

Sugarmade, Inc.
Form 10-Q
November 23, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended: September 30, 2016

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

For the transition period from N/A to N/A

Commission file number: **000-23446**

SUGARMADE, INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

94-3008888

(I.R.S. Employer
Identification No.)

167 N. Sunset Avenue, City of Industry, CA 91744

(Address of principal executive offices) (Zip Code)

(888) 982-1628

(Registrant's telephone number, including area code)

Indicate by check mark whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act of 1934 during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes 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 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 registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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Large accelerated filer
Non-accelerated filer

Accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

At November 23, 2016, there were 203,227,491 shares outstanding of the issuer's common, the only class of common equity.

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

SUGARMADE, INC.

FORM 10-Q

FOR THE PERIOD ENDED SEPTEMBER 30, 2016

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SPECIAL NOTE REGARDING FORWARD LOOKING STATEMENTS

In addition to historical information, this Quarterly Report on Form 10-Q includes forward-looking statements. Forward-looking statements are those that predict or describe future events or trends and that do not relate solely to historical matters. You can generally identify forward-looking statements as statements containing the words "believe," "expect," "will," "anticipate," "intend," "estimate," "project," "plan," "assume" or other similar expressions, or negatives of those expressions, although not all forward-looking statements contain these identifying words. All statements contained or incorporated by reference in this quarterly report regarding our future strategy, future operations, projected financial position, estimated future revenues, projected costs, future prospects, the future of our industry and results that might be obtained by pursuing management's current plans and objectives are forward-looking statements.

You should not place undue reliance on our forward-looking statements because the matters they describe are subject to known and unknown risks, uncertainties and other unpredictable factors, many of which are beyond our control. Our forward-looking statements are based on the information currently available to us and speak only as of the date on the cover of this quarterly report, or, in the case of forward-looking statements in documents incorporated by reference, as of the date of the filing of the document that includes the statement. New risks and uncertainties arise from time to time, and it is impossible for us to predict these matters or how they may affect us. Over time, our actual results, performance or achievements will likely differ from the anticipated results, performance or achievements that are expressed or implied by our forward-looking statements, and such difference might be significant and materially adverse to our security holders. We do not undertake and specifically decline any obligation to update any forward-looking statements or to publicly announce the results of any revisions to any statements to reflect new information or future events or developments.

We have identified some of the important factors that could cause future events to differ from our current expectations and they are described in this quarterly report under the caption "Risk Factors," below, and elsewhere in this quarterly report, which you should review carefully. Please consider our forward-looking statements in light of those risks as you read this quarterly report.

[\(table of contents\)](#)**PART 1: Financial Information****Item I****Sugarmade, Inc. and Subsidiary****Consolidated Balance Sheets**

	September 30, 2016 (Unaudited)	June 30, 2016
Assets		
Current assets:		
Cash	\$ 14,422	\$ 911
Accounts receivable, net	57,341	117,866
Inventory, net	341,346	468,262
Loan receivables	20,000	20,000
Other current assets	112,368	84,505
Total current assets	545,477	691,543
Equipment, net	67,505	78,453
Other assets	23,281	23,281
Total assets	\$ 636,263	\$ 793,277
Liabilities and Stockholders' Deficiency		
Current liabilities:		
Bank overdraft	\$ 45,704	\$ 28,377
Note payable due to bank	25,982	25,982
Accounts payable and accrued liabilities	1,230,895	1,481,961
Customer deposits	182,320	248,299
Unearned revenue	51,240	93,522
Other payable	241,307	296,259
Accrued interest	268,116	272,708
Accrued compensation and personnel related payables	11,403	11,403
Notes payable due to others	85,666	85,666
Loans payable	712,926	427,581
Convertible notes payable, net	365,000	394,167
Derivative liabilities	458,000	701,000
Total liabilities	3,678,559	4,066,923
Stockholders' deficiency:		
Preferred stock (\$0.001 par value, 10,000,000 shares authorized,		

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none issued and outstanding)	—	—
Common stock (\$0.001 par value, 300,000,000 shares authorized, 200,740,944 and 178,685,388 shares issued and outstanding at Sept 30 and June 30, 2016 respectively	200,741	178,686
Additional paid-in capital	21,023,583	17,151,379
Shares to be issued, preferred shares	2,000,000	2,000,000
Shares to be issued, common shares	101,157	1,246,000
Accumulated deficit	(26,367,777)	(23,849,712)
Total stockholders' deficiency	(3,042,296)	(3,273,647)
Total liabilities and stockholders' deficiency	\$636,263	\$793,277

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

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[\(table of contents\)](#)**Sugarmade, Inc. and Subsidiary****Consolidated Statements of Operations****For the three months ended September 30, 2016 and 2015****(Unaudited)**

	Three months ended September 30,	
	2016	2015
Revenues, net	\$1,127,554	\$1,402,911
Cost of goods sold:		
Materials and freight costs	699,651	928,659
Total cost of goods sold	699,651	928,659
Gross profit	427,903	474,252
Operating expenses:		
Selling, general and administrative expenses	489,495	701,909
Total operating expenses	489,495	701,909
Loss from operations	(61,592)	(227,657)
Non-operating income (expense):		
Interest expense	(12,363)	(15,067)
Change in fair value of derivative liabilities	243,000	(498,000)
Loss on extinguishment of debt	(17,295)	—
Other expense	(10,553)	(9,501)
Total non-operating income (expense)	202,789	(522,568)
Net income (loss)	\$141,197	\$(750,225)
Basic and diluted net income (loss) per share	\$0.00	\$(0.00)
Diluted net income (loss) per share	\$0.00	\$(0.00)
Basic and diluted weighted average common shares outstanding	184,439,011	157,745,198

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

[\(table of contents\)](#)**Sugarmade, Inc. and Subsidiary****Condensed Consolidated Statements of Cash Flows****For the three months ended September 30, 2016 and 2015****(Unaudited)**

	For the three months ended September 30,	
	2016	2015
Cash flows from operating activities:		
Net income (loss)	\$ 141,197	\$(750,225)
Adjustments to reconcile net loss to cash flows from operating activities:		
Loss on extinguishment of liability	17,295	—
Change in fair value of derivative liability	(243,000)	498,000
Depreciation and amortization	10,948	—
Changes in operating assets and liabilities		
Accounts receivable	60,525	(190,814)
Inventory	126,916	273,020
Other assets	(22,865)	(21,387)
Bank overdraft	17,327	10,624
Accounts payable and accrued liabilities	(251,069)	(211,661)
Customer deposits	(65,978)	(25,773)
Unearned revenue	(42,282)	—
Accrued interest and other payables	(45,848)	44,986
Net cash used in operating activities	(296,834)	(373,230)
Cash flows from investing activities:		
Loan receivables	—	(3,500)
Payment for acquisition of property and equipment	—	(4,177)
Net cash used in investing activities	—	(7,677)
Cash flows from financing activities:		
Proceeds from shares to be issued	25,000	—
Proceeds from issuance of common stock	—	150,000
Proceeds from (repayments of) loan	285,345	(211,438)
Payments for note payable	—	(105,000)
Proceeds from EB-5 investment	—	500,000
Net cash provided by financing activities	310,345	333,562
Net increase (decrease) in cash	13,511	(47,345)
Cash, beginning of period	911	58,260

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Cash, end of period	\$14,422	\$10,915
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Supplemental disclosure of cash flow information:

Cash paid during the period for:

Interest	\$—	\$—
Income taxes	\$7,769	\$—

Supplemental disclosure of non-cash financing activities

Debts settled through shares issuance	\$42,862	\$—
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The accompanying notes are an integral part of these condensed unaudited consolidated financial statements

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Sugarmade, Inc. and Subsidiary

Notes to Unaudited Condensed Consolidated Financial Statements

1. Nature of Business

Sugarmade, Inc. (hereinafter referred to as “we”, “us” or “the/our Company”) is a publicly traded company incorporated in state of Delaware. Our previous legal name was Diversified Opportunities, Inc. Our Company, Sugarmade, Inc. operates through our subsidiary, Sugarmade, Inc., a California corporation (“SWC Group, Inc., - CA”). As of the end of the reporting period, Sept 30, 2016, we were involved in several businesses including the supply of products to the quick service restaurant sub-sector of the restaurant industry and as a distributor of paper products derived from non-wood sources. We are headquartered in City of Industry, California, a suburb of Los Angeles, with two additional warehouse locations in Southern California. As of date of this filing, we employ 21 full and part-time workers and contractors.

Our main business operation, CarryOutSupplies.com, is a producer and wholesaler of custom printed and generic supplies servicing more than 3,000 quick service restaurants. Our products include double poly paper cups for cold beverage; disposable, clear, plastic cold cups, paper coffee cups, yogurt cups, ice cream cups, cup lids, cup sleeves, food containers, soup containers, plastic spoons and many other similar products for this market sector. CarryOutSupplies.com was founded in 2009 when the founders gained first-hand experience within the restaurant industry of the difficulty for restaurant owners to acquire custom printed supplies at a reasonable cost. Many quick service restaurants wish to acquire custom printed products, such as those embossed with logos, but the minimum order size for such customization had been cost prohibitive. With that in mind, carry out supplies was founded to provide products to this underserved section of the market. Since that time, the company has become a key supplier to many popular U.S. franchises, particularly in the frozen dessert segments. The company estimates it holds approximately 40% market share of generic and printed products within the take out frozen yogurt and ice cream industries. We also hold a product supply and licensing agreement FreeHand® ThumbTray™ for the western part of the United States.

We are also a distributor of paper made from 100% reclaimed sugarcane fiber, enhanced with bamboo. Sugarcane fiber, called bagasse, is a discarded byproduct of sugarcane production. Sugarmade, Inc. was founded in 2010. As is explained below, in 2014, CarryOutSupplies.com was acquired by Sugarmade, Inc., creating the Company as it is today. Relative to Sugarmade Paper, our third-party contract manufacturer uses bagasse and bamboo, as opposed to wood products significantly reducing its manufacturing carbon footprint, energy consumption, and attendant water pollution during the manufacture of its products. This allows us to offer our unique, exclusive, tree-free paper products at price-parity equal to or less than current recycled fiber products already on the market. Our products are unique and we believe offer an ideal solution for those consumers (both corporate and individual) seeking to meet their sustainability mandates or personal environmentally conscious goals, at a price that is equal to or less than current recycled products. Our primary focus for this business unit as of filing of this report is the organization and administration of fundraisers and paper drives for schools, non-profits and other institutions.

During September of 2016, the Company completed negotiations for and signed a license agreement with HUY FONG FOODS, INC. (“HFFI”), the maker of Sriracha Hot Chili Sauce. Under the terms of the agreement, the Company is granted license to use the licensed marks of HFFI on and for products the Company is currently in process of designing and testing. Based on this agreement and a separate license agreement signed during 2015 with Seasoning Stixs International, LLC, the Company plans to introduce a new culinary seasoning product named Sriracha Seasoning Stixs. Sriracha Seasoning Stixs are encapsulated Huy Fong Sriracha Sauce and other seasonings in the form of a stick, which are inserted into meat, fish and poultry prior to cooking. Sriracha Seasoning Stixs are a hard solid at room temperature, but as heat is applied the sticks begin to liquefy allowing the meat fibers to act like a sponge absorbing the seasonings and flavors that had previously been encapsulated in the stick. The Company plans to introduce this product via a nationwide advertising and social media campaign during the December quarter of 2016.

2. Summary of Significant Accounting Policies

Basis of presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and the rules and regulations of the United States Securities and Exchange Commission for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. 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.

These interim condensed consolidated financial statements should be read in conjunction with our Company’s Annual Report on Form 10-K for the year ended June 30, 2015, which contains our audited consolidated financial statements and notes thereto, together with the Management’s Discussion and Analysis of Financial Condition and Results of Operation, for the period ended June 30, 2015, filed on or about August 6, 2016. The interim results for the period ended September 30, 2015 are not necessarily indicative of the results for the full fiscal year.

Principles of consolidation

The condensed consolidated unaudited financial statements include the accounts of our Company and its wholly-owned subsidiaries, Sugarmade-CA and SWC. All significant intercompany transactions and balances have been eliminated in consolidation.

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Going concern

The Company sustained continued losses from operations during the three months ended September 30, 2016 and for the fiscal year ended June 30, 2016. The Company's continuation as a going concern is dependent on its ability to generate sufficient cash flows from operations to meet its obligations, in which it has not been successful, and/or obtaining additional financing from its shareholders or other sources, as may be required.

Our condensed consolidated financial statements have been prepared assuming that we will continue as a going concern. Such assumption contemplates the realization of assets and satisfaction of liabilities in the normal course of business. These condensed consolidated financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classifications of liabilities that may result should the Company be unable to continue as a going concern.

Management is endeavoring to increase revenue-generating operations. While priority is on generating cash from operations through the sale of the Company's products, management is also seeking to raise additional working capital through various financing sources, including the sale of the Company's equity and/or debt securities, which may not be available on commercially reasonable terms to our Company, or which may not be available at all. If such financing is not available on satisfactory terms, we may be unable to continue our business as desired and our operating results will be adversely affected. In addition, any financing arrangement may have potentially adverse effects on us and/or our stockholders. Debt financing (if available and undertaken) will increase expenses, must be repaid regardless of operating results and may involve restrictions limiting our operating flexibility. If we issue equity securities to raise additional funds, the percentage ownership of our existing stockholders will be reduced and the new equity securities may have rights, preferences or privileges senior to those of the current holders of our common stock.

Use of estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires our 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. Actual results could differ significantly from those estimates.

Revenue recognition

We recognize revenue in accordance with Financial Accounting Standards Board Accounting Standards Codification ("FASB ASC") No. 605, *Revenue Recognition*. Revenue is recognized when an arrangement and a determinable fee

occur, and when collection is considered to be probable and products are delivered or title has been transferred. This generally occurs upon shipment of the merchandise, which is when legal transfer of title occurs. In the event that final acceptance of our product by the customer is uncertain, revenue is deferred until all acceptance criteria have been met. We currently have a consignment arrangement with two of our customers. We record revenue on consignment goods when the consigned goods are sold by the consignee and all other above mentioned revenue recognition criteria have been satisfied. Cash deposits received in connection with the sales of our products prior to their being delivered or acceptance if applicable is recorded as deferred revenue.

Cash

Cash and cash equivalents consist of amounts held as bank deposits and highly liquid debt instruments purchased with an original maturity of three months or less.

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From time to time, we may maintain bank balances in interest bearing accounts in excess of the \$250,000 currently insured by the Federal Deposit Insurance Corporation for interest bearing accounts (there is currently no insurance limit for deposits in noninterest bearing accounts). We have not experienced any losses with respect to cash. Management believes our Company is not exposed to any significant credit risk with respect to its cash.

Accounts receivable

Accounts receivable are carried at their estimated collectible amounts, net of any estimated allowances for doubtful accounts. We grant unsecured credit to our customer's deemed credit worthy. Ongoing credit evaluations are performed and potential credit losses estimated by management are charged to operations on a regular basis. At the time any particular account receivable is deemed uncollectible, the balance is charged to the allowance for doubtful accounts. The Company had accounts receivable net of allowances of \$57,341 as of September 30, 2016 and of \$117,866 as of June 30, 2016.

Inventory

Inventory consists of finished goods paper and paper-based products such as paper cups and food containers ready for sale and is stated at the lower of cost or market. We value our inventory using the weighted average costing method. Our Company's policy is to include as a part of inventory any freight incurred to ship the product from our contract manufacturers to our warehouses. Outbound freights costs related to shipping costs to our customers are considered period costs and reflected in selling, general and administrative expenses. We regularly review inventory and consider forecasts of future demand, market conditions and product obsolescence.

If the estimated realizable value of our inventory is less than cost, we make provisions in order to reduce its carrying value to its estimated market value. On a consolidated basis, as of September 30, 2016 and June 30, 2016, the balance for the inventory totaled \$341,346 and \$468,262, respectively. No amounts were recognized as an obsolescence reserve at September 30, 2016 and June 30, 2016.

Income taxes

We account for income taxes under the asset and liability method. Deferred tax assets and liabilities are recognized for future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their perspective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which the temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Valuation allowances are recorded, when necessary, to reduce deferred tax assets to

the amount expected to be realized.

As a result of the implementation of certain provisions of ASC 740, Income Taxes (“ASC 740”), which clarifies the accounting and disclosure for uncertainty in tax position, as defined, ASC 740 seeks to reduce the diversity in practice associated with certain aspect of the recognition and measurement related to accounting for income taxes. We adopted the provisions of ASC 740 as of October 2, 2008, and have analyzed filing positions in each of the federal and state jurisdictions where we are required to file income tax returns, as well as open tax years in these jurisdictions. We have identified the U.S. federal and California as our “major” tax jurisdictions and generally, we remain subject to Internal Revenue Service examination of our 2013 U.S. federal income tax returns. However, we have certain tax attribute carryforwards, which will remain subject to review and adjustment by the relevant tax authorities until the statute of limitations closes with respect to the year in which such attributes are utilized.

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We believe that our income tax filing positions and deductions will be sustained on audit and do not anticipate any adjustments that will result in a material change to our financial position. Therefore, no reserves for uncertain income tax positions have been recorded pursuant to ASC 740. In addition, we did not record a cumulative effect adjustment related to the adoption of ASC 740. Our policy for recording interest and penalties associated with income-based tax audits is to record such items as a component of income taxes. We have no interest or penalties as of September 30, 2015.

Stock based compensation

Stock based compensation cost to employees is measured at the date of grant, based on the calculated fair value of the stock-based award, and will be recognized as expense over the employee's requisite service period (generally the vesting period of the award). We estimate the fair value of employee stock options granted using the Black-Scholes-Merton Option Pricing Model. Key assumptions used to estimate the fair value of stock options will include the exercise price of the award, the fair value of our common stock on the date of grant, the expected option term, the risk free interest rate at the date of grant, the expected volatility and the expected annual dividend yield on our common stock. We use our company's own data among other information to estimate the expected price volatility and the expected forfeiture rate. 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.

Loss per share

We calculate basic earnings per share ("EPS") by dividing our net loss by the weighted average number of common shares outstanding for the period, without considering common stock equivalents. Diluted EPS is computed by dividing net income or net loss by the weighted average number of common shares outstanding for the period and the weighted average number of dilutive common stock equivalents, such as options and warrants. Options and warrants are only included in the calculation of diluted EPS when their effect is dilutive. 5,819,105 potential shares issuable upon conversion of convertible debts and 0 potential shares issuable upon exercising of warrants were excluded in calculating diluted loss per share for the three months ended September 30, 2016 due to the fact that issuance of the shares is anti-dilutive as a result of the Company's net loss

Fair value of financial instruments

ASC Topic 820 defines fair value, establishes a framework for measuring fair value, establishes a three-level valuation hierarchy for disclosure of fair value measurement and enhances disclosure requirements for fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

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

Level 2 - include other inputs that are directly or indirectly observable in the marketplace.

Level 3 - unobservable inputs which are supported by little or no market activity.

The Company used Level 2 inputs for its valuation methodology for the derivative liabilities in determining the fair value using the Black-Scholes option-pricing model with the following assumption inputs:

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September
30, 2016

Annual dividend yield	—
Expected life (years)	0.45
Risk-free interest rate	0.18 %
Expected volatility	398 %

June
30,
2016

Annual dividend yield	—
Expected life (years)	0.01
Risk-free interest rate	0.21 %
Expected volatility	449 %

Carrying Value Fair Va