

MusclePharm Corp
Form 10-Q/A
November 15, 2013

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

**FORM 10-Q/A
(Amendment No. 1)**

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

For the quarterly period ended: **September 30, 2013**

OR

**“ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE
ACT OF 1934**

For the transition period from _____ to _____

Commission File Number: **000-53166**

MUSCLEPHARM CORPORATION
(Exact name of registrant as specified in its charter)

Nevada
(State or other jurisdiction of
incorporation or organization)

77-0664193
(I.R.S. Employer
Identification No.)

4721 Ironton Street, Building A
Denver, Colorado 80239
(Address of principal executive offices and zip code)

(303) 396-6100
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 12 months, and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files. Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller

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reporting company” in Rule 12b-2 of the Exchange Act:

Large accelerated filer	..	Accelerated filer	..
Non-accelerated filer	..	Smaller reporting company	x

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

As of November 14, 2013, there were 8,865,990 shares outstanding of the registrant’s common stock.

Explanatory Note

The sole purpose of this Amendment No. 1 (this “Amendment”) to MusclePharm Corporation’s Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2013, filed with the Securities and Exchange Commission on November 14, 2013 (the “Form 10-Q”), is to correct a typographical error in Note 15 of the Consolidated Financial Statements. Specifically, Note 15, Subsection (E) was changed to indicate that in November, the Company sold an aggregate of 5,000,000 shares of common stock in Biozone Laboratories, instead of the previously disclosed 1,000,000 shares.

No other modifications or changes have been made to the Form 10-Q. This Amendment speaks as of the original filing date of the Form 10-Q, does not reflect events that may have occurred subsequent to the original filing date and does not modify or update in any way disclosures made in the original Form 10-Q.

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Part I FINANCIAL INFORMATION**Item 1. Financial Statements****MusclePharm Corporation and Subsidiary****Consolidated Balance Sheets**

	September 30, 2013 (unaudited)	December 31, 2012 (audited)
Assets		
Current Assets:		
Cash	\$ 5,683,656	\$ -
Cash restricted	-	9,148
Debt Securities	925,574	-
Accounts receivable net	10,911,439	3,302,344
Derivative instrument	1,692,351	-
Inventory	9,633,164	257,975
Prepaid giveaways	592,422	358,800
Prepaid stock compensation	3,368,692	44,748
Prepaid sponsorship fees	692,536	6,249
Deferred equity costs	-	698,500
Other assets	907,881	272,117
Total current assets	34,407,715	4,949,881
Property and equipment net	1,668,944	1,356,364
Debt issue costs net	-	335,433
Prepaid stock compensation	5,171,400	-
Other assets	299,404	125,049
Total Assets	\$ 41,547,463	\$ 6,766,727
Liabilities and Stockholders' Equity		
Current Liabilities:		
Accounts payable and accrued liabilities	\$ 16,543,261	\$ 11,721,205
Customer deposits	356,469	336,211
Debt net	70,456	4,463,040
Derivative liabilities	1,895,085	-
Total current liabilities	18,865,271	16,520,456
Long Term Liabilities:		
Debt net	-	4,523
Other	7,554	-
Total Liabilities	18,872,825	16,524,979
Commitments and Contingencies		
Stockholders' Equity:		
Series A, Convertible Preferred Stock, \$0.001 par value; 5,000,000 shares	-	-
authorized, none issued and outstanding		
Series B, Preferred Stock, \$0.001 par value; 0 and 51 shares authorized, 51	-	-
issued and none and 51 outstanding		
Series C, Convertible Preferred Stock, \$0.001 par value; 500 shares	-	-
authorized, 190 and none issued and outstanding		

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Series D, Convertible Preferred Stock, \$0.001 par value; 1,600,000 shares		
authorized, 1,500,000 and none issued and 144,000 and none outstanding	144	-
Common Stock, \$0.001 par value; 100,000,000 shares authorized, 8,915,911		
and 2,778,404 issued and 8,865,990 and 2,747,308 outstanding	8,916	2,778
Treasury Stock, at cost; 49,921 and 31,096 shares	(564,515)	(460,978)
Additional paid-in capital	101,025,625	54,817,341
Accumulated deficit	(77,839,103)	(64,109,476)
Accumulated other comprehensive income (loss)	43,571	(7,917)
Total Stockholders' Equity	22,674,638	(9,758,252)
Total Liabilities and Stockholders' Equity	\$ 41,547,463	\$ 6,766,727

See accompanying notes to unaudited financial statements.

MusclePharm Corporation and Subsidiary
Consolidated Statements of Operations
(unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2013	2012	2013	2012
Sales - gross	\$ 31,080,225	\$ 20,627,691	\$ 84,519,744	\$ 58,799,563
Discounts and sales allowances	(5,736,257)	(2,053,965)	(11,134,551)	(8,235,817)
Sales - net	25,343,968	18,573,726	73,385,193	50,563,746
Cost of sales	17,937,768	14,507,761	49,900,891	40,345,528
Gross profit	7,406,200	4,065,965	23,484,302	10,218,218
Advertising and promotion	4,043,064	2,599,691	9,635,642	6,576,531
General and administrative	1,936,610	1,141,435	5,000,831	3,146,029
Professional and R&D fees	2,429,361	2,881,235	10,452,208	3,776,033
Salaries and benefits	3,869,945	1,254,417	6,730,813	2,922,072
Total operating expenses	12,278,980	7,876,778	31,819,494	16,420,665
Loss from operations	(4,872,780)	(3,810,813)	(8,335,192)	(6,202,447)
Other income (expense)				
Derivative expense	-	(1,922,763)	(96,913)	(4,409,214)
Change in fair value of derivative liabilities	305,421	4,403,875	(5,466,542)	5,900,749
Gain (loss) on settlement of accounts payable and debt	67,489	(1,510,613)	392,144	(4,452,439)
Gain on derivative instrument	444,059	-	444,059	-
Accretion of note discount	115,429	-	115,429	-
Interest expense	(1,302)	(3,265,053)	(782,747)	(6,812,255)
Foreign currency transaction (gain) loss	(4,152)	14,342	(9,865)	12,769
Other income	-	16,988	10,000	35,411
Total other income (expense) - net	926,944	(2,263,224)	(5,394,435)	(9,724,979)
Net loss	(3,945,836)	(6,074,037)	(13,729,627)	(15,927,426)
Other comprehensive income				
Net change in foreign currency translation	(13,027)	(33,163)	(6,950)	7,556
Net change in debt securities	58,438	-	58,438	-
Total other comprehensive (loss) income	45,411	(33,163)	51,488	7,556
Total comprehensive loss	\$ (3,900,425)	\$ (6,107,200)	\$ (13,678,139)	\$ (15,919,870)
Net loss per share available to common stockholders - basic and diluted	\$ (0.47)	\$ (3.21)	\$ (2.07)	\$ (9.62)
Weighted average number of common shares outstanding during the period - basic and diluted	8,475,084	1,894,202	6,626,125	1,656,218

See accompanying notes to unaudited financial statements.

MusclePharm Corporation and Subsidiary
Consolidated Statements of Cash Flows
(unaudited)

	Nine Months Ended September 30, 2013	2012
Cash Flows From Operating Activities:		
Net loss	\$ (13,729,627)	\$ (15,927,426)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:		
Depreciation	510,890	325,185
Bad debt	158,578	9,490
Amortization of prepaid stock and deferred compensation	9,828,760	718,173
Amortization of debt discount	-	6,086,521
Amortization of debt issue costs	335,433	286,523
Accretion of note discount	(115,429)	-
(Gain) loss on settlement of accounts payable, debt and conversion of Series C preferred stock	(392,144)	3,261,897
Derivative expense	96,913	4,409,214
Change in fair value of derivative liabilities	5,466,541	(5,900,749)
Change in fair value of derivative assets	(444,059)	
Changes in operating assets and liabilities:		
(Increase) decrease in:		
Restricted cash balance	9,148	(74,202)
Accounts receivable	(7,767,673)	(1,478,270)
Prepaid and other	(3,549,221)	(339,088)
Inventory	(9,608,811)	(396,873)
Increase (decrease) in:		
Accounts payable and accrued liabilities	11,127,500	8,384,755
Customer deposits	20,258	921,675
Other	7,554	-
Net Cash (Used In) Provided by Operating Activities	(8,045,389)	286,825
Cash Flows From Investing Activities:		
Purchase of convertible promissory note and warrant	(2,000,000)	-
Purchase of property and equipment	(825,164)	(899,823)
Proceeds from disposal of property and equipment	1,694	-
Purchase of trademark	(104,725)	(35,000)
Net Cash Used In Investing Activities	(2,928,195)	(934,823)
Cash Flows From Financing Activities:		
Proceeds from issuance of debt	-	4,823,950
Debt issue costs	-	(166,950)
Repayment of debt	(4,397,107)	(5,241,234)
Repurchase of common stock (treasury stock)	(103,537)	(460,978)
Proceeds from issuance of preferred stock	12,000,000	-
Proceeds from issuance of common stock and warrants	10,827,501	1,660,760
Stock issuance costs	(1,662,667)	-
Net Cash Provided Financing Activities	16,664,190	615,548

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Cash Flows From Equity Activities:

Effect of exchange rates on cash and cash equivalents	(6,950)	7,556
Net Cash (Used In) Provided by Equity Activities	(6,950)	7,556
Net increase (decrease) in cash	5,683,656	(24,894)
Cash at beginning of period	-	659,764
Cash at end of period	\$ 5,683,656	\$ 634,870
Supplemental disclosures of cash flow information:		
Cash paid for interest	\$ 410,846	\$ 423,705
Cash paid for taxes	\$ -	\$ -

Supplemental disclosure of non-cash investing and financing activities:

Stock issued for future services - third parties	\$ 13,879,997	\$ 1,001,519
Warrants issued in conjunction with equity issuances	\$ 8,175,459	\$ 427,759
Debt discount recorded on convertible and unsecured debt accounted for as a derivative liability	\$ -	\$ 3,554,672
Stock issued to settle accounts payable and accrued expenses third parties	\$ 5,760,887	\$ 1,392,143
Conversion of convertible debt and accrued interest for common stock	\$ -	\$ 1,069,402
Stock issued for executive and board compensation	\$ 152,412	\$ 4,667,764
Reclassification of derivative liability to additional paid in capital	\$ 11,688,463	\$ 9,759,079
Stock issued to settle accrued liabilities	\$ -	\$ 384,500
Change in fair value of debt securities in other comprehensive income	\$ 58,438	\$ -
Stock issued to settle contracts	\$ 155,365	\$ 3,932

See accompanying notes to unaudited financial statements.

MusclePharm Corporation and Subsidiary
Notes to Consolidated Financial Statements
(September 30, 2013)
(Unaudited)

Note 1: Nature of Operations and Basis of Presentation

Nature of Operations

MusclePharm Corporation (the “Company”, “we”, “our”, or “MusclePharm”), was incorporated in the state of Nevada on August 4, 2006 under the name Tone in Twenty for the purpose of engaging in the business of providing personal fitness training using isometric techniques. The Company is headquartered in Denver, Colorado.

MusclePharm currently manufactures and markets a wide-ranging variety of high-quality sports nutrition products.

Basis of Presentation

The accompanying unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) and the rules and regulations of the U.S. Securities and Exchange Commission (“SEC”), as amended for interim financial information.

The financial information as of December 31, 2012 is derived from the audited financial statements presented in the Company’s Annual Report on Form 10-K for the year ended December 31, 2012 and filed with the SEC on April 1, 2013. The unaudited interim consolidated financial statements should be read in conjunction with the Company’s Annual Report on Form 10-K, which contains the audited financial statements and notes thereto, together with Management’s Discussion and Analysis of Financial Condition and Results of Operations, for the years ended December 31, 2012 and 2011.

Certain information or footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted, pursuant to the rules and regulations of the SEC for interim financial reporting. Accordingly, they do not include all the information and footnotes necessary for a comprehensive presentation of financial position, results of operations, or cash flows. It is management’s opinion, however, that all material adjustments (consisting of normal recurring adjustments) have been made which are necessary for a fair financial statement presentation. The interim results for the nine months ended September 30, 2013 are not necessarily indicative of results for the full fiscal year.

Note 2: Summary of Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements include the accounts of MusclePharm Corporation and its wholly-owned subsidiary MusclePharm Canada Enterprises Corp (“MusclePharm Canada”). MusclePharm Canada began operations in April of 2012. All intercompany accounts and transactions between MusclePharm Corporation and MusclePharm Canada have been eliminated upon consolidation.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period.

Making estimates requires management to exercise significant judgment. It is reasonably possible that the estimate of the effect of a condition, situation or set of circumstances that existed at the date of the financial statements, which management considered in formulating its estimate could change in the near term due to one or more future non-conforming events. Accordingly, the actual results could differ significantly from estimates.

Risks and Uncertainties

The Company operates in an industry that is subject to rapid change and intense competition. The Company's operations will be subject to significant risk and uncertainties including financial, operational, technological, regulatory, industry adverse publicity and other risks, including the potential risk of business failure.

MusclePharm Corporation and Subsidiary
Notes to Consolidated Financial Statements
(September 30, 2013)
(Unaudited)

Cash and Cash Equivalents

The Company considers all highly liquid instruments purchased with an original maturity of three months or less and money market accounts to be cash equivalents. At September 30, 2013 and December 31, 2012, respectively, the Company had no cash equivalents.

Accounts Receivable and Allowance for Doubtful Accounts

Accounts receivable represents trade obligations from customers that are subject to normal trade collection terms. Prior to July 1, the accounts receivable were sent directly to the Company's third party manufacturer and netted with any outstanding liabilities to the manufacturer. Subsequent to July 1, the Company took over the receipt and processing of accounts receivable. The Company periodically evaluates the collectability of its accounts receivable and considers the need to establish an allowance for doubtful accounts based upon historical collection experience and specific customer information. Accordingly, the actual amounts could vary from the recorded allowances. There is also a review of customer discounts at the period end and an accrual made for discounts earned but not yet received by quarter end.

Management reserves for bad debt expense based on the aging of accounts receivable. Bad debt expense is classified under general & administrative expense in the Consolidated Statement of Operations.

The Company does not charge interest on past due receivables. Receivables are determined to be past due based on the payment terms of the original invoices. Accounts receivable consisted of the following at September 30, 2013 and December 31, 2012:

	As of September 30, 2013	As of December 31, 2012
Accounts receivable	\$ 11,833,677	\$ 4,416,193
Less: allowance for discounts	(750,000)	(1,088,720)
Less: allowance for doubtful accounts	(172,238)	(25,129)
Accounts receivable net	\$ 10,911,439	\$ 3,302,344

At September 30, 2013 and December 31, 2012, the Company had the following concentrations of accounts receivable with significant customers:

Customer	As of September 30, 2013		As of December 31, 2012	
A	20	%	24	%
B	16	%	6	%
C	15	%	20	%

Inventory

Inventory is valued at the lower of cost or market value. Product-related inventories are primarily maintained using the First-In First-Out method.

Prepaid Giveaways

Prepaid giveaways represent non-inventory sample items, which are given away to aid in promotion of the brand.

Prepaid Sponsorship Fees

Prepaid sponsorship fees represents fees paid in connection with future advertising to be received.

Property and Equipment

Property and equipment are stated at cost and depreciated to their estimated residual value over their estimated useful lives. When assets are retired or otherwise disposed of, the assets and related accumulated depreciation are relieved from the accounts and the resulting gains or losses are included in operating income in the Consolidated Statements of Operations. Repairs and maintenance costs are expensed as incurred. Depreciation is provided using the straight-line method for all property and equipment.

MusclePharm Corporation and Subsidiary
Notes to Consolidated Financial Statements
(September 30, 2013)
(Unaudited)

Website Development Costs

Costs incurred in the planning stage of a website are expensed, while costs incurred in the development stage are capitalized and amortized over the estimated useful life of the asset.

Long-Lived Assets

The Company reviews long-lived assets for impairment whenever events or changes in circumstances, such as service discontinuance or technological obsolescence, indicate that the carrying amount of the long-lived asset may not be recoverable. When such events occur, the Company compares the carrying amount of the asset to the undiscounted expected future cash flows related to the asset. If the comparison indicates that impairment is present, the amount of the impairment is calculated as the difference between the excess of the carrying amount over the fair value of the asset. If a readily determinable market price does not exist, fair value is estimated using discounted expected cash flows attributable to the asset. During the nine months ended September 30, 2013 and 2012, the Company recorded no impairment expense.

Fair Value of Financial Instruments

The Company measures assets and liabilities at fair value based on an expected exit price which represents the amount that would be received on the sale of an asset or paid to transfer a liability, as the case may be, in an orderly transaction between market participants. As such, fair value may be based on assumptions that market participants would use in pricing an asset or liability. The authoritative guidance on fair value measurements contains a consistent framework for measuring fair value on either a recurring or nonrecurring basis whereby inputs, used in valuation techniques, are assigned a hierarchical level.

The following are the hierarchical levels of inputs to measure fair value:

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

Level 2: Inputs reflect quoted prices for identical assets or liabilities in markets that are not active; quoted prices for similar assets or liabilities in active markets; inputs other than quoted prices that are observable for the assets or liabilities; or inputs that are derived principally from or corroborated by observable market data by correlation or other means.

Level 3: Unobservable inputs reflecting the Company's assumptions incorporated in valuation techniques used to determine fair value. These assumptions are required to be consistent with market participant assumptions that are reasonably available.

The determination of where assets and liabilities fall within this hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The following are the major categories of assets and liabilities measured at fair value on a recurring basis as of September 30, 2013 and December 31, 2012, using quoted prices in active markets for identical liabilities (Level 1); significant other observable inputs (Level 2); and significant unobservable inputs (Level 3):

	As of September 30, 2013	As of December 31, 2012
Assets		
Debt securities (Level 2)	\$ 925,574	\$ -

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Derivative instruments	Biozone warrants (Level 2)	1,692,351	-
		2,617,925	-

Liabilities

Derivative liabilities (Level 2)	\$	1,895,085	\$	-
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The Company's financial instruments consisted primarily of marketable securities, accounts receivable, notes receivable, accounts payable and accrued liabilities, and debt. The Company's debt approximates fair value based upon current borrowing rates available to the Company for debt with similar maturities. The carrying amounts of the Company's financial instruments generally approximated their fair values as of September 30, 2013 and December 31, 2012, respectively, due to the short-term nature of these instruments.

MusclePharm Corporation and Subsidiary
Notes to Consolidated Financial Statements
(September 30, 2013)
(Unaudited)

Due to the thinly traded nature of the underlying stock of the debt securities and derivative instrument above, the Company has classified them as Level 2 inputs, and has employed a lattice pricing model for valuation purposes. Refer to Notes 5 and 6 for further details of the valuation.

Debt Securities

The Company classifies its investment securities as either held-to-maturity, available-for-sale or trading. The Company's debt securities are classified as available-for-sale and are carried at fair value, with the unrealized gains and losses reported in shareholders' equity under accumulated other comprehensive income (loss). See Note 5 for further discussion of the Company's debt securities.

Revenue Recognition

The Company records revenue when all of the following have occurred: (1) persuasive evidence of an arrangement exists, (2) product has been shipped or delivered, (3) the sales price to the customer is fixed or determinable, and (4) collectability is reasonably assured.

Depending on individual customer agreements, sales are recognized either upon shipment of products to customers or upon delivery. For all of our Canadian sales, which represent 3% of total sales, recognition occurs upon shipment.

The Company has determined that advertising related credits that are granted to customers fall within the guidance of ASC No. 605-50-55 ("*Revenue Recognition*" *Customer Payments and Incentives Implementation Guidance and Illustrations*). The guidance indicates that, absent evidence of benefit to the vendor, appropriate treatment requires netting these types of payments against revenues and not expensing as advertising expense.

The Company records sales allowances and discounts as a direct reduction of sales.

Sales for the three and nine months ended September 30, 2013 and 2012 were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Sales	\$ 31,080,225	\$ 20,627,691	\$ 84,519,744	\$ 58,799,563
Discounts	(5,736,257)	(2,053,965)	(11,134,551)	(8,235,817)
Sales - Net	\$ 25,343,968	\$ 18,573,726	\$ 73,385,193	\$ 50,563,746

The Company has an informal seven day right of return for products. There were nominal returns for the three and nine months ended September 30, 2013 and 2012.

For the nine months ended September 30, 2013 and 2012, the Company had the following concentrations of revenues with significant customers:

Customer	Nine Months Ended September 30,			
	2013		2012	
A	28	%	39	%

B	9	%	8	%
C	5	%	10	%

Licensing Income and Royalty Revenue

On May 5, 2011, the Company granted an exclusive indefinite license to market, manufacture, design and sell the Company's existing apparel line. The licensee paid an initial fee of \$250,000 in June 2011, and will pay the Company a 10% net royalty based on its net income at the end of each fiscal year. To date, no royalty revenue has been earned by the Company.

MusclePharm Corporation and Subsidiary
Notes to Consolidated Financial Statements
(September 30, 2013)
(Unaudited)

Cost of Sales

Cost of sales represents costs directly related to the production, manufacturing and freight of the Company's products.

Shipping and Handling

Prior to March 1, 2013 MusclePharm used a manufacturer from Tennessee to ship directly to our customers. After that date, MusclePharm took control of the shipping and began shipping products from a previously leased, 152,000 square foot distribution center in Franklin, Tennessee.

Prior to June 30, 2013, our products were transported from our manufacturer to the MusclePharm distribution center, but title did not pass from the manufacturer until loaded on the truck for shipment to the customer. As a result, MusclePharm did not take title to our products.

On July 1, 2013, the Company terminated a distribution agreement dated November 17, 2010 with one of our key product manufacturers in which the manufacturer received and fulfilled customer sales orders for a majority of our products. In connection with the termination of the agreement, the Company took control of customer order fulfillment through our Franklin, Tennessee warehouse. The facility is operated with the Company's equipment and employees.

The Company also uses a manufacturer in New York for the manufacture of one of the Company's products. These orders are typically large and heavy and are drop shipped directly to our customers at the time of order. Costs associated with these shipments are recorded in cost of sales.

For Canadian sales, the product is shipped from our Canadian warehouse to our customers. Costs associated with the shipments are recorded in cost of sales.

Advertising and Promotion Expenses

Advertising and promotion expenses include digital and print advertising, trade show events, athletic endorsements and sponsorships, and promotional giveaways. Advertising expenses are recognized in the month that the advertising appears while costs associated with trade show events are expensed when the event occurs. Costs related to promotional giveaways are expensed when the product is either given out at a promotional event or shipped to the customer.

A significant amount of the Company's promotional expenses results from payments under endorsement and sponsorship contracts. Accounting treatment for endorsement and sponsorship payments is based upon specific contract provisions. Generally, endorsement payments are expensed straight-line over the term of the contract after giving recognition to periodic performance compliance provisions of the contract. Prepayments made under the contracts are included in either current or long-term prepaid expenses depending on the period to which the prepayment applies.

Some of the contracts provide for contingent payments to endorsers or athletes based upon specific achievement in their sports (e.g. winning a championship). The Company records expense for these payments when the endorser achieves the specific achievement.

Advertising and promotion expense for the three and nine months ended September 30, 2013 and 2012 were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Advertising	\$ 4,043,064	\$ 2,599,691	\$ 9,635,642	\$ 6,576,531

Beneficial Conversion Feature

For conventional convertible debt where the rate of conversion is below market value, the Company records a “beneficial conversion feature” (“BCF”) and related debt discount.

When the Company records a BCF, the relative fair value of the BCF is recorded as a debt discount against the face amount of the respective debt instrument. The discount is amortized to interest expense over the life of the debt.

MusclePharm Corporation and Subsidiary
Notes to Consolidated Financial Statements
(September 30, 2013)
(Unaudited)

Accounts payable and Accrued Liabilities

Accounts payable and accrued liabilities consist of the Company's trade payables as well as amounts estimated by management for future liability payments that relate to the current accounting period. Management reviews these estimates periodically to determine their reasonableness and fair presentation.

Debt

The Company defines short term debt as any debt payment due less than one year from the date of the financial statements. Long term debt is defined as any debt payment due more than one year from the date of the financial statements. Refer to Note 7 for further disclosure of debt liabilities.

Derivative Instruments

Fair value accounting requires bifurcation of embedded derivative instruments such as conversion features in equity instruments and warrants granted, and measurement of their fair value. In determining the appropriate fair value, the Company uses Black-Scholes or lattice option-valuation models. In assessing the convertible equity instruments, management determines if the convertible equity instrument is conventional convertible equity and further if the beneficial conversion feature requires separate measurement.

Once derivative instruments are determined, they are adjusted to reflect fair value at the end of each reporting period. Any increase or decrease in the fair value is recorded in results of operations as an adjustment to fair value of derivatives. In addition, the fair value of freestanding derivative instruments such as warrants, are also valued using a Black-Scholes or lattice option-pricing model. Once a derivative liability ceases to exist any remaining fair value is reclassified to additional paid-in capital if redeemed or through earnings if forfeited or expired.

Deferred Equity Costs

The Company may pay costs related to the underwriting and offering of equity securities. These costs are treated as a reduction to equity capital raised and recorded in equity when the share issuances are recorded. Until the shares are recorded or until offering is aborted, these costs will be held on the balance sheet as a deferred asset.

Debt Issue Costs and Debt Discount

The Company may pay debt issue costs, and record debt discounts in connection with raising funds through the issuance of debt. These costs are amortized over the life of the debt to interest expense. If a conversion of the underlying debt occurs, a proportionate share of the unamortized amounts is immediately expensed.

Original Issue Discount

For certain convertible debt issued, the Company provides the debt holder with an original issue discount. The original issue discount is recorded to debt discount and additional paid-in capital at an amount not to exceed gross proceeds raised, reducing the face amount of the debt, and is amortized to interest expense over the life of the debt.

Share-Based Payments

Generally, all forms of share-based payments, including stock option grants, warrants and restricted stock grants and stock appreciation rights are measured at their fair value on the awards' grant date, based on estimated number of awards that are ultimately expected to vest. Share-based compensation awards issued to non-employees for services rendered are recorded at either the fair value of the services rendered or the fair value of the share-based payment, whichever is more readily determinable.

Earnings (loss) Per Share

Net earnings (loss) per share is computed by dividing net income (loss) for the period by the weighted average number of shares of common stock outstanding during each period. Diluted earnings (loss) per share is computed by dividing net income (loss) for the period by the weighted average number of shares of common stock, common stock equivalents and potentially dilutive securities outstanding during each period.

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The Company uses an “if converted” method to determine whether there is a dilutive effect of outstanding option and warrant contracts. For the three months and nine months ended September 30, 2013 and 2012 the Company reflected net loss and a dilutive net loss, respectively, and the effect of considering any common stock equivalents would have been anti-dilutive for these periods. Therefore, separate computation of diluted earnings (loss) per share is not presented.

The Company has the following common stock equivalents for the nine months ended September 30, 2013 and 2012, respectively:

	Nine Months Ended September 30,	
	2013	2012
Stock options (exercise price - \$425/share)	472	1,847
Warrants (exercise price \$4 - \$1,275/share)	288,089	4,990
Convertible debt (exercise price \$17/share)	-	2,471
Total common stock equivalents	288,561	9,308

In the above table, some of the outstanding instruments from 2013 and 2012 contain ratchet provisions that would cause variability in the exercise price at the balance sheet date. As a result, common stock equivalents could change at each reporting period.

Foreign Currency

MusclePharm began operations in Canada in April of 2012. The Canadian Dollar was determined to be the functional currency as the majority of the transactions related to the day to day operations of the business are exchanged in Canadian Dollars. At the end of the period, the financial results of the Canadian operation are translated into United States Dollars, which is our reporting currency, and added to the U.S. operations for consolidated company financial results. The revenue and expense items are translated using the average rate for the period and the assets and liabilities at the end of period rate. Transactions that have completed the accounting cycle and resulted in a gain or loss related to translation are recorded in realized gain or loss due to foreign currency translation under other income expense on the income statement. Transactions that have not completed their accounting cycle but appear to have gain or loss due to the translation process are recorded as unrealized gain or loss due to translation and held in the equity section on the balance sheet until such date the accounting cycle of the transaction is complete and the actual realized gain or loss is recognized.

Reclassification

The Company has reclassified certain prior period amounts to conform to the current period presentation. These reclassifications had no effect on the financial position, results of operations or cash flows for the periods presented.

Note 3: Property and Equipment

Property and equipment consisted of the following at September 30, 2013 and December 31, 2012:

	As of September 30, 2013	As of December 31, 2012	Estimated Useful Life
Furniture, fixtures and gym equipment	\$ 1,666,922	\$ 1,323,998	From 36 to 60 months

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Leasehold improvements	752,968	563,204	From 20 to 66 months
Vehicles	391,365	100,584	5 years
Displays	32,057	32,057	5 years
Website	11,462	11,462	3 years
Total	2,854,774	2,031,305	
Less: Accumulated depreciation and amortization	(1,185,830)	(674,941)	
	\$ 1,668,944	\$ 1,356,364	

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Note 4: Inventory

On July 1, 2013, the Company terminated a Distribution Agreement dated November 17, 2010 with one of our key product manufacturers in which the manufacturer received and fulfilled customer sales orders for a majority of our products as more fully discussed in the “Shipping and Handling” section of Note 2 above. In connection with the termination of the agreement, we purchased an aggregate \$4,664,421 of product inventory, and the Company took over control of customer order fulfillment through our Franklin, Tennessee warehouse.

Inventory consisted of the following at September 30, 2013 and December 31, 2012:

	As of September 30, 2013	As of December 31, 2012
Product Inventory	9,633,164	257,975

The Company reserves for obsolete and slow moving inventory based on the age of the product as determined by the expiration date. Products within one year of their expiration dates are considered for reserve purposes. Historically, we have had minimal returns, and any damaged packaging is sent back to the manufacturer for replacement. The Company has determined that an inventory reserve was immaterial as of September 30, 2013.

Note 5: Debt Securities

On August 26, 2013, the Company purchased, for an aggregate \$2,000,000, a secured convertible promissory note from Biozone Pharmaceuticals, Inc. (“Biozone”) (OTC:BZNE) that matures one year from the date of issuance, and certain derivative instruments (Note 6), the value of which was recorded as a discount to the note to be accreted over the note’s term. In addition, a change of control put option was identified but is not recorded as a derivative because the value was determined to be de minimus. The promissory note bears interest at a rate of 10% per annum, is convertible at any time prior to the maturity date into 10,000,000 shares of Biozone common stock at the conversion rate of \$0.20 per share, and contains certain put and call features. The Company’s ability to convert into Biozone Common Stock is restricted by a beneficial ownership limitation of 4.99% of the number of the common stock outstanding after giving effect to the issuance of common stock issuable upon conversion. This conversion limit can be changed by the Company upon at least 60 days’ notice.

The Company has classified this note as a Level 2 available-for-sale security and has engaged an independent third party firm to value the note and its embedded conversion features each reporting period. Changes in the reported value of the note will be included as a component of other comprehensive income. The note had a fair value on the purchase date of \$1,955,462, which was purchased at a \$44,538 premium. The premium has been netted against the discount of \$1,248,292 attributable to the derivative instrument and will be accreted to interest income over the stated maturity of the note. The debt security is recorded at fair value net of any recorded discount not yet accreted. As of September 30, 2013, the portion of the discount not yet accreted was \$1,132,863.

The following table summarizes the Company’s marketable securities activity for the nine months ended September 30, 2013:

	Convertible Note
FV of debt security on 8/26/13	\$ 1,955,462

Premium on purchase date	44,538
Discount for value of derivative instrument	(1,248,292)
Accretion of net discount	115,428
Unrealized gain in OCI	58,438
Balance September 30, 2013	\$ 925,574

See Note 15(c) for subsequent event related to this debt security.

Note 6: Derivative Instrument

In conjunction with the purchase of the convertible promissory note discussed in Note 5, the Company received a callable warrant to purchase up to 10,000,000 shares of Biozone at an exercise price of \$0.40 with an expiration date of 10 years from the date of issuance. The initial value of the warrant was \$1,248,292 and was recorded as a discount against the note. The Company's ability to exercise the warrant is limited by a beneficial ownership limitation of 4.99% of the number of the common shares outstanding in Biozone after giving effect to the exercise of the warrant.

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The Company has classified the warrant as Level 2 inputs, and engaged an independent third party firm to value the warrant. The warrant was valued using a binomial lattice pricing model where the option value is calculated using a backward induction process.

This model considers price volatility, time, and dilutive effect of exercising. The pricing model assumes a volatility of 70% at the dates of purchase and period end.

The following table summarizes the Company's derivative asset activity for the nine months ended September 30, 2013:

Balance December 31, 2012	\$-
Purchases	1,248,292
Sales	-
Realized gain (loss)	-
Unrealized gain (loss)	444,059
Balance September 30, 2013	\$1,692,351

Note 7: Debt

At September 30, 2013 and December 31, 2012, debt consists of the following:

	As of September 30, 2013	As of December 31, 2012
Auto loan - secured	\$ 5,856	15,380
Unsecured debt	64,600	4,452,183
Less: debt discount	-	-
Unsecured debt - net	64,600	4,452,183
Total debt	70,456	4,467,563
Less: current portion	(70,456)	(4,463,040)
Long term debt	\$ -	\$ 4,523

Debt in default of \$64,600 at September 30, 2013 and December 31, 2012 is included as a component of short-term debt.

Future annual principal payments for the above debt are as follows:

Years Ending December 31,	
2013 (3 months)	\$66,967
2014	3,489
Total annual principal payments	\$70,456

Convertible Debt Secured - Derivative Liabilities

During the year ended December 31, 2012, the Company issued convertible debt totaling \$519,950. The convertible debt includes the following terms:

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