IVANHOE ENERGY INC
Form 10-Q
November 10, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

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

For the quarterly period ended September 30, 2008

or

o **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 000-30586

IVANHOE ENERGY INC.

(Exact name of registrant as specified in its charter)

Yukon, Canada	**98-0372413**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
Suite 654 999 Canada Place Vancouver, British Columbia, Canada	**V6C 3E1**
(Address of principal executive office)	*(zip code)*

(604) 688-8323

(registrant s telephone number, including area code)

No Changes

(Former name, former address and former fiscal year, if changed since last report)

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 preceding 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. þ Yes o No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o	Smaller reporting company o
		(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).
o Yes þ No

The number of shares of the registrant s capital stock outstanding as of November 3, 2008 was 279,211,916 Common Shares, no par value.

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Part I Financial Information

Item 1 Financial Statements
IVANHOE ENERGY INC.
Unaudited Condensed Consolidated Balance Sheets
(stated in thousands of U.S. Dollars, except share amounts)

	September 30, 2008	December 31, 2007
Assets		
Current Assets:		
Cash and cash equivalents	**$ 61,649**	$ 11,356
Accounts receivable	**13,811**	9,376
Advance		825
Prepaid and other current assets	**485**	602
Future income tax assets	**1,161**	
	77,106	22,159
Oil and gas properties and development costs, net	**179,641**	111,853
Intangible assets technology	**102,153**	102,153
Long term assets	**4,104**	751
	$ 363,004	$ 236,916
Liabilities and Shareholders Equity		
Current Liabilities:		
Accounts payable and accrued liabilities	**$ 13,074**	$ 9,538
Income tax payable	**358**	
Debt current portion	**18,111**	6,729
Derivative instruments	**9,310**	9,432
	40,853	25,699
Long term debt	**45,640**	9,812
Asset retirement obligations	**3,673**	2,218
Long term obligation	**1,900**	1,900
	92,066	39,629
Commitments and contingencies		
Shareholders Equity:		
Share capital, issued 279,211,916 common shares; December 31, 2007 244,873,349 common shares	**413,918**	324,262
Purchase warrants	**18,805**	23,078
Contributed surplus	**16,332**	9,937
Convertible note	**2,086**	

Accumulated deficit		**(180,203)**		(159,990)
		270,938		197,287
	$	**363,004**	$	236,916

(See accompanying notes)

IVANHOE ENERGY INC.
Unaudited Condensed Consolidated Statements of Operations,
Comprehensive Income (Loss) and Accumulated Deficit
(stated in thousands of U.S. Dollars, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Revenue				
Oil and gas revenue	**$ 20,437**	$ 10,864	**$ 53,459**	$ 30,249
Gain (loss) on derivative instruments	**14,818**	(2,153)	**(9,915)**	(2,928)
Interest income	**371**	112	**479**	348
	35,626	8,823	**44,023**	27,669
Expenses				
Operating costs	**8,211**	4,266	**20,217**	12,174
General and administrative	**5,255**	2,725	**13,749**	8,981
Business and technology development	**1,969**	2,831	**4,889**	7,341
Depletion and depreciation	**8,183**	6,044	**24,678**	18,960
Interest expense and financing costs	**463**	189	**1,500**	571
	24,081	16,055	**65,033**	48,027
Income (Loss) before Income Taxes	**11,545**	(7,232)	**(21,010)**	(20,358)
(Provision for) recovery of income taxes				
Current	**(358)**		**(364)**	
Future	**(1,125)**		**1,161**	
	(1,483)		**797**	
Net Income (Loss) and Comprehensive Income (Loss)	**10,062**	(7,232)	**(20,213)**	(20,358)
Accumulated Deficit, beginning of period	**(190,265)**	(133,909)	**(159,990)**	(120,783)
Accumulated Deficit, end of period	**$ (180,203)**	$ (141,141)	**$ (180,203)**	$ (141,141)
Net Income (Loss) per share Basic and Diluted	**$ 0.04**	$ (0.03)	**$ (0.08)**	$ (0.08)
Weighted Average Number of Shares (in thousands)				

Basic	**265,372**	242,747	**251,907**	241,812
Diluted	**279,641**	242,747	**251,907**	241,812

(See accompanying notes)

IVANHOE ENERGY INC.
Unaudited Condensed Consolidated Statements of Cash Flows
(stated in thousands of U.S. Dollars)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Operating Activities				
Net income (loss) and comprehensive income (loss)	**$ 10,062**	$ (7,232)	**$ (20,213)**	$ (20,358)
Items not requiring use of cash:				
Depletion and depreciation	**8,183**	6,044	**24,678**	18,960
Stock based compensation	**1,114**	758	**3,025**	2,613
Unrealized (gain) loss on derivative instruments	**(18,553)**	1,730	**(122)**	2,682
Unrealized foreign exchange loss	**314**		**397**	
Future income tax provision (recovery)	**1,125**		**(1,161)**	
Provision for uncollectible accounts	**725**		**725**	
Other	**238**	151	**697**	481
Changes in non-cash working capital items	**(1,535)**	315	**(627)**	188
	1,673	1,766	**7,399**	4,566
Investing Activities				
Capital investments	**(8,956)**	(9,100)	**(16,872)**	(22,557)
Acquisition of oil and gas assets	**(22,308)**		**(22,308)**	
Proceeds from sale of assets			**100**	1,000
Recovery of development costs				9,000
Advance repayments			**100**	400
Other	**(714)**	**(47)**	**(817)**	28
Changes in non-cash working capital items	**2,869**	**2,189**	**337**	695
	(29,109)	(6,958)	**(39,460)**	(11,434)
Financing Activities				
Shares issued on private placements, net of share issue costs	**82,687**		**82,687**	
Proceeds from exercise of options	**518**	113	**1,204**	278
Proceeds from debt obligations, net of financing costs		9,335	**5,490**	9,335
Payments of debt obligations	**(615)**	(615)	**(1,845)**	(1,845)
Payments of deferred financing costs	**(542)**		**(2,606)**	
Other		62		
Changes in non-cash working capital items	**(711)**		**(9)**	
	81,337	8,895	**84,921**	7,768
	(2,466)		**(2,567)**	

Foreign Exchange Loss on Cash and Cash Equivalents Held in a Foreign Currency				
Increase in Cash and Cash Equivalents, for the period	**51,435**	3,703	**50,293**	900
Cash and cash equivalents, beginning of period	**10,214**	11,076	**11,356**	13,879
Cash and Cash Equivalents, end of period	**$ 61,649**	$ 14,779	**$ 61,649**	$ 14,779

(See accompanying notes)

Notes to the Condensed Consolidated Financial Statements
September 30, 2008
(all tabular amounts are expressed in thousands of U.S. dollars except per share amounts)
(Unaudited)

1. BASIS OF PRESENTATION

Ivanhoe Energy Inc s (the **Company** or **Ivanhoe Energy**) accounting policies are in accordance with accounting principles generally accepted in Canada. These policies are consistent with accounting principles generally accepted in the U.S., except as outlined in Note 16. The unaudited condensed consolidated financial statements have been prepared on a basis consistent with the accounting principles and policies reflected in the December 31, 2007 consolidated financial statements except as discussed in Note 2. These interim condensed consolidated financial statements do not include all disclosures normally provided in annual consolidated financial statements and should be read in conjunction with the most recent annual consolidated financial statements. The December 31, 2007 condensed consolidated balance sheet was derived from the audited consolidated financial statements, but does not include all disclosures required by generally accepted accounting principles (**GAAP**) in Canada and the U.S. In the opinion of management, all adjustments (which included normal recurring adjustments) necessary for the fair presentation for the interim periods have been made. The results of operations and cash flows are not necessarily indicative of the results for a full year.

The Company currently anticipates incurring substantial expenditures to further its capital development programs, particularly those related to the development of two recently acquired oil sands leases in Alberta and the development of a heavy oil field in Ecuador under a recently announced specific services contract with the state oil company of Ecuador. The continued existence of the Company is dependent upon its ability to obtain capital to fund further development and to meet obligations to preserve its interests in these properties and to meet the obligations associated with other potential HTL and GTL projects. The Company intends to finance the future payments required for its capital projects from a combination of strategic investors and/or traditional debt and equity markets, either at a parent company level or at the project level. The Company believes that it has sufficient funds to reach final investment decisions on its projects, however significant amounts of new capital will be required. These interim condensed consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles applicable to a going concern, which assumes that the Company will continue in operation for the foreseeable future and will be able to realize its assets and discharge its liabilities in the normal course of operations. If the going concern assumption was not appropriate for these condensed consolidated financial statements, then adjustments would be necessary to the carrying values of assets and liabilities, the reported expenses and the balance sheet classifications used.

2. CHANGES IN ACCOUNTING POLICIES

2008 Accounting Changes

On January 1, 2008, the Company adopted three new accounting standards that were issued by the Canadian Institute of Chartered Accountants (**CICA**): Handbook Section 1535 Capital Disclosures (**S.1535**), Handbook Section 3862 Financial Instruments Disclosures (**S.3862**), and Handbook Section 3863 Financial Instruments Presentation (**S.3863**). S.1535 establishes standards for disclosing information about an entity s capital and how it is managed. The objective of S.3862 is to require entities to provide disclosures in their financial statements that enable users to evaluate both the significance of financial instruments for the entity s financial position and performance; and the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the balance sheet date, and how the entity manages those risks. The purpose of S.3863 is to enhance financial statement users understanding of the significance of financial instruments to an entity s financial position, performance and cash flows. The latter two replaced Handbook Section.3861 Financial Instruments Disclosure and Presentation . The Company adopted the new standards on January 1, 2008 with additional disclosures included in these condensed consolidated financial statements. There was no transitional adjustment to the condensed consolidated financial statements as a result of having adopted these standards.

Impact of New and Pending Canadian GAAP Accounting Standards

In February 2008, the CICA issued Handbook Section 3064, Goodwill and Intangible assets, (**S.3064**) replacing Handbook Section 3062, Goodwill and Other Intangible Assets (**S.3062**) and Handbook Section 3450, Research and Development Costs . S.3064 will be applicable to financial statements relating to fiscal years beginning on or after October 1, 2008. Accordingly, the Company will adopt the new standards for its fiscal year beginning January 1, 2009. The new section establishes standards for the recognition, measurement, presentation and disclosure of goodwill subsequent to its initial recognition and of intangible assets by profit-oriented enterprises. Standards concerning goodwill are unchanged from the standards included in the previous S.3062. Management has concluded that the requirements of this new Section as they relate to goodwill will not have a material impact on its consolidated financial statements; however, management is still evaluating the impact of the requirements related to

development costs. Also in February 2008, the CICA amended portions of Handbook Section 1000, Financial Statement Concepts , which the CICA concluded permitted deferral of costs that did not meet the definition of an asset. The amendments apply to annual and interim financial statements relating to fiscal years beginning on or after October 1, 2008. Upon adoption of S.3064 and the amendments to Section 1000 on January 1, 2009, capitalized amounts that no longer meet the definition of an asset will be expensed retrospectively. The Company is currently reviewing the potential impact, if any, on its consolidated statements.

Convergence of Canadian GAAP with International Financial Reporting Standards

In April 2008, the CICA published the exposure draft Adopting IFRSs in Canada . The exposure draft proposes to incorporate International Financial Reporting Standards (**IFRS**) into the CICA Accounting Handbook effective for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. At this date, publicly accountable enterprises will be required to prepare financial statements in accordance with IFRS. The Company is currently reviewing the standards to determine the potential impact on its consolidated financial statements.

3. OIL AND GAS PROPERTIES AND DEVELOPMENT COSTS

The Company has four reportable business segments: Oil and Gas Integrated, Oil and Gas - Conventional, Business and Technology Development and Corporate as further described in Note 9. These segments are different than those reported in the Company s previous financial statements included in its Form 10-Qs and Form 10-Ks and as such the presentation has been changed to conform to the new segments.

	As at September 30, 2008				
		Oil and Gas		Business	
	Integrated	Conventional		and Technology	
	Canada	China	U.S.	Development	Total
Oil and Gas Properties:					
Proved	$	$ 139,313	$ 110,914	$	$ 250,227
Unproved	78,348	4,197	4,394		86,939
	78,348	143,510	115,308		337,166
Accumulated depletion		(76,461)	(31,877)		(108,338)
Accumulated provision for impairment		(16,550)	(50,350)		(66,900)
	78,348	50,499	33,081		161,928
Development Costs:					
Feasibility studies and other deferred costs				5,592	5,592
Feedstock test facility				7,902	7,902
Commercial demonstration facility				11,037	11,037
Accumulated depreciation				(7,095)	(7,095)
				17,436	17,436
Furniture and equipment	14	120	537	270	941
Accumulated depreciation	(5)	(92)	(467)	(100)	(664)
	9	28	70	170	277

$ 78,357	$ 50,527	$ 33,151	$ 17,606	$ 179,641

	As at December 31, 2007			
	Oil and Gas Conventional		Business and Technology	
	China	U.S.	Development	Total
Oil and Gas Properties:				
Proved	$ 134,648	$ 107,040	$	$ 241,688
Unproved	3,297	4,373		7,670
	137,945	111,413		249,358
Accumulated depletion	(58,583)	(27,091)		(85,674)
Accumulated provision for impairment	(16,550)	(50,350)		(66,900)
	62,812	33,972		96,784
Development Costs:				
Feasibility studies and other deferred costs			5,443	5,443
Feedstock test facility			4,724	4,724
Commercial demonstration facility			9,903	9,903
Accumulated depreciation			(5,159)	(5,159)
			14,911	14,911
Furniture and equipment	119	529	107	755
Accumulated depreciation	(77)	(449)	(71)	(597)
	42	80	36	158
	$ 62,854	$ 34,052	$ 14,947	$ 111,853

Costs as at September 30, 2008 of $86.9 million ($7.7 million at December 31, 2007), related to unproved oil and gas properties have been excluded from costs subject to depletion and depreciation. Included in the depletion calculation are $15.2 million for future development costs associated with proven undeveloped reserves as at September 30, 2008 ($8.9 million at December 31, 2007).

For the three-month and nine-month periods ended September 30, 2008, general and administrative expenses related directly to oil and gas acquisition, exploration and development activities of $0.7 million and $1.9 million ($0.7 million and $2.5 million for those same periods in 2007) were capitalized.

For both the three-month and nine-month periods ended September 30, 2008, interest on debt related to oil and gas acquisition activities of $0.8 million (nil for the same periods in 2007) was capitalized.

4. INTANGIBLE ASSETS TECHNOLOGY

The Company s intangible assets consist of the following:

HTL^{TM} Technology

The Company owns an exclusive, irrevocable license to deploy, worldwide, the patented rapid thermal processing process (**RTP^{TM} Process**) for petroleum applications as well as the exclusive right to deploy the RTP^{TM} Process in all applications other than biomass. The Company s carrying value of the RTP^{TM} Process for heavy oil upgrading (**HTL^{TM} Technology** or **HTL^{TM}**) as at September 30, 2008 and December 31, 2007 was $92.2 million. Since the Company acquired the technology, it has continued to expand its patent coverage to protect innovations to the HTL Technology as they are developed and to significantly extend the Company s portfolio of HTL intellectual property.

The Company is the assignee of three granted patents and currently has five patent applications pending in the U.S. The Company also has multiple patents pending in numerous other countries.

Syntroleum Master License

The Company owns a master license from Syntroleum Corporation (**Syntroleum**) permitting the Company to use Syntroleum s proprietary gas-to-liquids (**GTL Technology** or **GTL**) process in an unlimited number of projects around the world. The Company s master license expires on the later of April 2015 or five years from the effective date of the last site license issued to the Company by Syntroleum. In respect of GTL projects in which both the Company and Syntroleum participate, no additional license fees or royalties will be payable by the Company and Syntroleum will contribute, to any such project, the right to manufacture specialty and lubricant products. Both companies have the right to pursue GTL projects independently, but the Company would be required to pay the normal license fees and royalties in such projects. The Company s carrying value of the Syntroleum GTL master license as at September 30, 2008 and December 31, 2007 was $10.0 million.

Recovery of capitalized costs related to potential HTL[TM] and GTL projects is dependent upon finalizing definitive agreements for, and successful completion of, the various projects. These intangible assets were not amortized and their carrying values were not impaired for the three-month and nine-month periods ended September 30, 2008 and 2007.

5. LONG TERM DEBT

Notes payable consisted of the following as at:

	September 30, 2008		December 31, 2007	
Variable rate bank note, (5.61% at September 30, 2008), due April 2009	$	5,200	$	4,500
Variable rate bank note (6.54% at September 30, 2008) due September 2010		10,000		10,000
Non-interest bearing promissory note, due 2006 through 2009		1,031		2,876
Convertible note (6.75% at September 30, 2008) due July 2011		38,106		
Promissory note (6.75% at September 30, 2008) due December 2008		11,908		
		66,245		17,376
Less:				
Unamortized discount		(2,024)		(139)
Unamortized deferred financing costs		(470)		(696)
Current maturities		(18,111)		(6,729)
		(20,605)		(7,564)
	$	45,640	$	9,812

Bank Loan

In October 2006, the Company arranged a Senior Secured Revolving/Term Credit Facility of up to $15 million with an initial borrowing base of $8 million. In October 2008, the original due date of the revolving facility of October 2008 was extended to April 2009 and $5.2 million was outstanding at September 30, 2008.

Promissory Note

In connection with the acquisition in July 2008 described in Note 14, the Company issued a promissory note to Talisman Energy Canada (**Talisman**) in the principal amount of Cdn.$12.5 million bearing interest at a rate per year equal to the prime rate plus 2%, calculated daily and not compounded, and maturing on December 31, 2008 (the **2008 Note**).

Convertible Note

Also in connection with the acquisition in July 2008, the Company issued a convertible promissory note to Talisman in the principal amount of Cdn.$40.0 million bearing interest at a rate per year equal to the prime rate plus 2%, calculated daily and not compounded, and payable semi-annually, maturing in July 2011 and convertible (as to the outstanding principal amount), at Talisman s option, into a maximum of 12,779,552 common shares of the Company at Cdn.$3.13 per common share (the **Convertible Note**). There were no conversions of this note in the three-month period ended September 30, 2008.

Under Canadian GAAP, the Convertible Note should be assessed based on the substance of the contractual arrangement in determining whether it exhibits the fundamental characteristic of a financial liability or equity. Management has assessed that this debenture instrument mainly exhibits characteristics that are liability in nature, however, the embedded conversion feature is equity in nature and is required to be bifurcated and disclosed separately within shareholders equity. Management has applied residual basis and has valued the liability component first and

assigned the residual value to the equity component. Management has fair valued the liability component by discounting the expected interest and principal payments using an interest rate of 8.75% being management s estimate of the expected interest payments for a similar instrument without the conversion feature. The liability component was valued at Cdn.$37.9 and the remaining balance of Cdn.$2.1 was allocated to the equity component. The liability component will be accreted over the three-year maturity period to bring the liability back to Cdn.$40,000,000 using the effective interest method.

The Company s obligations under the 2008 Note, the Convertible Note and the Contingent Payment (see Note 14) are secured by a first fixed charge and security interest in favor of Talisman against the acquired Talisman leases and the related assets acquired by the Company pursuant to the Talisman lease acquisition, and a subordinate security interest in and to all other present and after-acquired property of the Company other than the shares of any subsidiary of Ivanhoe Energy. The Talisman security interest also does not extend to any assets of any subsidiary of Ivanhoe Energy.

The scheduled maturities of the Company s long term debt, excluding unamortized discount and unamortized deferred financing costs, as at September 30, 2008 were as follows:

2008	12,523
2009	5,616
2010	10,000
2011	38,106
	$ 66,245

6. ASSET RETIREMENT OBLIGATIONS

The Company provides for the expected costs required to abandon its producing U.S. oil and gas properties and the HTL™ commercial demonstration facility (**CDF**). The undiscounted amount of expected future cash flows required to settle the Company s asset retirement obligations for these assets as at September 30, 2008 was estimated at $6.3 million. These payments are expected to be made over the next 30 years; with over half of the payments between 2010 and 2025. To calculate the present value of these obligations, the Company used an inflation rate of 3% and the expected future cash flows have been discounted using a credit-adjusted risk-free rate of 6%. A reconciliation of the beginning and ending aggregate carrying amount of the obligation associated with the retirement of oil and gas properties and the CDF were as follows:

	As at September, 30 2008	As at December, 31 2007
Carrying balance, beginning of year	$ 2,218	$ 1,953
Liabilities incurred	219	20
Liabilities settled		(792)
Accretion expense	101	119
Revisions in estimated cash flows	1,135	918
Carrying balance, end of period	$ 3,673	$ 2,218

7. COMMITMENTS AND CONTINGENCIES

Zitong Block Exploration Commitment

At December 31, 2005, the Company held a 100% working interest in a thirty-year production-sharing contract with China National Petroleum Corporation (**CNPC**) in a contract area, known as the Zitong Block, located in the northwestern portion of the Sichuan Basin. In January 2006, the Company farmed-out 10% of its working interest in the Zitong block to Mitsubishi Gas Chemical Company Inc. of Japan (**Mitsubishi**) for $4.0 million.

The Company has completed the first phase of this project and in December 2007, the Company and Mitsubishi (the **Zitong Partners"**) made a decision to enter into the next three-year exploration phase (**Phase 2**) of the project. By electing to participate in Phase 2 the Zitong Partners must relinquish 30%, plus or minus 5%, of the Zitong block acreage and complete a minimum work program involving the acquisition of approximately 200 miles of new seismic lines and the drilling of approximately 23,700 feet of new wellbore, (including a 700 foot shortfall from the first phase), with total estimated minimum expenditures for this program of $25.0 million. The Phase 2 seismic line acquisition commitment was fulfilled in the first phase exploration program and no further seismic acquisition is required by the contract. The Zitong Partners must complete the minimum work program by December 31, 2010, or will be obligated to pay to CNPC the cash equivalent of the deficiency in the work program for that exploration phase and perform an impairment assessment on the costs incurred to date. The May 2008 earthquake in China s Sichuan Province resulted in some delays in analyzing and reviewing geophysical data. The Company will be evaluating

whether these delays will prohibit it from completing the work program within the required time frame and address whether or not an extension of that time frame is needed in the near future. Following the completion of Phase 2, the Zitong Partners must relinquish all of the remaining property except any areas identified for development and production.

Long Term Obligation

As part of its 2005 merger with Ensyn Group, Inc., the Company assumed an obligation to pay $1.9 million in the event, and at such time that, the sale of units incorporating the HTL™ Technology for petroleum applications reach a total of $100.0 million. This obligation is recorded in the Company s consolidated balance sheet.

Income Taxes

The Company s income tax filings are subject to audit by taxation authorities, which may result in the payment of income taxes and/or a decrease in its net operating losses available for carry-forward in the various jurisdictions in which the Company operates. While the Company believes its tax filings do not include uncertain tax positions, except as noted below, the results of potential audits or the effect of changes in tax law cannot be ascertained at this time.

The Company has an uncertain tax position related to when its entitlement to take tax deductions associated with development costs commenced. In March 2007, the Company received a preliminary indication from local Chinese tax authorities as to a potential change in the rule under which development costs are deducted from taxable income effective for the 2006 tax year. The Company discussed this matter with Chinese tax authorities and subsequently filed its 2006 tax return for Sunwing s wholly-owned subsidiary Pan-China Resources Ltd. (**Pan-China**) taking a new filing position in which development costs are capitalized and amortized on a straight line basis over six years starting in the year the development costs are incurred rather than deducted in their entirety in the year incurred. This change resulted in a $50.3 million reduction in tax loss carry-forwards in 2007 with an equivalent increase in the tax basis of development costs available for application against future Chinese income. The Company has received no formal notification of this rule change, however it will continue to file tax returns under this new approach. To the extent that there is a different interpretation in the timing of the deductibility of development costs this could potentially result in an increase in the current tax provision of $1.9 million.

The Company has an uncertain tax position related to the calculation of a gain on the consideration received from two farm-out transactions (Richfirst January 2004 see Note 5 and Mitsubishi January 2006 see under Zitong Block Exploration Commitment in this Note 7) and the designation of whether the taxable gains may be subject to a withholding tax of 10% pursuant to Chinese tax law for income derived by a foreign entity. The Company is waiting for the Chinese tax authorities to reply to its request to validate in writing that its current treatment of such tax position is appropriate. To the extent that the calculation of a gain is interpreted differently and the amounts are subject to withholding tax there would be an additional current tax provision of approximately $0.7 million.

No amounts have been recorded in the financial statements related to the above mentioned uncertain tax positions as management has determined the likelihood of an unfavorable outcome to the Company to be low.

Other Commitments

From time to time the Company enters into consulting agreements whereby a success fee may be payable if and when either a definitive agreement is signed or certain other contractual milestones are met. Under the agreements, the consultant may receive cash, Company shares, stock options or some combination thereof. These fees are not considered to be material in relation to the overall capital costs and funding requirements of the future individual projects.

Also see Note 14 for commitment related to acquisition of properties in Alberta.

The Company may provide indemnities to third parties, in the ordinary course of business, that are customary in certain commercial transactions such as purchase and sale agreements. The terms of these indemnities will vary based upon the contract, the nature of which prevents the Company from making a reasonable estimate of the maximum potential amounts that may be required to be paid. The Company s management is of the opinion that any resulting settlements relating to potential litigation matters or indemnities would not materially affect the financial position of the Company.

8. SHARE CAPITAL AND WARRANTS

Following is a summary of the changes in share capital and stock options outstanding for the nine-month period ended September 30, 2008:

	Common Shares					Stock Options	
	Number (thousands)	Amount	Purchase Warrants	Contributed Surplus	Convertible Note	Number (thousands)	Wtd. Avg Exercise Price Cdn.$
Balance December 31, 2007	244,873	$ 324,262	$ 23,078	$ 9,937	$	12,945	$ 2.37
Shares issued for:							
Private placement, net of share issue costs	29,334	82,687					
Exercise of convertible debt	2,291	4,862					
Services	217	490					
Exercise of options	2,497	1,617		(413)		(2,897)	$ 0.82
Options:							
Granted				2,535		3,832	$ 1.79
Cancelled/forfeited						(447)	$ 2.62
Convertible note issued					2,086		
Purchase warrants expired			(4,273)	4,273			
Balance September 30, 2008	279,212	$ 413,918	$ 18,805	$ 16,332	$ 2,086	13,433	$ 2.53

Special Warrants Offering

In July 2008, the Company completed a Cdn.$88.0 million private placement consisting of 29,334,000 Special Warrants (**Special Warrants**) at Cdn.$3.00 per Special Warrant (the **Offering**). Each Special Warrant entitled the holder to one common share of the Company upon exercise of the Special Warrant. In August 2008, all of the Special Warrants were exercised for 29,334,000 common shares. The net proceeds from the Offering of the Special Warrants was approximately Cdn.$83.4 million after deducting the agents commission of Cdn.$4.0 million and the expenses of the Offering of Cdn.$0.6 million. The Company used Cdn.$22.5 million of the net proceeds of the Offering to complete the cash component of the Talisman lease acquisition described in Note 14.

Purchase Warrants

The only changes to the number of the Company s purchase warrants and common shares issuable upon the exercise of the purchase warrants for the nine-month period ended September 30, 2008 were the expiration of 4.1 million and 11.0 million purchase warrants in April and May 2008. The combined value of $4.3 million associated with these warrants was reclassified from Purchase Warrants to Contributed Surplus at the time of expiration.

Convertible Notes

As described in Note 5, in connection with the acquisition in July 2008, the Company issued the Convertible Note to Talisman in the principal amount of Cdn.$40.0 million bearing interest at a rate per year equal to the prime rate plus 2%, calculated daily and not compounded, and payable semi-annually, maturing in July 2011 and convertible (as to the outstanding principal amount), at Talisman s option, into a maximum of 12,779,552 common shares of the Company at Cdn.$3.13 per common share. Also described in Note 5, management accounted for this convertible note by assigning a portion of the value, Cdn.$2.1 million, of the instrument to equity.

In April 2008, the Company obtained a loan from a third party finance company in the amount of Cdn.$5.0 million bearing interest at 8% per annum. The principal and accrued and unpaid interest matured and was repayable in August 2008. The lender exercised its option to convert the entire outstanding balance into the Company s common shares at the conversion price of Cdn.$2.24 per share.

As at September 30, 2008, the following purchase warrants were exercisable to purchase common shares of the Company until the expiry date at the price per share as indicated below:

		Purchase Warrants						
Year of Issue	Price per Special Warrant	Issued	Exercisable	Common Shares Issuable	Value	Expiry Date	Exercise Price per Share	Value on Exercise ($U.S. 000)
			(thousands)		($U.S. 000)			
2006	U.S.$2.23	11,400	11,400	11,400	18,805	May 2011	Cdn. $2.93 (1)	31,821

(1) Each common share purchase warrant originally entitled the holder to purchase one common share at a price of $2.63 per share until the fifth anniversary date of the closing of the transaction. In September 2006, these warrants were listed on the Toronto Stock Exchange and the exercise price was changed to Cdn.$2.93.

9. SEGMENT INFORMATION

The Company has four reportable business segments: Oil and Gas Integrated, Oil and Gas - Conventional, Business and Technology Development and Corporate. These segments are different than those reported in the Company s previous financial statements included in its Form 10-Qs and Form 10-Ks and as such the presentation has been changed to conform to the new segments. Due to newly established geographically focused entities and the initiation of two new integrated projects, new segments are being reported to reflect how management now analyzes and manages the Company.

Oil and Gas

Integrated

Projects in this segment will have two primary components. The first component consists of conventional exploration and production activities together with enhanced oil recovery techniques such as steam assisted gravity drainage. The second component consists of the deployment of the HTL^{TM} Technology which will be used to upgrade heavy oil at

facilities located in the field to produce lighter, more valuable crude. The Company has two such projects currently reported in this segment a heavy oil project in Alberta (see Note 14) and a heavy oil property in Ecuador (see Note 15).

Conventional

The Company explores for, develops and produces crude oil and natural gas in China and in the U.S. In China, the Company s development and production activities are conducted at the Dagang oil field located in Hebei Province and its exploration activities are conducted on the Zitong block located in Sichuan Province. In the U.S., the Company s exploration, development and production activities are primarily conducted in California and Texas.

Business and Technology Development

The Company incurs various costs in the pursuit of HTL™ and GTL projects throughout the world. Such costs incurred prior to signing a memorandum of understanding (**MOU**) or similar agreement, are considered to be business and technology development and are expensed as incurred. Upon executing an MOU to determine the technical and commercial feasibility of a project, including studies for the marketability for the projects products, the Company assesses whether the feasibility and related costs incurred have potential future value, are probable of leading to a definitive agreement for the exploitation of proved reserves and should be capitalized.

Additionally, the Company incurs costs to develop, enhance and identify improvements in the application of the HTL™ and GTL technologies it owns or licenses. The cost of equipment and facilities acquired, or construction costs for such purposes, are capitalized as development costs and amortized over the expected economic life of the equipment or facilities, commencing with the start up of commercial operations for which the equipment or facilities are intended.

Corporate

The Company s corporate segment consists of costs associated with the board of directors, executive officers**,** corporate debt, financings and other corporate activities.

The following tables present the Company s segment information for the three-month and nine-month periods ended September 30, 2008 and 2007 and identifiable assets as at September 30, 2008 and December 31, 2007:

	Three-Month Period Ended September 30, 2008						
	Oil and Gas				Business and Technology		
	Integrated		Conventional				
	Canada	Ecuador	China	U.S.	Development	Corporate	Total
Revenue							
Oil and gas revenue	$	$	$ 14,912	$ 5,525	$	$	$ 20,437
Gain on derivative instruments			10,898	3,920			14,818
Interest income			11	22		338	371
			25,821	9,467		338	35,626
Expenses							
Operating costs			6,626	1,585			8,211
General and administrative	655	102	639	856		3,003	5,255
Business and technology development	(20)				1,989		1,969
Depletion and depreciation			5,891	1,660	632		8,183
Interest expense and financing costs			169	128	22	144	463
	635	102	13,325	4,229	2,643	3,147	24,081
Income (Loss) before Income Taxes	(635)	(102)	12,496	5,238	(2,643)	(2,809)	11,545
Provision for income taxes							
Current			(358)				(358)
Future			(1,125)				(1,125)
			(1,483)				(1,483)
Net Income (Loss) and Comprehensive Income (Loss)	$ (635)	$ (102)	$ 11,013	$ 5,238	$ (2,643)	$ (2,809)	$ 10,062
Capital Investments	$ 3,999	$	$ 1,795	$ 596	$ 2,566	$	$ 8,956

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	Nine-Month Period Ended September 30, 2008						
	Oil and Gas				Business and Technology Development	Corporate	Total
	Integrated		Conventional				
	Canada	Ecuador	China	U.S.			
Revenue							
Oil and gas revenue	$	$	$ 37,547	$ 15,912	$	$	$ 53,459
Loss on derivative instruments			(6,793)	(3,122)			(9,915)
Interest income			36	88		355	479
			30,790	12,878		355	44,023
Expenses							
Operating costs			16,239	3,978			20,217
General and administrative	1,404	102	1,902	1,734		8,607	13,749
Business and technology development	129				4,760		4,889
Depletion and depreciation			17,891	4,814	1,969	4	24,678
Interest expense and financing costs			642	408	54	396	1,500
	1,533	102	36,674	10,934	6,783	9,007	65,033
Income (Loss) before Income Taxes	(1,533)	(102)	(5,884)	1,944	(6,783)	(8,652)	(21,010)
(Provision for) recovery of income taxes							
Current			(358)	(4)	(2)		(364)
Future			1,161				1,161
			803	(4)	(2)		797
Net Income (Loss) and Comprehensive Income (Loss)	$ (1,533)	$ (102)	$ (5,081)	$ 1,940	$ (6,785)	$ (8,652)	$ (20,213)
Capital Investments	$ 3,999	$	$ 5,566	$ 3,797	$ 3,510	$	$ 16,872
Identifiable Assets:							

As at September 30, 2008	$ 78,548	$ 168	$ 71,832	$ 39,252	$ 120,171	$ 53,033	$ 363,004
As at December 31, 2007	$	$	$ 73,298	$ 40,726	$ 117,529	$ 5,363	$ 236,916

	Three-Month Period Ended September 30, 2007				
	Oil and Gas Conventional		Business and Technology		
	China	U.S.	Development	Corporate	Total
Revenue					
Oil and gas revenue	$ 7,994	$ 2,870	$	$	$ 10,864
Loss on derivative instruments	(720)	(1,433)			(2,153)
Interest income	12	32		68	112
	7,286	1,469		68	8,823
Expenses					
Operating costs	3,220	1,046			4,266
General and administrative	416	381		1,928	2,725
Business and technology development			2,831		2,831
Depletion and depreciation	4,537	1,306	199	2	6,044
Interest expense and financing costs		110	7	72	189
	8,173	2,843	3,037	2,002	16,055
Net Loss and Comprehensive Loss	$ (887)	$ (1,374)	$ (3,037)	$ (1,934)	$ (7,232)
Capital Investments	$ 7,735	$ 645	$ 720	$	$ 9,100

	Nine-Month Period Ended September 30, 2007				
	Oil and Gas Conventional		Business and Technology		
	China	U.S.	Development	Corporate	Total
Revenue					
Oil and gas revenue	$ 21,869	$ 8,380	$	$	$ 30,249
Loss on derivative instruments	(720)	(2,208)			(2,928)
Interest income	31	93		224	348
	21,180	6,265		224	27,669
Expenses					
Operating costs	8,991	3,183			12,174
General and administrative	1,446	1,564		5,971	8,981
Business and technology development			7,341		7,341
Depletion and depreciation	13,591	4,402	963	4	18,960
Interest expense and financing costs	5	295	20	251	571
	24,033	9,444	8,324	6,226	48,027
Net Loss and Comprehensive Loss	$ (2,853)	$ (3,179)	$ (8,324)	$ (6,002)	$ (20,358)
Capital Investments	$ 18,053	$ 2,438	$ 2,066	$	$ 22,557

10. FINANCIAL INSTRUMENTS AND FINANCIAL RISK FACTORS

The accounting classification of each category of financial instruments, and their carrying amounts, are set out below.

	As at September 30, 2008				
	Loans and receivables	Available-for-sale financial assets	Held-for-trading	Financial liabilities measured at amortized cost	Total carrying amount
Financial Assets:					
Cash and cash equivalents	$	$	$ 61,649	$	$ 61,649
Accounts receivable	13,811				13,811
Financial Liabilities:					
Accounts payable and accrued liabilities				(13,074)	(13,074)
Income tax payable				(358)	(358)
Derivative instruments			(9,310)		(9,310)
Long term debt				(63,751)	(63,751)

	$ 13,811	$	$ 52,339	$ (77,183)	$ (11,033)

As at December 31, 2007

	Loans and receivables	Available-for-sale financial assets	Held-for-trading	Financial liabilities measured at amortized cost	Total carrying amount
Financial Assets:					
Cash and cash equivalents	$	$	$ 11,356	$	$ 11,356
Accounts receivable	9,376				9,376
Advance	825				825
Financial Liabilities:					
Accounts payable and accrued liabilities				(9,538)	(9,538)
Derivative instruments			(9,432)		(9,432)
Long term debt				(16,541)	(16,541)
	$ 10,201	$	$ 1,924	$ (26,079)	$ (13,954)

Financial Risk Factors

The Company is exposed to a number of different financial risks arising from typical business exposures as well as its use of financial instruments including market risk relating to commodity prices, foreign currency exchange rates and interest rates, credit risk and liquidity risk. There have been no significant changes to the Company s exposure to risks nor to management s objectives, policies and processes to manage risks from the previous year. The risks associated with our financial instruments and our policies for minimizing these risks are detailed below.

Market Risk

Market risk is the risk that the fair value or future cash flows of our financial instruments will fluctuate because of changes in market prices. Components of market risk to which we are exposed are discussed below.

Commodity Price Risk

Commodity price risk refers to the risk that the value of a financial instrument or cash flows associated with the instrument will fluctuate due to the changes in market commodity prices. Crude oil prices and quality differentials are influenced by worldwide factors such as OPEC actions, political events and supply and demand fundamentals. The Company may periodically use different types of derivative instruments to manage its exposure to price volatility as well as being a requirement of the Company s lenders.

The Company entered into costless collar derivatives to minimize variability in its cash flow from the sale of up to 14,700 Bbls per month of the Company s production from its South Midway Property in California and Spraberry Property in West Texas over a two-year period starting November 2006 and a six-month period starting November 2008. The derivatives had a ceiling price of $65.20, and $70.08, per barrel and a floor price of $63.20, and $65.00, per barrel, respectively, using WTI as the index traded on the NYMEX. The Company also entered into a costless collar derivative to minimize variability in its cash flow from the sale of up to 18,000 Bbls per month of the Company s production from its Dagang field in China over a three-year period starting September 2007. This derivative had a ceiling price of $84.50 per barrel and a floor price of $55.00 per barrel using WTI as the index traded on the NYMEX.

Results of these derivative transactions for the three-month and nine-month periods ended September 30:

	Three Month Periods Ended September 30,	
	2008	**2007**
Realized losses on derivative transactions	$ (3,735)	$ (423)
Unrealized gains (losses) on derivative transactions	18,553	(1,730)
	$ 14,818	$ (2,153)

	Nine Month Periods Ended September 30,	
	2008	**2007**
Realized losses on derivative transactions	$ (10,037)	$ (246)
Unrealized gains (losses) on derivative transactions	122	(2,682)
	$ (9,915)	$ (2,928)

Both realized and unrealized gains and losses on derivatives have been recognized in the results of operations.

On September 30, 2008, the Company s open positions on the derivative liabilities referred to above had a fair value of $9.3 million. A 10% increase in oil prices would increase the fair value, and consequently increase the net loss (or decrease net income), by approximately $3.3 million, while a 10% decrease in prices would reduce the fair value, and consequently reduce the net loss (or increase net income), by approximately $3.1 million. The fair value change assumes volatility based on prevailing market parameters at September 30, 2008.

Foreign Currency Exchange Rate Risk

Foreign currency risk refers to the risk that the value of a financial commitment, recognized asset or liability will fluctuate due to changes in foreign currency rates. The main underlying economic currency of the Company s cash flows is the U.S. dollar. This is because the Company s major product, crude oil, is priced internationally in U.S. dollars. Accordingly, the Company does not expect to face foreign exchange risks associated with its production revenues. However, some of the Company s cash flow stream relating to certain international operations is based on the U.S. dollar equivalent of cash flows measured in foreign currencies. The majority of the operating costs incurred in the Chinese operations are paid in Chinese renminbi. The majority of costs incurred in the

administrative offices in Vancouver and Calgary, as well as some business development costs, are paid in Canadian dollars. In addition, with the recent property acquisition in Alberta (see Note 14) the Company s Canadian dollar expenditures have increased during the most recent quarter along with an increase in cash and debt balances denominated in Canadian dollars. Disbursement transactions denominated in Chinese renminbi and Canadian dollars are converted to U.S. dollar equivalents based on the exchange rate as of the transaction date. Foreign currency gains and losses also come about when monetary assets and liabilities, mainly short term payables and receivables, denominated in foreign currencies are translated at the end of each month. The estimated impact of a 10% strengthening or weakening of the Chinese renminbi, and Canadian dollar, as of September 30, 2008 on net loss and accumulated deficit for the nine-month period ended September 30, 2008 is a $1.8 million increase, and a $1.4 million decrease, respectively. To help reduce the Company s exposure to foreign currency risk it seeks to maximize the expenditures and contracts denominated in U.S. dollars and minimize those denominated in other currencies, except for its Canadian activities where it attempts to hold cash denominated in Canadian dollars in order to manage its currency risk related to outstanding debt and current liabilities denominated in Canadian dollars.

Interest Rate Risk

Interest rate risk refers to the risk that the value of a financial instrument or cash flows associated with the instrument will fluctuate due to the changes in market interest rates. Interest rate risk arises from interest-bearing borrowings which have a variable interest rate. The Company estimates that its interest income generated by its cash equivalents for the three-month period ended September 30, 2008 would have changed $0.3 million for a 0.5% change in average interest rates over the period. The Company currently has two separate bank loan facilities, a promissory note and a convertible note with fluctuating interest rates. The Company estimates that its net loss and accumulated deficit for the nine-month period ended September 30, 2008 would have changed $0.1 million for every 1% change in interest rates as of September 30, 2008. The Company is not currently actively attempting to mitigate this interest rate risk given the limited amount and term of its borrowings and the current global interest rate environment.

Credit Risk

The Company is exposed to credit risk with respect to its cash held with financial institutions, accounts receivable and advance balances. The Company believes its exposure to credit risk related to cash held with financial institutions is minimal due to the quality of the institutions where the cash is held and the nature of the deposit instruments. Most of the Company s accounts receivable balances relate to oil and natural gas sales and are exposed to typical industry credit risks. In addition, accounts receivable balances consist of costs billed to joint venture partners where the Company is the operator and advances to partners for joint operations where the Company is not the operator. The advance balance relates to an arrangement whereby scheduled advances were made to a third party contractor associated with negotiating an HTL™ and/or GTL project for the Company. The Company manages its credit risk by entering into sales contracts only with established entities and reviewing its exposure to individual entities on a regular basis. Of the $13.8 million trade receivables balance as at September 30, 2008, $10.3 million is due from a single customer and $1.4 million is due from another single customer. There are no other customers who represent more than 5% of the total balance of trade receivables. As noted below, included in the Company s trade receivable balance are debtors with a carrying amount of $1.3 million as of the quarter ended September 30, 2008 which are past due at the reporting date for which the Company has not provided an allowance, as there has not been a significant change in credit quality and the amounts are still considered recoverable. During the quarter ended September 30, 2008 the Company recorded an allowance associated with the advance balance for the entire outstanding amount of $0.7 million. The provision was recorded in General and Administrative expense in the accompanying Statement of Operations and Comprehensive Income (Loss). There were no other changes to the allowance for credit losses account during the three-month and nine-month periods ended September 30, 2008 and no other losses associated with credit risk were recorded during these same periods.

	September 30, 2008	**December 31, 2007**
Accounts Receivable:		

Neither impaired nor past due	$	12,465	$	8,259
Impaired (net of valuation allowance)				
Not impaired and past due in the following periods:				
within 30 days		566		347
31 to 60 days		39		
61 to 90 days		11		4
over 90 days		730		766
		13,811		9,376
Advance				
Not impaired and past due over 90 days				825
	$	13,811	$	10,201

Our maximum exposure to credit risk is based on the recorded amounts of the financial assets above.

Liquidity Risk

Liquidity risk is the risk that suitable sources of funding for the Company s business activities may not be available, which means it may be forced to sell financial assets or non-financial assets, refinance existing debt, raise new debt or issue equity. The Company s present plans to generate sufficient resources to assure continuation of its operations and achieve its capital investment objectives include alliances or other arrangements with entities with the resources to support the Company s projects as well as project financing, debt financing or the sale of equity securities.

The contractual maturity of the fixed and floating rate financial liabilities and derivatives are show in the table below. The amounts presented represent the future undiscounted principal and interest cash flows and therefore do not equate to the values presented in the balance sheet.

	As at September 30, 2008 Contractual Maturity (Nominal Cash Flows)				As at December 31, 2007 Contractual Maturity (Nominal Cash Flows)			
	Less than 1 year	1 to 2 years	2 to 5 years	Over 5 years	Less than 1 year	1 to 2 years	2 to 5 years	Over 5 years
Derivative financial liabilities:								
Costless Collars oil price commodity	$6,421	$2,888	$	$	$7,156	$2,276	$	$
Non derivative financial liabilities:								
Trade accounts payable	$6,359	$	$	$	$6,897	$	$	$
Accruals	$6,714	$	$	$	$2,641	$	$	$
Long term debt and interest	$13,723	$6,281	$46,321	$	$8,240	$1,541	$10,277	$

11. CAPITAL MANAGEMENT

The Company manages its capital so that the Company and its subsidiaries will be able to continue as a going concern and to create shareholder value through exploring, appraising and developing its assets including the major initiative of implementing multiple, full-scale, commercial HTL heavy oil projects in Canada and internationally. There have been no significant changes in management s objectives, policies and processes to manage capital or the components of capital from the previous year.

The Company defines capital as total equity or deficiency plus cash and cash equivalents and long term debt. Total equity is comprised of share capital, warrants, convertible note, shares to be issued and accumulated deficit as disclosed in Note 8. Cash and cash equivalents consist of $61.6 million and $11.4 million at September 30, 2008 and December 31, 2007. Long term debt is disclosed in Note 5.

The Company s management reviews the capital structure on a regular basis to maintain the most optimal debt to equity balance. In order to maintain or adjust its capital structure, the Company may refinance its existing debt, raise new debt, seek cost sharing arrangements with partners or issue new shares.

The Company s U.S. and Chinese oil and gas subsidiaries are subject to financial covenants, such as interest coverage ratios, under each of their revolving/term credit facilities which are measured on a quarterly or semi-annual basis. The Company is in compliance with all financial covenants for the quarter ended September 30, 2008.

12. SUPPLEMENTAL CASH FLOW INFORMATION

Supplemental cash flow information for the three-month and nine-month periods ended September 30:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Supplemental Cash Flow Information				
Cash paid during the period for				
Income taxes	**$**	$ 1	**$ 6**	$ 6
Interest	**$ 168**	$ 22	**$ 773**	$ 108
Investing and Financing activities, non-cash				
Debt issued for the acquisition of oil and gas assets	**$ 52,052**	$	**$ 52,052**	$
Conversion of debt to shares				
Extinguishment of debt	**$ 4,737**	$	**$ 4,737**	$
Extinguishment of interest	**125**		**125**	
	$ 4,862	$	**$ 4,862**	$
Shares issued for bonuses	**$ 490**	$ 413	**$ 490**	$ 692
Changes in non-cash working capital items				
Operating Activities				
Accounts receivable	**$ (1,366)**	$ (921)	**$ (3,915)**	$ (453)
Prepaid and other current assets	**(15)**	155	**116**	407
Accounts payable and accrued liabilities	**(512)**	1,081	**2,814**	234
Income tax payable	**358**		**358**	
	(1,535)	315	**(627)**	188
Investing Activities				
Accounts receivable	**(552)**	(5)	**(520)**	(139)
Prepaid and other current assets	**(9)**	19	**1**	79
Accounts payable and accrued liabilities	**3,430**	2,175	**856**	755
	2,869	2,189	**337**	695
Financing Activities				
Accounts payable and accrued liabilities	**(711)**		**(9)**	

$ 623	$ 2,504	**$ (299)**	$ 883

Cash and cash equivalents consisted of the following as at:

	September 30, 2008	&nN: left">	**December 31,** –			
Total operating costs and expenses	95,628		181,647	92,361	54,084	52,898
Loss from operations	(4,419)		(90,168)	(9,299)	(9,477)	(5,917)
Interest expense and other, net	4,425		4,043	1,690	3,416	2,257
Loss from continuing operations before income taxes	(8,844)		(94,211)	(10,989)	(12,893)	(8,174)
Income tax (benefit) provision	-		(961)	961	–	–
Loss from continuing operations	(8,844)		(93,250)	(11,950)	(12,893)	(8,174)
Loss from discontinued operations, net of income taxes	(1,862)		(17,779)	(2,429)	-	(3,650)
Net loss	(10,706)		(111,029)	(14,379)	(12,893)	(11,824)
Preferred dividends, beneficial conversion and warrant modification charges	–		–	–	9,831	3,042
Net loss attributable to common shareholders	$ (10,706)		$ (111,029)	$ (14,379)	$ (22,724)	$ (14,866)
Basic and diluted loss per common share:						
Loss from continuing operations attributable to common shareholders	$ (0.37)		$ (3.93)	$ (0.55)	$ (5.81)	$ (7.72)
Loss from discontinued operations attributable to common shareholders	(0.08)		(0.75)	(0.11)	–	(2.51)
Net loss attributable to common shareholders	$ (0.45)		$ (4.68)	$ (0.66)	$ (5.81)	$ (10.23)
Basic and diluted weighted average common shares outstanding	23,935		23,725	21,652	3,910	1,453

	As of December 31,				
	2013	2012	2011	2010	2009
Consolidated balance sheet data:					
Cash	$394	$234	$751	$443	–
Total assets	70,971	81,775	184,449	139,611	22,368
Current portion of long-term debt	16	15	14,514	11	426
Long-term debt, net of current maturities	22,654	21,251	44	17,945	14,403
Other long-term obligations	330	352	4,710	748	1,048

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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion of our financial condition and results of operations should be read in conjunction with the consolidated financial statements and notes thereto included elsewhere in this report.

Overview

Primo Water Corporation (together with its consolidated subsidiaries, "Primo", "we", "our," "us") is a leading provider of multi-gallon purified bottled water, self-service refill water and water dispensers sold through major retailers in the United States and Canada. We believe the market for purified water is growing due to evolving taste preferences, perceived health benefits and concerns regarding the quality of municipal tap water. Our products provide an environmentally friendly, economical, convenient and healthy solution for consuming purified and filtered water. We are a Delaware corporation that was founded in 2004 and is headquartered in Winston-Salem, North Carolina.

Our business is designed to generate recurring demand for our purified bottled water or self-serve filtered drinking water through the sale of innovative water dispensers. This business strategy is commonly referred to as "razor-razorblade" because the initial sale of a product creates a base of users who frequently purchase complementary consumable products. We believe dispenser owners consume an average of 35 multi-gallon bottles of water annually. Once our bottled water is consumed using a water dispenser, empty bottles are exchanged at our recycling center displays, which provide a recycling ticket that offers a discount toward the purchase of a new bottle of Primo purified water ("Exchange") or they are refilled at a self-serve filtered drinking water location ("Refill"). Each of our multi-gallon water bottles can be sanitized and reused up to 40 times before being taken out of use, crushed and recycled, substantially reducing landfill waste compared to consumption of equivalent volumes of single-serve bottled water. As of December 31, 2013, our products and services were offered in each of the contiguous United States and in Canada at approximately 22,900 combined retail locations, including Lowe's Home Improvement, Walmart, Kmart, Meijer, Kroger, Food Lion, H-E-B Grocery, Sobeys and Walgreens.

We provide major retailers throughout the United States and Canada with single-vendor solutions for Exchange and Refill services, addressing a market demand that we believe was previously unmet. Our solutions are easy for retailers to implement, require minimal management supervision and store-based labor, and provide centralized billing and detailed performance reports. Our Exchange solution offers retailers attractive financial margins and the ability to optimize typically unused retail space with our displays. Our Refill solution provides filtered water through the installation and servicing of reverse osmosis water filtration systems in the back room of the retailer's store location, which minimizes the usage of the customer's retail space. The refill machine, which is typically accompanied by a sales display containing empty reusable bottles, is located within the retailer customer's floor space. Additionally, due to the recurring nature of water consumption, retailers benefit from year-round customer traffic and highly predictable revenue.

Business Segments

We have two operating segments and two reportable segments: Primo Water ("Water") and Primo Dispensers ("Dispensers").

Our Water segment sales consist of our Exchange and Refill services, which are offered through retailers in each of the contiguous United States and Canada. Our Water services are offered through point of purchase display racks or self-serve filtered water displays and recycling centers that are prominently located at major retailers in space that is often underutilized.

Our Dispensers segment sells water dispensers that are designed to dispense Primo and other dispenser-compatible bottled water. Our Dispensers sales are primarily generated through major U.S. retailers and are sold primarily through a direct-import model, where we recognize revenues for the sale of the water dispensers when title is transferred. We support retail sell-through with domestic inventory. We design, market and arrange for certification and inspection of our water dispensers.

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

Cost of sales for Water consists of costs for distribution, bottles and related packaging materials for our Exchange services and servicing and material costs for our Refill services. Cost of sales for Dispensers consists of contract manufacturing, freight and duties.

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

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

In this Management's Discussion and Analysis of Financial Condition and Results of Operations, when we refer to "same-store unit growth" for our Water segment, we are comparing retail locations at which our Exchange services have been available for at least 12 months at the beginning of the relevant period. In addition, "gross margin percentage" is defined as net sales less cost of sales, as a percentage of net sales.

Recent Developments

DS Waters' Agreement

On November 12, 2013, we entered into a strategic alliance agreement (the "DS Agreement") with DS Waters of America, Inc. ("DS Waters") pursuant to which DS Waters will act as our primary bottler and distributor and provider of exchange and supply services for the Exchange business in the United States. Pursuant to the DS Agreement, DS Waters will become our primary bottler and distributor in the United States in all territories for which we do not currently have an existing distributor agreement and in other territories as existing distributor arrangements expire or are terminated. We currently expect the transition from our current network of distributors to DS Waters to occur over a two year period.

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Results of Operations

The following table sets forth our results of operations:

	Years Ended December 31, 2013		2012	
Consolidated statements of operations data:				
Net sales	$	91,209	$	91,479
Operating costs and expenses:				
Cost of sales		68,367		70,081
Selling, general and administrative expenses		15,151		17,708
Non-recurring costs		777		743
Depreciation and amortization		11,333		11,102
Goodwill and other impairments		–		82,013
Total operating costs and expenses		95,628		181,647
Loss from operations		(4,419)		(90,168)
Interest expense and other, net		4,425		4,043
Loss from continuing operations before income taxes		(8,844)		(94,211)
Income tax benefit		–		(961)
Loss from continuing operations		(8,844)		(93,250)
Loss from discontinued operations		(1,862)		(17,779)
Net loss	$	(10,706)	$	(111,029)

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

	Years Ended December 31, 2013	2012
Consolidated statements of operations data:		
Net sales	100.0 %	100.0 %
Operating costs and expenses:		
Cost of sales	75.0	76.6
Selling, general and administrative expenses	16.6	19.4
Non-recurring costs	0.9	0.8
Depreciation and amortization	12.4	12.1
Goodwill and other impairments	–	89.7
Total operating costs and expenses	104.9	198.6
Loss from operations	(4.8)	(98.6)
Interest expense and other, net	4.9	4.4
Loss from continuing operations before income taxes	(9.7)	(103.0)
Income tax provision	–	(1.1)
Loss from continuing operations	(9.7)	(101.9)
Loss from discontinued operations	(2.0)	(19.4)
Net loss	(11.7 %)	(121.3 %)

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

	Years Ended December 31, 2013	2012
Segment net sales		
Water	$ 63,828	$ 62,667
Dispensers	27,381	28,812
Total net sales	$ 91,209	$ 91,479
Segment income (loss) from operations		
Water	$ 17,591	$ 16,477
Dispensers	827	(1,319)
Corporate	(10,727)	(11,468)
Non-recurring costs	(777)	(743)
Depreciation and amortization	(11,333)	(11,102)
Goodwill and other impairments	–	(82,013)
Loss from operations	$ (4,419)	$ (90,168)

Year Ended December 31, 2013 Compared to Year Ended December 31, 2012

Net Sales. Net sales decreased 0.3%, or $0.3 million, to $91.2 million for the year ended December 31, 2013 from $91.5 million for the year ended December 31, 2012. The decrease in net sales resulted from a $1.5 million decrease in Dispenser sales partially offset by a $1.2 million increase in Water sales.

Water. Water net sales increased 1.9% to $63.8 million, representing 70.0% of our total net sales for 2013. Five-gallon equivalent units for Water increased 0.7% to 27.8 million units for 2013 from 27.6 million units for 2012. The increase in Water net sales was primarily due to a 4.9% increase in U.S. Exchange sales, driven by same-store unit growth of 10.4% during 2013. Same-store sales increased greater than the overall increase in sales due to a decrease of 700 locations during the year. The increase in U.S. Exchange sales was partially offset by a reduction of 1.0% in Refill sales.

Dispensers. Dispensers net sales decreased 5.0% to $27.4 million, representing 30.0% of our total net sales for 2013. The decrease is primarily due to additional sales in 2012 related to the rollout of new dispenser retail locations for a major retailer and the tighter management of inventory levels by retailers during 2013. Despite the 6.2% decline in dispenser unit sell-in to retailers, dispenser unit sell-thru to consumers increased 11.1% for 2013 compared to 2012.

Gross Margin Percentage. Our overall gross margin percentage increased to 25.0% for 2013 from 23.4% for 2012 due to improvements in both Water and Dispensers margins.

Water. Gross margin as a percentage of net sales in our Water segment increased to 32.9% for 2013 compared to 32.5% for 2012. An improvement in Exchange gross margin percentage for the year, due primarily to improvements in supply chain costs, was partially offset by a slight reduction in Refill gross margin percentage. We currently expect supply chain costs to continue to decrease primarily as a result of the DS Agreement, which should result in an improved gross margin percentage. The improvement in supply chain costs should occur as we transition our current network of Exchange distributors to DS Waters in the United States, over the next two years.

Dispensers. Gross margin as a percentage of net sales in our Dispensers segment increased to 6.7% for 2013 from 3.7% for 2012. The increase in gross margin percentage was primarily due to price increases to our customers that

became effective during the third quarter of 2012 and the mix of higher margin products being sold.

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Selling, General and Administrative Expenses ("SG&A"). SG&A decreased 14.4% to $15.2 million for 2013 from $17.7 million for 2012. As a percentage of net sales, SG&A decreased to 16.6% for 2013 from 19.4% for 2012.

Water. SG&A for our Water segment decreased 11.5% to $3.4 million for 2013 from $3.9 million for 2012. Water SG&A as a percentage of Water net sales decreased to 5.3% for 2013 compared to 6.2% for 2012. The decrease in Water SG&A was primarily a result of the reduction in advertising and marketing-related costs. We expect to continue to leverage costs with sales growth and the anticipated impact of the DS Agreement.

Dispensers. SG&A for our Dispensers segment decreased 57.5% to $1.0 million for 2013 from $2.4 million for 2012. SG&A as a percentage of Dispensers segment net sales decreased to 3.7% for 2013 from 8.3% for 2012. The change was primarily related to a decrease for adverstising and marketing expenses, partially attributable to a one-time expense of $0.35 million related to the rollout of new dispenser locations for 2012.

Corporate. Corporate SG&A decreased 6.5% to $10.8 million for 2013 from $11.4 million for 2012. Corporate SG&A as a percentage of consolidated net sales decreased to 11.8% for 2013 from 12.5% for 2012. We expect to continue to leverage Corporate SG&A costs with future sales growth.

Non-Recurring Costs. Non-recurring costs increased to $0.8 million for 2013 from $0.7 million for 2012. Non-recurring costs for 2013 were primarily related to legal and other expenses associated with our partnership with DS Waters as well as non-recurring severance and restructuring-related expenses. We expect to incur non-recurring, transition costs relating to the DS Agreement ranging between $2.0 million and $2.5 million for 2014. Non-recurring costs for 2012 were primarily related to employee severance costs associated with the elimination of duplicate management roles related to the Refill services business, the restructuring and consolidation of Water operations and litigation-related expenses.

Depreciation and Amortization. Depreciation and amortization increased 2.1% to $11.3 million for 2013 from $11.1 million for 2012. The increase was primarily due to increased depreciation on bottles used in our Exchange business attributable to our change in the estimated useful life of bottles from three years to two years effective July 1, 2012.

Goodwill and Other Impairments. We recorded non-cash goodwill impairment charges of $79.1 million for the Water reporting unit for 2012. We also recorded non-cash impairment charges of $2.9 million related to other current assets for 2012. No such charges were incurred for 2013.

Interest Expense and Other, net. Interest expense increased to $4.4 million for 2013 from $4.0 million for 2012. Lower deferred loan cost amortization was offset by the impact of supplier financing costs incurred in 2013 which were not incurred in 2012.

Income Tax Benefit. In 2012, the impairment of the goodwill (see Note 2 of the Notes to the Consolidated Financial Statements) resulted in a reversal of the related deferred tax liability recorded at December 31, 2011and the recognition of a deferred tax asset and an income tax benefit. We have provided valuation allowances to fully offset the net deferred tax assets at December 31, 2013 and 2012.

Discontinued Operations. Loss from discontinued operations was $1.9 million for 2013 compared to $17.8 million for 2012. The decrease is due primarily to the impact of impairment charges to goodwill and developed technology recorded for 2012.

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Liquidity and Capital Resources

Adequacy of Capital Resources

Since our inception, we have financed our operations primarily through the sale of stock, the issuance of debt and borrowings under credit facilities. While we had no material commitments for capital expenditures as of December 31, 2013, we anticipate net capital expenditures to range between $5.5 million and $7.5 million for 2014. Anticipated capital expenditures are related primarily to growth in Water locations. In addition, we expect to incur non-recurring, transition costs ranging between $2.0 million and $2.5 million for 2014 related to the DS Agreement.

At December 31, 2013, our cash totaled $0.4 million and we had approximately $0.5 million in additional availability under the Senior Revolving Credit Facility. This availability is subject to borrowing base requirements related to our eligible accounts receivable and inventory. In January 2014, we received the $2.5 million proceeds from the "Third Add-on Term Loan" described below. At February 28, 2014, we had approximately $2.7 million in additional availability under the Senior Revolving Credit Facility. We anticipate that our current cash and cash equivalents, availability under the Senior Revolving Credit Facility and cash flow from operations will be sufficient to meet our current capital needs for general corporate purposes.

Our future capital requirements may vary materially from those now anticipated and will depend on many factors including: the rate of growth in new Water locations and related display, rack and reverse osmosis filtration system costs, cost to develop new Dispenser product lines, sales and marketing resources needed to further penetrate our markets, the expansion of our operations in the United States and Canada, the response of competitors to our solutions and products, as well as acquisitions of other businesses. Historically, we have experienced increases in our capital expenditures consistent with the growth in our operations and personnel, and we anticipate that our expenditures will continue to increase as we grow our business, subject to limits related to our Term Loans and Senior Revolving Credit Facility.

Our ability to satisfy our obligations or to fund planned capital expenditures will depend on our future performance, which to a certain extent is subject to general economic, financial, competitive, legislative, regulatory and other factors beyond our control. We also believe that if we pursue any material acquisitions in the foreseeable future we will need to finance this activity through the issuance of equity or additional debt financing.

Changes in Cash Flows

The following table shows the components of our cash flows for the periods presented (in millions):

	Years Ended December 31,	
	2013	2012
Net cash provided by operating activities	$ 6.6	$ 5.9
Net cash used in investing activities	$ (7.3)	$ (5.9)
Net cash provided by financing activities	$ 0.9	$ 5.1

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Net Cash Flows from Operating Activities

Net cash provided by operating activities increased to $6.6 million for 2013 from $5.9 million for 2012, driven primarily by the lower loss from continuing operations partially offset by an increase in cash used to fund net working capital components.

Net Cash Flows from Investing Activities

Net cash used in investing activities increased to $7.3 million for 2013 from $5.9 million for 2012, caused by increases in cash used for capital expenditures.

Our primary investing activities are typically capital expenditures for property, equipment and bottles and include expenditures related to the installation of our recycle centers, display racks and reverse osmosis filtration systems at new Water locations. For 2013, investing activities also included capital expenditures for the implementation of a remote monitoring technology used in our Refill services business.

Net Cash Flows from Financing Activities

Net cash provided by financing activities decreased to $0.9 million for 2013 from $5.1 million for 2012. During 2013, cash provided by financing activities was primarily related to net borrowings on our credit facility and term loans of $1.6 million, which were partially offset by debt issuance costs of $0.8 million. During 2012, cash provided by financing activities was primarily related to net borrowings on our credit facilities and term loans of $7.7 million, which were partially offset by debt issuance costs of $2.2 million.

Senior Revolving Credit Facility

We entered into the Senior Revolving Credit Facility on April 30, 2012, as amended on February 21, 2013, that replaced our prior senior credit facility. The Senior Revolving Credit Facility provides for total borrowing availability of up to $20.0 million, subject to borrowing base requirements related to our eligible accounts receivable and inventory and subject to a $2.0 million reserve requirement. The Senior Revolving Credit Facility has a three and one-half year term and is secured either on a first priority or second priority basis by substantially all of our assets. The term of the Senior Revolving Credit Facility may be extended up to April 30, 2017 so long as the maturity of the Comvest Term Loans (as defined below) is extended to at least October 30, 2017. At December 31, 2013, we had $3.1 million in outstanding borrowings at a weighted-average interest rate of 6.0%, with $0.5 million in additional availability under the Senior Revolving Credit Facility after giving effect to the borrowing base requirements.

Interest on outstanding borrowings under the Senior Revolving Credit Facility is payable at our option at either a floating base rate or a one-, two- or three-month LIBOR rate. We are also required to pay a commitment fee on the unused amount of the commitment under the Senior Revolving Credit Facility. The Senior Revolving Credit Facility contains a limit on capital expenditures of $6.0 million for the year ended December 31, 2013 and for each year thereafter. The limit for capital expenditures may be increased based upon meeting the fixed charge coverage ratio, as stipulated and defined in the Senior Revolving Credit Facility. For the year ended December 31, 2013, the limit was increased based upon our fixed charge coverage ratio. In addition, the Senior Revolving Credit Facility does cross default to the Comvest Credit Agreement (as defined below). Life-to-date costs associated with the Senior Revolving Credit Facility were $0.9 million, which were capitalized and will be amortized as part of interest expense over the term of the debt. At December 31, 2013, accumulated amortization related to Senior Revolving Credit Facility deferred loan costs was $0.4 million.

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Comvest Term Loans

We entered into a credit and security agreement on April 30, 2012 (the "Credit Agreement") pursuant to which a $15.2 million term loan (the "Term Loan") was provided. The Credit Agreement was amended on November 6, 2012 (the "First Amendment") to contemplate the plan to exit the Flavorstation business (see Note 4 of the Notes to the Consolidated Financial Statements) and provide for the classification of the operating results related to the Disposal Group as discontinued operations. In connection with the amendment, the lender consented to our sale of inventory and other assets related to the Disposal Group outside the ordinary course of business. Also in connection with the First Amendment, we paid the lender a $0.15 million fee and agreed to certain changes to prepayment penalties and financial covenants.

The Credit Agreement was amended on June 14, 2013 (the "Second Amendment") to provide for an additional $3.0 million in borrowing under an additional term loan (the "First Add-On Term Loan", and together with the Term Loan, the "Second Add-On Term Loan" and the "Third Add-On Term Loan" described below, the "Comvest Term Loans"), adjust the interest rate on the Term Loan, eliminate certain financial covenants and make further adjustments to prepayment penalties. Under the terms of the Second Amendment, interest on outstanding amounts owed under the Comvest Term Loans is payable at the rate of 12.5% per annum in cash. Also in connection with the Second Amendment, we paid the lender amendment and funding fees of $0.4 million.

On December 24, 2013, we entered into an amendment (the "Third Amendment") to the Credit Agreement to provide for two additional term loans: the $2.5 million "Second Add-On Term Loan" provided on the date of the Third Amendment; and the $2.5 million "Third Add-On Term Loan" provided in January 2014. The interest and other terms of the Second and Third Add-On Term Loans are consistent with those described above for the First Add-On Term Loan. The Third Amendment also revised the Credit Agreement to make certain adjustments to the definition of EBITDA to contemplate the strategic alliance with DS Waters and the increasing minimum EBITDA thresholds applicable to Primo that are measured at the end of each quarter, as described below. Also in connection with the Third Amendment, we paid the lender amendment and funding fees of $0.3 million.

The outstanding balance of the Comvest Term Loans is due and payable in a single installment on April 30, 2016, subject to prepayment in specified circumstances, including sales or dispositions of assets outside the ordinary course of business and sales of equity or debt securities by the Company. The Comvest Term Loans are secured by substantially all of our assets on either a first priority or second priority basis. The first priority assets consist of substantially all of the assets related to our refill services business. The security interest in all of our other assets is subordinate to the security interest securing the Senior Revolving Credit Facility. At December 31, 2013, our outstanding balance under our Comvest Term Loans was $21.0 million and at January 31, 2014, our outstanding balance under our Comvest Term Loans increased to $23.5 million as a result of the Third Add-On Term Loan.

The Credit Agreement contains the following financial covenants: (i) a limit on capital expenditures of $12.0 million for the year ended December 31, 2013 and for each year thereafter; (ii) an increasing minimum adjusted earnings before interest, taxes, depreciation and amortization ("Adjusted EBITDA") threshold that is measured at the end of each quarter, and (iii) a decreasing total debt to Adjusted EBITDA ratio that is measured at the end of each quarter.

At December 31, 2013 we were in compliance with all covenants, including the following: the minimum Adjusted EBITDA threshold was $8.8 million and our Adjusted EBITDA was $9.1 million for the twelve months ended December 31, 2013; and the maximum allowed total debt to Adjusted EBITDA ratio was 3.7:1 and our ratio was 2.7:1 for the twelve months ended December 31, 2013.

Life-to-date costs associated with the Term Loan were $1.1 million, which were capitalized and will be amortized as part of interest expense over the term of the debt. Life-to-date costs associated with the Second and Third

Amendments were $0.8 million, which were reflected as adiscount on our debt and will be amortized as part of interest expense over the remaining term of the debt.

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Adjusted EBITDA U.S. GAAP Reconciliation

Adjusted EBITDA is a non-U.S. GAAP financial measure that is calculated as loss from continuing operations before income tax benefit, interest expense and other, net, depreciation and amortization, goodwill and other impairment, non-cash stock-based compensation expense, non-recurring costs, loss on disposal of assets and other.

Our Credit Agreement contains financial covenants that use Adjusted EBITDA. We believe Adjusted EBITDA provides useful information to management and investors regarding certain financial and business trends relating to our financial condition and results of operations. Adjusted EBITDA is used by management to compare our performance to that of prior periods for trend analyses and planning purposes and is presented to our board of directors.

Non-U.S. GAAP measures should not be considered a substitute for, or superior to, financial measures calculated in accordance with U.S. GAAP. Adjusted EBITDA excludes significant expenses that are required by U.S. GAAP to be recorded in our financial statements and is subject to inherent limitations. In addition, other companies in our industry may calculate this non-U.S. GAAP measure differently than we do or may not calculate it at all, limiting its usefulness as a comparative measure. The table below provides a reconciliation between loss from continuing operations and Adjusted EBITDA.

	Years ended December 31,	
	2013	2012
Loss from continuing operations	$ (8,844)	$ (93,250)
Depreciation and amortization	11,333	11,102
Interest expense and other, net	4,425	4,043
Income tax benefit	–	(961)
EBITDA	6,914	(79,066)
Goodwill and other impairments	–	82,013
Non-cash, stock-based compensation expense	1,034	1,252
Non-recurring costs	777	743
Loss on disposal of assets and other	342	509
Adjusted EBITDA	$ 9,067	$ 5,451

Off-Balance Sheet Arrangements

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

Inflation

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

Seasonality; Fluctuations of Results

We have experienced and expect to continue to experience seasonal fluctuations in our sales and operating income. Our sales and operating income have been highest in the spring and summer and lowest in the fall and winter. Our Water segment, which generally enjoys higher margins than our Dispensers segment, experiences higher sales and operating income in the spring and summer. We have historically experienced higher sales and operating income from

our water dispensers in spring and summer; however, we believe the seasonality of dispenser sales are more dependent on retailer inventory management and purchasing cycles and not correlated to weather. Sustained periods of poor weather, particularly in the spring and summer, can negatively impact our sales in our higher margin Water segment. Accordingly, our results of operations in any quarter will not necessarily be indicative of the results that we may achieve for a year or any future quarter.

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Critical Accounting Policies and Estimates

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

Revenue Recognition. Revenue is recognized for the sale of multi-gallon purified bottled water upon either the delivery of inventory to the retail store or the purchase by the consumer. Revenue is either recognized as an exchange transaction (where a discount is provided on the purchase of a multi-gallon bottle of purified water for the return of an empty multi-gallon bottle) or a non-exchange transaction. Revenues on exchange transactions are recognized net of the exchange discount. Self-service refill water revenue is recognized as the water is filtered, which is measured by the water dispensing equipment meter.

Revenue is recognized for the sale of our water dispenser products when title is transferred to our retail customers. We have no contractual obligation to accept returns nor do we guarantee sales. However, we will at times accept returns or issue credits for manufacturer defects or that were damaged in transit. Revenues are recognized net of an estimated allowance for returns using an average return rate based upon historical experience.

In addition, we offer certain incentives such as coupons and rebates that are netted against and reduce net sales in the consolidated statements of operations. With the purchase of certain of our water dispensers we include a coupon for a free multi-gallon bottle of purified water. No revenue is recognized with respect to the redemption of the coupon for a free multi-gallon bottle of water and the estimated cost of the multi-gallon bottle of purified water is included in cost of sales.

Allowance for Doubtful Accounts. We maintain an allowance for doubtful accounts for estimated losses resulting from our retail customers' inability to pay us. The allowance for doubtful accounts is based on a review of specifically identified accounts in addition to an overall aging analysis. Judgments are made with respect to the collectability of accounts receivable based on historical experience and current economic trends. These amounts are continuously monitored as additional information is obtained. Any material change in our customers' business or cash flows would affect our ability to collect amounts due.

Long-Lived Assets. We review long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. The carrying amount of a long-lived asset is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset at the date it is tested for recoverability, whether in use or under development. An impairment loss is measured as the amount by which the carrying amount of a long-lived asset exceeds its fair value.

Goodwill and Intangible Assets. We classify intangible assets into three categories: (1) intangible assets with definite lives subject to amortization, (2) intangible assets with indefinite lives not subject to amortization and (3) goodwill. We determine the useful lives of our identifiable intangible assets after considering the specific facts and circumstances related to each intangible asset. Factors we consider when determining useful lives include the contractual term of any agreement related to the asset, the historical performance of the asset, our long-term strategy for using the asset, any laws or other local regulations which could impact the useful life of the asset, and other

economic factors, including competition and specific market conditions. Intangible assets that are deemed to have definite lives are amortized, primarily on a straight-line basis, over their useful lives.

We test intangible assets determined to have indefinite useful lives for impairment annually, or more frequently if events or circumstances indicate that assets might be impaired. We perform these annual impairment tests as of the first day of our fourth quarter. In evaluating goodwill for impairment, we perform a two-step goodwill impairment test. The first step involves a comparison of the fair value of a reporting unit to its carrying value. The fair value is estimated based on a number of factors including operating results, business plans, future cash flows and the market approach. If the carrying amount of the reporting unit exceeds its fair value, the second step of the process is performed which compares the implied value of the reporting unit goodwill with the carrying value of the goodwill of that reporting unit. If the carrying value of the goodwill of a reporting unit exceeds the implied fair value of that goodwill, an impairment loss is recognized in an amount equal to that excess. As described in Note 2 in the Notes to the Consolidated Financial Statements, we recorded non-cash goodwill impairment charges of $67.7 million and $11.5 million effective December 31, 2012 and June 30, 2012, respectively, for the Water reporting unit. As a result of these impairments, no Goodwill was reported on our Consolidated Balance Sheets for the years ended December 31, 2013 and 2012.

We determine the fair value of our reporting units based on a combination of the income approach, weighted based on the circumstances, using a discounted cash flow model, and a market approach, which considers comparable companies and transactions. Under the income approach, the discounted cash flow model determines fair value based on the present value of projected cash flows over a specific projection period and a residual value related to future cash flows beyond the projection period. Both values are discounted using a rate which reflects our best estimate of the weighted average cost of capital of a market participant, and is adjusted for appropriate risk factors. We perform sensitivity tests with respect to growth rates and discount rates used in the income approach. Under the market approach, valuation multiples are derived based on a selection of comparable companies and acquisition transactions, and applied to projected operating data for each reporting unit to arrive at an indication of fair value.

For indefinite-lived intangible assets, other than goodwill, the impairment test consists of a comparison of the fair value of the intangible asset with its carrying amount. If the carrying amount exceeds the fair value, an impairment charge is recognized in an amount equal to that excess.

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

As required by U.S. GAAP, we recognize the financial statement benefit of a tax position only after determining that the relevant tax authority would more likely than not sustain the position following an audit. For tax positions meeting the more-likely-than-not threshold, the amount recognized in the financial statements is the largest benefit that has a greater than 50 percent likelihood of being realized upon ultimate settlement with the relevant tax authority.

Stock-Based Compensation. We account for our stock-based employee and director compensation plans in accordance with U.S. GAAP, which requires recognition of the cost of employee services received in exchange for an award of equity instruments in the financial statements over the period the employee is required to perform the services in exchange for the award (presumptively the vesting period).

We measure the fair value of each stock option grant at the date of grant using a Black-Scholes option pricing model. Stock options are granted with an exercise price equal to 100% of the fair market value per share of the common stock on the date of grant. The options generally vest over a period of one to four years, based on graded vesting, and expire ten years from the date of grant. The terms and conditions of the awards made under the Plans vary

but, in general, are at the discretion of the board of directors or its appointed committee.

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The risk free interest rate is based on the U.S. Treasury rate for the expected life at the time of grant. As a result of our limited trading history beginning on November 5, 2010, our expected volatility is based on the average long-term historical volatilities of peer companies. We intend to continue to consistently use the same group of publicly traded peer companies to determine expected volatility in the future until sufficient information regarding volatility of our share price becomes available or the selected companies are no longer suitable for this purpose. Also, due to our limited trading history, we are using the "simplified method" to calculate expected holding periods, which represents the period of time that options granted are expected to be outstanding. We will continue to use this method until we have sufficient historical exercise experience to give us confidence that our calculations based on such experience will be reliable. The dividend yield assumption is based on our current intent not to issue dividends.

Recent Accounting Pronouncements

Reporting of Amounts Reclassified out of Accumulated Other Comprehensive Income

February 2013, the FASB issued updated guidance which requires companies to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, companies are required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by respective line items of net income but only if the amount reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures required under U.S. GAAP that provide additional detail about those amounts. We have adopted this updated guidance effective January 1, 2013. The adoption did not have a significant impact on our consolidated financial statements.

Presentation of Unrecognized Tax Benefits

In July 2013, the FASB issued updated guidance requiring that an unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except as follows. To the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented as a liability and should not be combined with deferred tax assets. We will adopt this updated guidance effective January 1, 2014. The amendments are not expected to have a significant impact on our consolidated financial statements.

Item 7A. Quantitative and Qualitative Disclosure About Market Risk

The information required by Item 7A is not required to be provided by issuers that satisfy the definition of "smaller reporting company" under SEC rules.

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Item 8. Financial Statements and Supplementary Data

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Management’s Report on Internal Control Over Financial Reporting

The Company’s management is responsible for establishing and maintaining adequate internal control over financial reporting. Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

The Company’s internal control over financial reporting includes policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect transactions and dispositions of assets; (2) provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures are being made only in accordance with authorizations of management and the board of directors of Primo; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company’s assets that could have a material effect on our financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of the Company’s internal control over financial reporting as of December 31, 2013. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework (1992 framework). Based on our assessment and those criteria, management has concluded that we maintained effective internal control over financial reporting as of December 31, 2013.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Primo Water Corporation

We have audited the accompanying consolidated balance sheets of Primo Water Corporation and subsidiaries (the "Company") as of December 31, 2013 and 2012, and the related consolidated statements of operations, comprehensive loss, stockholders' equity (deficit) and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Primo Water Corporation and subsidiaries as of December 31, 2013 and 2012, and the results of their operations and their cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

/s/ McGladrey LLP

Raleigh, North Carolina
March 17, 2014

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PRIMO WATER CORPORATION
CONSOLIDATED BALANCE SHEETS
(In thousands, except par value information)

	December 31, 2013	December 31, 2012
ASSETS		
Current assets:		
Cash	$394	$234
Accounts receivable, net	7,614	9,894
Inventories	6,346	7,572
Prepaid expenses and other current assets	1,274	812
Current assets of disposal group held for sale	225	3,041
Total current assets	15,853	21,553
Bottles, net	4,104	3,838
Property and equipment, net	38,634	41,947
Intangible assets, net	10,872	12,477
Other assets	1,508	1,960
Total assets	$70,971	$81,775
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$10,943	$11,455
Accrued expenses and other current liabilities	3,380	4,305
Current portion of capital leases and notes payable	16	15
Current liabilities of disposal group held for sale	92	2,784
Total current liabilities	14,431	18,559
Long-term debt, capital leases and notes payable, net of current portion	22,654	21,251
Other long-term liabilities	330	352
Liabilities of disposal group held for sale, net of current portion	2,000	–
Total liabilities	39,415	40,162
Commitments and contingencies		
Stockholders’ equity:		
Preferred stock, $0.001 par value - 10,000 shares authorized, none issued and outstanding	–	–
Common stock, $0.001 par value - 70,000 shares authorized, 24,076 and 23,772 shares issued and outstanding at December 31, 2013 and 2012, respectively	24	24
Additional paid-in capital	273,379	272,336
Common stock warrants	8,420	8,420
Accumulated deficit	(249,837)	(239,131)
Accumulated other comprehensive loss	(430)	(36)
Total stockholders’ equity	31,556	41,613
Total liabilities and stockholders’ equity	$70,971	$81,775

The accompanying notes are an integral part of the consolidated financial statements.

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PRIMO WATER CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share amounts)

	Years Ended December 31,	
	2013	2012
Net sales	$91,209	$91,479
Operating costs and expenses:		
Cost of sales	68,367	70,081
Selling, general and administrative expenses	15,151	17,708
Non-recurring costs	777	743
Depreciation and amortization	11,333	11,102
Goodwill and other impairments	–	82,013
Total operating costs and expenses	95,628	181,647
Loss from operations	(4,419)	(90,168)
Interest expense and other, net	4,425	4,043
Loss from continuing operations before income taxes	(8,844)	(94,211)
Income tax benefit	–	(961)
Loss from continuing operations	(8,844)	(93,250)
Loss from discontinued operations	(1,862)	(17,779)
Net loss	$(10,706)	$(111,029)
Basic and diluted loss per common share:		
Loss from continuing operations	$(0.37)	$(3.93)
Loss from discontinued operations	(0.08)	$(0.75)
Net loss	$(0.45)	$(4.68)
Basic and diluted weighted average common shares outstanding	23,935	23,725

The accompanying notes are an integral part of the consolidated financial statements.

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PRIMO WATER CORPORATION
CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS
(In thousands)

	Years Ended December 31,	
	2013	2012
Net loss	$(10,706)	$(111,029)
Other comprehensive (income) loss:		
Foreign currency translation adjustments, net	(394)	484
Comprehensive loss	$(11,100)	$(110,545)

The accompanying notes are an integral part of the consolidated financial statements

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PRIMO WATER CORPORATION
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)
(In thousands)

	Common Stock		Additional Paid-in Capital	Common Stock Warrants	Accumulated Other Comprehensive Income	Accumulated Deficit	Total Stockholders' Equity
	Shares	Amount					
Balance, December 31, 2011	23,658	$ 24	$ 271,220	$ 7,007	$ (520)	$ (128,102)	$ 149,629
Employee stock compensation plans, net	114	–	1,290	–	–	–	1,290
Issuance of common stock, net of issuance costs	–	–	(174)	–	–	–	(174)
Issuance and modification of warrant	–	–	–	1,413	–	–	1,413
Net loss	–	–	–	–	–	(111,029)	(111,029)
Other comprehensive income	–	–	–	–	484	–	484
Balance, December 31, 2012	23,772	$ 24	$ 272,336	$ 8,420	$ (36)	$ (239,131)	$ 41,613
Employee stock compensation plans, net	304	–	1,047	–	–	–	1,047
Issuance of common stock, net of issuance costs	–	–	(4)	–	–	–	(4)
Net loss	–	–	–	–	–	(10,706)	(10,706)
Other comprehensive loss	–	–	–	–	(394)	–	(394)
Balance, December 31, 2013	24,076	$ 24	$ 273,379	$ 8,420	$ (430)	$ (249,837)	$ 31,556

The accompanying notes are an integral part of the consolidated financial statements.

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PRIMO WATER CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Years Ended December 31,	
	2013	2012
Cash flows from operating activities:		
Net loss	$(10,706)	$(111,029)
Less: Loss from discontinued operations	(1,862)	(17,779)
Loss from continuing operations	(8,844)	(93,250)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	11,333	11,102
Stock-based compensation expense	1,034	1,252
Non-cash interest expense	1,162	2,002
Deferred income tax expense	–	(961)
Goodwill impairment	–	82,013
Other	(6)	263
Changes in operating assets and liabilities:		
Accounts receivable	2,464	2,253
Inventories	1,205	(1,257)
Prepaid expenses and other assets	(308)	(100)
Accounts payable	(437)	943
Accrued expenses and other liabilities	(970)	1,602
Net cash provided by operating activities	6,633	5,862
Cash flows from investing activities:		
Purchases of property and equipment	(4,793)	(4,038)
Purchases of bottles, net of disposals	(2,507)	(1,291)
Proceeds from the sale of property and equipment	38	81
Additions to and acquisitions of intangible assets	(45)	(663)
Net cash used in investing activities	(7,307)	(5,911)
Cash flows from financing activities:		
Borrowings under revolving credit facilities	91,135	46,194
Payments under revolving credit facilities	(95,067)	(53,617)
Borrowings under Comvest Term loans	5,500	15,150
Note payable and capital lease payments	(15)	(14)
Debt issuance costs	(797)	(2,203)
Proceeds from sale of common stock, net of issuance costs	(4)	(491)
Stock option and employee stock purchase activity, net	130	39
Net cash provided by financing activities	882	5,058
Net increase in cash	208	5,009
Cash, beginning of year	234	751
Effect of exchange rate changes on cash	(104)	9
Cash provided by (used in) discontinued operations from:		
Operating activities	56	(5,226)
Investing activities	–	(309)

Cash provided by (used in) discontinued operations	56	(5,535)
Cash, end of period	$394	$234

The accompanying notes are an integral part of the consolidated financial statements.

PRIMO WATER CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except per share amounts)

1. Description of Business and Significant Accounting Policies

Business

Primo Water Corporation (together with its consolidated subsidiaries, "Primo", "we", "our," "us") is a leading provider of multi-gallon purified bottled water, self-service refill water and water dispensers sold through major retailers in the United States and Canada.

Principles of Consolidation

Our consolidated financial statements include the accounts of Primo and our wholly-owned subsidiaries. All intercompany amounts and transactions have been eliminated in consolidation. Our consolidated statements have been prepared in accordance with generally accepted accounting principles in the United States ("U.S. GAAP").

Use of Estimates

The preparation of our financial statements in conformity with U.S. GAAP requires us to make certain estimates, judgments and assumptions. We believe that the estimates, judgments and assumptions used to determine certain amounts that affect the financial statements are reasonable, based on information available at the time they are made. To the extent there are material differences between these estimates and actual results, our consolidated financial statements may be affected. Some of the more significant estimates include allowances for doubtful accounts, valuation of inventories, future cash flows associated with long-lived assets, fair value assumptions in analyzing goodwill, depreciation, valuation of intangible assets, valuation of deferred taxes and allowance for sales returns.

Reclassifications

Certain amounts reported previously have been reclassified to conform to the current year presentation, with no effect on stockholders' equity or net loss as previously presented.

Discontinued Operations

As described in Note 4, during 2012, we committed to a plan to sell the assets of the sparkling beverage appliances, flavorings, CO2 cylinders and accessories business sold under the Flavorstation brand (the "Disposal Group"). We determined that the Disposal Group meets the criteria for classification as discontinued operations. As a result, the results of operations and financial position of the Disposal Group for the current and prior year are reflected as discontinued operations.

DS Waters' Agreement

On November 12, 2013, we entered into a strategic alliance agreement (the "DS Agreement") with DS Waters of America, Inc. ("DS Waters") pursuant to which DS Waters will act as our primary bottler and distributor and provider of exchange and supply services for the Exchange business in the United States. Pursuant to the DS Agreement, DS Waters will become our primary bottler and distributor in the United States in all territories for which we do not currently have an existing distributor agreement and in other territories as existing distributor arrangements expire or are terminated. We currently expect the transition from our current network of distributors to DS Waters to occur over

a two year period.

Revenue Recognition

Revenue is recognized for the sale of multi-gallon purified bottled water upon either the delivery of inventory to the retail store or the purchase by the consumer. Revenue is either recognized as an exchange transaction (where a discount is provided on the purchase of a multi-gallon bottle of purified water for the return of an empty multi-gallon bottle) or a non-exchange transaction. Revenues on exchange transactions are recognized net of the exchange discount. Self-service refill water revenue is recognized as the water is filtered, which is measured by the water dispensing equipment meter.

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Revenue is recognized for the sale of our water dispenser products when title is transferred to our retail customers. We have no contractual obligation to accept returns nor do we guarantee sales. However, we will at times accept returns or issue credits for manufacturer defects or that were damaged in transit. Revenues are recognized net of an estimated allowance for returns using an average return rate based upon historical experience.

In addition, we offer certain incentives such as coupons and rebates that are netted against and reduce net sales in the consolidated statements of operations. With the purchase of certain of our water dispensers we include a coupon for a free multi-gallon bottle of purified water. No revenue is recognized with respect to the redemption of the coupon for a free multi-gallon bottle of water and the estimated cost of the multi-gallon bottle of purified water is included in cost of sales.

Cash and Cash Equivalents

All highly liquid investments with an original maturity of three months or less at the date of purchase are considered to be cash equivalents.

Accounts Receivable

All trade accounts receivable are due from customers located within the United States and Canada. We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. Accounts receivable, net includes allowances for doubtful accounts of $321 and $792 at December 31, 2013 and 2012, respectively. The allowance for doubtful accounts is based on a review of specifically identified accounts in addition to an overall aging analysis. Judgments are made with respect to the collectability of accounts receivable based on historical experience and current economic trends. Actual losses could differ from those estimates.

	Beginning Balance	Amounts Charged or (Credited) to Expense	Deductions	Ending Balance
Year ended December 31, 2013	$ 792	(275)	(196)	$ 321
Year ended December 31, 2012	$ 471	410	(89)	$ 792

Inventories

Our inventories consist primarily of finished goods and are valued at the lower of cost or realizable value, with cost determined using the first-in, first-out (FIFO) method. Miscellaneous selling supplies such as labels are expensed when purchased.

Bottles

Bottles consist of three- and five- gallon refillable polycarbonate bottles used in our exchange business and are stated at cost, less accumulated depreciation. Depreciation is calculated using the straight-line method over the estimated useful life of two years. During 2012, we changed our estimate of the useful life of bottles which resulted in incremental depreciation expense of $358 for the last six months of 2012 reported in depreciation and amortization in our Consolidated Statements of Operations.

Property and Equipment

Property and equipment are stated at cost, less accumulated depreciation and amortization. Internal and external costs incurred to acquire and create internal use software are capitalized and amortized over the useful life of the software. Depreciation and amortization is generally calculated using straight-line methods over estimated useful lives that range from two to ten years, taking into account estimated salvage values for certain assets.

We incur maintenance costs on our major equipment. Maintenance, repair and minor refurbishment costs are charged to expense as incurred, while additions, renewals, and improvements are capitalized.

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Customer Bottle Deposits

In our Canadian Exchange business, we collect a refundable deposit on each customer's initial purchase of our water. If a customer decides to exit our program, the deposit is refunded. At December 31, 2013 and 2012, customer bottle deposits of $708 and $773, respectively, were reported in accrued expenses and other current liabilities on our Consolidated Balance Sheets. Beginning in 2013, we estimate a portion of deposits which, based on historical experience, we do not believe will be refunded to customers. For the year ended December 31, 2013, the customer bottle deposit liability was reduced by $180 for such estimates.

Goodwill and Intangible Assets

We classify intangible assets into three categories: (1) intangible assets with definite lives subject to amortization, (2) intangible assets with indefinite lives not subject to amortization and (3) goodwill. We determine the useful lives of our identifiable intangible assets after considering the specific facts and circumstances related to each intangible asset. Factors we consider when determining useful lives include the contractual term of any agreement related to the asset, the historical performance of the asset, our long-term strategy for using the asset, any laws or other local regulations which could impact the useful life of the asset, and other economic factors, including competition and specific market conditions. Intangible assets that are deemed to have definite lives are amortized, primarily on a straight-line basis, over their useful lives.

We test intangible assets determined to have indefinite useful lives for impairment annually, or more frequently if events or circumstances indicate that assets might be impaired. We perform these annual impairment tests as of the first day of our fourth quarter. In evaluating goodwill for impairment, we perform a two-step goodwill impairment test. The first step involves a comparison of the fair value of a reporting unit to its carrying value. The fair value is estimated based on a number of factors including operating results, business plans, future cash flows and the market approach. If the carrying amount of the reporting unit exceeds its fair value, the second step of the process is performed which compares the implied value of the reporting unit goodwill with the carrying value of the goodwill of that reporting unit. If the carrying value of the goodwill of a reporting unit exceeds the implied fair value of that goodwill, an impairment loss is recognized in an amount equal to that excess. We recorded non-cash goodwill impairment charges of $67,658 and $11,488 effective December 31, 2012 and June 30, 2012, respectively, for the Water reporting unit. As a result of these impairments, no Goodwill was reported on our Consolidated Balance Sheets for the years ended December 31, 2013 and 2012.

We determine the fair value of our reporting units based on a combination of the income approach, weighted based on the circumstances, using a discounted cash flow model, and a market approach, which considers comparable companies and transactions. Under the income approach, the discounted cash flow model determines fair value based on the present value of projected cash flows over a specific projection period and a residual value related to future cash flows beyond the projection period. Both values are discounted using a rate which reflects our best estimate of the weighted average cost of capital of a market participant, and is adjusted for appropriate risk factors. We perform sensitivity tests with respect to growth rates and discount rates used in the income approach. Under the market approach, valuation multiples are derived based on a selection of comparable companies and acquisition transactions, and applied to projected operating data for each reporting unit to arrive at an indication of fair value.

For indefinite-lived intangible assets, other than goodwill, the impairment test consists of a comparison of the fair value of the intangible asset with its carrying amount. If the carrying amount exceeds the fair value, an impairment charge is recognized in an amount equal to that excess.

Long-Lived Assets

We review long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. The carrying amount of a long-lived asset is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset at the date it is tested for recoverability, whether in use or under development. An impairment loss is measured as the amount by which the carrying amount of a long-lived asset exceeds its fair value.

Stock-Based Compensation

U.S. GAAP requires recognition of the cost of employee services received in exchange for an award of equity instruments in the financial statements over the period the employee is required to perform the services in exchange for the award (presumptively the vesting period). We measure the fair value of each stock option grant at the date of grant using a Black-Scholes option pricing model. Stock options are granted with an exercise price equal to 100% of the fair market value per share of the common stock on the date of grant. The options generally vest over a period of one to four years, based on graded vesting, and expire ten years from the date of grant.

Research, Development and Engineering

Research, development and engineering costs, primarily related to the design and innovation of water dispensers, are expensed as incurred.

Advertising Costs

Costs incurred for producing and distributing advertising and advertising materials are expensed as incurred or the first time the advertising takes place. Advertising costs totaled $70 and $230 for 2013 and 2012, respectively, and are included in selling, general, and administrative expenses.

Concentrations of Risk

Our principal financial instruments subject to potential concentration of credit risk are cash and cash equivalents, trade receivables, accounts payable and accrued expenses. We invest our funds in a highly rated institution and believe the financial risks associated with cash and cash equivalents are minimal. At December 31, 2013 and 2012, $171 and $233, respectively, of our cash on deposit exceeded the insured limits.

We perform ongoing credit evaluations of our customers' financial condition and maintain allowances for doubtful accounts that we believe are sufficient to provide for losses that may be sustained on realization of accounts receivable. We had two customers that accounted for approximately 45% and 25% of sales in 2013 and two customers that accounted for approximately 43% and 22% of sales in 2012. We had three customers that accounted for approximately 42%, 11% and 8% of total trade receivables at December 31, 2013 and three customers that accounted for approximately 49%, 8% and 7% of total trade receivables at December 31, 2012.

Basic and Diluted Net loss Per Share

Net loss per share has been computed using the weighted average number of shares of common stock outstanding during each period. Diluted amounts per share include the dilutive impact, if any, of our outstanding potential common shares, such as options and warrants and convertible preferred stock. Potential common shares that are anti-dilutive are excluded from the calculation of diluted net loss per common share.

For the years ended December 31, 2013 and 2012, stock options, unvested shares of restricted stock, restricted stock units and warrants with respect to an aggregate of 2,611 and 1,976 shares have been excluded from the computation of the number of shares used in the diluted earnings per share, respectively. These shares have been excluded because we incurred a net loss for each of these periods and their inclusion would be anti-dilutive.

Income Taxes

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

As required by U.S. GAAP, we recognize the financial statement benefit of a tax position only after determining that the relevant tax authority would more likely than not sustain the position following an audit. For tax positions meeting the more-likely-than-not threshold, the amount recognized in the financial statements is the largest benefit that has a greater than 50 percent likelihood of being realized upon ultimate settlement with the relevant tax authority.

Cumulative Translation Adjustment and Foreign Currency Transactions

The local currency of our operations in Canada is considered to be the functional currency. Assets and liabilities of the Canada subsidiary are translated into U. S. dollars using the exchange rates in effect at the balance sheet date. Results of operations are translated using the average exchange rate prevailing throughout the period. The effects of unrealized exchange rate fluctuations on translating foreign currency assets and liabilities into U. S. dollars are accumulated as the cumulative translation adjustment included in accumulated other comprehensive income (loss) in the statement of stockholders' equity. With the exception of transaction gains and losses on certain intercompany balances which we have determined are of a long-term investment nature, realized gains and losses on foreign currency transactions are included in the statement of operations. At December 31, 2013 and 2012, accumulated other comprehensive loss balances of $430 and $36, respectively, were related to unrealized foreign currency translation adjustments and transaction gains and losses on certain intercompany balances.

Non-recurring costs

Transactions that are unusual in nature or which occur infrequently, but not both, are reported as non-recurring costs on our Consolidated Statements of Operations. Non-recurring costs consist primarily of legal and other expenses associated with the DS Agreement as well as other legal, severance and restructuring-related expenses.

Recent Accounting Pronouncements

Reporting of Amounts Reclassified out of Accumulated Other Comprehensive Income

February 2013, the FASB issued updated guidance which requires companies to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, companies are required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by respective line items of net income but only if the amount reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures required under U.S. GAAP that provide additional detail about those amounts. We have adopted this updated guidance effective January 1, 2013. The adoption did not have a significant impact on our consolidated financial statements.

Presentation of Unrecognized Tax Benefits

In July 2013, the FASB issued updated guidance requiring that an unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except as follows. To the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented as a liability and should not be combined with deferred tax assets. We will adopt this updated guidance effective January 1, 2014. The amendments are not expected to have a significant impact on our consolidated financial statements.

2. Goodwill and Other Impairments

Goodwill

The changes in the carrying amount of goodwill for 2012 are summarized as follows:

		Water
Balance at December 31, 2011	$	78,823
Goodwill impairment		(79,146)
Effect of foreign currency translation		323
Balance at December 31, 2012	$	–

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Effective October 1, 2012, we performed the annual impairment test of our goodwill. The first step of the impairment test involves a comparison of the fair value of each reporting unit that carries goodwill to its carrying value. As of our impairment testing date, the Water reporting unit was the only reporting unit carrying goodwill. The fair value is estimated based on a number of factors including operating results, business plans, future cash flows and the market approach. Based on the results of step one of the impairment test, we determined that our Water reporting unit had a carrying value higher than its estimated fair value. We performed the second step of impairment test which required us to compare the implied value of the reporting unit goodwill to its carrying value. If the carrying value of the goodwill of a reporting unit exceeds the implied fair value of that goodwill, an impairment loss is recognized in an amount equal to that excess. We had to determine the implied fair value of goodwill in the same manner as if we had acquired the reporting unit in an arm's length transaction as of the testing date. We performed this analysis by deducting the estimated fair value of all tangible and identifiable intangible net assets of the reporting unit from the estimated fair value of the reporting unit. Because the recorded amount of goodwill exceeded the amount of goodwill that would have been recorded under the second step as of the impairment testing date, we recorded a non-cash goodwill impairment charge of $67,658 million for the Water reporting unit, representing a full impairment. The impairment was primarily the result of placing greater weight on the market valuation approach. The sustained decrease in our stock price relative to our book value resulted in placing a greater weight on the market approach in determining the fair value of the Water reporting unit compared to our annual 2011 and interim 2012 impairment tests.

Effective June 30, 2012, we performed a step one interim impairment test of our goodwill and other identifiable intangible assets due to events and changes in circumstances that indicated impairment might have occurred. The factor deemed by management to have constituted a potential impairment triggering event was the sustained decrease in our stock price relative to our book value. This test was performed for each of our reporting units that carried goodwill as of the testing date: Water and the Disposal Group. See Note 4 for further discussion of the impairment recorded for the Disposal Group. Based on the results of the step one test we determined that our Water reporting unit had a carrying value higher than its estimated fair value. We performed the second step of the impairment test following the same approach described for our annual test and recorded an $11,488 million non-cash goodwill impairment charge in the quarter ended June 30, 2012.

Electrotemp Receivable

In October 2011, Primo, through a wholly-owned subsidiary, filed a complaint against our third-party manufacturer, Electrotemp Technologies China, Inc. for breach of contract that arose out of failure to credit us for defective water coolers (see "Electrotemp" in Note 11). In connection with the warranty claims we had recorded a warranty receivable of $2,866 from the manufacturer, Electrotemp Technologies China, Inc. As of December 31, 2012, as a result of the uncertainties of the outcome of the arbitration we recorded an impairment charge for the full amount of the warranty receivable reflected in Goodwill and other impairments in the Consolidated Statements of Operations.

3. Intangible Assets

Intangible assets are summarized as follows:

	December 31, 2013			December 31, 2012		
	Gross Carrying Amount	Accumulated Amortization	Net Intangible Assets	Gross Carrying Amount	Accumulated Amortization	Net Intangible Assets
Amortized intangible assets:						
Customer relationships	$ 15,926	$ (5,687)	$ 10,239	$ 16,228	$ (4,704)	$ 11,524
Patent costs	1,188	(785)	403	1,151	(420)	731

	17,114	(6,472)	10,642	17,379	(5,124)	12,255
Unamortized intangible assets:						
Trademarks	230	–	230	222	–	222
Total	$ 17,344	$ (6,472)	$ 10,872	$ 17,601	$ (5,124)	$ 12,477

Amortization expense for intangible assets was $1,410 and $1,385 in 2013 and 2012, respectively. Amortization expense related to intangible assets, which is an estimate for each future year and subject to change, is as follows:

2014	1,222
2015	1,006
2016	871
2017	852
2018	848
Thereafter	5,843
Total	$ 10,642

4. Omnifrio Acquisition and Discontinued Operations

Omnifrio Single-Serve Beverage Business

On April 11, 2011, we completed the acquisition of certain intellectual property and other assets (the “Omnifrio Single-Serve Beverage Business”) from Omnifrio Beverage Company, LLC (“Omnifrio”) for total consideration of up to $14,060, consisting of: (i) a cash payment at closing of $2,000; (ii) the issuance at closing of 501 shares of our common stock; (iii) a cash payment of $2,000 on the 15-month anniversary of the closing date (subject to our setoff rights in the asset purchase agreement); (iv) up to $3,000 in cash milestone payments; and (v) the assumption of certain specified liabilities relating to the Omnifrio Single-Serve Beverage Business.

On March 15, 2012, we entered into the Second Amendment to Asset Purchase Agreement (the "Second Amendment") with Omnifrio and the other parties thereto. The Second Amendment amends the Asset Purchase Agreement dated March 8, 2011, as amended on May 11, 2011, by and among the Primo, Omnifrio and the other parties thereto (the "Purchase Agreement”) to revise the cash milestone payments and deferred purchase price payments payable under the Purchase Agreement.

Under the Second Amendment, we agreed to make milestone payments consisting of (i) a cash payment of $1,000, subject to certain offset amounts, upon our shipment of 5 single-serve beverage dispensing appliances to a retail customer, (ii) a second cash payment of $1,000, subject to certain offset amounts, upon our shipment of the next 10 single-serve beverage dispensing appliances to a retail customer, and (iii) a final cash payment of $1,000, subject to certain offset amounts, upon our shipment of the next 10 single-serve beverage dispensing appliances to a retail customer. Additionally, under the Second Amendment, our deferred purchase price payments were revised as follows: (i) $1,000 on June 11, 2012 and (ii) $1,000 on January 4, 2013.

Delays in the development and manufacturing of the Omnifrio appliance caused us to significantly decrease our future sales projections, which caused the reduction in the estimated fair value of the milestone payments. We do not expect to make any cash milestone payments. The decrease in estimated fair value of the milestone payments resulted in other operating income of $2,457 for the year ended December 31, 2012, which is shown as a component of the loss from discontinued operations (see “Discontinued Operations” below for details for the loss from discontinued operations; see Note 13 for full fair value information).

On July 19, 2013, we entered into a conditional settlement and release agreement with Omnifrio and certain other parties pursuant to which we agreed to, among other things, use commercially reasonable efforts to sell the assets purchased from Omnifrio and to provide Omnifrio certain amounts of the proceeds of any such sale in exchange for Omnifrio agreeing to release us from any claims related to the milestone payments included in our original purchase agreement with Omnifrio and, upon the sale of such assets, to release us from any claims related to the deferred purchase price payments included in such agreement. At December 31, 2013, no such sale had been negotiated and deferred purchase price payments totaling $2,000 were included within liabilities of Disposal Group held for sale, net of current portion on the consolidated balance sheets. The deferred purchase price payments totaled $2,000 at December 31, 2012 and were included within current liabilities of Disposal Group held for sale on the consolidated balance sheets.

Discontinued Operations

During 2012, we committed to a plan to sell the assets of the Disposal Group, which includes sparkling beverage appliances, flavorings, CO2 cylinders and accessories sold under the Flavorstation brand as well as the Omnifrio Single-Serve Business and initiated an active program to execute this plan. In addition, we determined that the Disposal Group met all of the criteria for classification as discontinued operations. As a result, current and prior year

amounts and disclosures reflect these operations as discontinued operations.

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The assets and liabilities of the Disposal Group classified as held for sale are summarized as follows:

	Years Ended December 31, 2013		2012	
Current assets of disposal group held for sale				
Accounts receivable, net	$	15	$	–
Inventories		200		2,794
Prepaid expenses and other current assets		10		247
	$	225	$	3,041
Current liabilities of disposal group held for sale				
Accounts payable		39		146
Accrued expenses and other current liabilities		53		2,638
	$	92	$	2,784
Liabilities of disposal group held for sale, net of current portion				
Other long-term liabilities		2,000		–
	$	2,000	$	–

The net sales and operating results classified as discontinued operations were as follows:

	Years Ended December 31, 2013		2012	
Net sales	$	2,706	$	363
Operating costs and expenses:				
Cost of sales		3,020		3,491
Selling, general and administrative		479		1,600
Other operating income		–		(2,457)
Depreciation and amortization		–		650
Goodwill and other impairments		1,069		14,742
Loss on disposal of fixed assets		–		116
Total operating costs and expenses		4,568		18,142
Loss from discontinued operations	$	(1,862)	$	(17,779)

Goodwill and Other Impairments

During the first quarter of 2013, we sold a portion of the inventory of the Disposal Group in a transaction in which we received cash and barter credits. We valued the barter credits at the fair value of the products and services to be received upon exchange as they have a more readily determinable fair value than the products exchanged. We initially recorded the barter credits at their estimated fair value of $266 and $1,009 in prepaid expenses and other current assets and in other assets, respectively, on the Consolidated Balance Sheets. Subsequently, during the fourth quarter of 2013, based on changes in our estimated future levels of usage, we recorded a non-cash impairment of $1,069 for the barter credits reflected in the results of discontinued operations for the year ended December 31, 2013. At December 31, 2013, the barter credits were recorded at their fair value of $10 and $187 in prepaid expenses and other current assets and in other assets, respectively, on the Consolidated Balance Sheets.

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As described in Note 2, effective June 30, 2012, we performed goodwill and other intangible asset impairment tests. In addition to the sustained decrease in our stock price relative to our book value, we noted that delays in product development and manufacturing of the Omnifrio Single-Serve Business appliance created an indication of impairment in the related goodwill and developed technology definite-lived intangible asset. We recorded a non-cash goodwill impairment of $6,433. The developed technology intangible asset was also considered impaired as its carrying value exceeded its undiscounted cash flows. We recorded a non-cash impairment charge of $7,013 for the developed technology intangible asset. These impairment charges are included in the results of discontinued operations for the year ended December 31, 2012.

5. Bottles

Bottles are summarized as follows at December 31:

	2013	2012
Cost	$ 4,535	$ 4,439
Less accumulated depreciation	(431)	(601)
	$ 4,104	$ 3,838

Depreciation expense for bottles was $2,186 and $1,908 for 2013 and 2012, respectively.

6. Property and Equipment

Property and equipment is summarized as follows at December 31:

	2013	2012
Leasehold improvements	$ 87	$ 87
Machinery and equipment	8,347	8,046
Vending equipment	24,083	21,757
Racks and display panels	33,562	32,452
Office furniture and equipment	234	234
Software and computer equipment	3,972	3,738
Equipment not in service	1,525	1,396
	71,810	67,708
Less accumulated depreciation and amortization	(33,176)	(25,761)
	$ 38,634	$ 41,947

Depreciation expense for property and equipment was $7,737 and $7,809 for 2013 and 2012, respectively.

7. Accrued Expenses and Other Current Liabilities

Accrued expenses and other current liabilities are summarized as follows:

	2013	2012
Accrued payroll and related items	$ 335	$ 351
Accrued severance	164	363
Accrued professional and other expenses	1,405	1,905
Accrued interest	229	219
Accrued sales tax payable	217	351
Customer bottle deposits	708	773

Other		322		343
	$	3,380	$	4,305

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8. Debt, Capital Leases and Notes Payable

Debt, capital leases and notes payable are summarized as follows at December 31:

	Years Ended December 31, 2013	2012
Senior revolving credit facility	$ 3,145	$ 7,077
Comvest Term Loans, net of discount	19,496	14,145
Notes payable and capital leases	29	44
	22,670	21,266
Less current portion	(16)	(15)
Long-term debt, notes payable and capital leases, net of current portion	$ 22,654	$ 21,251

Prior Senior Revolving Credit Facility

We entered into a senior revolving credit facility in November 2010 that was amended in April 2011, September 2011, November 2011 and March 2012 ("Prior Senior Revolving Credit Facility"). The Prior Senior Revolving Credit Facility matured on April 30, 2012 and was repaid in full in connection with the closing of the Senior Revolving Credit Facility (as defined below) and the Term Loan (as defined below). We amortized the remaining amount of deferred loan costs related to the Prior Senior Revolving Credit Facility at maturity. Interest expense related to deferred loan costs amortization for the Prior Senior Revolving Credit Facility totaled $1,246 for the year ended December 31, 2012.

Senior Revolving Credit Facility

We entered into the Senior Revolving Credit Facility on April 30, 2012, as amended on February 21, 2013, that replaced our prior senior credit facility. The Senior Revolving Credit Facility provides for total borrowing availability of up to $20,000, subject to borrowing base requirements related to our eligible accounts receivable and inventory and subject to a $2,000 reserve requirement. The Senior Revolving Credit Facility has a three and one-half year term and is secured either on a first priority or second priority basis by substantially all of our assets. The term of the Senior Revolving Credit Facility may be extended up to April 30, 2017 so long as the maturity of the Comvest Term Loans (as defined below) is extended to at least October 30, 2017. At December 31, 2013, we had $3,145 in outstanding borrowings at a weighted-average interest rate of 6.0%, with $511 in additional availability under the Senior Revolving Credit Facility after giving effect to the borrowing base requirements.

Interest on outstanding borrowings under the Senior Revolving Credit Facility is payable at our option at either a floating base rate or a one-, two- or three-month LIBOR rate. We are also required to pay a commitment fee on the unused amount of the commitment under the Senior Revolving Credit Facility. The Senior Revolving Credit Facility contains a limit on capital expenditures of $6,000 for the year ended December 31, 2013 and for each year thereafter. The limit for capital expenditures may be increased based upon meeting the fixed charge coverage ratio, as stipulated and defined in the Senior Revolving Credit Facility. For the year ended December 31, 2013, the limit was increased based upon our fixed charge coverage ratio. In addition, the Senior Revolving Credit Facility does cross default to the Term Loan. Life-to-date costs associated with the Senior Revolving Credit Facility were $883, which were capitalized and will be amortized as part of interest expense over the term of the debt. At December 31, 2013, accumulated amortization related to Senior Revolving Credit Facility deferred loan costs was $418.

Comvest Term Loans

We entered into a credit and security agreement on April 30, 2012 (the “Credit Agreement”) pursuant to which a $15,150 term loan (the “Term Loan”) was provided. The Credit Agreement was amended on November 6, 2012 (the “First Amendment”) to contemplate the plan to exit the Flavorstation business (see Note 4) and provide for the classification of the operating results related to the Disposal Group as discontinued operations. In connection with the amendment, the lender consented to our sale of inventory and other assets related to the Disposal Group outside the ordinary course of business. Also in connection with the First Amendment, we paid the lender a $150 fee and agreed to certain changes to prepayment penalties and financial covenants.

The Credit Agreement was amended on June 14, 2013 (the "Second Amendment") to provide for an additional $3,000 in borrowing under an additional term loan (the "First Add-On Term Loan", and together with the Term Loan, the "Second Add-On Term Loan" and the "Third Add-On Term Loan" described below, the "Comvest Term Loans"), adjust the interest rate on the Term Loan, eliminate certain financial covenants and make further adjustments to prepayment penalties. Under the terms of the Second Amendment, interest on outstanding amounts owed under the Comvest Term Loans is payable at the rate of 12.5% per annum in cash. Also in connection with the Second Amendment, we paid the lender amendment and funding fees of $425.

On December 24, 2013, we entered into an amendment (the "Third Amendment") to the Credit Agreement to provide for two additional term loans: the $2,500 "Second Add-On Term Loan" provided on the date of the Third Amendment; and the $2,500 "Third Add-On Term Loan" provided in January 2014. The interest and other terms of the Second and Third Add-On Term Loans are consistent with those described above for the First Add-On Term Loan. The Third Amendment also revised the Credit Agreement to make certain adjustments to the definition of EBITDA to contemplate the strategic alliance with DS Waters and the increasing minimum EBITDA thresholds applicable to Primo that are measured at the end of each quarter, as described below. Also in connection with the Third Amendment, we paid the lender amendment and funding fees of $263.

The outstanding balance of the Comvest Term Loans is due and payable in a single installment on April 30, 2016, subject to prepayment in specified circumstances, including sales or dispositions of assets outside the ordinary course of business and sales of equity or debt securities by the Company. The Comvest Term Loans are secured by substantially all of our assets on either a first priority or second priority basis. The first priority assets consist of substantially all of the assets related to our refill services business. The security interest in all of our other assets is subordinate to the security interest securing the Senior Revolving Credit Facility. At December 31, 2013, our outstanding balance under our Comvest Term Loans was $20,999.

The Credit Agreement contains the following financial covenants: (i) a limit on capital expenditures of $12,000 for the year ended December 31, 2013 and for each year thereafter; (ii) an increasing minimum adjusted earnings before interest, taxes, depreciation and amortization ("Adjusted EBITDA") threshold that is measured at the end of each quarter, and (iii) a decreasing total debt to Adjusted EBITDA ratio that is measured at the end of each quarter, and.

At December 31, 2013 we were in compliance with all covenants, including the following: the minimum Adjusted EBITDA threshold was $8,800 and our Adjusted EBITDA was $9,067 for the twelve months ended December 31, 2013; and the maximum allowed total debt to Adjusted EBITDA ratio was 3.7:1 and our ratio was 2.7:1 for the twelve months ended December 31, 2013.

Life-to-date costs associated with the Term Loan were $1,124, which were capitalized and will be amortized as part of interest expense over the term of the debt. Life-to-date costs associated with the Second and Third Amendments were $761, which were reflected as a discount on our debt and will be amortized as part of interest expense over the remaining term of the debt.

Concurrently with the closing of the Term Loan, five of our current directors or stockholders (the "Insider Participants") purchased an aggregate of $1,150 in non-recourse, non-voting, last-out participation interests from the bank providing the Term Loan. These participation interests allow each holder to participate to the extent of such holder's percentage share in the Term Loan and such participations are secured by the same assets as the Term Loan. The Insider Participants include Billy D. Prim, Malcolm McQuilkin and Jack C. Kilgore, all three of whom are current directors of Primo. Mr. Prim is also our Chairman and Chief Executive Officer. Mr. Prim, Mr. McQuilkin and Mr. Kilgore purchased $250, $500 and $50 in participation interests, respectively.

The Term Loan was accompanied by a detachable warrant to purchase 1,731 shares of our common stock, including detachable warrants to purchase 131 shares of our common stock received by the Insider Participants. The warrant is immediately exercisable at an exercise price of $2.30 per share and expires April 30, 2020. The terms of the warrants issued to the Insider Participants are identical to the terms of the warrant described above. Mr. Prim, Mr. McQuilkin and Mr. Kilgore were issued warrants to purchase 29, 57 and 6 shares of our common stock, respectively. The initial fair value of the warrants as determined using the Black-Scholes pricing model was $1,108 that resulted in an original issue discount on the Term Loan that will be amortized into interest expense through the maturity of the Term Loan. For the non-Insider Participants, the exercise price was adjusted to $1.20 as part of the amendment on November 6, 2012. Due to the price adjustment, $305 was added to the original issue discount on the Term Loan, representing the change in the estimated fair value immediately before and after the modification, and will be amortized into interest expense through the remaining maturity of the Term Loan. The revised warrant exercise price was set at 150% of the 30 day trailing average stock price. No changes were made to the warrants we issued to the five directors and stockholders of Primo.

We periodically enter into notes for purchases of delivery vehicles for field operations and had three such notes outstanding at December 31, 2013.

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The aggregate future maturities of debt, capital leases and notes payable as of December 31, 2013 were as follows:

2014	$16
2015	3,156
2016	21,001
2017	–
	$24,173
Less: amounts representing interest	(1)
	$24,172

Accounts payable included $5,050 and $5,310 at December 31, 2013 and 2012, respectively, of amounts owed to a supplier with extended payment terms allowing us to pay in 120 days. $1,728 and $2,338 of these amounts were aged greater than 60 days at December 31, 2013 and 2012, respectively. Interest expense includes financing costs of $669 for the year ended December 31, 2013 related to amounts owed to this supplier.

9. Stockholders' Equity

Common Stock Warrants

As described in Note 8, the Term Loan was accompanied by a detachable warrant to purchase 1,731 shares of our common stock. The initial fair value of the warrants as determined using the Black-Scholes pricing model of $1,108 was recorded as an increase to original issue discount on the Term Loan and to Common stock warrants.

For the non-Insider Participants, the exercise price was adjusted to $1.20 as part of the amendment on November 6, 2012. The original issue discount on the Term Loan and Common stock warrants were increased by $305, representing the change in the estimated fair value immediately before and after the modification. The revised warrant exercise price was set at 150% of the 30-day trailing average stock price. No changes were made to the warrants we issued to the five directors and stockholders of Primo.

A summary of common stock warrant activity for the years ended December 31, 2013 and 2012 is presented below:

	Warrants	Weighted Average Exercise Price	Weighted Average Remaining Life (Years)
Warrants outstanding, December 31, 2011	871	$ 12.23	
Granted	1,731	$ 1.28	
Warrants outstanding, December 31, 2012	2,602	$ 4.95	6.34
Warrants outstanding, December 31, 2013	2,602	$ 4.95	5.34

10. Stock-Based Compensation

Overview

In 2004, our Board of Directors adopted the Primo Water Corporation 2004 Stock Plan (the "2004 Plan") for employees, including officers, non-employee directors and non-employee consultants. The Plan provides for the issue of incentive

or nonqualified stock options and restricted common stock. We have reserved 431 shares of common stock for issuance under the Plan. We do not intend to issue any additional awards under the 2004 Plan; however, all outstanding awards will remain in effect and will continue to be governed by their existing terms.

In April 2010, our stockholders adopted the 2010 Omnibus Long-Term Incentive Plan (the "2010 Plan"). The 2010 Plan is limited to employees, officers, non-employee directors, consultants and advisors. The 2010 Plan provides for the issuance of incentive or nonqualified stock options, restricted stock, stock appreciation rights, restricted stock units, cash- or stock-based performance awards and other stock-based awards. We have reserved 2,219 shares of common stock for issuance under the 2010 Plan. To date all equity awards under the 2010 Plan have consisted of nonqualified stock options, restricted stock and restricted stock units.

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We recorded non-cash expense related to our stock-based compensation plans of $1,034 and $1,252 for the years ended December 31, 2013 and 2012, respectively, all of which is included in selling, general and administrative expenses from continuing operations. As of December 31, 2013, there were 799 shares available for future issuance under our stock-based compensation plans.

Stock Options

For purposes of determining compensation expense for stock option awards, the fair value of each option award is estimated on the date of grant using the Black-Scholes option pricing model. The key assumptions used in the Black-Scholes model for options granted during 2013 and 2012 were as follows:

	2013	2012
Expected life of options in years	6.3	5.5 - 6.3
Risk-free interest rate	1.1% - 2.0%	0.8% - 1.0%
Expected volatility	47.0%	46.0% - 48.0%
Dividend yield	0.0%	0.0%

The risk free interest rate is based on the U.S. Treasury rate for the expected life at the time of grant. As a result of our limited trading history beginning on November 5, 2010, our expected volatility is based on the average long-term historical volatilities of peer companies. We intend to continue to consistently use the same group of publicly traded peer companies to determine expected volatility in the future until sufficient information regarding volatility of our share price becomes available or the selected companies are no longer suitable for this purpose. Also, due to our limited trading history, we are using the “simplified method” to calculate expected holding periods, which represents the period of time that options granted are expected to be outstanding. We will continue to use this method until we have sufficient historical exercise experience to give us confidence that our calculations based on such experience will be reliable. The dividend yield assumption is based on our current intent not to issue dividends.

A summary of stock option activity for the year ended December 31, 2013, is presented as follows:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Life (Years)	Aggregate Intrinsic Value
Options outstanding, December 31, 2012	1,350	$ 3.93		
Granted	250	$ 2.07		
Exercised	(53)	$ 1.26		
Forfeited	(160)	$ 4.27		
Options outstanding, December 31, 2013	1,387	$ 3.66	8.0	$ 1,355
Options vested and expected to vest, December 31, 2013	1,289	$ 3.79	7.9	$ 1,248
Options exercisable, December 31, 2013	595	$ 5.89	6.9	$ 492

The weighted-average fair value per share of the options granted during 2013 and 2012 was $1.02 and $0.52, respectively. The total intrinsic value of the options exercised during 2013 and 2012 was $44 and $0, respectively.

As of December 31, 2013, there was $440 of unrecognized compensation expense, net of estimated forfeitures, related to outstanding stock options which is expected to be recognized over a weighted-average period of 2.0 years. Cash received from option exercises for 2013 and 2012 was $66 and $0, respectively.

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Restricted Stock

A summary of restricted stock activity for the year ended December 31, 2013 is presented below:

	Number of Shares	Weighted Average Grant Date Price Per Share
Unvested at December 31, 2012	173	$ 5.49
Granted	80	$ 1.44
Vested	(189)	$ 4.09
Forfeited	(1)	$ 12.45
Unvested at December 31, 2013	63	$ 4.36

The fair value of restricted stock awards is estimated based on the closing price of our stock on the date of grant, and, for the purposes of expense recognition, the total new number of shares expected to vest is adjusted for estimated forfeitures. As of December 31, 2013, there was $91 of unrecognized compensation expense, net of estimated forfeitures, related to non-vested restricted stock which is expected to be recognized over a weighted-average period of 1.4 years.

Employee Stock Purchase Plan

In April 2010, our stockholders approved the 2010 Employee Stock Purchase Plan (the "ESPP") which was effective upon the consummation of our IPO. The ESPP provides for the purchase of common stock and is generally available to all employees. Shares are purchased at six-month intervals at 85% of the lower of the fair market value on the first day of the offering or the last day of each six-month purchase period. Employees may purchase shares having a fair value not exceeding 15% of their annual compensation, or $25, whichever is less. During the year ended December 31, 2013, employees purchased 65 shares at an average price of $1.01 per share. At December 31, 2013, there were 147 shares of common stock reserved for future issuance under the ESPP.

Value Creation Plan

On May 7, 2012, we established a Value Creation Plan, which was amended on May 14, 2013, which provides the opportunity for awards comprised of cash and/or equity for eligible employees as determined by the Compensation Committee. Award issuance under the Plan would be based on our achieving targets of at least $15,000, $20,000 and $25,000 in Adjusted EBITDA for any fiscal year between 2014 and 2018. No awards were issued under the Plan during 2013 or 2012.

11. Commitments and Contingencies

Operating Leases

We lease office space and vehicles under various lease arrangements. Total rental expense from continuing operations was $1,209 and $1,456 for 2013 and 2012, respectively. At December 31, 2013, future minimum rental commitments under non-cancelable operating leases are as follows:

2014	$412
2015	142

2016	53
2017	37
2018	37
Thereafter	81
Total	$762

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Class Action Suit

On August 14, 2013, the United States District Court for the Middle District of North Carolina granted the defendants' motion to dismiss the securities class action lawsuit brought against Primo, certain members of our board of directors, certain members of management, and certain shareholders and company advisors. The plaintiffs' complaint alleged violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended, and Rule 10b-5 promulgated thereunder, and Sections 11, 12(a)(2), and 15 of the Securities Act of 1933 and asserted such claims on behalf of a class of persons who acquired our common stock in or traceable to our initial public offering and secondary offering as well as purchasers of common stock between November 4, 2010 and August 10, 2011. The Court dismissed all claims asserted in the case with prejudice, and entered judgment in favor of all defendants. No appeal was taken by the plaintiffs, and the judgment became final as of September 13, 2013.

Electrotemp

On October 14, 2011, Primo, through a wholly-owned subsidiary, filed a complaint against Electrotemp Technologies China, Inc. ("Electrotemp") in Mecklenburg County (North Carolina) Superior Court, alleging breach of contract, quantum meruit/unjust enrichment, and violation of the North Carolina Products Liability Act/breach of implied warranty. The parties filed a Joint Motion to stay litigation so that they could proceed with mediation and arbitration pursuant to the dispute resolution clause in their agreement. On May 1, 2012, the Court ordered that the litigation would be stayed once the parties formally enter into arbitration. Electrotemp asserted counterclaims in the arbitration. On September 26, 2013, the parties reached a settlement that resulted in termination of the arbitration and dismissal of the lawsuit. The lawsuit was dismissed with prejudice on October 3, 2013. We do not believe that the terms of the settlement will have a material impact on our financial statements.

Florida Concentrates Suit

On October 16, 2012, Primo was served with the Summons and Complaint in a suit filed in the Florida state courts on September 26, 2012. Plaintiffs in the suit are Florida Concentrates International, LLC (a Florida limited liability company), Florida Sparkling DS, LLC (a Florida limited liability company), and Didier Hardy (a Florida resident and apparently the principal of the LLC plaintiffs). Also named as defendants are Susan and Scott Ballantyne (alleged to be Florida residents) and SDS-IC. The suit was filed in the Circuit Court for the Twentieth Judicial District (Collier County, Florida). Plaintiffs' allegations include breach of contract, misappropriation of trade secrets and certain additional claims and plaintiffs seek monetary damages. We filed a motion to dismiss all claims, which was granted in part and denied in part on June 21, 2013. Plaintiffs filed an amended complaint on July 10, 2013 to which we responded on August 28, 2013. We do not believe that the suit has any merit whatsoever, and plan to vigorously contest and defend against it.

Omnifrio Single-Serve Beverage Business

Deferred purchase price payments totaling $2,000 were included within liabilities of disposal group held for sale, net of current portion and current liabilities of disposal group held for sale on the consolidated balance sheets as of December 31, 2013 and 2012, respectively. These payments were related to the April 11, 2011 acquisition of certain intellectual property and other assets from the seller, Omnifrio Beverage Company LLC ("Omnifrio"). On July 19, 2013, we entered into a conditional settlement and release agreement with Omnifrio and certain other parties pursuant to which we agreed to, among other things, use commercially reasonable efforts to sell the assets purchased from Omnifrio in April 2011 and to provide Omnifrio certain amounts of the proceeds of any such sale in exchange for Omnifrio agreeing to release us from any claims related to the milestone payments included in our original purchase agreement with Omnifrio and, upon the sale of such assets, to release us from any claims related to the deferred purchase price payments included in such agreement.

Sales Tax

We routinely purchase equipment for use in operations from various vendors. These purchases are subject to sales tax depending on the equipment type and local sales tax regulations; however, we believe certain vendors have not assessed the appropriate sales tax. For purchases that are subject to sales tax in which we believe the vendor did not assess the appropriate amount, we accrue an estimate of the sales tax liability we ultimately expect to pay.

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Other Contingencies

From time to time, we are involved in various claims and legal actions that arise in the normal course of business. Management believes that the outcome of such legal actions will not have a significant adverse effect on our financial position, results of operations or cash flows.

12. Income Taxes

A reconciliation of the statutory U.S. federal tax rate and effective tax rates is as follows:

	2013		2012	
Federal statutory taxes	34.0	%	34.0	%
State income taxes, net of federal tax benefit	3.8	%	4.0	%
Foreign taxes less than the domestic rate	(0.4	%)	(1.2	%)
Permanent differences	(0.2	%)	0.0	%
Change in valuation allowance	(27.6	%)	(34.8	%)
Changes in rates	(9.1	%)	0.0	%
Other	(0.5	%)	(1.0	%)
	0.0	%	1.0	%

Deferred income taxes are recorded based upon differences between the financial reporting and income tax basis of assets and liabilities. The following deferred income taxes are recorded:

		2013		2012
Deferred tax assets:				
Federal net operating loss carryforward	$	40,308	$	34,868
State loss carryforward		3,943		3,860
Goodwill		24,528		27,961
Other intangible assets		3,651		3,844
Allowance for bad debts		533		637
Stock-based compensation		1,473		1,214
Accrued expenses		62		140
Inventory		75		93
Fixed assets		662		77
Other		1,076		941
Total gross deferred tax assets		76,311		73,635
Deferred tax liabilities:				
Fixed assets				-
Goodwill				-
Total gross deferred tax liabilities				-
Valuation allowance		(76,311)		(73,635)
Total net deferred liability	$	-	$	-

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion of the deferred tax assets will be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, available taxes in the carryback periods, projected future taxable income, and tax planning strategies in making this assessment. Accordingly, we have provided valuation allowances to fully offset the net deferred tax assets at December 31, 2013 and 2012. The $2,676 and $39,044 net increase in the valuation allowance for 2013 and 2012, respectively, primarily reflects the net increase in the federal and state loss carryfoward deferred tax assets.

We have approximately $118,552 in U.S. federal net operating loss carryforwards that expire between 2025 through 2033, approximately $7,926 in Canadian federal and provincial net operating loss carryforwards that expire between 2030 through 2033 and approximately $99,569 in state loss carryforwards that expire between 2013 through 2034. Section 382 of the U.S. Internal Revenue Code imposes an annual limitation on the amount of net operating loss carryforwards that might be used to offset taxable income when a corporation has undergone significant changes in stock ownership. We believe that an annual limit will be imposed by Section 382, however, should taxable income be generated in future years, we expect to be able to utilize our net operating loss carryforwards during their respective carryforward periods.

We have no unrecognized tax benefits and there are no uncertain tax positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase within the next 12 months.

13. Fair Value Measurements

Fair value rules currently apply to all financial assets and liabilities and for certain nonfinancial assets and liabilities that are required to be recognized or disclosed at fair value. For this purpose, fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Valuation techniques used to measure fair value must maximize the use of observable inputs and minimize the use of unobservable inputs.

U.S. GAAP establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include:

- Level 1 — quoted prices in active markets for identical assets and liabilities.
- Level 2 — observable inputs other than quoted prices in active markets for identical assets and liabilities.
- Level 3 — unobservable inputs in which there is little or no market data available, which require the reporting entity to develop its own assumptions.

During 2012, the Omnifrio milestone payments were required to be measured at fair value on a recurring basis. The Omnifrio milestone payments were measured at fair value using significant unobservable inputs (Level 3 inputs). As described more fully in Note 4, the milestone payments were estimated to have a fair value of $0 as of December 31, 2013 and 2012 and are part of the Disposal Group and classified as discontinued operations.

The following tables present our activity for the Omnifrio which are measured at fair value on a recurring basis using significant unobservable inputs (Level 3), for the years ended December 31, 2013 and 2012:

Fair value measurements

Description	using signficant unobservable inputs (Level 3) Omnifrio Milestone payments
Balance at December 31, 2011	$ 2,559
Change in value of milestones, included in loss from discontinued operations	(2,559)
Balance at December 31, 2012	$ –
Change in value of milestones, included in loss from discontinued operations	$ –
Balance at December 31, 2013	$ –

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As of December 31, 2013, the barter credits (see Note 4) reported in prepaid and other current assets and in other assets on our consolidated balance sheets were measured at their estimated fair values of $10 and $187, respectively, on a nonrecurring basis. The barter credits are measured at fair value using significant unobservable inputs, primarily based on the fair value of the products and services to be received upon exchange (Level 3 inputs).

The carrying amounts of our financial instruments, which include cash and cash equivalents, accounts receivable, accounts payable, and other accrued expenses, approximate their fair values due to their short maturities. Assets and liabilities of the Disposal Group held for sale are presented at their carrying value, which approximates fair value based on current market rates. Based on borrowing rates currently available to us for loans with similar terms, the carrying value of debt, capital leases and notes payable approximates fair value. For goodwill impairment testing we rely in part on a discounted cash flow approach, using Level 3 inputs. This approach requires significant estimates and judgmental factors, including revenue growth rates, terminal values, and weighted average cost of capital, which are used to discount future cash flows.

14. Segments

We have two operating segments and two reportable segments: Primo Water ("Water") and Primo Dispensers ("Dispensers").

Our Water segment sales consist of the sale of multi-gallon purified bottled water (exchange services) and our self-service refill water service (refill services) offered through retailers in each of the contiguous United States and Canada. Our Water services are offered through point of purchase display racks or self-serve filtered water displays and recycling centers that are prominently located at major retailers in space that is often underutilized.

Our Dispensers segment sells water dispensers that are designed to dispense Primo and other dispenser-compatible bottled water. Our Dispensers sales are primarily generated through major U.S. retailers and are sold primarily through a direct-import model, where we recognize revenues for the sale of the water dispensers when title is transferred. We support retail sell-through with domestic inventory. We design, market and arrange for certification and inspection of our water dispensers.

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

Cost of sales for Water consists of costs for distribution, bottles and related packaging materials for our exchange services and servicing and material costs for our refill services. Cost of sales for Dispensers consists of contract manufacturing, freight and duties.

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

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

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The following table presents segment information for each of the last two years:

	Years Ended December 31, 2013	2012
Segment net sales		
Water	$ 63,828	$ 62,667
Dispensers	27,381	28,812
	$ 91,209	$ 91,479
Segment income (loss) from operations		
Water	$ 17,591	$ 16,477
Dispensers	827	(1,319)
Corporate	(10,727)	(11,468)
Non-recurring costs	(777)	(743)
Depreciation and amortization	(11,333)	(11,102)
Goodwill and other impairments	–	(82,013)
	$ (4,419)	$ (90,168)
Depreciation and amortization expense:		
Water	$ 10,057	$ 9,777
Dispensers	575	633
Corporate	701	692
	$ 11,333	$ 11,102
Capital expenditures:		
Water	$ 6,964	$ 4,315
Dispensers	62	910
Corporate	274	104
	$ 7,300	$ 5,329

Identifiable assets:	At December 31, 2013	2012
Water	$ 58,057	$ 65,483
Dispensers	9,757	9,490
Corporate	2,932	3,761
Assets of disposal group held for sale	225	3,041
	$ 70,971	$ 81,775

15. Supplemental Cash Flow Information

	Year ended December 31, 2013	2012
Cash paid for interest	$ 3,278	$ 1,841
Noncash investing activities:		
Accrued capital expenditures	$ 1,313	$ 1,090

16. Employee Retirement Savings Plan

We sponsor a defined contribution plan that covers substantially all full-time employees who are at least 21 years of age and who have completed at least two months of service. Plan participants may make before tax elective contributions up to the maximum percentage of compensation and dollar amount allowed under the Internal Revenue Code. Plan participants are 100% vested in their elective contributions at all times and are vested 25% per year of service for four years in our discretionary contributions. A year of service for vesting purposes is 1,000 hours of service in a Plan year. In 2010, our Board of Directors established a company match of up to 50% of the employee contributions up to 6% of their salaries, with 50% of the matching amount being contingent upon our achievement of certain specified objectives to be determined by our Board of Directors. Contribution expense for the plan was $47 and $47 for 2013 and 2012, respectively.

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17. Subsequent Events

Third Add-On Term Loan

As described in Note 8, in January 2014 we received the proceeds from the $2,500 Third Add-On Term Loan. At January 31, 2014, our outstanding balance under our Comvest Term Loans was $23,499.

DS Waters' Common Stock Warrant

As part of the DS Agreement, on January 1, 2014, we granted DS Waters a warrant to purchase 475 shares of our common stock. The warrant is immediately exercisable at an exercise price of $3.04 per share and expires January 1, 2021.

Item 9.Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this report, an evaluation was performed under the supervision and with the participation of our management, including the chief executive officer ("CEO"), and chief financial officer ("CFO"), of the effectiveness of the design and operation of our "disclosure controls and procedures" (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934 (the "Exchange Act")) pursuant to Rule 13a-15(b) of the Exchange Act. Based on that evaluation, our management, including the CEO and CFO, concluded that our disclosure controls and procedures are effective for the purpose of providing reasonable assurance that the information required to be disclosed in the reports we file or submit under the Exchange Act (i) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and (ii) is accumulated and communicated to our management, including our CEO and CFO, as appropriate to allow timely decisions regarding required disclosures.

Changes in Internal Control over Financial Reporting

There was no change in our internal control over financial reporting identified in connection with the evaluation required by Rule 13a-15(d) and 15d-15(d) of the Exchange Act that occurred during the period covered by this report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Management's Annual Report on Internal Control over Financial Reporting

Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2013. See page 48 for "Management's Report on Internal Control over Financial Reporting."

Item 9B. Other Information

None.

PART III

Item 10. Directors, Executive Officers and Corporate Governance

For information with respect to the executive officers of Primo, see the "Executive Officers" and "Executive Compensation" sections of the Proxy Statement for the 2014 Annual Meeting of Stockholders, which are incorporated herein by reference. For information with respect to the Directors of Primo, see the "Proposal 1: Election of Directors" section of the Proxy Statement for the 2014 Annual Meeting of Stockholders, which is incorporated herein by reference. For information with respect to Section 16 reports, see the "Section 16(a) Beneficial Ownership Reporting Compliance" section of the Proxy Statement for the 2014 Annual Meeting of Stockholders, which is incorporated herein by reference. For information with respect to the Audit Committee of the Board of Directors, see the "Corporate Governance — Board Committees" section of the Proxy Statement for the 2014 Annual Meeting of Stockholders, which is incorporated herein by reference.

We have adopted a Code of Business Conduct and Ethics, which is intended to qualify as a "code of ethics" within the meaning of Item 406 of Regulation S-K of the Exchange Act. This code applies to all of the directors, officers and employees of Primo and its subsidiaries. A copy of our Code of Business Conduct and Ethics is available on our corporate website (www.primowater.com). We expect that any amendments to the code, or any waivers of its requirements, will be disclosed on our website.

Item 11. Executive Compensation

For information with respect to executive and director compensation, see the "Executive Compensation", "Additional Information About Directors and Executive Officers", "Director Compensation" and "Corporate Governance" sections of the Proxy Statement for the 2014 Annual Meeting of Stockholders, which are incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

For information with respect to security ownership of certain beneficial owners and management, see the "Principal Stockholders" section of the Proxy Statement for the 2014 Annual Meeting of Stockholders, which is incorporated herein by reference. For information with respect to securities authorized for issuance under equity compensation plans, see the "Equity Compensation Plan Information" section of the Proxy Statement for the 2014 Annual Meeting of Stockholders, which is incorporated herein by reference.

Item 13. Certain Relationships and Related Transactions, and Director Independence

For information with respect to certain relationships and related transactions, see the "Related Persons Transactions" section of the Proxy Statement for the 2014 Annual Meeting of Stockholders, which is incorporated herein by reference. For certain information with respect to director independence, see the disclosures in the "Corporate Governance" section of the Proxy Statement for the 2014 Annual Meeting of Stockholders, which is incorporated herein by reference.

Item 14. Principal Accountant Fees and Services

For information with respect to principal accountant fees and services, see "Proposal 2: Ratification of Appointment of Independent Registered Public Accounting Firm" section of the Proxy Statement for the 2014 Annual Meeting of Stockholders, which is incorporated herein by reference.

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PART IV

Item 15. Exhibits and Financial Statement Schedules

a) Financial Information

(1) Financial Statements: See "Index to Consolidated Financial Statements" in Part II, Item 8 of this Form 10-K.

(2) Financial Statement Schedule: Information required by this item is included within the consolidated financial statements

(3) Exhibits

See (b) below.

b) Exhibits

See Exhibit Index on page 78.

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EXHIBIT INDEX

Exhibit Number	Description
3.1	Sixth Amended and Restated Certificate of Incorporation of Primo Water Corporation (incorporated by reference to Exhibit 3.1 to Amendment No. 2 to the Registrant's Registration Statement on Form S-1/A (File No. 333-173554) filed on May 31, 2011)
3.2	Amended and Restated Bylaws of Primo Water Corporation (incorporated by reference to Exhibit 3.1 to the Company's Form 8-K filed November 16, 2010)
4.1	Specimen Certificate representing shares of common stock of Primo Water Corporation (incorporated by reference to Exhibit 4.1 to Amendment No. 5 to the Company's Registration Statement on Form S-1 (Registration No. 333-165452) filed August 11, 2010)
4.2	Form of Indenture relating to the issuance from time to time in one or more series of debentures, notes, bonds or other evidences of indebtedness (incorporated by reference to Exhibit 4.4 to the Registrant's Registration Statement on Form S-3 (File No. 333-178820) filed on December 21, 2011)
10.1	Form of Subordinated Convertible Debt – Common Stock Purchase Warrant, dated as of December 30, 2009 (incorporated by reference to Exhibit 10.9 to Amendment No. 1 to the Company's Registration Statement on Form S-1 (Registration No. 333-165452) filed April 26, 2010)
10.2	2004 Stock Plan (incorporated by reference to Exhibit 10.15 to Amendment No. 1 to the Company's Registration Statement on Form S-1 (Registration No. 333-165452) filed April 26, 2010)*
10.3	2010 Omnibus Long-Term Incentive Plan ("2010 Omnibus Plan") (incorporated by reference to Exhibit 10.16 to Amendment No. 1 to the Company's Registration Statement on Form S-1 (Registration No. 333-165452) filed April 26, 2010)*
10.4	Form of Option Agreement under 2010 Omnibus Plan (incorporated by reference to Exhibit 10.17 to Amendment No. 1 to the Company's Registration Statement on Form S-1 (Registration No. 333-165452) filed April 26, 2010)*
10.5	Form of Restricted Stock Award Agreement under 2010 Omnibus Plan (incorporated by reference to Exhibit 10.18 to Amendment No. 1 to the Company's Registration Statement on Form S-1 (Registration No. 333-165452) filed April 26, 2010)*
10.6	2010 Employee Stock Purchase Plan (incorporated by reference to Exhibit 10.19 to Amendment No. 1 to the Company's Registration Statement on Form S-1 (Registration No. 333-165452) filed April 26, 2010)*
10.7	Non-Employee Director Compensation Policy (incorporated by reference to Exhibit 10.1 to the Company's Form 10-Q filed August 12, 2011)*
10.8	Form of Indemnification Agreement for Directors (incorporated by reference to Exhibit 10.26 to Amendment No. 1 to the Company's Registration Statement on Form S-1 (Registration No. 333-165452) filed April 26, 2010)*
10.9	Form of Amended and Restated Series B Common Stock Purchase Warrant (incorporated by reference to Exhibit 10.43 to Amendment No. 7 to the Company's Registration Statement on Form S-1 (Registration No. 333-165452) filed October 6, 2010)
10.10	Form of Amended and Restated Series C Common Stock Purchase Warrant (incorporated by reference to Exhibit 10.44 to Amendment No. 7 to the Company's Registration Statement on Form S-1 (Registration No. 333-165452) filed October 6, 2010)
10.11	Registration Rights Agreement dated November 10, 2010 between the Company and Culligan International Company (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed November 16, 2010)

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10.12	Asset Purchase Agreement dated March 8, 2011 by and among the Company, Omnifrio Beverage Company, LLC and the other parties thereto (incorporated by reference to Exhibit 10.4 to the Company's Form 8-K filed March 9, 2011)
10.13	Form of Restricted Stock Unit Award Agreement under 2010 Omnibus Plan (incorporated by reference to Exhibit 10.30 to the Company's Form 10-K filed March 30, 2011)*
10.14	Registration Rights Agreement dated April 11, 2011 between the Company and Omnifrio Beverage Company, LLC (incorporated by reference to Exhibit 10.1 to the Company'sForm 8-K filed April 12, 2011)
10.15	Loan and Security Agreement dated April 30, 2012 by and among the Company, certain subsidiaries of the Company party thereto, the lenders party thereto and TD Bank, N.A., as arranger and syndication agent and bookrunner for the lenders thereunder (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed May 2, 2012)
10.16	Credit and Security Agreement dated as of April 30, 2012 by and among the Company, certain subsidiaries of the Company party thereto and Comvest Capital II, L.P. (incorporated by reference to Exhibit 10.2 to the Company's Form 8-K filed May 2, 2012)
10.17	Term Note dated as of April 30, 2012 by and among the Company, certain subsidiaries of the Company party thereto and Comvest Capital II, L.P. (incorporated by reference to Exhibit 10.3 to the Company's Form 8-K filed May 2, 2012)
10.18	Form of Warrant to Purchase Common Stock dated as of April 30, 2012 (incorporated by reference to Exhibit 10.4 to the Company's Form 8-K filed May 2, 2012)
10.19	Registration Rights Agreement dated as of April 30, 2012 by and among the Company and certain holders of warrants issued by the Company on April 30, 2012 (incorporated by reference to Exhibit 10.5 to the Company's Form 8-K filed May 2, 2012)
10.20	Amended and Restated 2010 Omnibus Long-Term Incentive Plan (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed May 17, 2012) *
10.21	Amendment No. 1 to 2010 Employee Stock Purchase Plan (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed May 17, 2012) *
10.22	First Amendment to Credit and Security Agreement dated as of November 6, 2012 by and among the Company, certain subsidiaries of the Company party thereto and Comvest Capital II, L.P. (incorporated by reference to Exhibit 10.1 to the Company's Form 10-Q filed November 8, 2012)
10.23	First Amendment to Warrant dated as of November 6, 2012 by and between the Company and Comvest Capital II, L.P. (incorporated by reference to Exhibit 10.2 to the Company's Form 10-Q filed November 8, 2012)
10.24	Amendment No. 1 to Loan and Security Agreement and Consent dated as of February 21, 2013 between the Company and TD Bank, N.A., as agent for the lenders thereunder (incorporated by reference to Exhibit 99.1 to the Company's Form 10-K filed March 15, 2013)
10.25	Primo Water Corporation Value Creation Plan (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed June 14, 2013)*
10.26	Primo Water Corporation 2013 Annual Incentive Plan (incorporated by reference to Exhibit 10.2 to the Company's Form 10-Q filed August 14, 2013)*
10.27	Amended and Restated Employment Agreement dated as of June 10, 2013 between the Company and Billy D. Prim (incorporated by reference to Exhibit 10.3 to the Company's Form 8-K filed June 14, 2013)*
10.28	Amended and Restated Employment Agreement dated as of June 10, 2013 between the Company and Mark Castaneda (incorporated by reference to Exhibit 10.4 to the Company's Form 8-K filed June 14, 2013)*
10.29	Employment Agreement dated as of June 10, 2013 between the Company and Matthew T Sheehan (incorporated by reference to Exhibit 10.5 to the Company's Form 8-K filed June 14, 2013)*

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10.30	Second Amendment to Credit and Security Agreement dated as of June 14, 2013 by and among the Company, certain subsidiaries of the Company party thereto and Comvest Capital II, L.P. (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed June 19, 2013)
10.31	Add-On Term Note dated as of June 14, 2013 by and among the Company, certain subsidiaries of the Company party thereto and Comvest Capital II, L.P. (incorporated by reference to Exhibit 10.2 to the Company's Form 8-K filed June 19, 2013)
10.32	Amended and Restated Closing Date Term Note dated as of June 14, 2013 by and among the Company, certain subsidiaries of the Company party thereto and Comvest Capital II, L.P. (incorporated by reference to Exhibit 10.3 to the Company's Form 8-K filed June 19, 2013)
10.33†	Strategic Alliance Agreement dated as of November 12, 2013 by and between the Company and DS Waters of America, Inc. (incorporated by reference to Exhibit 10.1 to the Company’s Form 10-Q filed November 14, 2013)
10.34	Warrant dated as of January 1, 2014 by and between the Company and DS Waters of America, Inc. (filed herewith)
10.35	Third Amendment to Credit and Security Agreement dated as of December 24, 2013 by and among the Company, certain subsidiaries of the Company party thereto and Comvest Capital II, L.P. (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed December 30, 2013)
10.36	Add-On Term Note dated as of December 24, 2013 by and among the Company, certain subsidiaries of the Company party thereto and Comvest Capital II, L.P. (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed December 30, 2013)
10.37	Add-On Term Note dated as of January 13, 2014 by and among the Company, certain subsidiaries of the Company party thereto and Comvest Capital II, L.P. (filed herewith)
10.38	Primo Water Corporation Annual Incentive Plan (filed herewith)
21.1	List of subsidiaries of Primo Water Corporation (filed herewith)
23.1	Consent of McGladrey LLP (filed herewith)
31.1	Certification of Periodic Report by Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14a and pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith)
31.2	Certification of Periodic Report by Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14a and pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith)
32.1	Certification of Periodic Report by Chief Executive Officer and Chief Financial Officer pursuant to U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith)
101.INS**	XBRL Instance Document
101.SCH**	XBRL Taxonomy Extension Schema Document
101.CAL**	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF**	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB**	XBRL Taxonomy Extension Label Linkbase Document
101.PRE**	XBRL Taxonomy Extension Presentation Linkbase Document

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* Indicates management contract or compensatory plan or arrangement.

** Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934 and otherwise are not subject to liability under those sections.

† Confidential treatment has been granted with respect to portions of this exhibit, indicated by asterisks, which have been filed separately with the Securities and Exchange Commission.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Annual Report to be signed on its behalf by the undersigned, thereunto duly authorized.

PRIMO WATER CORPORATION

Dated: March 17, 2014	By:	/s/ Billy D. Prim Billy D. Prim Chairman and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this Annual Report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Signature	Capacity	Date
/s/ Billy D. Prim Billy D. Prim	Chairman and Chief Executive Officer (Principal Executive Officer)	March 17, 2014
/s/ Mark Castaneda Mark Castaneda	Chief Financial Officer (Principal Financial Officer)	March 17, 2014
/s/ David J. Mills David J. Mills	Vice President of Finance (Principal Accounting Officer)	March 17, 2014
/s/ Richard A. Brenner Richard A. Brenner	Director	March 17, 2014
/s/ Jack C. Kilgore Jack C. Kilgore	Director	March 17, 2014
/s/ Malcolm McQuilkin Malcolm McQuilkin	Director	March 17, 2014
/s/ David L. Warnock David L. Warnock	Director	March 17, 2014
/s/ Susan E. Cates Susan E. Cates	Director	March 17, 2014