JONES SODA CO
Form 10KSB
March 31, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-KSB

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2005

¨ **TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from __________ to ________

Commission File Number 000-28820

JONES SODA CO.

(Exact name of small business issuer as specified in its charter)

Washington	**91-1696175**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

234 Ninth Avenue North

Seattle, WA 98109

(Address of principal executive offices)

(206) 624-3357

(Issuer s telephone number)

Securities registered under Section 12(b) of the Exchange Act: (none)

Securities registered under Section 12(g) of the Exchange Act: **Common Stock, no par value per share**

Check whether the issuer is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act. ¨

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act 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 x No ¨

Check if no disclosure of delinquent filers in response to Item 405 of Regulation S-B is contained in this form, and no disclosure will be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. ¨

Check whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

Issuer s revenues for its most recent fiscal year: $33,511,053

As of March 24, 2006, there were 22,117,721 shares of the Company s common stock issued and outstanding, and the aggregate market value of such common stock held by non-affiliates was approximately $167,527,891, based on the average of the bid ($8.22) and ask ($8.30) prices of such stock on that date of $8.26.

Documents Incorporated By Reference: The information required by Part III of this Report, to the extent not set forth herein, is incorporated in this Report by reference to the Company s definitive proxy statement relating to its 2006 annual meeting of shareholders, to be held on May 18, 2006. The definitive proxy statement will be filed with the Securities and Exchange Commission within 120 days after the end of the 2005 fiscal year.

Transitional Small Business Disclosure Format (Check one): Yes ¨ No x

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JONES SODA CO.

FORM 10-KSB ANNUAL REPORT

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** Items 9 through 12 and Item 14 of Part III are incorporated by reference from the definitive proxy statement for our 2006 annual meeting of shareholders, to be held on May 18, 2006, which will be filed with the Securities and Exchange Commission within 120 days after the close of the 2005 fiscal year.

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EXPLANATORY NOTE

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

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

CAUTIONARY NOTICE REGARDING FORWARD LOOKING STATEMENTS

We desire to take advantage of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. This Annual Report on Form 10-KSB contains a number of forward-looking statements that reflect management s current views and expectations with respect to our business, strategies, products, future results and events and financial performance. All statements other than statements of historical fact, including future results of operations or financial position, made in this Annual Report on Form 10-KSB are forward looking. In particular, the words believe, expect, intend, anticipate, estimate, may, will, variations of such words, and similar expressions identify forward-looking statements, but the exclusive means of identifying such statements and their absence does not mean that the statement is not forward-looking. These forward-looking statements are subject to certain risks and uncertainties, including those discussed below. Our actual results, performance or achievements could differ materially from our historical results as well as from those expressed in, anticipated or implied by these forward-looking statements. We do not undertake any obligation to revise these forward-looking statements to reflect any future events or circumstances.

For a discussion of some of the factors that may affect our business, results and prospects, see ITEM 1. OUR BUSINESS Risk Factors. Readers are urged to carefully review and consider the various disclosures made by us in this Report and in our other reports previously filed with the Securities and Exchange Commission, including our periodic reports on Forms 10-QSB and 8-K, and those described from time to time in our press releases and other communications, which attempt to advise interested parties of the risks and factors that may affect our business, prospects and results of operations.

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PART I

ITEM 1. OUR BUSINESS.

Overview

We develop, produce, market and distribute alternative or New Age beverages. We currently produce, market and distribute five unique beverage brands:

- *Jones Soda Co.*®, a premium soda;
- *Jones Organics*, a ready-to-drink organic tea;
- *Jones Energy*, a citrus energy drink;
- *WhoopAss*, a citrus energy drink; and
- *Jones Naturals*, a non-carbonated juice & tea.

Our business strategy is to increase sales by expanding distribution of our internally developed brands in new and existing markets, stimulating consumer trial of our products and increasing consumer awareness of, and brand loyalty to, our unique brands and products. Key elements of our business strategy include:

- creating strong distributor relationships and key accounts;
- stimulating strong consumer demand for our existing brands and products with primary emphasis in the United States and Canada;
- developing unique alternative beverage brands and products; and
- licensing our brand equity for the creation of other beverage or non-beverage products.

We currently sell and distribute our products throughout the United States and Canada through our network of independent distributors (DSD) and our national retail accounts (DTR), as well as through licensing and distribution arrangements.

With respect to our distributors (DSD) we have focused our sales and marketing resources on the expansion and penetration of our products through our independent distributor network in our core markets consisting of the Northwest, Southwest and Midwest U.S., and Western Canada. In 2005, we continued to focus on growing our distribution network in our four core markets as well as targeted expansion into our less penetrated markets consisting of the Northeast and Southeast U.S., and Eastern Canada.

We launched our direct to retail business strategy in 2003 as a complementary channel of distribution to our DSD channel, targeting large national retail accounts. Through these programs, we negotiate directly with large national retailers, primarily premier food-service based businesses, to carry our products, serviced through the retailer s appointed distribution system. During 2003, we entered into distribution arrangements with Barnes & Noble, Panera Bread Company and Cost Plus World Markets to carry certain of our products in their stores nationwide in the United States. In addition, in March 2004 we entered into a distribution arrangement with Starbucks Coffee Company for two flavors of our *Jones Soda* product in all of its stores in the United States. This distribution arrangement with Starbucks in the United States was in addition to our existing arrangement for their stores in Canada that had been in place since 1999. In addition, in October 2004, in connection with our licensing arrangement with Target Corporation for our *Jones Soda* 12-ounce cans, we began selling *Jones Soda* (in 12-ounce bottles) and *Jones Energy* (in our 8.4 ounce four-pack format) to Target for distribution through their stores in the United States.

Beginning in 2004, we launched our licensing business strategy as a method to extend our brand into non-alternative beverage products and non-beverage products. In July 2004, we entered into a two-year licensing and distribution agreement with Target Corporation which provides Target with exclusive rights in the United

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States to market and sell 12-ounce cans of *Jones Soda*. We launched our 12-ounce cans in a fridge pack format into Target Corporation in October 2004 and with this product we now compete in the highly competitive carbonated soft drink (CSD) industry. In September 2004, we entered into an agreement with Lime-Lite Marketing Corporation to manufacture and distribute Jones Soda lip balms. In March 2005, we also announced a licensing and distribution agreement with The Kroger Corporation, providing Kroger exclusive rights to manufacture and distribute Jones Soda Frozen Soda Pops through all Kroger and Kroger-affiliated grocery stores in the United States. In September 2005, we entered into a licensing agreement with Big Sky Brands, Inc. to manufacture and distribute Jones Soda Flavor Booster hard candy. With these licensing agreements, we believe that we are able to partner with companies that are able to manufacture Jones related products and extend our Jones brand into select products that we feel enhance our brand image.

Our company is a Washington corporation and our principal place of business is located at 234 Ninth Avenue North, Seattle, Washington 98109. Our telephone number is (206) 624-3357.

The New Age or Alternative Beverage Industry

Jones Soda, *Jones Organics*, *Jones Energy*, *WhoopAss* and *Jones Naturals*, which are classified as New Age or alternative beverages, as well as other unique brands and products that we may develop in the future, compete with beverage products of all types, including soft drinks, fruit juices and drinks and bottled water.

According to Beverage Marketing Corporation, the New Age or alternative beverage markets was approximately $16.9 billion in total sales in 2005.

New Age or alternative beverages are distinguishable from mainstream carbonated soft drinks in that they tend to contain less sugar, less carbonation, and natural ingredients. As a general rule, three criteria have been established for such a classification: (1) relatively new introduction to the market-place; (2) a perception by consumers that consumption is healthful compared to mainstream carbonated soft drinks; and (3) the use of natural ingredients and flavors in the products. According to Beverage Marketing Corporation (*www.beverageworld.com*), for 2005, the New Age or alternative beverage category consisted of the following segments: energy drinks; premium soda; ready-to-drink (RTD) coffee; RTD tea; RTD tea (nutrient-enhanced); shelf-stable dairy (regular/diet); shelf-stable dairy (nutrient-enhanced); single-serve-fruit beverages (regular/diet); single-serve-fruit beverages (nutrient enhanced); smoothies; sparkling water; sports drinks; vegetable/fruit juice blends; and other New Age beverages.

The Carbonated Soft Drink (CSD) Industry

In October 2004, we entered the mainstream of the carbonated soft drink industry with the launch of our *Jones Soda* product in the 12-ounce can format. Currently, these 12-ounce cans of *Jones Soda* are sold under our two-year exclusive marketing and distribution agreement with Target Corporation.

The CSD industry includes all soda products that are sold primarily in 12-ounce cans and generally compete on price. According to Beverage Marketing Corporation, the carbonated soft drink category for the year ending 2005 was estimated at approximately $65.9 billion in total sales. Following many years of growth, in 1999, the CSD category began to experience six straight years of sub-1% growth and showed per capita consumption declines. However, the CSD category remains significant in size, in terms of both volume and sales, and its market share is far larger than any other beverage category. The primary companies participating in this category include Coca Cola, Pepsi, Dr. Pepper/Seven Up, Cott Corporation and National Beverage.

Business Strategy

We believe that *Jones Soda* is a leading brand in the premium soda segment of the New Age beverage category, and we recently entered the broader, more competitive carbonated soft drink industry with the introduction of our 12-ounce cans.

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In late 1995, we launched *Jones Soda*, our premium soda product under our trademarked brand. By launching *Jones Soda*, we believed we were creating a new category in the New Age beverage market and that we were offering distributors something new to sell. In its January 1998 issue, Beverage Aisle magazine changed the name of the all-natural soda segment to the premium soda segment and cited *Jones Soda* as an example of a beverage in this category. Thus, we believe that the *Jones Soda* brand and product line helped to create a new segment in the New Age or alternative beverage industry. In developing the *Jones Soda* brand, we have marketed our products with a distinct fashion component consisting of black and white photos on our labels, which is representative of current overall fashion trends. See Products *Jones Soda*.

Utilizing creative but relatively low cost marketing and brand promotion techniques, we have focused on building a strong distributor network and presence with national retail accounts for our lead brand, *Jones Soda*. We believe that our past experience as a distributor of licensed and non-licensed New Age beverage brands has given, and will continue to give, our company credibility in connection with our efforts to build a quality network of independent distributors. Sales of our products through our distributor network, and the uniqueness and strength of our brand, provided us with opportunities to implement and grow our DTR strategy through national retail accounts. These national accounts have further increased the public awareness of and strength of our brand and have provided us with other cross-selling opportunities through our licensing business strategy.

Our business strategy is to attempt to increase sales by expanding product distribution in new and existing markets (primarily within North America), stimulating consumer trial of our products and creating and increasing consumer awareness of and brand loyalty to our unique brands and products. We focus our resources on four core markets, namely the Midwest, Northwest and Southwest U.S., and Western Canada. In 2005, through our independent distributor network, we continued to focus on these four core markets, as well as targeted expansion into our less penetrated markets consisting of the Northeast and Southeast U.S., and Eastern Canada.

During 2005 and 2004, we grew our direct to retail distribution strategy to large national retail accounts, currently consisting of Target Corporation, Starbucks Coffee Company, Panera Bread Company, Barnes & Noble and Cost Plus World Markets. During 2006, we intend to continue servicing and expanding our direct to retail channel to national retail accounts.

In 2004, we also launched our licensing business strategy as a method to extend our brand into non-alternative beverage products and non-beverage products. In July 2004, we entered into a licensing agreement with Target Corporation to market and sell *Jones Soda* in a 12-ounce can format and we now compete directly in the carbonated soft drink industry. In September 2004, we entered into an agreement with Lime-Lite Marketing Corporation to manufacture and distribute Jones Soda lip balms, and in March 2005, we signed a licensing agreement with The Kroger Corporation to manufacture and distribute Jones Soda Frozen Soda Pops. In September 2005, we entered into a licensing agreement with Big Sky Brands, Inc. to manufacture and distribute Jones Soda Flavor Booster hard candy.

Jones Soda understands the importance of creating new beverage items that meet the ever changing consumer taste profile. Our strategy is to be focused on innovating new products that will be accepted by the retailers, distributors and consumers. We believe this is accomplished by keeping open dialog with our retail and distributor partners to ensure we are current with the consumer trends in the beverage industry.

Key elements of our business strategy include the following:

Building our Brand

We believe the market for alternative beverages is dependent to a large extent on image as well as taste, and that this market is driven by trendy, young consumers between the ages of 12 and 34. Accordingly, our strategy is to develop unique brand names, slogans and trade dress. In addition to unique labeling on our products, we provide each of our distributors with point-of-sale promotional materials and branded apparel items. We promote

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interaction with our customers through the use of these point-of-sale items, such as posters, stickers, table cards, shelf danglers, post cards, hats, pins, T-shirts, and our proprietary lighted display box. In addition, through the labels on our bottles, we invite consumers to access our website and to send in photographs to be featured on the *Jones Soda* and *Jones Naturals* labels. We believe that our labeling, marketing and promotional materials are important elements to creating and increasing distributor, retailer and consumer awareness of our brands and products.

Independent Distributor Network (DSD)

We distribute our products through a network of independent distributors in the United States and Canada. We have also obtained listings for selected skus of our *Jones Soda*, *Jones Organics, Jones Energy*, *Whoopass* and *Jones Naturals* brands with certain key retail grocery accounts, including QFC, Meijer, Allsups, Kroger, Albertsons, Safeway and Speedway Super America, which are serviced through our independent distributor network. We have pursued this strategy both in an effort to increase sales and to encourage distributors to distribute our brands and products to our key accounts and other accounts of our distributors.

We usually grant independent distributors the right to distribute finished cases of one or more of our brands in a particular region, province, state or local territory, subject to our overall management directives. We select distributors who we believe will have the ability to get our unique brands and products on the street level retail shelves in convenience stores, delicatessens, sandwich shops and selected supermarkets. Ultimately, we have chosen, and will continue to choose, our distributors based upon their perceived ability to build our brand franchise. We currently maintain a network of approximately 188 distributors in 44 states in the United States and 9 provinces in Canada.

We have additionally pursued distribution to alternative or non-traditional beverage retailers. We have entered into agreements with approximately 750 independent non-traditional beverage retailers, including music stores, skateboard shops, comic book stores and clothing stores in major markets across North America, primarily in the western markets of the United States and Canada, pursuant to which generally these retailers agree to exclusively carry our beverage products. We intend to selectively pursue distribution to these national and independent non-traditional beverage accounts as part of our distribution and marketing strategy. Also, in April 2004, we entered into an agreement with Zumiez Corporation, an alternative skate/snow-wear clothing store chain, to sell our product in all 140 Zumiez s retail stores in the United States.

Direct to Retail National Accounts (DTR)

Beginning in 2003, we launched our direct to retail business strategy as a complementary channel of distribution, targeting large national retail accounts. Through these programs, we negotiate directly with large national retailers, primarily premier food-service based businesses, to carry our products, serviced by the retailer s appointed distribution system. We currently have distribution arrangements with five national retail accounts, consisting of the following:

Target Corporation launched in October 2004, currently for 5 flavors of *Jones Soda* (in addition to the 12-ounce can fridge pack described below) and 3 flavors of our *Jones Energy* (8.4 ounce four-pack format) in all Target stores in the United States;

Starbucks Coffee Company launched in March 2004, originally for 2 flavors of *Jones Soda*, and recently increased to 3 flavors in 2006, in all Starbucks stores in the United States (which is in addition to our DSD arrangement for Starbucks stores in Canada that has been in place since 1999);

Panera Bread Company launched in June 2003, currently for 6 flavors of *Jones Soda* and 3 flavors of *Jones Naturals* in all Panera bakery cafés in the United States;

Barnes & Noble launched in February 2003, currently for 5 flavors of *Jones Naturals* in all Barnes & Noble café stores in the United States; and

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Cost Plus World Markets launched in November 2003, currently for 6 flavors of *Jones Soda* in all Cost Plus stores in the United States.

Licensing Arrangements

Beginning in 2004, we launched our licensing business strategy as a method to extend our brand into non-alternative beverage products and non-beverage products. In July 2004, we entered into a two-year licensing and distribution agreement with Target Corporation which provides Target with exclusive rights in the United States to market and sell 12-ounce cans of *Jones Soda*. Under this arrangement, our 12-ounce can products are produced by a third-party manufacturer selected by us and approved by Target. We launched our 12-ounce cans in a fridge pack format into Target Corporation in October 2004 and with this product we now compete in the highly competitive carbonated soft drink (CSD) industry. In September 2004, we entered into an agreement with Lime-Lite Marketing Corporation to manufacture and distribute Jones Soda lip balms. In March 2005, we also announced a licensing and distribution agreement with The Kroger Corporation, providing Kroger exclusive rights to manufacture and distribute Jones Soda Frozen Soda Pops through all Kroger and Kroger-affiliated grocery stores in the United States. In September 2005, we entered into a licensing agreement with Big Sky Brands, Inc. to manufacture and distribute Jones Soda Flavor Booster hard candy. With these licensing agreements, we believe that we are able to partner with companies that are able to manufacture Jones related products and extend our Jones brand into select products that we feel enhance our brand image.

In-House Brand and Product Development

We have developed and intend to continue to develop our brands and products in-house. We used a similar process initially to create the *Jones Soda* brand, and we intend to continue utilizing this process in connection with the creation of our future brands. This process primarily consists of the following steps:

Market Evaluation. We perform a complete review of the beverage industry in general, including a review of existing beverage categories and segments, and the product life cycle stages of such categories and segments. We evaluate the strengths and weaknesses of certain categories and segments of the beverage industry with a view to pinpointing potential opportunities.

Distributor Evaluation. We prepare a thorough analysis of existing and potential distribution channels, whether DSD or DTR. This analysis addresses, among other things, which companies will distribute particular beverage brands and products, where such companies may distribute such brands and products, and what will motivate these distributors to distribute such brands and products.

Production Evaluation. We review all aspects of production in the beverage industry, including current contract packing capacity, strategic production locations, and quality control, and prepare a cost analysis of the various considerations that will be critical to producing our unique brands and products.

Image And Design. In light of our market, distributor and production evaluations, we create and develop the concept for a beverage brand or product extension. Although we control all aspects of the creation of each brand or product extension, we contract with outside creative artists to help design our brand labels and imagery. Our technical services department then works with various flavor concentrate houses to test, choose and develop product flavors for the brand.

Due to the limited life cycle of beverages in the New Age or alternative category, we believe that the ongoing process of creating new brands, products and product extensions will be an important factor in our long-term success.

Products

We currently produce, market and distribute five unique beverage brands: *Jones Soda, Jones Organics, Jones Energy*, *WhoopAss* and *Jones Naturals*.

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Jones Soda

We believe that our trademarked *Jones Soda* brand and product line is a leader in the Premium Soda segment of the New Age beverage category. We originally launched *Jones Soda* in November 1995. The *Jones Soda* product line currently consists of 12 flavors.

In 2003, we launched a sugar-free version of our *Jones Soda* line. These sugar-free sodas are sweetened with Splenda® and have zero calories and zero carbohydrates. We believe that the launch of our sugar-free *Jones Soda* provides a healthier alternative to our regular *Jones Soda* line and is an important product extension, especially in light of the recent concern and media coverage regarding obesity in young people. We currently have 5 flavors of sugar-free *Jones Soda*.

In March 2004, we launched our Watermelon Soda, which was the first mid-calorie premium soda on the market, with 50% less sugar, carbohydrates and calories then regular premium sodas and soft drinks. Our mid-calorie sodas contain 90 calories and 21 grams of sugar per 12-ounce serving. We currently have four mid-calorie flavors of *Jones Soda*:

Our strategy is to introduce new flavors each year and selectively retire flavors. In general, our target is to have at least 12 active flavors of our regular *Jones Soda* product, and at least 4 flavors of our sugar free sodas.

Each of the current *Jones Soda* products is made from natural and/or artificial flavors. Some flavors distributed in the U.S. market may contain caffeine (whereas in Canada only Vanilla Cola and Root Beer contain caffeine). Each flavor has a different color profile that we believe is readily distinguishable on a retail shelf. All *Jones Soda* beverage products come in 12-ounce (355 ml) clear long-neck bottles with primarily black and white photos on our labels displaying a variety of urban images. We also encourage consumers of *Jones Soda*, through the labels on our bottles, to send in photographs that may potentially be used on one of the *Jones Soda* labels.

In October 2004, we launched Jones Soda in a 12-ounce can fridge pack through a two year exclusive agreement with Target Corporation. The packaging of Jones Soda includes brightly colored cans in the color of the soda, with black and white photos (seven in total) on the fridge pack container. Jones Soda flavors are currently available in the 12-ounce can fridge pack format throughout all Target locations.

Jones Organics

In April 2005, we launched *Jones Organics*, a ready-to-drink organic tea, with 60 calories per serving, sweetened with organic cane sugar. *Jones Organics* comes in 14-ounce proprietary clear glass bottles with a design of the fruit on the front label, but does not contain the usual black and white photograph labels used on *Jones Soda* and *Jones Naturals* product labels. The *Jones Organics* line currently consists of 6 flavors.

Jones Energy

In November 2001, we launched *Jones Energy*. *Jones Energy* is a citrus energy drink in an 8.4 ounce (250 ml) slim can containing vitamin B6, riboflavin, niacin, thiamin, caffeine and coQ-10. In March 2003, we launched *Jones Energy* in a new 16 ounce can, as an alternative to our other energy products. In March 2004, we launched our sugar-free *Jones Energy* in the 16-ounce can. In September 2004, we re-created and launched *Jones Energy* in an 8.4 ounce four-pack carrier format and in three different flavors Mixed Berry, Orange and Lemon Lime. This four-pack format was initially created for non-exclusive sale in Target Corporation and has since been launched into additional retail stores in the United States. Our *Jones Energy* products compete in the Energy Drink category of the New Age beverage industry.

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Whoopass

We originally launched *WhoopAss* in October 1999. *WhoopAss* is a citrus energy drink in an 8.4 ounce (250 ml) slim can containing riboflavin, niacin, vitamin B6 and thiamin. In 2005, we launched a 16 ounce version of our Whoopass energy drink. *WhoopAss* competes in the Energy Drink category of the New Age beverage industry.

Jones Naturals

In April 2001, we launched *Jones Naturals*, our non-carbonated beverage. The *Jones Naturals* products have 100% natural flavors and contain ingredients such as ginseng, zinc, and various vitamins. *Jones Naturals* comes in 20 ounce (591 ml) clear bottles with primarily black and white photograph labels, similar to the *Jones Soda* product labels The *Jones Naturals* line currently consists of 8 flavors.

Marketing, Sales and Distribution

Marketing

Our pricing policies for the *Jones* and *Whoopass* brands take into consideration competitors prices and our perception of what a consumer is willing to pay for the particular brand and product. The goal is to price our unique products at a premium to other premium sodas and New Age beverages.

For our products sold through our national direct to retail channels, the suggested retail prices are approximately $1.60 1.75 for *Jones Soda* and $1.75 1.95 for *Jones Naturals*.

We primarily use point-of-sale materials such as posters, stickers, table cards, shelf danglers, post cards, hats, pins, T-shirts and jackets to create and increase consumer awareness of our proprietary products and brands. In response to consumer demand, we also sell *Jones* and *Whoopass* products and our wearables on our web site *(http://www.jonessodastore.com)*. Through cooperative advertising, the majority of our independent distributors fund a portion of our marketing budget, based upon case sales. In selected cities, we participate on a grass roots level at certain events in an attempt to create and increase brand awareness and loyalty. We also have a program of sponsoring alternative sport athletes to promote *Jones* and *Whoopass*, and we have signed up several athletes in the skateboard, snowboard and bmx bike arenas. We also use leased recreational vehicles and vans painted with the *Jones* colors and logos to create consumer awareness and enthusiasm to assist distributors as they open new retail accounts and markets. In addition to these marketing techniques, we also pursue cross-promotional campaigns with other companies.

We maintain and utilize our unique website, *www.myjones.com* to allow our *Jones Soda* consumers to create their own personalized 12-pack of *Jones Soda* (12-ounce bottles) with their unique photo in the labels. The strategy of *www.myjones.com* is to provide a unique product offering to our consumers as well as provide a unique marketing opportunity for our *Jones Soda* brand. Consumers can scan their unique photo through the web and crop and create their own myjones labels. The unique labels are downloaded at our office in Seattle and we send out 12-packs of the personalized soda to the consumer. We believe this strategy has increased awareness for the *Jones Soda* brand as well as provided for increased consumer interactivity with the *Jones Soda* brand, and we anticipate that it will continue to do so. In December 2002, we received notice of issuance of a patent (Patent No. 6,493,677) from the U.S. Patent and Trademark Office for our myjones.com business operation. The patent is titled Method and Apparatus for Creating and Ordering Branded Merchandise over a Computer Network.

In 2002, we launched a new program, yourjones, which is the customization of the front panel of the label of *Jones Soda* similar to our myjones business, however on a larger, commercial scale. The premise behind yourjones is to create uniquely customized *Jones Soda* or *Jones Naturals* bottles, with a unique photo or brand image, for cross promotion and co-branding purposes or for sale in retail accounts. Like myjones.com, the Jones Soda name always appears on the labels and customers can add their own photo/brand and words. We have negotiated arrangements with our co-packing facilities to create short-run productions for these purposes.

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Sales

Our products are sold in 44 states in the United States and 9 provinces in Canada primarily in convenience stores, delicatessens, sandwich shops and selected supermarkets, as well as through our national accounts with several large retailers. During 2005, sales in the U.S. represented approximately 88% of total sales, while sales in Canada represented approximately 11%, and we had approximately 1% in other international sales. We may consider expanding sales of our products to select international markets in the future.

During 2005, our DSD sales force was organized into seven regional groups, consisting of the Northwest, Southwest, Midwest, Northeast and Southeast regions of the United States and Western and Eastern regions of Canada. We have two Vice Presidents of Sales, one of whom is responsible for our Northwest and Southwest U.S. regions and Western and Eastern Canada and the other is responsible for our Midwest, Northeast and Southeast regions. Regional Managers are ultimately responsible for the separate regions. Senior sales personnel are responsible for large retail grocery accounts located in their regions, the management of existing independent distributor relations and the selection of new independent distributors as may be required. Junior sales personnel work closely with our independent distributors and their sales representatives to help them open street level retail accounts and train them in our sales and marketing techniques. In addition, we maintain personnel who are responsible for our direct to retail national accounts. In February 2006, we hired an Executive Vice-President of Sales to manage the DSD sales force.

Distribution

We sell a majority of our products through our DSD network, and we currently have relationships with approximately 188 independent distributors throughout North America. Our policy is to grant our distributors rights to sell particular brands within a defined territory. We believe that substantially all of our distributors also carry other beverage products. Agreements with our distributors vary; we have entered into written agreements with many of our top distributors for varying terms of years; most of our other distribution relationships are oral (based solely on purchase orders) and are terminable by either party at will.

In addition, we sell our products directly to certain large national retail accounts, such as Target Corporation, Starbucks, Panera Bread Company, Barnes & Noble and Cost Plus World Markets. Distribution of our products into these DTR accounts is handled by the retailer s distribution system or by its designated food-service or other distributors.

For the year ended December 31, 2005, three of our customers represented approximately 21% of total revenues. We anticipate that, as consumer awareness of our brands develops and increases, we will continue to upgrade and expand our distributor network and DTR accounts, which may result in a decreased dependence on any one or more of our independent distributors or accounts.

We generally require our independent distributors to place their purchase orders for our products at least 10 days in advance of shipping. To the extent we have additional product available in inventory, we will fulfill other purchase orders when and as received. We contract with independent trucking companies to have product shipped from our contract packers to independent warehouses, and then on to our distributors. Distributors then sell and deliver our products either to sub-distributors or directly to retail outlets, and such distributors or sub-distributors stock the retailers shelves with our products. We recognize revenue upon receipt by our distributors and customers of our products, net of discount and allowances, and all sales are final and we have a no return policy; however, in limited instances, due to credit issues or distributor changes, we may take back product.

Production

Contract Packing Arrangements

We currently use seven primary independent contract packers known as co-packers to prepare, bottle and package our products. Our contract packers are located in the Canadian Provinces of British Columbia and Ontario

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and the States of Missouri, Oregon, Minnesota, Pennsylvania, and Indiana. We continually review our contract packing needs in light of regulatory compliance and logistical requirements and may add or change co-packers based on those needs. A majority of our co-packing is handled in Canada, and with the recent strengthening of the Canadian dollar against the U.S. dollar, our co-packing costs have increased. As a result, in 2004 we added a co-packer in Missouri and in 2005 we added a co-packer in Pennsylvania. We expect to continue to look for alternative or lower-cost co-packing arrangements for our products in the United States and in Canada.

As is customary in the contract packing industry, we are expected to arrange for our contract packing needs sufficiently in advance of anticipated requirements. Accordingly, it is our business practice to require our independent distributors to place their purchase orders for our products at least 10 days in advance of delivery. Other than minimum case volume requirements per production run, we do not have any minimum production requirements.

Raw Materials

Substantially all of the raw materials used in the preparation, bottling and packaging of our products are purchased by us or by our contract packers in accordance with our specifications. The raw materials used in the preparation and packaging of our products consist primarily of concentrate, glass, labels, caps and packaging. These raw materials are purchased from suppliers selected by us or by our contract packers.

We believe that we have adequate sources of raw materials, which are available from multiple suppliers. Currently, we purchase our flavor concentrate from two flavor concentrate suppliers, Virginia Dare and Wild Flavors, Inc. We anticipate that for future flavors and additional products, we may purchase flavor concentrate from other flavor houses with the intention of developing other sources of flavor concentrate for each of our products. The water used to produce our products is filtered and is also treated to reduce alkalinity.

Quality Control

Our products are made from high quality ingredients and natural and/or artificial flavors. We seek to ensure that all of our products satisfy our quality standards. Contract packers are selected and monitored by our own quality control representatives in an effort to assure adherence to our production procedures and quality standards. Samples of our products from each production run undertaken by each of our contract packers are analyzed and categorized in a reference library.

For every run of product, our contract packer undertakes extensive on-line testing of product quality and packaging. This includes testing levels of sweetness, carbonation, taste, product integrity, packaging and various regulatory cross checks. For each product, the contract packer must transmit all quality control test results to us for reference following each production run.

Testing includes microbiological checks and other tests to ensure the production facilities meet the standards and specifications of our quality assurance program. Water quality is monitored during production and at scheduled testing times to ensure compliance with beverage industry standards. Flavors are pre-tested before shipment to contract packers from the flavor manufacturer. We are committed to an on-going program of product improvement with a view toward ensuring the high quality of our product through a program for stringent contract packer selection, training, and communication.

We believe we source and select only those suppliers that use only quality components. We also monitor product quality of the packaging suppliers production facilities.

Regulation

The production and marketing of our licensed and proprietary beverages are subject to the rules and regulations of various federal, provincial, state and local health agencies, including in particular Health Canada,

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Agriculture and Agri-Food Canada and the U.S. Food and Drug Administration. The FDA and Agriculture and Agri-Food Canada also regulate labeling of our products. From time to time, we may receive notifications of various technical labeling or ingredient reviews with respect to our licensed products. We believe that we have a compliance program in place to ensure compliance with production, marketing and labeling regulations on a going-forward basis. There are no regulatory notifications or actions currently outstanding. See Risk Factors below.

Trademarks, Flavor Concentrate Trade Secrets and Patent

We own a number of trademarks, including, in the United States and Canada, *Jones Soda Co.*®, *Jones Naturals*, *Jones Energy* and *WhoopAss*. In the United States our trademarks expire 10 years from the registration date and in Canada 15 years from the registration date, although in both Canada and the United States, they may be renewed for a nominal fee. In addition, we have trademark protection in the United States and Canada for a number of other trademarks for slogans and product designs, including *Wet Yourself*®, *I ve Got A Jones For A Jones*®, *Jones Soda Co. and Design*, *Whoopass and Design*® and *My Jones*®. We have also applied for trademark protection for several marks, including *Jones Soda Co.*®, in the United Kingdom, Germany, Japan, and other foreign jurisdictions.

We have the exclusive rights to 30 flavor concentrates developed with our current flavor concentrate suppliers, which we protect as trade secrets. We will continue to take appropriate measures, such as entering into confidentiality agreements with our contract packers and exclusivity agreements with our flavor houses, to maintain the secrecy and proprietary nature of our flavor concentrates.

We have a patent on our myjones.com business operation. In December 2002, the U.S. Patent and Trademark Office issued us Patent No. 6,493,677, titled Method and Apparatus for Creating and Ordering Customized Branded Merchandise over a Computer Network . We originally created the myjones.com system in mid-1999 and applied for this patent in January 2000. The term of U.S. patents is 20 years from the date of filing and this patent can be viewed by accessing the U.S. Patent Office s website at *www.uspto.gov*. We intend to explore potential licensing arrangements with third parties to commercialize this patented methodology.

We consider our trademarks, patent and trade secrets to be of considerable value and importance to our business. No successful challenges to our registered trademarks have arisen and we have no reason to believe that any such challenges will arise in the future. See Risk Factors below.

Competition

The beverage industry is highly competitive. Principal methods of competition in the beverage industry include

- distribution,
- brand name,
- brand image,

price,

labeling and packaging,

advertising,

product quality and taste,

trade and consumer promotions, and

the development of new brands, products and product extensions.

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We compete with other beverage companies not only for consumer acceptance but also for shelf space in retail outlets and for marketing focus by our distributors, all of who also distribute other beverage brands. Our products compete with all non-alcoholic beverages, most of which are marketed by companies with substantially greater financial resources than we have. We also compete with regional beverage producers and private label soft drink suppliers. Our direct competitors in the alternative beverage industry include Cadbury Schweppes (Stewarts and IBC) and Thomas Kemper. We also compete against Coke, Pepsi, Hansen s, Stewarts, IBC and other traditional soft drink manufacturers and distributors. We also compete against other category leaders such as Redbull for the energy drink category.

In order to compete effectively in the beverage industry, we believe that we must convince independent distributors that *Jones Soda* is a leading brand in the premium soda segment of the alternative or New Age beverage industry. In connection with or as a follow-up to the establishment of an independent distributor relationship for the *Jones Soda* brand, we sell *Jones Organics, Jones Energy*, *WhoopAss* and *Jones Naturals* as complementary products that may replace other non-carbonated single-serve fruit beverages or ready-to-drink (RTD) teas or energy drinks. In addition, we have created *Jones Soda* in a 12-ounce can format that allows us to compete directly in the carbonated soft drink industry. As a means of maintaining and expanding our distribution network, we intend to introduce new products and product extensions, and when warranted, new brands. Although we believe that we will be able to continue to create unique, exciting and fashionable brands, there can be no assurance that we will be able to do so or that other companies will not be more successful in this regard over the long term. See Risk Factors below.

In addition, in light of the competition for product placement with independent distributors, we obtained several national retail accounts as an additional distribution channel for our products. We currently have distribution arrangements with Target Corporation, Starbucks, Panera Bread Company, Barnes & Noble and Cost Plus World Markets. We believe that this diversification strategy is helpful in alleviating the risk inherent in competition for independent distributors.

Pricing of the products is also important. We believe that our *Jones Soda*, *Jones Organics, Jones Energy*, *Whoopass* and *Jones Naturals* products are priced in the same price range or higher than competitive New Age beverage brands and products.

Employees

As of December 31, 2005, we had 52 full-time employees, 29 of whom were employed in sales and marketing capacities, 17 were employed in administrative capacities, and 6 were employed in manufacturing and quality control capacities. None of our employees is represented by labor unions. We believe that our relationships with our employees are good.

Risk Factors

The following discussion in this Annual Report on Form 10-KSB contains forward-looking statements regarding our business, prospects and results of operations that involve risks and uncertainties. Our actual results could differ materially from the results that may be anticipated by such forward-looking statements and discussed elsewhere in this Report. Factors that could cause or contribute to such differences include, but are not limited to, those discussed below, as well as those discussed under the captions Business and Management s Discussion and Analysis of Financial Condition and Results of Operations as well as those discussed elsewhere in this Report. In evaluating our business, prospects and results of operations, readers should carefully consider the following factors in addition to other information presented in this Report and in our other reports filed with the Securities and Exchange Commission that attempt to advise interested parties of the risks and factors that may affect our business, prospects and results of operations. See Cautionary Notice Regarding Forward Looking Statements above.

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Risk Factors Relating to Our Company and Our Business

Our business plan and future growth is dependent in part on our distribution arrangements directly with retailers and national retail accounts. There are risks associated with this distribution strategy. The loss of any of our national DTR accounts could adversely affect us.

We currently have distribution arrangements with several large national retail accounts to distribute our products directly through their stores, consisting of Barnes & Noble, Panera Bread Company, Cost Plus World Markets, Starbucks Coffee Company and Target Corporation. Although we believe that our direct to retail program will increase our national visibility among consumers, there are several risks associated with this distribution strategy. First, we do not have long-term agreements in place with each of these accounts. In particular, we do not have a distribution agreement with Starbucks and we operate based solely on purchase orders we receive from Starbucks. There is no assurance that we will be able to maintain continuing relationships with any of these national accounts, or that we will be able to renew any of these accounts upon expiration of the term of the existing arrangements. Also, any of our agreements may be terminated early. The loss of any of these high-profile national accounts could negatively impact our revenues and our reputation. In addition, we may not be able to establish additional distribution arrangements with other national retailers. Second, as we become more dependent on national retail chains, these retailers may assert pressure on us to reduce our pricing to them or seek significant product discounts. Any increase in our costs for their carrying our product, reduction in price, or demand for product discounts could have a material adverse affect on our profit margin. Finally, our direct to retail distribution arrangements may have an adverse impact on our existing relationships with our independent regional distributors, although we believe that increased visibility of our product through these national retailers may lead to increased product sales through our network of independent distributors.

Our business plan and future growth is dependent in part on licensing strategy. There are risks associated with this licensing strategy.

Over the past two years, we entered into several licensing agreements. These licensing agreements provide for each company with which we partner to manufacture and distribute products carrying the Jones Soda Co. brand. To date, these products include *Jones Soda* in a 12-ounce can, Jones Soda lip balms and Jones Soda Frozen Soda Pops. Although we believe that our licensing strategy will increase our national visibility among consumers, there are several risks associated with implementing this licensing strategy. First, there is no assurance that the licensing partner will maintain the same level of quality assurance, inventory management and oversight we are able to maintain with products directly under our supervision. Second, our expertise is in beverages and there is no assurance to us that the same quality standards are required of other products in other industries. Finally, there is no assurance that the licensing partner will provide the same focus on distribution or management of the brand as is done with our own products. In addition, any of our agreements may be terminated early.

We need to effectively manage our growth and resources in order to execute on our business plan. Any failure to do so would negatively impact our profitability.

To manage operations effectively and maintain profitability, we must continue to improve our operational, financial and other management processes and systems. Our success also depends largely on our ability to maintain high levels of employee utilization, manage our production costs and general and administrative expense, and otherwise execute on our business plan. In addition, in order to grow and execute on our business plan and opportunities, we need to have available to us adequate resources, including capital and personnel, which may not be available when needed. We also need to maintain adequate operational controls and focus as we add new brands and products, distribution channels, and business strategies. We may not be able to effectively and efficiently manage our growth. Any inability to do so could increase our expenses and negatively impact our profit margin.

We have a lean management team.

We currently have a lean management structure, with our Chief Executive Officer and Executive Vice President of Sales responsible for most of our management. Our former Chief Financial Officer resigned in December 2005 and we have commenced a search for a permanent Chief Financial Officer. As we grow and execute our business plan, our management may be too thin and we may need to bring in additional members of management. We may not be successful in finding appropriate executives when needed, which could negatively impact our operations, growth and profitability.

The loss of key personnel would directly affect our efficiency and profitability.

We are dependent upon the creative skills and leadership of our founder, Peter M. van Stolk, who serves as President and Chief Executive Officer. We have in place with Mr. van Stolk a two-year employment agreement that expires on November 30, 2007. The loss of Mr. van Stolk s services could have a material adverse affect on our business and operations, including our ability to develop and execute on a long-term, profitable business plan. In addition, our management team consists of several key production, distribution, sales and financial personnel who have been recruited within the past several years. The loss of any of these key personnel could delay or negatively impact our operations, profitability and employee morale.

There are no assurances that we will be able to continue profitable operations into the future.

We believe that to continue to operate at a profit we must:

- increase the sales volume for our unique brands and products;
- achieve and maintain efficiencies in operations;
- maintain fixed costs at or near current levels; and
- avoid significant increases in variable costs relating to production, marketing and distribution.

We may not be able to meet these objectives and sustain profitability. We have incurred significant operating expenses in the past and may do so again in the future and, as a result, will need to increase revenues in order to maintain profitability. Our ability to increase sales from current sales levels will depend primarily on success in expanding our current markets, improving our distribution base, entering into direct to retail arrangements with national accounts, and introducing new unique brands, products or product extensions to the market. Our ability to successfully enter new distribution areas and obtain national accounts will, in turn, depend on various factors, many of which are beyond our control including, but not limited to, the continued demand for our brands and products in target markets, the ability to price our products at levels competitive with competing products, the ability to establish and maintain relationships with distributors in each geographic area of distribution and the ability in the future to create, develop and successfully introduce one or more new brands, products, and product extensions.

We have limited working capital and may need to raise additional capital in the future.

At December 31, 2005, our cash and cash equivalents was approximately $1,176,000, we had approximately $3,700,000 in accounts receivable and approximately $4,694,000 in inventory. Our working capital at December 31, 2005 was approximately $5,699,000. Although we believe that net cash provided by operations and amounts available under our bank line of credit will be sufficient to meet anticipated cash needs for our operations during fiscal 2006, a revenue shortfall could deplete our limited financial resources and require us to reduce costs and operations substantially or to raise additional funds through equity or debt financings.

Our capital needs in the future will depend upon factors such as our growth strategy, market acceptance of our products and any other new products we launch, the success of our DTR, DSD and licensing relationships and our production, marketing and sales costs. None of these factors can be predicted with certainty. We may need to raise capital in the future to fund any one or more of these efforts.

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We may need substantial additional debt or equity financing in the future for which we currently have no commitments or arrangement. We cannot assure you that any additional financing, if required, will be available or, even if it is available that it will be on terms acceptable to us. If we raise additional funds by selling stock, the ownership of our existing shareholders will be diluted. Any inability to obtain required financing could have a material adverse effect on our business, results of operations and financial condition.

We face currency risks associated with fluctuating foreign currency valuations.

For the year ended December 31, 2005, approximately 11.0% of our sales were denominated in the Canadian dollar. A decrease in the value of the Canadian dollar in relation to the U.S. dollar after establishing prices and before our receipt of payment and conversion of such payment to U.S. dollars would have an adverse effect on our operating results. Although the recent strengthening of the Canadian dollar has had a positive impact on our revenues attributable to sales in Canada, it has also negatively impacted our costs of goods. The majority of our products are produced and bottled in Canada through two of our co-packers. Accordingly, an increase in the value of the Canadian dollar in relation to the U.S. dollar has similar relative adverse effect on our production costs. In an attempt to reduce the impact of these currency fluctuations on our production costs, during the second quarter of fiscal 2005 we established a new bottling relationship in the U.S. and shifted a portion of our bottling requirements to this facility beginning in the third quarter of fiscal 2005. In addition, the financial statements for our Canadian subsidiary are denominated in Canadian dollars; accordingly, on a consolidated financial statement reporting basis these numbers are converted into U.S. dollars and are affected by currency conversion rates. As of December 31, 2005, we have not entered into foreign currency contracts or other derivatives to mitigate the potential impact of foreign currency fluctuations.

We rely on our independent distributors, and this could affect our ability to efficiently and profitably distribute and market our products, and maintain our existing markets and expand our business into other geographic markets.

Our ability to establish a market for our unique brands and products in new geographic distribution areas, as well as maintain and expand our existing markets, is dependent on our ability to establish and maintain successful relationships with reliable independent distributors strategically positioned to serve those areas. Most of our larger distributors sell and distribute competing products, including non-alcoholic and alcoholic beverages, and our products may represent a small portion of their business. To the extent that our distributors are distracted from selling our products or do not employ sufficient efforts in managing and selling our products, including re-stocking the retail shelves with our products, our sales and profitability will be adversely affected. Our ability to maintain our distribution network and attract additional distributors will depend on a number of factors, many of which are outside our control. Some of these factors include

- the level of demand for our brands and products in a particular distribution area,
- our ability to price our products at levels competitive with those offered by competing products, and
- our ability to deliver products in the quantity and at the time ordered by distributors.