle units sold of 1.2 million or 61.2% to 3.2 million units sold in 2008. The increase in units was driven by a same store sales increase of 22.0% as well as a 36.1% increase in selling locations to approximately 6,400 selling locations at December 31, 2008. The average price per unit increased 9.7% in 2008 primarily as a result of a price increase implemented in mid-2008.

Products. Products net sales increased $12.8 million to $13.8 million, representing 39.7% of our total net sales in 2008. The increase is due to the successful launch of our Products business segment in late 2007. Product sales increased by approximately 165,000 units to approximately 177,000 units sold in 2008.

Gross Margin. Our overall gross margin, defined as net sales less cost of sales, as a percentage of net sales increased to 11.2% for 2008 from 11.0% for 2007.

Exchange. Gross margin as a percentage of net sales in our Exchange segment increased to 15.2% for 2008 from 6.1% in 2007 due primarily to decreased freight costs as a result of the addition of 28 bottlers and ten distributors in 2008.

Products. Gross margin as a percentage of net sales in our Products segment improved to 0.5% for 2008 from (23.2)% in 2007 due primarily to limited sales volume in 2007.

Selling, General and Administrative Expenses. Selling, general and administrative expenses, excluding impairment charges, for 2008 increased $3.4 million or 33.2% to $13.8 million from $10.4 million and, as a percentage of net sales, decreased to 39.8% for 2008 from 77.0% for 2007.

Exchange. Selling, general and administrative expenses of our Exchange segment increased $0.7 million or 19.5% to $4.2 million from $3.5 million and as a percentage of Exchange segment net sales decreased to 21.8% in 2008 from 32.2% in 2007. The increase is primarily due to higher employee-related costs as a result of headcount additions, consulting fees and related travel and benefit costs resulting in about $0.3 million of the overall increase. The additional personnel and resources were related to our efforts to expand our supply chain with more bottling and distribution capacity. Selling, general and administrative expenses as a percentage of Exchange segment net sales decreased significantly as we grew net sales at a faster rate than our expense growth.

Products. Selling, general and administrative expenses of our Products segment increased $1.1 million or 270.3% to $1.5 million from $0.4 million and as a percentage of Products segment net sales to 11.1% in 2008 from 43.3% in 2007. The increase is primarily due to increases in employee headcount resulting from our expanded product line and significant increase in net sales in 2008.

Other. Other selling, general and administrative expenses for 2008, which includes our Other segment and Corporate, increased $1.6 million or 24.5% to $8.1 million from $6.5 million, and as a percentage of consolidated net sales decreased to 23.3% for 2008 from 48.3% in 2007. The increase is primarily due to higher employee-related costs as a result of additional headcount, consulting fees and related travel and benefit costs related to our efforts in 2008 to expand our information system and financial infrastructure as well as our efforts to establish new business segments.

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Depreciation and Amortization. Depreciation and amortization increase $0.2 million or 7.5% to $3.6 million in 2008 from $3.4 million in 2007.

Interest Expense and Other Income, Net. Net interest and other income for 2008 decreased to an expense of $70,000 from income of $65,000 in 2007 as a result of the use of debt to fund business operations, which were primarily funded with equity in 2007.

Preferred Dividends and Beneficial Conversion Charge. Dividends on our Series B preferred stock increased $0.2 million to $2.3 million in 2008 from $2.1 million in 2007. At both December 31, 2008 and 2007, the accrued and unpaid dividends on our Series B preferred stock were $0.6 million, which is included in accrued expenses and other current liabilities in the consolidated balance sheet. Our Series C preferred stock is convertible into common stock at a ratio of 1:0.184, which was based upon a formula taking into account sales for 2008, compared to the original conversion ratio of 1:0.096. The change in the conversion resulted in a $17.6 million beneficial conversion or deemed dividend on the Series C preferred Stock for 2008, which is included in the $19.9 million of preferred dividends and beneficial conversion charge in 2008.

Liquidity and Capital Resources

The following table shows the components of our cash flows for the periods presented:

	Year Ended December 31,			Six Months Ended June 30,	
	2007	2008	2009	2009	2010
				(Unaudited)	
	(In thousands)				
Net cash provided by (used in):					
Operating activities	$ (6,752)	$ (11,832)	$ (1,972)	$ (2,426)	$ (4,558)
Investing activities	(4,992)	(9,628)	(2,450)	(1,345)	(1,712)
Financing activities	12,529	24,361	6,274	5,304	7,030

Since inception, we have financed our operations primarily through the sale of preferred stock, the issuance of long term debt and borrowings under credit facilities. At June 30, 2010, our principal sources of liquidity were accounts receivable, net of allowance for doubtful accounts, of $5.3 million compared to cash of $0.8 million and borrowing availability under our current senior revolving credit facility.

During the first half of 2010, our primary source of capital was proceeds from borrowings under our current senior revolving credit facility, which had a balance of $8.9 million at June 30, 2010. During 2009, the primary source of capital was proceeds from the issuance of long term debt and, as of December 31, 2009, we had an outstanding debt balance of $14.8 million, net of a $0.6 million discount. During 2008 and 2007, our primary source of capital was the proceeds of preferred stock issuances of $19.6 million and $14.1 million, respectively. Additionally, during 2008 we made borrowings under our current senior revolving credit facility, which had a balance of $7.0 million at December 31, 2008.

Net Cash Flows from Operating Activities

During the first half of 2010, we used $4.6 million in operations primarily as a result of $5.0 million of loss from continuing operations, offset by non-cash depreciation and amortization of $2.0 million. During the first half of 2009, we used $2.4 million in operating activities as a result of $4.0 million of loss from continued operations, offset by non-cash depreciation and amortization of $2.1 million.

Net cash used in operating activities was $2.0 million for 2009, $11.8 million for 2008 and $6.8 million for 2007. For 2009, net cash used in operations was primarily the result of $8.2 million of loss from continuing operations, partially offset by non-cash depreciation and amortization of $4.2 million, non-cash interest expense of $0.7 million related to our long term debt issuances and reduction in working capital components of $0.8 million. For 2008, net cash used in operations was primarily the result of $13.6 million of loss from continuing operations, partially offset by depreciation and amortization of $3.6 million. Additional working capital for accounts receivable and inventory due to revenue growth resulted in a use of cash of $1.9 million and $1.3 million, respectively, and was partially offset by an increase in accounts payable of $1.1 million.

For 2007, net cash used in operations was primarily the result of $12.2 million of loss from continuing operations, partially offset by depreciation and amortization of $3.4 million and the increase of accounts payable and accrued expenses of $1.0 million and $1.3 million, respectively.

Net Cash Flows from Investing Activities

Our primary investing activities are capital expenditures for property, equipment and bottles. Our capital expenditures in the past have been primarily for the installation of our recycle centers and display racks at new locations that offer our water bottle exchange service as well as related transportation racks and bottles. We also invest in technology infrastructure to manage our national network.

During the first half of 2010 and 2009, cash flows from investing activities primarily consisted of capital expenditures for property, equipment and bottles of $1.7 million and $1.3 million, respectively. During 2009, 2008 and 2007 cash flows from investing activities included capital expenditures for property and equipment and bottles of $2.4 million, $9.4 million and $5.0 million, respectively.

Net Cash Flows from Financing Activities

During the first half of 2010, cash provided by financing activities was primarily from borrowings under our current senior revolving credit facility of $8.5 million offset by dividends paid of $0.2 million and equity issuance costs of $1.4 million. During the first half of 2009, cash provided by financing activities was primarily from the issuance of long term debt of $10.0 million offset by payments on our current senior revolving credit facility of $3.0 million, debt issuance costs of $0.6 million and dividends paid of $0.8 million.

For 2009, financing activities were primarily the issuance of long term debt of $20.4 million that was partially offset by payments of $6.6 million on our current senior revolving credit facility, payments of $5.4 million related to other long term debt, Series B preferred stock dividend payments of $1.3 million and payment of debt issuance costs of $0.6 million. The cash component of our Series B preferred stock dividends was partially reduced in 2009 and accrued as opposed to paid currently. Additionally, the cash dividends paid will be further reduced for 2010 to approximately $0.2 million.

For 2008, financing activities were primarily the issuance of preferred stock of $19.6 million and borrowings of $7.0 million on our current senior revolving credit facility that were partially offset by payments of $2.3 million of Series B preferred stock dividends. For 2007, financing activities were primarily the issuance of preferred stock of $14.1 million that was partially offset by $1.6 million of Series B Preferred Stock dividend payments.

Current Senior Revolving Credit Facility

We originally entered into a revolving credit facility with Wachovia Bank National Association in June 2005 and have subsequently amended the facility and extended the term to January 30, 2011. The current facility commitment is $10.0 million, allows for up to a $3.0 million overadvance line (the Overadvance Line) and is subject to a customary borrowing base calculation for advances. Interest on the outstanding borrowings under the current senior revolving credit facility is payable quarterly at our option at: (i) the greater of (A) the LIBOR Market Index Rate or (B) 2.0% plus in either such case the applicable margin or (ii) the greater of (X) the Federal Funds Rate plus 0.50% or (Y) the bank s prime rate plus in either such case the applicable margin. At December 31, 2009 and 2008, the interest rate on the outstanding balance under the facility was at the bank s prime rate plus 2.50% and 0.75%, respectively (5.75% at

December 31, 2009 and 4.00% at December 31, 2008). Effective with a June 2010 amendment, the applicable margin was increased to 4.00% for a Libor Market Index Rate loan (5.00% when borrowings under the Overadvance Line are outstanding) and 2.00% for a loan provided at the Federal Funds Rate plus 0.50% or the bank s prime rate (3.00% when borrowings under the Overadvance Line are outstanding). At June 30, 2010, the interest rate on outstanding borrowings was 5.25% and availability under the facility was $0.9 million.

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We are required to pay a fee per annum equal to 3.50% of the outstanding amount of letters of credit issued under the current senior revolving credit facility. In addition, there is a fee of 0.50% on the unused portion of the revolver lending commitment. At June 30, 2010, there were outstanding letters of credit totaling approximately $0.2 million.

The current senior revolving credit facility contains various conditions for extensions of credit and restrictive covenants including minimum quarterly EBITDA and gross revenue requirements. Substantially all of our assets are pledged as collateral to borrowings under the current senior revolving credit facility.

Finally, Billy Prim, our Chief Executive Officer, has agreed to personally guarantee our borrowings with respect to the Overadvance Line in an amount up to $3.0 million. As an inducement to Mr. Prim to guarantee the $3.0 million Overadvance Line, the Company will issue Mr. Prim $150,000 of restricted stock with the per share value equal to (i) the initial public offering price or (ii) if the initial public offering does not occur, the lesser of (a) $12.84 per share (the fair value of our common stock based upon the valuation we obtained from a third party in December 2009) or (b) the price per share we issue equity in our next financing round. The restricted stock will be issued within 30 days after our initial public offering or the closing of our next financing round and will vest in full on January 2, 2011. The award of restricted stock was approved by the independent members of the board of directors and the amount of the award was based upon 5% of the guaranteed obligations (which the board members believed was an appropriate amount in light of their experience with similar transactions and representative of a 2.5% commitment fee and a 2.5% draw-down fee).

14% Subordinated Convertible Notes due March 31, 2011

In December 2009 and October 2010, we issued our 14% subordinated convertible notes due March 31, 2011 (2011 Notes) to 34 investors, including existing stockholders, affiliates of existing stockholders and senior management. The 2011 Notes have a total face value of $18.4 million and are subordinated to our current senior revolving credit facility. The 2011 Notes pay quarterly interest at a rate of 14% per annum. We intend to use proceeds of this offering to repay the 2011 Notes.

Warrants to purchase 130,747 shares of our common stock were issued in connection with the 2011 Notes. The initial fair value of the warrants is approximately $0.7 million and resulted in an original issue discount on the 2011 Notes which will be amortized as interest expense over the term of the 2011 Notes. The fair value of the warrants is included in other long-term liabilities in the consolidated balance sheet and will be adjusted periodically until such time as the exercise price becomes fixed at which time the then fair value will be reclassified as a component of stockholders equity (deficit).

New Senior Revolving Credit Facility

In connection with and as a condition to the closing of this offering and in order to partially finance the Culligan Refill Acquisition, we intend to enter into a new $40.0 million senior revolving credit facility with Wells Fargo Bank, National Association, Bank of America, N.A. and Branch Banking & Trust Company that will replace our current senior revolving credit facility. The new senior revolving credit facility will have a three-year term and will be secured by substantially all of the assets of the Company. The commitment letter related to this new senior revolving credit facility effectively limits our ability to borrow more than $20.0 million under this facility on the closing of the offering and the senior revolving credit facility. Interest on the outstanding borrowings under the new senior revolving credit facility will be payable at our option at either a floating base rate plus an interest rate spread or a floating rate of LIBOR plus an interest rate spread. We will also be required to pay a commitment fee on the unused amounts of the commitments under the new senior revolving credit facility. Both the interest rate spreads and the commitment fee rate are determined from a pricing grid based on the Company s total leverage ratio. The new senior revolving credit will contain the following financial covenants: (i) a maximum total leverage ratio that will initially be set at 3.5 to 1.0

and that will step down to 2.5 to 1.0 for the quarter ending December 31, 2011; (ii) a minimum EBITDA threshold initially set at $7.5 million for the quarter ended December 31, 2010 and increasing for the two quarters thereafter; and (iii) a minimum interest coverage ratio of 3.0 to 1.0 beginning with the quarter ended September 30, 2011.

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Adequacy of Capital Resources

Our future capital requirements may vary materially from those now anticipated and will depend on many factors, including acquisitions of other businesses, the rate of growth in new locations and related display and rack costs, cost to develop new water dispensers, sales and marketing resources needed to further penetrate our markets, the expansion of our operations in the United States and the response of competitors to our solutions and products. Historically, we have experienced increases in our capital expenditures consistent with the growth in our operations and personnel, and we anticipate that our expenditures will continue to increase as we grow our business.

While we had no material commitments for capital expenditures as of June 30, 2010, we do anticipate incurring between $2.0 million and $3.0 million of capital expenditures related to our anticipated growth in exchange locations and new water dispenser lines for the remainder of 2010. Upon completion of the Culligan Refill Acquisition, we estimate that we will incur between $1.0 million and $2.0 million of additional capital expenditures in 2010 related to current locations and future customer growth in connection with the Culligan Refill Business. In addition, we anticipate that we may incur additional expenses related to the integration of the Culligan Refill Acquisition.

In addition, following the completion of this offering, we expect to incur approximately $1.0 million per year in increased costs as a public company related to compliance, reporting and insurance. Mitigating these additional expenses, our Series B preferred stock dividends will terminate upon the completion of this offering.

Following the completion of this offering (assuming an initial public offering price of $12.00 per share) and our entering into our new senior revolving credit facility and the application of the proceeds therefrom as described herein (including consummation of the Culligan Refill Acquisition), we anticipate having $5.0 million in initial availability under our new senior revolving credit facility. We anticipate this availability will increase to approximately $13.0 million following the closing of this new facility. We believe our cash, the proceeds from this offering, funds available under our new senior revolving credit facility and future cash flows from our operations will be sufficient to meet our currently anticipated working capital and capital expenditure requirements for at least the next twelve months.

During the last three years, trends and conditions in the retail environment and credit markets, inflation and changing prices have not had a material effect on our business and we do not expect that these trends and conditions, inflation or changing prices will materially affect our business in the foreseeable future.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements, investments in special purpose entities or undisclosed borrowings or debt. Additionally, we are not a party to any derivative contracts or synthetic leases.

Contractual and Commercial Commitment Summary

Our contractual obligations and commercial commitments as of December 31, 2009 are summarized below:

	Payments Due by Period				
Contractual Obligations[1]	**Total**	**Less Than 1 Year**	**1-3 Years**	**3-5 Years**	**More Than 5 Years**
			(In thousands)		

Long-term debt obligations	$ 15,000	$	$ 15,000	$	$
Capital lease obligations	7	4	3		
Operating lease obligations	2,008	691	841	394	82
Current senior revolving credit facility	423	423			
Total	$ 17,438	$ 1,118	$ 15,844	$ 394	$ 82

(1) No amounts are included herein with respect to dividends related to our Series B preferred stock as all such shares will be converted or redeemed in connection with this offering.

Inflation

During the last three years, inflation and changing prices have not had a material effect on our business and we do not expect that inflation or changing prices will materially affect our business in the foreseeable future.

Quantitative and Qualitative Disclosures About Market Risk

For fixed rate debt, interest rate changes affect the fair value of financial instruments but do not impact earnings or cash flows. Conversely, for floating rate debt, interest rate changes generally do not affect the fair market value but do impact future earnings and cash flows, assuming other factors are held constant. The recorded carrying amounts of cash and cash equivalents approximate fair value due to their short maturities.

We are exposed to market risk related to changes in interest rates on borrowings under our current senior revolving credit facility. Our current senior revolving credit facility bears interest based on LIBOR and the prime rate, plus an applicable margin. To quantify our exposure to interest rate risk, a 100 basis point increase in interest rates would have increased interest expense for the years ended December 31, 2007, 2008, and 2009 by approximately $8,000, $29,000 and $132,000, respectively. Actual changes in interest rates may differ materially from the hypothetical assumptions used in computing this exposure.

Seasonality

We have experienced and expect to continue to experience seasonal fluctuations in our sales and operating income. Our sales and operating income have been highest in the spring and summer, and lowest in the fall and winter. Our Exchange segment, which generally enjoys higher margins than our Products segment, experiences higher sales and operating income in the spring and summer. Our Products segment had historically experienced higher sales and operating income in spring and summer, however, we believe the seasonality of this segment will be more dependent on retailer inventory management and purchasing cycles and not correlated to weather. Sustained periods of poor weather, particularly in the spring and summer, can negatively impact our sales in our higher margin Exchange segment. Accordingly, our results of operations in any quarter will not necessarily be indicative of the results that we may achieve for a fiscal year or any future quarter.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements and related notes, which have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The preparation of our financial statements in conformity with GAAP requires us to make certain estimates, judgments and assumptions. We believe that the estimates, judgments and assumptions used to determine certain amounts that affect the financial statements are reasonable, based on information available at the time they are made. To the extent there are material differences between these estimates, judgments and assumptions and actual results, our consolidated financial statements may be affected. Some of the more significant estimates include allowances for doubtful accounts, valuation of inventories, depreciation, valuation of deferred taxes and allowance for sales returns.

Revenue Recognition. Revenue is recognized for the sale of three- and five-gallon purified bottled water upon either the delivery of inventory to the retail stores or the purchase by the consumer. Revenue is either recognized as an exchange transaction (where a discount is provided on the purchase of a three- or five-gallon bottle of purified water for the return of an empty three- or five-gallon bottle) or a non-exchange transaction. Revenues on exchange transactions are recognized net of the exchange discount. Our water dispensers are sold primarily through a direct-import model, where we recognize revenue when title is transferred to our retail customers. We have no contractual obligation to accept returns of water dispensers nor do we guarantee water dispenser sales. However, we will at times accept returns or issue credits for water dispensers that have manufacturer defects or that were damaged in transit. Revenues of water dispensers are recognized net of an estimated allowance for returns using an average return rate based upon historical experience. In addition, we offer certain incentives such as coupons and rebates that are netted against and reduce net sales in the consolidated statements of operations. Historically, these incentives have not been material to the overall consolidated results of operations. With the purchase of certain of our water dispensers we include a coupon for a free three- or five-gallon bottle of water. No revenue is recognized with respect to the

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redemption of the coupon for a free three- and five-gallon bottle of water and the estimated cost of the three- and five-gallon bottle of water is included in cost of sales.

Allowance for Doubtful Accounts. We maintain an allowance for doubtful accounts for estimated losses resulting from our retail customers   inability to pay us. The allowance for doubtful accounts is based on a review of specifically identified accounts in addition to an overall aging analysis. Judgments are made with respect to the collectability of accounts receivable based on historical experience and current economic trends. Actual losses could differ from those estimates.

Long-Lived Assets. We review long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. The carrying amount of a long-lived asset is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset at the date it is tested for recoverability, whether in use or under development. An impairment loss is measured as the amount by which the carrying amount of a long-lived asset exceeds its fair value. We recorded an impairment charge in 2008 of $98,000, related to display racks no longer in use and to be disposed.

Income Taxes. We account for income taxes using the asset and liability method, which requires recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities, using enacted tax rates in effect for the year in which the differences are expected to reverse. Deferred tax assets are reduced by a valuation allowance to the extent that utilization is not presently more likely than not.

Effective January 1, 2007, we adopted the provisions of Accounting Standards Codification (ASC   ) 740-10, *Income Taxes*. Previously, we had accounted for tax contingencies in accordance with ASC 450-10, *Contingencies*. As required by ASC 740-10, we recognize the financial statement benefit of a tax position only after determining that the relevant tax authority would more likely than not sustain the position following an audit. For tax positions meeting the more-likely-than-not threshold, the amount recognized in the financial statements is the largest benefit that has a greater than 50 percent likelihood of being realized upon ultimate settlement with the relevant tax authority. At the adoption date, we applied ASC 740-10 to all tax positions for which the statute of limitations remained open. The implementation of ASC 740-10 did not have a material impact on our consolidated financial statements.

Stock-Based Compensation. We account for our stock-based employee and director compensation plans in accordance with ASC 718, *Compensation-Stock Compensation*. ASC 718 requires recognition of the cost of employee services received in exchange for an award of equity instruments in the financial statements over the period the employee is required to perform the services in exchange for the award (presumptively the vesting period). In 2007, 2008 and 2009 compensation expense related to stock options was approximately $157,000, $215,000 and $298,000 and is included in selling, general and administrative expenses from continuing operations, respectively, and approximately $25,000, $61,000 and $80,000 is included in discontinued operations, respectively. For the six months ended June 30, 2010, compensation expense related to stock options was approximately $153,000, which is included in selling, general and administrative expenses from continuing operations.

We measure the fair value of each stock option grant at the date of grant using the Black-Scholes option pricing model. The weighted-average fair value per share of the options granted during 2007, 2008 and 2009 was $6.99, $8.66 and $5.11, respectively. The weighted-average fair value per share of the options granted during the six months ended June 30, 2010 was $6.16. The following assumptions were used in arriving at the fair value of options granted:

		Year Ended December 31,		Six Months Ended June 30,
	2007	2008	2009	2010
Risk-free interest rate	4.6%	3.2%	2.0%	2.8%
Expected life of options in years	6.3	5.9	5.5	6.3
Estimated volatility	45.0%	39.0%	39.0%	45.5%
Dividend yield				

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The risk-free interest rate is based on the implied yield available on U.S. Treasury zero-coupon issues with a remaining term approximately equal to the expected life of our stock options. The estimated pre-vesting forfeiture rate is based on our historical experience. The expected term of the options is based on evaluations of historical and expected future employee exercise behavior. As a non-public entity, historic volatility is not available for our shares. As a result, we estimated volatility based on a peer group of companies, which we believe collectively provide a reasonable basis for estimating volatility. We intend to continue to consistently use the same group of publicly traded peer companies to determine volatility in the future until sufficient information regarding volatility of our share price becomes available or the selected companies are no longer suitable for this purpose. We do not expect to declare dividends on our common stock in the foreseeable future. As of each stock option grant date, we considered the fair value of the underlying common stock, determined as described below, in order to establish the option exercise price.

During 2009 a total of 13,608 common stock options were granted, all on one date during the quarter ended March 31, 2009, at an exercise price of $13.04 per share. The estimated fair value of our common stock on the issuance date was $13.04 per share.

During the six months ended June 30, 2010, a total of 31,145 common stock options were granted, all in the first quarter of 2010, at an exercise price of $12.84 per share. The estimated fair value of our common stock on the issuance date was $12.84 per share. In addition, we granted 105,654 shares of restricted stock that generally cliff-vest over a three-year period and we recognized compensation expense of $127,000 related to these awards, which is included in selling, general, and administrative expenses from continuing operations.

At June 30, 2010, we had approximately 307,000 stock options outstanding, approximately 250,000 of which were vested with an intrinsic value of approximately $210,000, and approximately 57,000 of which were unvested with no intrinsic value. The intrinsic value reflects the amount by which $12.00 (the midpoint of our estimated public offering price) exceeds the exercise price of the outstanding stock options.

In April 2010, the Board of Directors approved the 100% vesting of all unvested stock option awards upon the successful completion of an initial public offering of the Company s common stock. All unrecognized compensation cost at the time the stock option awards become fully vested would then be expensed.

Significant Factors Used in Determining Fair Value of Our Common Stock. The fair value of the shares of common stock that underlie the stock options we have granted has historically been determined by our board of directors based upon information available to it at the time of grant. Because, prior to this offering, there has been no public market for our common stock, our board of directors has determined the fair value of our common stock by utilizing, among other things, recent or contemporaneous valuation information from negotiated equity transactions with third parties or third party valuations. The valuation information included reviews of our business and general economic, market and other conditions that could be reasonably evaluated at that time, including our financial results, business agreements, intellectual property and capital structure. These valuation approaches are based on a number of assumptions, including our future sales and industry, general economic, market and other conditions that could reasonably be evaluated at the time of the valuation.

For the 13,608 stock options granted on one date in the first quarter of 2009, the fair value of our common stock was determined by the board of directors to be $13.04 per share. The fair value was based in part upon the finalization of the conversion ratio of the Series C Preferred Stock on December 31, 2008. The Series C Preferred Stock was issued in an arms-length transaction primarily to unrelated third parties in 2008 with an initial conversion to common stock ratio of 1:0.096 or $25.04 per share. However, the Series C Preferred Stock contained a beneficial conversion feature that was negotiated with the primarily unrelated third parties that adjusted and was finalized based upon the consolidated net sales for the year ending December 31, 2008. The adjusted conversion ratio was 1:0.184 or $13.04 per share. In addition, the board of directors considered the Company s most recent independent valuation and then current expectations of the Company s future performance in determining that $13.04 per share was a reasonable fair valuation of common stock at December 31, 2008 and that there were not any significant changes in the business or results of operations from December 31, 2008 to the date in the first quarter of 2009 the stock options were issued that would change that estimated fair value.

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For the 31,145 stock options and 105,654 restricted stock awards granted during the first quarter of 2010, the fair value of our common stock was determined by the board of directors to be $12.84 per share. The fair value was based upon a valuation obtained by the Company from an unrelated party in December 2009 that determined the fair value of the Company s common stock to be $12.84 per share. The fair value method utilized by the unrelated party was the income approach. The income approach recognizes that the current value is premised upon the expected receipt of future economic benefits or cash flows. The fair value is developed utilizing management s estimates of expected future cash flows and discounting them to their present value utilizing a discount rate of 20.0%. In addition, there were not any significant changes in the business, results of operations or expected future cash flows from the valuation date in December 2009 to the dates in the first quarter of 2010 the stock options and restricted stock awards were granted that would change the estimated fair value.

Recent Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (FASB) issued authoritative guidance which established the Accounting Standards Codification (ASC or Codification) as the source of authoritative GAAP recognized by the FASB to be applied to nongovernmental entities, and rules and interpretive releases of the SEC as authoritative GAAP for SEC registrants. The Codification supersedes all existing non-SEC accounting and reporting standards upon its effective date and, subsequently, the FASB will not issue new standards in the form of Statements, FASB Staff Positions or Emerging Issues Task Force Abstracts.