

PEACE ARCH ENTERTAINMENT GROUP INC
Form 6-K
April 18, 2006

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

FORM 6-K
REPORT OF FOREIGN PRIVATE ISSUER PURSUANT TO RULE 13a-16 OR 15D-16
UNDER THE SECURITIES EXCHANGE ACT OF 1934

For the month of April, 2006

PEACE ARCH ENTERTAINMENT GROUP INC.
(Translation of Registrant's name into English)

407-124 Merton Street, Toronto, Ontario M4S 2Z2
(Address of principal executive office)

[Indicate by check mark whether the registrant files or will file annual reports under cover of Form 20-F or Form 40-F.]

Form 20-F

☐

Form 40-F

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[Indicate by check mark whether the registrant by furnishing the information contained in this Form is also thereby furnishing the information to the Commission pursuant to rule 12g3-2(b) under the

Securities Exchange Act of 1934.

Yes

☐

No

☐

(If ☐ Yes is marked, indicate below the file number assigned to the registrant in connection with Rule 12g3-2(b):
82-_____

EXHIBIT LIST

Confirmation of Mailing to Shareholders

Management's Discussion and Analysis, dated April 13, 2006

CEO Certification of Interim Filings, Form 52-109F2

CFO Certification of Interim Filings, Form 52-109F2

Quarterly Consolidated Financial Statements

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Peace Arch Entertainment Group Inc.
(Registrant)

Date April 10, 2006

By Mara Di Pasquale
(Signature)*

Mara Di Pasquale, Chief Financial Officer

*Print the name and title under the signature of the signing officer.

GENERAL INSTRUCTIONS

A.

Rule as to Use of Form 6-K,

This form shall be used by foreign private issuers which are required to furnish reports pursuant to Rule 13a-16 or 15d-16 under the Securities Exchange Act of 1934.

B.

Information and Document required to be Furnished,

Subject to General Instruction D herein, an issuer furnishing a report on this form shall furnish whatever information, not required to be furnished on Form 40-F or previously furnished, such issuer (I) makes or is required to make public pursuant to the law of the jurisdiction of its domicile or in which it is incorporated or organized, or (ii) files or is required to file with a stock exchange on which its securities are traded and which was ;made public by that exchange, or (iii) distributes or is required to distribute to its security holders.

The information required to be furnished pursuant to (I), (ii) or (iii) above is that which is material with respect to the issuer and its subsidiaries concerning: changes in business; changes in management or control; acquisitions or

dispositions of assets; bankruptcy or receivership; changes in registrant's certifying accountants; the financial condition and results of operations; material legal proceedings; changes in securities or in the security for registered securities; defaults upon senior securities; material increases or decreases in the amount outstanding of securities or indebtedness; the results of the submission of matters to a vote of security holders; transactions with directors, officers or principal security holders; the granting of options or payment of other compensation to directors or officers; and any other information which the registrant deems of material importance to security holders.

This report is required to be furnished promptly after the material contained in the report is made public as described above. The information and documents furnished in this report shall not be deemed to be filed for the purpose of Section 18 of the Act or otherwise subject to the liabilities of that section.

If a report furnished on this form incorporates by reference any information not previously filed with the Commission, such information must be attached as an exhibit and furnished with the form.

C.

Preparation and Filing of Report

This report shall consist of a cover page, the document or report furnished by the issuer, and a signature page. Eight complete copies of each report on this form shall be deposited with the Commission. At least one complete copy shall be filed with each United States stock exchange on which any security of the registrant is listed and registered under Section 12(b) of the Act. At least one of the copies deposited with the Commission and one filed with each such exchange shall be manually signed. Unsigned copies shall be conformed.

D.

Translations of Papers and Documents into English

Reference is made to Rule 12b-12(d) [17 CFR 240.12b-12(d)]. Information required to be furnished pursuant to General Instruction B in the form of press releases and all communications or materials distributed directly to security holders of each class of securities to which any reporting obligation under Section 13(a) or 15(d) of the Act relates shall be in the English language. English versions or adequate summaries in the English language of such materials may be furnished in lieu of original English translations.

Notwithstanding General Instruction B, no other documents or reports, including prospectuses or offering circulars relating to entirely foreign offerings, need be furnished unless the issuer otherwise has prepared or caused to be prepared English translations, English versions or summaries in English thereof. If no such English translations,

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versions or summary have been prepared, it will be sufficient to provide a brief description in English of any such documents or reports. In no event are copies of original language documents or reports required to be furnished.

April 13, 2006

TO WHOM IT MAY CONCERN:

Dear Sir or Madam:

Re:

Quarterly Report, Peace Arch Entertainment Group Inc.

Results for Six months ended February 28, 2006

I hereby confirm that the unaudited Consolidated Financial Statements and the Management Discussion and Analysis for the results for six months ended February 28, 2006 were sent by first class mail to the registered shareholders and the shareholders of the supplemental mailing list of Peace Arch Entertainment Group Inc. on the above date.

I trust you will find the above in order.

Yours truly,

PEACE ARCH ENTERTAINMENT GROUP INC.

/s/ Nicole Spracklin

Nicole Spracklin

Legal Assistant

Peace Arch Entertainment Group Inc.

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MANAGEMENT'S DISCUSSION AND ANALYSIS

of Financial Condition and Results of Operations

Management's Discussion and Analysis of the financial position and results of operations is prepared as at April 13, 2006, and should be read in conjunction with the accompanying unaudited financial statements and the notes therein.

This discussion contains forward-looking statements. Forward-looking statements are subject by their nature to risks and uncertainties, and actual results, actions or events could differ materially from those set forth in this discussion. The forward-looking information contained herein is current only as at the date of this document. There should not be an expectation that such information will in all circumstances be updated, supplemented or revised whether as a result of new information, changing circumstances, future events or otherwise.

OVERVIEW

Peace Arch Entertainment Group Inc. is a vertically integrated media company that produces, acquires and distributes feature films and television programming for the domestic and international marketplace.

Our revenues arise primarily from the following business segments:

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Motion Pictures, which includes revenues earned from the licensing of distribution rights to in-house and third party feature films to sub distributors in various territories and media throughout the world.

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Television, which includes revenues derived from the licensing of motion pictures and television programming produced or acquired by the Company to broadcasters, cable and satellite television providers domestically and abroad.

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Home entertainment, which includes revenues derived from the distribution of filmed entertainment and related products to retailers and rental outlets in Canada.

The Company's operating expenses include;

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Amortization of investment in film and television programming.

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Distribution and marketing expenses attributable to the exploitation of programming rights.

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Selling, general and administrative expenses, which include expenses directly attributable to each business segment and other expenses which are not directly attributable.

The Company's operates through five locations, two in Toronto and one each in Vancouver, Los Angeles and London, England. The entities through which these businesses operate are as follows:

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Peace Arch Entertainment Group Inc., ("PAE"), corporate and head office, based in Toronto, which focuses on the management of Motion Picture production activities, providing production administrative and financial structuring services to producers, licensing television rights in the Canadian market and the administration and collection of Canadian and international film tax incentives.

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Peace Arch LA, Inc. ("PALA"), based in Los Angeles, focuses on the packaging, financing and production of feature films and the licensing of those films in the United States.

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Peace Arch Films Ltd. ("PAF"), based in London, focuses on the international distribution of feature films produced or financed by the Company as well as acquired third party productions.

The Eyes Project Development Corp. ("TEPD"), based in Vancouver, develops and produces television series and documentary programming directed primarily to North American audiences that are reformatted to also serve the international marketplace. TEPD's television programs are currently distributed by a third party international (ex. North America) subdistributor.

Peace Arch Television Ltd. ("PATV"), based in Toronto, is involved in television program distribution. PATV distributes the programs to which PAE currently controls and also secures rights from third-party suppliers and sells those rights to broadcasters, cable and satellite television companies domestically and abroad.

kaBOOM! Entertainment Inc. ("kaBOOM") based in Toronto, is a distributor of DVDs and related home entertainment products.

Over the past year Peace Arch has shifted its emphasis from the production of feature film and television programming to the exploitation of that programming and third party projects through its internal sales operations. The Company licenses its proprietary and acquired programming to theatrical distributors, television broadcasters, cable companies, satellite services and home entertainment distributors. The Company believes that representing its own product assures meaningful control over the manner of presentation and provides invaluable input as to market perceptions at the packaging and development phase of programming.

At present, the Company is supporting the financing and packaging of an ongoing slate of feature films in the horror, thriller and action genres. It is currently in post-production on two theatrical films and is actively involved in the legal, administrative and executive work associated with a further two theatrical features, two cable films, four additional genre titles and a dramatic television series. For documentary and lifestyle productions many functions are performed using in-house resources.

While de-emphasizing traditional production activities in our business model, we plan to continue supervising the development, packaging and financing of many of our new projects. This strategy allows us to feed our distribution pipeline with a wider variety of new programming without assuming the burden of actively producing all of our film

and television projects.

Vision and Mission

Strategically the Company continues to move towards being the licensor of rights in film and television programming. Ownership of distribution rights in film and television programming will provide a source of future cash flows from a library of unsold distribution rights in addition to the cashflows that are expected to be generated from production activities thereby providing a more stable source of cash than would be generated from relying exclusively on production activities. It is our intention to establish value to the Company by building up and exploiting a library of film and television distribution rights. An additional benefit to taking an ownership position in the distribution rights of programming is that the distribution rights are sold for a fixed period of time for a license fee. At the expiration of that time period the distribution rights become available to be resold in the territory for another limited period of time. This cycle will continue thereby providing a long-term source of cash flow.

The mission of Peace Arch Entertainment Group Inc. is to become a world leading independent distributor of English-language feature film and television programming. In support of this, the Company is focused on the following:

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Business model with integrated production, marketing and sales operations

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Global financing relationships

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Distribution relationships and plans to increase global footprint

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Brand identity

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Management team

RECENT DEVELOPMENTS

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On March 30, 2006, Comerica agreed to convert its US\$1,075,000 loan for 215,000 shares of the Company's common stock.

On January 23, 2006, the Company acquired 100% of the issued and outstanding shares of kaBOOM! Entertainment Inc., a home entertainment studio in Canada. Total consideration of \$7,127,000 was provided in the form of 1,033,058 common shares of the Company valued at \$500,000, 50,000 stock options of the Company valued at \$17,000, cash consideration of \$3,000,000, future cash consideration of \$3,202,000 and direct costs of acquisition of \$408,000. The purchase price includes a provision for payment of the maximum additional consideration of \$1,000,000 contingent upon kaBOOM's results of operation for the year ended April 30, 2006. When the final determination of any contingent consideration due has been made, it will be recorded as an additional cost of acquisition.

On December 30, 2005, 1,435,897 Series II Preference Shares warrants were exercised at a subscription price of US\$0.50 per share for total proceeds of US\$717,948.

In a private placement on July 29, 2005 the Company issued 4,347,827 Units consisting of one Series

I Preference Share and one Series II Preference Share warrant for proceeds of \$2,349,000 or US\$0.46 per Unit. Each warrant, upon exercise, entitles the holder to acquire one Series II Preference Share at a price of US\$ 0.50 at any time up to July 29, 2009. Each Series I and Series II Preference Share is convertible into one Common Share of the Company. Each outstanding Series I and II Preference Share pays a 10% cumulative dividend on a quarterly basis. At August 31, 2005 all the Series II Preference Share warrants remained outstanding.

On March 31, 2005, Fremantle agreed to convert its \$8,793,000 note plus interest for 2,931,125 shares of the Company's common stock. As a result of Fremantle's conversion the Company has recognized a gain on settlement of the obligation to issue shares of \$1,105,000 representing the difference between the carrying amount of the obligation and the price of the Company's stock on the date of settlement.

SELECTED QUARTERLY INFORMATION

Three Months	Three Months
Ended	Ended
February, 28	February, 28
2006	2005

(in thousands except per share and deliveries information)

Deliveries

Feature Films	-	3
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TV Episodes	13	23
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Revenue	\$ 3,661	\$ 1,706
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Loss for the period	741	499
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Cash dividend on Preference Shares	76	-
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Basic and diluted loss per share	\$ 0.04	\$ 0.03
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The loss increased in the three months ended February 28, 2006 to \$0.7 million compared to the loss of \$0.5 million for the comparable period of the prior year.

For discussion on trends related to revenues in the above chart see section "Operating Results".

During fiscal 2005, the Company adopted AcG-15, Consolidation of Variable Interest Entities, as more fully described in note 2 of our consolidated financial statements. This change in accounting policy was applied on a retroactive basis effective December 1, 2004 without restatement of prior periods. This resulted in a cumulative increase of the Company's deficit in the amount of \$53,000.

OPERATING RESULTS*Quarterly Comparison*

For the three months ended February 28, 2006, the Company has reported a loss of \$0.7 million or \$0.04 diluted loss per share compared to a loss of \$0.5 million for the comparable period in fiscal 2005 or \$0.03 diluted loss per share.

Diluted loss per share is calculated on 21,905,000 weighted average shares outstanding at February 28, 2006 and 17,429,000 weighted average shares outstanding for the comparable period of the prior year.

Revenue. The Company reported revenue of \$3.7 million for the three month period ended February 28, 2006 compared to \$1.7 million for the comparable period in fiscal 2005 representing an increase of \$2.0 million or 118%

increase compared to the same period of the prior year. The following table presents revenues earned for each of our business segments;

(in thousands of dollars)	Three Months Ended February 28,	
	2006	2005
Segmented Information		
Motion Picture	\$ 429	\$ 454
Television	703	1,252
Home Entertainment	2,529	-
Total	\$ 3,661	\$ 1,706

Motion Picture revenue for the period ended February 28, 2006 was \$0.4 million compared to revenue of \$0.5 million for the comparable period in the prior year. The motion picture segmental revenue is comparable to the same period of the prior year.

Television revenue for the period ended February 28, 2006 was \$0.7 million representing a decrease of \$0.6 million from \$1.3 million for the comparable period of the prior year or a 46% decrease compared to the same period of the prior year. The decrease is mainly attributable to the recognition on 13 episodes of a television series during the quarter compared to revenue recognized on 26 episodes of two television series in the comparable period of the prior year.

Home entertainment revenue of \$2.5 million for the quarter represents the revenue recognized from the new kaBOOM business from the date of acquisition. There was no home entertainment revenue in the comparable period of the prior year.

Gross Profit. Gross profit is comprised of revenue less amortization of film and television programming and other production costs. Gross profit for the three months ended February 28, 2006 was \$1.3 million compared to \$0.6 million for the same period in the prior year.

(in thousands of dollars except gross profit %)	Three Months	Three Months	Change
	Ended	Ended	
	February 28	February 28	

	2006	2005	
Revenue	\$ 3,661	\$ 1,706	\$ 1,955
Amortization of investment in film and television programming and other production costs	2,354	1,097	1,257
Gross profit	\$ 1,307	\$ 609	\$ 698
Gross profit percentage	35.7%	35.7%	

As a percentage of revenue, gross profit was 35.7% for the three months ended February 28, 2006 which was comparable to the gross profit of 35.7% for the comparable period of the prior year.

Amortization. Amortization for the three months ended February 28, 2006 was higher than the same comparable period. Amortization was \$2.4 million for the three months ended February 28, 2006 compared to \$1.1 million for the three months ended February 28, 2005. The increase in amortization is reflective of the increase in revenues for the three months compared to the same period in the prior year.

Selling, General and Administrative Expense. Selling, general and administrative expense increased by \$0.8 million, or 85%, to \$1.7 million for the three months ended February 28, 2006 from \$0.9 million for the comparable period in the prior year. This increase was mainly due to additional costs associated with the new home entertainment business that have been incurred from the date of the kaBOOM acquisition compared to the three months ended February 28, 2005. During the three months ended February 28, 2006 there was no recovery of selling, general and administrative expenses as the time period over which the Company was entitled to recover such expenses associated with managing certain assets to realize cashflows to retire the Fremantle debt had ended in fiscal 2005. The following table presents the comparative net selling, general and administrative costs for the two comparable periods;

	Three Months Ended February 28 2006	Three Months Ended February 28 2005	Change
(in thousands of dollars)			
Selling, general and administrative expenses	\$ 1,671	\$ 933	\$ 738
Recovery of selling, general and administration	-	30	30
Total	\$ 1,671	\$ 903	\$ 768

Interest Income. Interest income was \$0.2 million for the three months ended February 28, 2006, compared to \$0.3 million for the same period of the prior year. Interest revenue represents interest earned on the Restricted Term Deposit. This interest revenue is offset by interest expense of the same amount recorded in respect of the Film

Financing Obligation.

Interest Expense. Interest expense was \$0.7 million for the three months ended February 28, 2006, representing an increase of \$0.3 million from \$0.4 million for the same period of the prior year. The increase is due to interest on outstanding production loans for projects produced and delivered in prior years which is no longer capitalized to the cost of the productions. Interest expense also includes interest of \$0.1 million on the deferred financing costs related to the kaBOOM acquisition. Interest expense includes interest incurred on the Film Financing Obligation. This interest expense was offset by interest revenue of the same amount recorded in respect of the Restricted Term Deposit.

Interest that is capitalized to the cost of film and television programs is charged to earnings in future periods as the related film and television programs are delivered and amortized. Interest component may vary each period depending on the dollar value of production during the period and the timing of production commencement and delivery during the period.

Other Amortization. For the three months ended February 28, 2006, other amortization consisting of amortization of property and equipment and amortization of intangible assets amounted to \$70,000 compared to \$23,000 for the comparable period of the prior year, representing a \$47,000 increase. This increase is due to amortization of \$45,000 during the quarter for intangible assets. In the comparable period of fiscal 2005, the Company did not have amortization related to intangible assets.

Year to Date Comparison

For the six months ended February 28, 2006, the Company has reported a loss of \$1.4 million or \$0.07 diluted loss per share compared to loss of \$1.1 million for the comparable period in fiscal 2005 or \$0.06 diluted loss per share.

Diluted loss per share is calculated on 21,540,000 weighted average shares outstanding at February 28, 2006 and 17,418,000 weighted average shares outstanding in the prior year.

Revenue. The Company reported revenue of \$4.6 million for the six month period ended February 28, 2006 compared to \$4.8 million for the comparable period in fiscal 2005 representing a decrease of \$0.2 million or 4% decrease compared the same period of the prior year. The following table presents revenues earned in each of our business segments;

Six Months Ended February 28,

(in thousands of 2006 2005
dollars)

**Segmented
Information**

Motion Picture	\$ 1,239	\$ 3,445
Television	802	1,359
Home Entertainment	2,529	-
Total	\$ 4,570	\$ 4,804

Motion Picture revenue for the period ended February 28, 2006 was \$1.2 million representing a decrease of \$2.2 million, or a 64% decrease compared to revenue of \$3.4 million for the comparable period in fiscal 2005. The decrease in revenues primarily reflects the lower number of projects produced by Peace Arch and is associated with the Company's strategy to prioritize the packaging, financing, and distribution of projects. This strategy results in lower presale revenues at the time a project is completed and delivered. During the six months ended February 28, 2006, the Company did not take delivery of any motion pictures. The revenues for the six month period arose from sales of distribution rights on programs completed and delivered in prior years.

Television revenue for the period ended February 28, 2006 was \$0.8 million representing a decrease of \$0.6 million from \$1.4 million for the same period of the prior year or a 41% decrease compared to the same period of the prior year. The decrease is mainly attributable to the recognition of 13 episodes of a television series during the six month period compared to revenue recognized on 26 episodes of two television series in the comparable period of the prior year.

Home entertainment revenue of \$2.5 million for the quarter represents the revenue recognized from the new kaBOOM business from the date of acquisition. There was no home entertainment revenue in the comparable period of the prior year.

Gross Profit. Gross profit is comprised of revenue less amortization of film and television programming and other production costs. Gross profit for the six months ended February 28, 2006 was \$1.4 million compared to \$0.8 million for the comparable period in the prior year.

	Six Months	Six Months	
	Ended	Ended	
	February 28	February 28	
(in thousands of dollars except gross profit %)	2006	2005	Change

Revenue	\$ 4,570	\$ 4,804	\$ (234)
Amortization of investment in film and television programming and other production costs	3,186	4,030	844
Gross profit	\$ 1,384	\$ 774	\$ 610
Gross profit percentage	30.3%	16.1%	

As a percentage of revenue, gross profit was 30.3% for the six months ended February 28, 2006 compared to the gross profit of 16.1% for the comparable period of the prior year. The increase in gross profit is due to the product mix on sales in the six months of film and television rights with a greater proportion of product sales with a higher gross profit compared to the sales of product in the comparable period of the prior year.

Amortization. Amortization for the six months ended February 28, 2006 was lower than that of the comparable period for the prior year. Amortization was \$3.2 million for the six months ended February 28, 2006 compared to \$4.0 million for the six months ended February 28, 2005. The decrease in amortization is reflective of the sales of product during the period with a higher gross margin, or lower amortization attached, compared to the sales of product in the comparable period of the prior year.

Selling, General and Administrative Expense. Selling, general and administrative expense increased by \$1.1 million, or 65.2%, to \$2.7 million for the six months ended February 28, 2006 from \$1.6 million for the comparable period in the prior year. This increase was mainly due to additional costs associated with the new home entertainment business that has been incurred from the date of the kaBOOM acquisition compared to the comparable period of the prior year. During the six months ended February 28, 2006 there was no recovery of selling, general and administrative expenses as the time period over which the Company was entitled to recover such expenses associated with managing certain assets to realize cashflows to retire the Fremantle debt had ended in fiscal 2005. The following table presents the comparative net selling, general and administrative costs for the last two comparable periods;

	Six Months Ended February 28 2006	Six Months Ended February 28 2005	Change
(in thousands of dollars)			
Selling, general and administrative expenses	\$ 2,691	\$ 1,772	\$ 909
Recovery of selling, general and administration	-	149	149
Total	\$ 2,691	\$ 1,623	\$ 1,058

Interest Income. Interest income was \$0.5 million for the six months ended February 28, 2006, compared to \$0.5 million for the comparable period of the prior year. Interest revenue represents interest earned on the Restricted Term

Deposit. This interest revenue is offset by interest expense of the same amount recorded in respect of the Film Financing Obligation.

Interest Expense. Interest expense was \$1.1 million for the six months ended February 28, 2006, representing an increase of \$0.4 million from \$0.7 million for the comparable period of the prior year. The increase is due to interest on outstanding production loans from projects produced and delivered in prior years which is no longer capitalized to the cost of the productions. Interest expense also includes \$0.1 million of interest on the deferred financing costs related to the kaBOOM acquisition. Interest expense includes interest incurred on the Film Financing Obligation. This interest expense was offset by interest revenue of the same amount recorded in respect of the Restricted Term Deposit.

Interest that is capitalized to the cost of film and television programs is charged to earnings in future periods as the related film and television programs are delivered and amortized. Interest component may vary each period depending on the dollar value of production during the period and the timing of production commencement and delivery during the period.

Other Amortization. For the six months ended February 28, 2006, other amortization consisting of amortization of property and equipment and amortization of intangible assets amounted to \$90,000 compared to \$27,000 for the comparable period of the prior year, representing a \$63,000 increase. This increase is due primarily to amortization of \$45,000 for intangible assets. In the comparable period of fiscal 2005, the Company did not have amortization related to intangible assets.

QUARTERLY CONSOLIDATED FINANCIAL DATA

(in thousands of dollars, except per share information)

(in thousands of Canadian dollars except per share amounts)

Fiscal 2006			Fiscal 2005		Fiscal 2004		
February 28,	November 30,	August 31,	May 31,	February 28,	November 30,	August 31,	May 31,
2006	2005	2005	2005	2005	2004	2004	2004

(Restated)

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Revenues	\$3,661	\$909	\$1,652	\$4,291	\$1,706	\$3,098	\$1,774	\$6,584
Net earnings (loss)	(741)	(699)	(198)	2,729	(499)	(583)	(2,448)	495
Basic earnings (loss) per common share								
	\$(0.04)	\$(0.04)	\$(0.01)	\$0.14	\$(0.03)	\$(0.03)	\$(0.14)	\$0.03

During the year ended August 31, 2005, the Company identified a required revision to its second quarter February 28, 2005 financial statements related to its accounting treatment of a complex arrangement with Showtime for the project "Our Fathers." We have determined the arrangement was in the nature of a co-financing relationship where both parties contributed financially to the production. Under GAAP, the co-financier's contribution to the project is considered a reduction of the film's negative costs. Previously, the co-financier's contribution to the production was recognized as revenue by the Company from sale of rights. The cost of the Company's investment in its film assets is similarly reduced.

The adjustment to the February 2005 quarter is a reversal of \$6.1 million in revenues and \$5.7 million in amortization resulting in an increase of net loss of \$0.4 million.

The preceding table reflects the revised results of operations for the quarter ended February 28, 2005.

The Company's revenues and net earnings are dependent on the timing of the completion of the production process. Delivery of motion picture business segment product occurs at any time during the year. There are no seasonal or cyclical factors involved with the delivery of motion pictures. Episodic television product is delivered to buyers as each episode is completed and may occur over two quarters.

Revenue recognized for the three months ended February 28, 2006 is primarily a result of distribution sales activity on film product delivered in prior years and sales generated from the new home entertainment business.

Quarterly net earnings (loss) have varied due to one time events that occurred during the third quarter of fiscal 2005 arising from the recognition of a one time \$2.1 million gain on the settlement of obligations as described in note 11 of the August 31, 2005 consolidated financial statements.

In the fourth quarter of fiscal 2004 the net loss can be attributed, for the most part, to a valuation impairment charge on the Company's investment in film and television after review of its future revenue estimates that support the carrying value of the investment in film and television.

OUTSTANDING SHARES

On January 23, 2006, in connection with the acquisition of kaBOOM, the Company issued 1,764,118 common shares of the Company for proceeds of \$0.8 million, net of issuance costs. The value of the common shares issued was \$0.44 or \$0.48, which was based on and determined by the average of the Company's common stock trading price for the 10 day period prior to the date of acquisition.

On December 30, 2005, 1,435,897 Series II Preference Share warrants were exercised at a subscription price of US\$0.50 per share for total proceeds of US\$ 717,948.

LIQUIDITY AND CAPITAL RESOURCES

As at February 28, 2006, the Company had available cash or cash equivalents of \$0.7 million. The Company borrows funds from banks and other financial institutions to finance the costs of production which are generally incurred in advance of contracted receipts and revenues from these programs. The Company typically finances the capitalized costs of its proprietary film and television programming through presales from customers, borrowings from bank facilities for individual production financing, government tax incentives, contributions from co-producers and working capital deployed as interim financing to contracted receipts. In the past, the Company has also funded capital requirements through the issuance of shares, warrants and debt. The Company has a term loan and a letter of credit provided by a financial institution due on July 30, 2006. Upon mutual agreement between the Company and the lender, the financing may be extended for a period of six months. The Company is currently identifying various financing alternatives to enable the timely discharge of the Company's obligations. Management will work toward funding capital requirements through the issuance of shares, warrants and debt, but there is no assurance that the Company will be successful in its financing efforts or the extension granted.

Cash Flows from Operating Activities

During the six months ended February 28, 2006, \$7.6 million was used by operating activities, compared to \$3.6 million used by operating activities for the same period in fiscal 2005. In the six months ended February 28, 2006, the Company increased its investment in film and television by \$9.3 million, net of amortization. This increase was offset by cash provided from a reduction of accounts receivables of \$2.8 million.

During the comparable period in fiscal 2005, the Company utilized \$3.6 million in operating activities. This was a result of the loss of \$1.0 million for the six months, an increase of \$1.5 million in film and television programming, net of amortization and a reduction in deferred revenue of \$3.2 million. This utilization of operating cash was offset by cash provided from a reduction in accounts receivable of \$2.3 million.

Cash Flows from Investing Activities

During the six months ended February 28, 2006, cash flow used in investing activities of \$3.3 million is primarily due to the net cash required for the acquisition of kaBOOM of \$3.2 million. For the comparable period of the prior year, cash used in investing activities of \$24,000 was a result of the purchase of property and equipment.

Cash Flows from Financing Activities

In the six months ended February 28, 2006, cash contributed from financing activities was \$10.2 million compared to cash provided from financing activities of \$4.1 million in the comparable period in fiscal 2005. Cash provided from financing activities was due to the net addition of production loans for the period of \$6.4 million, the issuance of \$3.5 million in a term loan in connection with acquisition of kaBOOM, the issuance of \$0.8 million in Series II Preferred Shares. For the comparable period of the prior year, cash contributed from financing activities amounted to \$4.1 million, which was due to a net issuance of production loans. The addition to production loans is reflective of the increase in investment in film and television.

Production loan repayments are solely due from cash flows derived from each film and is independently secured by a charge over all the assets of the production subsidiary and the exploitation rights, tax credits and subsidies associated with each film. Management expects that a significant portion of the loans due at February 28, 2006 will be payable over the next year. The Company has total loan and credit facilities of \$11.4 million which are due for annual renewal in the current fiscal year. The Company obtained extensions in the past since the timing of collection of receipts and revenue streams may extend beyond the original estimated date. Management seeks renewals and extensions of the individual production loan facilities and is confident that such an agreement will be achievable. However, there is no assurance the Company will be successful.

OFF BALANCE SHEET ARRANGEMENTS

During the year ended August 31, 2004, the Company provided a guarantee of the sales performance of its subsidiary Peace Arch Films Limited (PAF) of US\$2.5 million to assist with a producer's financing for a production for which PAF has acquired worldwide distribution rights. PAF has also provided financing contributions towards the cost of the production. The sales performance obligation is due one year after the production's initial theatrical release. The obligation is recoverable by PAF from the proceeds of the production's sales or the receipt of government incentives due to the producer. In return for providing the additional guarantee, the Company will obtain an additional interest in the films from its co-producer. Should the Company default in the guarantee payment, the co-producer is entitled to receive the Company's shares in satisfaction of the obligation which would be issued at market price at that time less 10%.

At February 28, 2006, the Company had commitments of \$4.7 million (August 31, 2005 - \$3.1 million) with respect to the acquisition of film distribution rights to 6 films (August 31, 2005 - 3 films), which will be delivered to the Company during the year ended August 31, 2006. These payments are required to be made at the date of delivery of the respective films which is expected to be no later than August 31, 2006.

RELATED PARTY TRANSACTIONS

The Company has entered into the following related party transactions. These transactions are measured at the exchange amount, which is the actual amount of consideration given as established and agreed between the related parties.

a)

During the six months ended February 28, 2006, the Company paid \$95,000 (2005 - \$90,000) to a company controlled by a shareholder, director and officer of the Company for executive services rendered. These expenditures are reflected in the Company's selling, general and administrative expenses.

b)

During the six months ended February 28, 2006, the Company paid \$nil (2005 - \$32,000) to a shareholder, director and officer of the Company for legal services rendered. These expenditures are reflected in the Company's selling, general and administrative expenses.

c)

As at February 28, 2006, the Company was owed \$nil (2005 - \$167,000) from a company controlled by a shareholder, director and officer of the Company. This amount is included in accounts and other receivables.

d)

As at February 28, 2006, included in accounts receivable was \$nil (August 31, 2005 - \$1,480,000 (US\$1,200,000)) from a company owned by a member of senior management. This amount is a result of a sale of distribution rights to the related company prior to the individual becoming a member of senior management. The amount is secured by an irrevocable letter of credit.

e)

As at February 28, 2006, the Company was indebted to a shareholder, director, and officer of the Company in the amount of \$50,000 (2005 - \$nil). The amount is due on demand and is entitled to a 10% finance fee of the amount of the loan. This amount payable is included in production loans.

f)

As at February 28, 2006 the Company was indebted to the preferred shareholders in the amount of \$108,000. This amount is the standby fee related to the letters of credit from the preferred shareholders, which is payable in cash or common shares at the option of the Company.

Other related party transactions and balances have been described elsewhere in these financial statements.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

During the quarter, the Company paid for goodwill in connection with the acquisition of kaBOOM.

The Company was required to make estimates in the determination of the fair valuation of kaBOOM's tangible and intangible assets and liabilities in accounting for the acquisition of kaBOOM.

Goodwill is reviewed for impairment at least annually. The Company makes estimates in the determination of any potential impairment of goodwill.

FINANCIAL INSTRUMENTS

As at February 28, 2006, the Company's financial instruments included cash and cash equivalents, restricted term deposits, accounts and other receivables, corporate loan, production loans, revenue guarantee obligation, business acquisition obligation and accounts payable and accrued liabilities. The carrying values of the restricted term deposits and the revenue guarantee obligations approximate fair value as the interest rates are reflective of current market rates as at February 28, 2006. The carrying value of the business acquisition obligation to issue shares reflects fair value as it is reported at the fair value of the shares at February 28, 2006. The carrying value of the remaining financial instruments approximated their fair value due to their ability for prompt liquidation or short term to maturity.

RISKS AND UNCERTAINTIES

There are risks and uncertainties that could impact the Company's revenues and earnings from operations.

BUSINESS RISKS

The business of producing and distributing film and television programming is highly competitive and involves a substantial degree of risk. The Company faces intense competition from other producers and distributors, many of whom are substantially larger and have greater financial resources. The Company competes with other companies for ideas and storylines created by third parties as well as for actors, directors and other personnel. The Company's future financial performance may be adversely affected if it is unable to compete successfully. Results of operations for any period depend on the number of film and television programs that are delivered. Consequently, results may vary from period to period and the results of any one period may not indicate results for future periods. Cash flows may also fluctuate and may not directly correspond with revenue recognition. Actual production costs may exceed budget, perhaps significantly, due to factors within or beyond the Company's control. These factors may delay completion of a production. If there are significant cost overruns the Company may have to seek additional financing to complete the production or will have the ability to call upon the bond in order to complete the film. The Company may be unable to recoup the additional costs which could have a material adverse impact on operating results and liquidity.

Revenues derived from the production and distribution of film and television programming depend primarily upon acceptance by the public which is difficult to predict. Some or all of the proprietary film and television programs may not be commercially successful, which could result in the Company's failure to recoup its investment or realize its anticipated profits.

The Company's business is substantially dependent on the services of a number of key personnel placed in several positions within the organization. The success of the Company depends to a certain degree upon the skill and efforts

of its management and upon its ability to attract and retain qualified management personnel. The loss of their services could have an effect on the Company's business.

The Company's international distribution revenue is subject to risks associated with local economic conditions, currency fluctuations, changes in local regulatory requirements, compliance with a variety of foreign laws and regulations, cultural barriers and political stability. The Company's international distribution revenue may be adversely affected by these risks.

The Company is expecting that if its efforts are successful it will experience a period of growth that could place a strain on its resources. If the Company's management is unable to manage growth effectively, operations could be adversely affected.

To date, the Company has been involved primarily in the development, production and distribution of feature film and television programs. The Company may be required to raise additional financing, make capital expenditures and hire additional personnel in connection with these proposed activities. If the Company is unsuccessful in these new business endeavors, it may have a material adverse effect on its results.

Investments in film and television programming are amortized against revenues in the ratio that current revenues bear to management's estimate of ultimate revenues for each program. The Company typically amortizes a minimum of 80% of film costs over a three-year period. Management periodically reviews its estimates and adjusts the amortization of its production costs accordingly. In the event that management should determine that the capitalized costs for a program exceed its fair value, capitalized costs would be written down in the current period, resulting in a corresponding decrease in earnings.

GOVERNMENT INCENTIVES

The Company accesses Canadian and United States State government incentives in the form of tax credits and utilizes structures which permit foreign country tax-assisted participation in the financing of its projects. If such subsidies and tax assistance were to be eliminated the Company's production operations could be adversely affected in the future.

CURRENCY RISK

The Company receives a portion of its revenues from the United States and international sources in United States dollars. A portion of a film and television program's financing of production costs may be denominated in United States dollars while production costs are payable primarily in Canadian dollars. Accordingly, operating results can be

affected by fluctuations in the United States dollar exchange rate as we do not hedge our foreign exchange exposure. In addition, costs may be payable in currencies other than Canadian and United States dollars. We monitor our currency exchange rate risks on an ongoing basis.

INTEREST RATE RISK

The Company is exposed to interest rate risk from production loans bearing interest rates that vary with fluctuations in interest rates.

OUTLOOK

The Company's primary objective is to expand operations in the development, production and distribution of proprietary programming, focusing on programming that will add long-term library value.

A key aspect of this objective is to formalize key international strategic relationships which can reliably support the financing and exploitation of products. The Company is also working to enhance its ability to support financing projects through exclusive support agreements with third party interim and equity financiers. Finally, the Company will seek to build working capital reserves to better prepare for timely and strategic acquisitions of product and to reduce costs of short term interim project financing activities.

ADDITIONAL INFORMATION

Additional information relating to the Company can be found on SEDAR at www.sedar.com

Additional information, including directors' and officers' remuneration and indebtedness, principal holders of Peace Arch Entertainment Group Inc.'s securities, options to purchase securities and interests of insiders in material transaction, where applicable, is contained in the Information Circular.

Additional financial information is provided in the Company's consolidated financial statements for its 2005 fiscal year and the Six Months ended February 28, 2006.

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The Company, upon request to the secretary of the Company at 407-124 Merton Street, Toronto, Ontario, M4S 2Z2, will provide to any person or company one copy of the Annual Information Form, together with one copy of the consolidated financial statements, Management Discussion and Analysis and of any interim financial statements, one copy of the information circular or any filing prepared instead of that information circular provided that the Company may require the payment of a reasonable charge if the request is made by a person or company who is not a security-holder of the Company.

Dated April 13, 2006.

Form 52-109F2 - Certification of Interim Filings

I Gary Howsam, *Peace Arch Entertainment Group Inc., Chief Executive Officer*, certify that:

1. I have reviewed the interim filings (as this term is defined in Multilateral Instrument 52-109 *Certification of Disclosure in Issuers' Annual and Interim Filings*) of Peace Arch Entertainment Group Inc., (the issuer) for the interim period ending February 28, 2006;

2. Based on my knowledge, the interim filings do not contain any untrue statement of a material fact or omit to state a material fact required to be stated or that is necessary to make a statement not misleading in light of the circumstances under which it was made, with respect to the period covered by the interim filings;

3. Based on my knowledge, the interim financial statements together with the other financial information included in the interim filings fairly present in all material respects the financial condition, results of operations and cash flows of the issuer, as of the date and for the periods presented in the interim filings;

4. The issuer's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures and internal control over financial reporting for the issuer, and we have:

(a) designed such disclosure controls and procedures, or caused them to be designed under our supervision, to provide reasonable assurance that material information relating to the issuer, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which the interim filings are being prepared; and

(b) designed such internal control over financial reporting, or caused it to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with the issuer's GAAP; and

Date: April 13, 2006

/s/ Gary Howsam

Gary Howsam

Chief Executive Officer

Form 52-109F2 - Certification of Interim Filings

I Mara Di Pasquale, *Peace Arch Entertainment Group Inc., Chief Financial Officer*, certify that:

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1. I have reviewed the interim filings (as this term is defined in Multilateral Instrument 52-109 *Certification of Disclosure in Issuers' Annual and Interim Filings*) of Peace Arch Entertainment Group Inc., (the issuer) for the interim period ending February 28, 2006;

2. Based on my knowledge, the interim filings do not contain any untrue statement of a material fact or omit to state a material fact required to be stated or that is necessary to make a statement not misleading in light of the circumstances under which it was made, with respect to the period covered by the interim filings;

3. Based on my knowledge, the interim financial statements together with the other financial information included in the interim filings fairly present in all material respects the financial condition, results of operations and cash flows of the issuer, as of the date and for the periods presented in the interim filings;

4. The issuer's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures and internal control over financial reporting for the issuer, and we have:

(a) designed such disclosure controls and procedures, or caused them to be designed under our supervision, to provide reasonable assurance that material information relating to the issuer, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which the interim filings are being prepared; and

(b) designed such internal control over financial reporting, or caused it to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with the issuer's GAAP; and

Date: April 13, 2006

/s/ Mara Di Pasquale

Mara Di Pasquale

Chief Financial Officer

Peace Arch Entertainment Group Inc.

Quarterly Consolidated Financial Statements

February 28, 2006

(in thousands of Canadian dollars)

Peace Arch Entertainment Group Inc.

Consolidated Balance Sheets

(expressed in thousands of Canadian dollars)

	February 28	August 31
	2006	2005
	\$	\$
	(unaudited)	(audited)
Assets		
Cash and cash equivalents	699	1,428
Accounts and other receivables (note 3)	14,096	13,022
Inventory	2,062	-
Investment in film and television programming (note 4)	25,330	15,559
Prepaid expenses and deposits	435	163
Property and equipment	606	399
Intangible assets (note 10(a))	1,755	-
Deferred financing costs (note 10(b))	604	-
Goodwill (note 9)	4,285	-
Restricted term deposits	19,694	20,597
	69,566	51,168
Liabilities		
Accounts payable and accrued liabilities (note 7)	10,430	4,519

Acquisition payable (note 9)	3,202	-
Term loan (note 5)	3,500	-
Production loans (note 6)	22,447	16,038
Deferred revenue	490	523
Obligation to issue shares (note 11(b))	142	142
Revenue guarantee obligation	19,694	20,597
	59,905	41,819
Shareholders' Equity		
Capital stock (note 13)	11,745	9,889
Contributed surplus	2,602	2,342
Warrants (note 14)	464	693
Other paid-in capital	680	680
Deficit	(5,830)	(4,255)
	9,661	9,349
	69,566	51,168

Nature of operations and going concern (note 1)

Approved by the Board of Directors

Director

Director

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

Peace Arch Entertainment Group Inc.

Consolidated Statements of Operations

(unaudited)

(expressed in thousands of Canadian dollars, except per share amounts)

	Three Months Ended		Six Months Ended	
	February 28		February 28	
	2006	2005	2006	2005
	\$	\$	\$	\$
		Restated		Restated
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Revenue	3,661	1,706	4,570	4,804
Expenses				
Amortization of investment in film and television programming and other production costs	2,354	1,097	3,186	4,030
Selling, general and administrative	1,671	933	2,691	1,772
	4,025	2,030	5,877	5,802
Loss from operations before the undernoted	(364)	(324)	(1,307)	(998)
Interest income	244	273	496	532
Interest expense	(658)	(390)	(1,088)	(728)
Other amortization	(70)	(23)	(90)	(27)
Foreign exchange gain (loss)	97	(83)	506	(28)
Gain on sale of asset (note 8)	10	32	43	32
Recovery of selling, general and administration expenses	-	30	-	149
Non-controlling interest (note 2)	-	(14)	-	(14)

Loss before income taxes	(741)	(499)	(1,440)	(1,082)
Income tax recovery	-	-	-	-
Loss for the period	(741)	(499)	(1,440)	(1,082)
Loss per common share (note 15)				
Basic	(0.04)	(0.03)	(0.07)	(0.06)
Diluted	(0.04)	(0.03)	(0.07)	(0.06)

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

Peace Arch Entertainment Group Inc.

Consolidated Statements of Deficit

(unaudited)

(expressed in thousands of Canadian dollars)

	Three Months Ended		Six Months Ended	
	February 28		February 28	
		2005		2005
	2006	\$	2006	\$
	\$	(Restated)	\$	(Restated)
Deficit - Beginning of period	(5,013)	(36,025)	(4,255)	(35,442)
Effect of adoption of Accounting Guideline -15 (note 2)	-	53	-	53
Preferred stock dividend	(76)	-	(135)	-
Loss for the period	(741)	(499)	(1,440)	(1,082)
Deficit - End of period	(5,830)	(36,471)	(5,830)	(36,471)

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

Peace Arch Entertainment Group Inc.

Consolidated Statements of Cash Flows

(unaudited)

(expressed in thousands of Canadian dollars)

	Three Months Ended		Six Months Ended	
	February 28		February 28	
		2005		2005
	2006	\$	2006	\$
	\$	(Restated)	\$	(Restated)
Cash flows from operating activities				
Loss for the period	(741)	(499)	(1,440)	(1,082)
Items not affecting cash				
Amortization of film and television programming	637	920	1,176	3,756
Other amortization	70	23	90	26
Amortization of deferred financing costs	112	-	112	-
Gain on sale of asset	(10)	(32)	(43)	(32)
Stock based compensation	187	220	243	220
Non-controlling interest	-	14	-	14
Investment in film and television programming	(5,952)	(4,723)	(10,455)	(5,133)
Changes in non-cash operating working capital, net of acquisitions (note 16)	829	2,854	2,706	(1,339)
	(4,868)	(1,223)	(7,611)	(3,570)
Cash flows from investing activities				
Acquisition of kaBOOM! Entertainment Inc., net of cash acquired (note 9)	(3,176)	-	(3,176)	-

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Property and equipment purchases	(95)	(2)	(127)	(24)
	(3,271)	(2)	(3,303)	(24)
Cash flows from financing activities				
Preferred stock dividends (note 13(a))	(76)	-	(135)	-
Issuance of term loan	3,500	-	3,500	-
Issuance of Series II Preferred shares	827	-	827	-
Deferred financing costs	(416)	-	(416)	-
Issuance of production loans	6,638	6,283	13,076	9,906
Repayment of production loans	(2,154)	(3,952)	(6,667)	(5,819)
	(8,319)	2,331	10,185	4,087
Increase (decrease) in cash and cash equivalents	180	1,106	(729)	493
Cash and cash equivalents - Beginning of period	519	871	1,428	1,484
Cash and cash equivalents - End of period	699	1,977	699	1,977
Supplemental cash flow information				
Interest paid	261	69	838	313
Non-cash transactions				
Warrant costs attributed to issuance of Series II Preference shares	229	-	229	-
Acquisition payable for purchase of kaBOOM! Entertainment Inc. (note 9)	3,202	-	3,202	-
Issuance of common shares for purchase of kaBOOM! Entertainment Inc. (note 9)	500	-	500	-
Issuance of common shares for deferred financing costs	300	-	300	-

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

Peace Arch Entertainment Group Inc.

Notes to Consolidated Financial Statements

February 28, 2006 and 2005

(Amounts in tables expressed in thousands of Canadian dollars, except per share amounts)

1

Nature of operations and going concern

Based in Toronto, Vancouver, Los Angeles and London, England, Peace Arch Entertainment Group Inc., together with its subsidiaries, (collectively, the Company) is an integrated company that creates, develops, produces and distributes film, television and video programming for worldwide markets.

While these consolidated financial statements have been prepared on the going concern basis, which assumes the realization of assets and the settlement of liabilities in the normal course of operations, there are conditions that cast substantial doubt on the validity of this assumption. The Company has undergone substantial restructuring and requires additional financing until it can generate positive cash flows from operations. While the Company continues to maintain its day-to-day activities and produce and distribute films and television programming, its working capital situation is severely constrained. Furthermore, the Company operates in an industry that has long operating cycles which require cash injections into new projects significantly ahead of the delivery and exploitation of the final production.

On July 29, 2005 the Company completed a private placement of 4,347,827 Preference Share Units of the Company for US\$2 million. On December 30, 2005 1,435,897 of the Series II Preference Share warrants were exercised for total proceeds of US\$717,948, which were used by the Company to fund working capital requirements and for general corporate purposes.

The Company has a term loan and a letter of credit provided by a financial institution which is due on July 30, 2006. Upon mutual agreement between the Company and the lender, the financing may be extended for a period of six months. The Company is currently identifying various financing alternatives to enable the timely discharge of the Company's obligations. Management will work toward funding capital requirements through the issuance of shares, warrants and debt, but there is no assurance that the Company will be successful in its financing efforts or the extension granted.

The application of the going concern basis is dependent upon the Company obtaining additional financing in the short term and achieving sufficient cash flows from operations to fund continuing operations and meet its obligations as they come due. There is no assurance that the Company will be successful in its financing efforts and in achieving sufficient cash flows from operations. If the Company is unsuccessful, the Company may be required to significantly

reduce or limit operations.

These consolidated financial statements do not reflect adjustments that would be necessary if the going concern basis is not appropriate. If the going concern basis is not appropriate for the consolidated financial statements, then significant adjustments would be necessary in the carrying value of assets and liabilities and the reported revenues and expenses.

2

Significant Accounting Policies

a)

Basis of Presentation

The interim consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in Canada for interim financial reporting. Accordingly, they do

t;Times New Roman", Times, serif; font-size: 10pt;">Carmel

Clay Terrace

2004

Texas

San Antonio

The Shops at La Cantera

2005

Texas

Dallas

North Park Mall

2006

Illinois

Lincolnshire

Lincolnshire Commons

2006

Texas

Houston

Houston Galleria

2006

Illinois

Oak Brook

Oak Brook Promenade

2006

Texas

Austin

The Domain

2007

Michigan

Troy

Big Beaver Road

2007

Connecticut

Stamford

Stamford Town Center

2007

Louisiana

Baton Rouge

Perkins Rowe

2007

Arizona

Gilbert

San Tan Village

2008

Arizona

Phoenix

City North

2008

Virginia

Richmond

West Broad Village

2009

New Jersey

Woodbridge

Woodbridge Conference Center

2009

Minnesota

Eden Prairie

Windsor Plaza

2009

Florida

Tampa

MetWest International

2009

Maryland

Baltimore

Downtown Baltimore

2010

Idaho

Boise

The Village at Meridian

2013

Texas

The Woodlands

The Woodlands Town Center

2013

Texas

Fort Worth

West 7th

2014

Texas

El Paso

Fountains at Farah

2014

Florida

Sarasota

University Town Center

2014

Georgia

Alpharetta

Avalon

2014

Ohio

Columbus

Easton Town Center

2014

Puerto Rico

San Juan

Mall of San Juan

2015

Texas

Plano

West Plano Village

2015

Virginia

Arlington

Rosslyn-Ballston Corridor

2015

Florida

Miami

Dolphin Mall

2015

Ohio

Cincinnati

Liberty Center

2015

Nevada

Las Vegas

Fashion Show Mall

2015

Texas

Friendswood

Baybrook Mall

2015

Alabama

Huntsville

Bridge Street Town Centre

2016

Hawaii

Honolulu

International Market Place

2016

Tennessee

Franklin

CoolSprings Galleria

2016

Virginia

Fairfax

Fair Oaks Mall

2016

Minnesota

Minnetonka

Ridgedale Center

2016

California

Irvine

Irvine Spectrum Center

2016

Florida

Winter Park

Lakeside Crossing

2016

Texas

San Antonio

North Star Mall

2016

Arizona

Scottsdale

Scottsdale Quarter

2017

Arizona

Scottsdale

Corporate Office at Scottsdale Quarter

2017

22

Item 3. Legal Proceedings

We are engaged in various legal actions, which arise in the ordinary course of our business. Although there can be no assurance as to the ultimate disposition of these matters, it is the opinion of our management, based upon the information available at this time, that the expected outcome of these matters, individually or in the aggregate, will not have a material adverse effect on the results of operations or financial condition of our company.

On December 13, 2012, Frank Neal Goss filed a lawsuit against Kona Grill Macadamia, Inc., a wholly-owned subsidiary of the Company (“Macadamia”) and Anthony DeAngelo in the Circuit Court of Jackson County, Kansas City, Missouri. The claim revolves around a fight that Goss and DeAngelo allegedly had outside of the Company’s Kansas City restaurant on March 1, 2011, which is claimed to have resulted in physical injury to the plaintiff. The plaintiff also claims that Macadamia failed to take certain actions that allegedly would have prevented the fight. A default judgment of approximately \$3.5 million was entered on December 18, 2013 against Macadamia, but was subsequently set aside by order of the Circuit Court on April 7, 2014. On August 17, 2015, we filed a Motion for Summary Judgment requesting judgment in our favor on all claims asserted against us by the plaintiff. On August 18, 2015, the plaintiff filed for a voluntary dismissal of the claim without prejudice; however, on April 22, 2016, the plaintiff re-filed the claim in the Circuit Court. A trial date was scheduled for June 12, 2017. The plaintiff filed for a motion of continuance on June 2, 2017 and the motion was granted. In January 2018, a confidential general release was signed by the plaintiff. On January 29, 2018, the Circuit Court dismissed the case with prejudice.

On July 27, 2017, the Company received a letter from an attorney purporting to represent two stockholders of the Company. The letter relates to a proposal to amend the Company’s 2012 Stock Award Plan (the “Plan”) that was brought before the Company’s shareholders at its 2015 annual stockholders’ meeting. The letter claims that although the Plan amendment received affirmative votes from stockholders holding 57.7% of the shares present and entitled to vote on the proposal, it was not duly approved by the appropriate voting standard. The Company investigated the claims made in the letter and determined that the Plan amendment did not receive sufficient votes to adopt the amendment in accordance with the Company’s bylaws. The Company has determined which stock options granted by the Company since April 2015 were not within the number of shares reserved under the Plan prior to the 2015 amendment (the “Excess Stock Options”). All of the Excess Stock Options were issued in 2016 and 2017 to an aggregate of 13 employees and directors at exercise prices of \$14.26 and \$8.15 per share, far in excess of the current trading price of \$2.05. The Company also determined that none of the Excess Stock Options have been exercised. The Company has entered into amendments with each of the 11 holders of Excess Stock Options who are still employees or directors of the Company. The amendments specify that such Excess Stock Options cannot be exercised until further stockholder approval is obtained for an amendment to the Plan that increases the authorized shares. Therefore, the Company believes it has taken appropriate corrective action. The Company does not expect that its receipt of the demand letter or the claims made therein will have a materially adverse effect on its financial condition or results of operation. However, the Nasdaq Marketplace Rules require that listed companies obtain stockholder approval prior to issuing securities under equity incentive plans when such plans are established or materially amended. Depending upon the validity of the claims made in the demand letter, Nasdaq may provide us with a deficiency letter and require that we present Nasdaq with a plan of compliance to correct the asserted violation, if Nasdaq does not agree that necessary corrective action has been taken.

Also on July 27, 2017, a class action complaint was filed against Kona Sushi, Inc., a wholly-owned subsidiary of the Company, by Mitchell Boots, individually and on behalf of a Proposed Rule 23 Class, in the United States District Court for Minnesota claiming, among other things, that the Company violated Minnesota gratuity/tip pooling laws with respect to certain classes of restaurant employees. The plaintiff has brought claims on behalf of a putative Minnesota class and a putative national class of employees. On October 25, 2017, the plaintiff amended the complaint to withdraw the national class claims and other common law claims, leaving one claim on behalf of a putative Minnesota class, and added a second named Plaintiff, Tracy Fortman. On January 9, 2018, a pre-trial scheduling order was issued by the District Court, setting pre-trial dates and setting a trial date of January 1, 2019. The Company is in the early stages of discovery and does not expect the result of such complaint to have a material adverse effect on the Company. However, there is no assurance that any adverse ruling or settlement in that matter would not have a material impact on the Company's cash position and operations.

On November 29, 2017, Continental Atrium Corporation filed a complaint for damages in the Superior Court for the State of California for the County of Los Angeles alleging, among other things, that the Company breached its written contract relating to the Company's decision in April 2017 to not move forward with the construction of a restaurant in El Segundo as discussed in Note 10 below (the "Complaint"). The Complaint alleges that beginning no later than August 15, 2017, the Company has failed to pay rent and other amounts owed to the plaintiff. A case management conference is scheduled for April 30, 2018. As of December 31, 2017, we had \$1.0 million in lease termination and exit costs recorded in accrued expenses in the accompanying Consolidated Balance Sheets associated with this matter.

Item 4. *Mine Safety Disclosures*

Not applicable.

PART II

Item 5. *Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities*

Market Information

Our common stock has traded on the NASDAQ Global Market under the symbol KONA since our initial public offering on August 16, 2005. The following table sets forth high and low sale prices of our common stock for each calendar quarter indicated as reported on the NASDAQ Global Market.

	High	Low
2017		
First quarter	\$ 12.85	\$ 5.80
Second quarter	\$ 6.35	\$ 3.25
Third quarter	\$ 4.30	\$ 1.50
Fourth quarter	\$ 3.95	\$ 1.70
2016		
First quarter	\$ 16.71	\$ 12.09
Second quarter	\$ 14.08	\$ 10.34
Third quarter	\$ 14.09	\$ 9.99
Fourth quarter	\$ 13.50	\$ 10.05

On February 28, 2018, the closing sale price of our common stock was \$1.80 per share. On February 28, 2018, there were 17 holders of record of our common stock.

Recent Sales of Unregistered Securities

None.

Dividend Policy

We have not paid any dividends to holders of our common stock since our initial public offering and do not anticipate that we will pay any dividends to holders of our common stock in the foreseeable future, but instead we currently plan to retain any earnings to finance our restaurant operations and the growth of our business. Payments of any cash dividends in the future, however, is within the discretion of our Board of Directors and will depend on our financial condition, results of operations, and capital and legal requirements as well as other factors deemed relevant by our Board of Directors.

Issuer Purchase of Equity Securities

In November 2015, our Board of Directors authorized a repurchase program of up to \$10 million of outstanding common stock. We completed the \$10 million stock repurchase program in June 2016 with the purchase and retirement of 832,937 shares under the 2015 authorization.

In October 2016, our Board of Directors authorized an additional stock repurchase of up to \$5 million of outstanding common stock. We completed the \$5 million stock repurchase program in February 2017 with the purchase and retirement of 532,376 shares.

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

The following discussion and analysis should be read in conjunction with our consolidated financial statements and related notes contained elsewhere in this report. This discussion contains forward-looking statements that involve risks, uncertainties, and assumptions. Our actual results may differ materially from those currently anticipated as a result of a variety of factors, including those set forth under Item 1A, "Risk Factors" and elsewhere in this report.

Overview

We currently own and operate 46 restaurants located in 23 states and Puerto Rico. Over the past four years, we have grown organically through opening new restaurants and doubled the number of domestic restaurants during this time from 23 to 46. Our unit growth rate was 22% in 2016, with eight openings during the year and we had 23% unit growth in 2015 with seven restaurant openings. We opened one restaurant in 2017. We believe that a modest growth rate over the next few years will allow us to focus our time and attention on restaurant operations and improving financial performance.

During the years ended December 31, 2017 and 2016, we recorded non-cash asset impairment charges of \$9.3 million and \$12.5 million, respectively, for certain underperforming restaurants based upon an assessment of each restaurant's historical operating performance combined with expected cash flows for these restaurants over the respective remaining lease term. During 2017, we executed lease amendments for rent concessions for five of our existing restaurants. We continue to negotiate with our landlords regarding rent abatement or closures of underperforming restaurants as part of our strategy to improve financial performance.

As part of our capital allocation strategy, during the second quarter of 2017, we made the decision to not move forward with the planned construction and opening of a restaurant in El Segundo, California and recognized \$1.4 million related to estimated lease termination and exit costs. See "Lease Termination and exit costs" in Note 10 of the Notes to the Consolidated Financial Statements for further discussion.

Cost of sales, labor, and other operating expenses for our restaurants open at least 12 months generally trend consistently with revenue, and we analyze those costs as a percentage of revenue. Our typical new restaurants experience gradually increasing unit volumes as customers discover our concept and we generate market awareness. We anticipate that our new restaurants will take up to twelve months to achieve the majority of operating efficiencies as a result of challenges typically associated with opening and operating new restaurants, including lack of market recognition and the need to hire and sufficiently train employees, as well as other factors. We expect cost of sales and labor expenses as a percentage of revenue to be higher when we open a new restaurant, but to decrease as a percentage of revenue as the restaurant matures and as the restaurant management and employees become more efficient in operating that unit. Occupancy and a portion of restaurant operating expenses are fixed. As a result, the volume and

timing of newly opened restaurants has had, and is expected to continue to have, an impact on cost of sales, labor, occupancy, and restaurant operating expenses measured as a percentage of revenue, which we expect will continue until these restaurants mature.

We continue to execute our strategy for international market expansion. As there is increased demand for upscale casual dining concepts overseas, we believe there is a significant opportunity to expand our concept in Canada, Latin America, the Middle East and beyond. In 2016, we signed agreements for the development of six Kona Grill restaurants in Mexico and six Kona Grill restaurants in the United Arab Emirates. In April 2017, we signed an agreement for the development of one Kona Grill restaurant in Vaughan, Canada. The agreement allows our franchisee the right to develop additional restaurants in the Toronto market for a specified period of time following the opening of the first restaurant. Each of our three international franchise partners opened a Kona Grill restaurant in their respective countries in the second half of 2017.

Key Measures We Use to Evaluate Our Company

Key measures we use to evaluate and assess our business include the following:

Same-Store Sales Percentage Change. Same-store sales percentage change reflects the periodic change in restaurant sales for the comparable restaurant base. In calculating the percentage change in same-store sales, we include a restaurant in the comparable restaurant base after it has been in operation for more than 18 months. We adjust the sales included in the same-store sales calculation for restaurant closures, primarily as a result of remodels, so that the periods will be comparable. Same-store sales growth can be generated by an increase in customer traffic counts or by increases in the per person average check amount. Menu price changes and the mix of menu items sold can affect the per person average check amount.

Operating Weeks. Operating weeks represent the number of weeks that our restaurants were open during the reporting period.

Sales per Square Foot. Sales per square foot is a measure of a restaurant's productivity and represents the amount of sales generated for each square foot.

Average Unit Volume. Average unit volume represents the average restaurant sales for the comparable restaurant base.

Restaurant Operating Profit. Restaurant operating profit is defined as revenue minus cost of sales, labor, occupancy, and restaurant operating expenses. Restaurant operating profit does not include general and administrative expenses, depreciation and amortization, or preopening expenses. We believe restaurant operating profit is an important component of financial results because it is a widely-used metric within the restaurant industry to evaluate restaurant-level productivity, efficiency, and performance prior to application of corporate overhead. We use restaurant operating profit as a percentage of revenue as a key metric to evaluate our restaurants' financial performance compared with our competitors. This measure provides useful information regarding our financial condition and results of operations and allows investors to better determine future financial results driven by growth and to compare restaurant level profitability.

EBITDA and Adjusted EBITDA. EBITDA is defined as net income (loss) plus the sum of interest, taxes, depreciation and amortization. Adjusted EBITDA is defined as EBITDA plus unusual or non-recurring items, such as impairment, lease termination and exit costs and write-off of deferred financing costs. EBITDA and Adjusted EBITDA are presented because: (i) we believe it is a useful measure for investors to assess the operating performance of our

business; (ii) we believe that investors will find these measures useful in assessing our ability to service or incur indebtedness; and (iii) we use EBITDA and Adjusted EBITDA internally as a benchmark to evaluate our operating performance and compare our performance to that of our competitors.

Key Financial Definitions

Revenue. Revenue include gross food and beverage sales, net of promotions and discounts and franchise-related revenues.

Cost of Sales. Cost of sales consists of food and beverage costs and related delivery fees.

Labor. Labor includes all direct and indirect labor costs incurred in operations.

Occupancy. Occupancy includes all rent payments associated with the leasing of real estate, including base, percentage and straight-line rent, real estate taxes, and common area maintenance expense. We record tenant improvement allowances as a reduction of occupancy expense over the term of the lease.

Restaurant Operating Expenses. Restaurant operating expenses consist of all other restaurant-level operating costs, the major components of which are utilities, credit card fees, advertising, supplies, marketing, repair and maintenance, and other expenses. Other operating expenses contain both variable and fixed components.

General and Administrative. General and administrative includes all corporate and administrative functions that support operations and provide infrastructure to facilitate our future growth. Components of this category include management and staff salaries, bonuses, stock-based compensation and related employee benefits, travel, information systems, corporate rent, professional and consulting fees, and corporate insurance costs.

Preopening Expense. Preopening expense consists of costs incurred prior to opening a new restaurant and is comprised principally of manager salaries, payroll and related training costs for new employees, including food and beverage costs associated with practice and rehearsal of service activities, and rent expense incurred from the date we obtain possession of the property until opening. We expense restaurant preopening expenses as incurred. We expect preopening expenses to commence six to eight months prior to a restaurant opening. Although the actual preopening expenses for a particular location depend upon numerous factors, our historical cash preopening expenses average approximately \$450,000 per location, and non-cash preopening rent expense typically ranges from \$50,000 to \$100,000 per location. Preopening costs will fluctuate from period to period depending upon the number of restaurants opened, the timing of new restaurant openings, the location of the restaurants, and the complexity of the staff hiring and training process.

Depreciation and Amortization. Depreciation and amortization expense consists of the depreciation of property and equipment. Depreciation and amortization expense also includes gains or losses on the disposal of fixed assets, primarily associated with remodel activities.

Interest Expense, net. Interest expense consists of the cost of servicing our debt obligations, the amortization of debt issuance costs and commitment fees on the credit facility. Interest expense is offset by interest earned on cash and investment balances. We capitalize interest incurred on borrowings for restaurant construction.

Income Tax Expense. Expense for income taxes represents amounts due for state income taxes.

Financial Performance Overview

The following table sets forth certain information regarding our financial performance for 2017, 2016 and 2015:

	Year Ended December 31,					
	2017		2016		2015	
Revenue growth	5.6	%	18.5	%	20.1	%
Same-store sales percentage change	(5.9))%	0.5	%	2.0	%
Average unit volume (in thousands)	\$4,119		\$4,531		\$4,506	
Sales per square foot	\$569		\$630		\$625	
Restaurant operating profit (in thousands)	\$19,099		\$23,688		\$23,212	
Restaurant operating profit as a percentage of sales	10.7	%	14.0	%	16.2	%
EBITDA (in thousands)	\$(6,375)		\$(6,571)		\$5,693	
EBITDA as a percentage of sales	(3.6))%	(3.9))%	4.0	%
Adjusted EBITDA (in thousands)	\$4,830		\$5,883		\$5,854	
Adjusted EBITDA as a percentage of sales	2.7	%	3.5	%	4.1	%

The table below sets forth our reconciliation of Net Loss to EBITDA, Adjusted EBITDA and restaurant operating profit to the most comparable U.S. GAAP measure.

	Year Ended December 31,		
	2017	2016	2015
	(In thousands)		
Net loss	\$(23,432)	\$(21,629)	\$(4,496)
Income tax expense	90	66	43
Interest expense, net	1,784	571	180
Depreciation and amortization	15,183	14,421	9,966
EBITDA	\$(6,375)	\$(6,571)	\$5,693
Asset impairment charge	9,341	12,454	—
Lease termination and exit costs	1,392	—	—
Other	—	—	161
Write-off of deferred financing costs	472	—	—
Adjusted EBITDA	4,830	5,883	5,854
General and administrative	13,453	13,272	12,612
Preopening expense	816	4,533	4,746
Restaurant operating profit	\$19,099	\$23,688	\$23,212

Percent of Revenue
Year Ended December
31,

	2017	2016	2015
Net loss	(13.1)%	(12.8)%	(3.1)%
Income tax expense	0.1	0.0	0.0
Interest expense, net	1.0	0.3	0.1
Depreciation and amortization	8.5	8.5	7.0
EBITDA	(3.6)	(3.9)	4.0
Asset impairment charge	5.2	7.3	—
Lease termination and exit costs	0.8	—	—
Other	—	—	0.1
Write-off of deferred financing costs	0.3	—	—
Adjusted EBITDA	2.7	3.5	4.1
General and administrative	7.5	7.8	8.8
Preopening expense	0.5	2.7	3.3
Restaurant operating profit	10.7 %	14.0 %	16.2%

Certain percentage amounts may not sum to total due to rounding.

Store Growth Activity

	2017	2016	2015
Number of Restaurants at Beginning of Year	45	37	30
Openings	1	8	7
Total	46	45	37

Results of Operations

The following table sets forth, for the years indicated, our Consolidated Statements of Comprehensive Loss expressed as a percentage revenue.

	Year Ended December 31,		
	2017	2016	2015
Revenue	100.0%	100.0%	100.0%
Costs and expenses:			
Cost of sales	27.2	26.7	27.1
Labor	36.7	36.6	35.1
Occupancy	9.3	8.1	7.4
Restaurant operating expenses	16.2	14.6	14.2
General and administrative	7.5	7.8	8.8
Preopening expense	0.5	2.7	3.3
Depreciation and amortization	8.5	8.5	7.0
Asset impairment charge	5.2	7.3	—
Lease termination and exit costs	0.8	—	—
Other	—	—	0.1
Total costs and expenses	111.8	112.4	103.0
Loss from operations	(11.8)	(12.4)	(3.0)
Write off of deferred financing costs	0.3	—	—
Interest expense, net	1.0	0.3	0.1
Loss before income taxes	(13.0)	(12.7)	(3.1)
Income tax expense	0.1	—	—
Net loss	(13.1)%	(12.8)%	(3.1)%

Certain percentage amounts may not sum to the total due to rounding.

Year Ended December 31, 2017 Compared with Year Ended December 31, 2016

Revenue. Revenue increased 5.6% to \$179.1 million for 2017 from \$169.5 million in the prior year period, primarily due to a 14.6% increase in the number of operating weeks from nine restaurants opened since April 2016. Same store sales decreased 5.9% in 2017 compared to an increase of 0.5% in 2016 driven primarily by a decline in customer traffic compared to the prior year period.

Cost of Sales. Cost of sales increased \$3.4 million, or 7.4% to \$48.7 million in 2017 compared to \$45.3 million in 2016. As a percentage of revenue, cost of sales was 27.2% compared to 26.7% during prior year, primarily reflecting unfavorable commodity pricing on certain seafood, meat and produce items and an increase in beer costs as a result of promotions offered at certain locations in an effort to increase customer traffic.

Labor. Labor costs for 2017 increased \$3.8 million, or 6.0% to \$65.8 million compared to \$62.0 million in the comparable prior year period, mainly due to incremental labor costs for nine new locations opened since April 2016. Labor expenses as a percentage of revenue increased slightly to 36.7% compared to 36.6% in the prior year period driven mainly by increased wage costs due to certain state mandated minimum wage increases.

Occupancy. Occupancy expenses increased \$2.8 million or 20.7% to \$16.6 million for 2017 compared to \$13.8 million in the prior year period. Higher base rent and common area maintenance charges associated with the new locations accounted for the majority of the total year over year increase. Occupancy expenses as a percentage of revenue were 9.3% in 2017 compared to 8.1% for 2016.

Restaurant Operating Expenses. Restaurant operating expenses increased \$4.2 million, or 16.9%, to \$28.9 million during 2017 compared to \$24.7 million in 2016, primarily due to incremental operating expenses associated with nine new locations opened since April 2016. Restaurant operating expenses as a percentage of revenue were 16.2% for 2017 compared to 14.6% for 2016. The year over year increase was driven primarily by higher advertising costs associated with increased marketing efforts to enhance brand awareness, increased repair and maintenance activity, and higher delivery and service related fees.

General and Administrative. General and administrative increased slightly to \$13.4 million during 2017 compared to \$13.3 million in the prior year period. General and administrative expenses as a percentage of sales decreased to 7.5% in 2017 compared to 7.8% in the prior year period. Decreased payroll, benefit costs and recruiting fees associated with a reduction in headcount as a result of the slow-down in growth, partially offset by higher professional fees associated with our increased marketing efforts contributed to the slight increase year over year in absolute dollars.

Preopening Expense. Preopening expenses were \$0.8 million and \$4.5 million for 2017 and 2016, respectively. Preopening expenses in 2017 were primarily attributable to the Scottsdale Quarter restaurant, which opened in June 2017. Preopening expenses in 2016 were primarily attributable to eight restaurants opened during 2016.

Depreciation and Amortization. Depreciation and amortization expense increased \$0.8 million or 5.3% to \$15.2 million year over year, primarily attributable to the nine new restaurants opened since April 2016 partially offset by the impact of certain assets that became fully depreciated in 2017, and a lower depreciable asset base as a result of the \$12.5 million asset impairment charge recorded in the fourth quarter of 2016. Depreciation and amortization expense as a percentage of revenue was 8.5% for 2017 and 2016, respectively.

Asset Impairment Charge. During 2017 and 2016, we recorded non-cash asset impairment charges of \$9.3 million and \$12.5 million, respectively, for certain underperforming restaurants based upon an assessment of each restaurant's historical operating performance combined with expected cash flows for these restaurants over the respective remaining lease term.

Lease Termination and Exit Costs. In the second quarter of 2017, we assessed our capital allocation strategy and made the decision to not move forward with the planned construction and opening of a restaurant in El Segundo, California. As such, we recognized \$1.4 million related to estimated lease termination costs and asset write-offs during 2017.

Write-Off of Deferred Financing Costs. Effective June 30, 2017 we amended our credit facility to provide additional flexibility with financial covenants and also decreased our revolver from \$45 million to \$30 million and shortened the maturity date to October 12, 2019. As a result, we wrote-off a portion of the unamortized deferred financing costs associated with the amendment of approximately \$0.5 million during the year ended December 31, 2017.

Interest Expense, Net. Interest expense increased year over year due to borrowings under the credit facility, with \$37.8 million and \$26.8 million outstanding under the credit facility as of the end of the fourth quarter 2017 and 2016, respectively. We used the borrowings to fund restaurant construction activities and stock repurchases during 2017 and 2016.

Income Tax Expense. Income tax expense was \$90,000 and \$66,000 during 2017 and 2016, respectively, related to state income tax expenses for which no state net operating loss carryforwards or other credits exist.

Year Ended December 31, 2016 Compared with Year Ended December 31, 2015

Revenue. Revenue increased 18.5% to \$169.5 million during 2016 from \$143.0 million in 2015, primarily due to a 24% increase in the number of operating weeks and same-store sales growth of 0.5% year over year. The increase is primarily due to revenue generated by eight restaurants opened during 2016 and a full year of sales for seven restaurants that opened during 2015.

Cost of Sales. Cost of sales increased \$6.5 million, or 16.8% to \$45.3 million in 2016 compared to \$38.8 million in 2015, with the increase primarily attributable to our new locations opened since the beginning of the fourth quarter of 2015. As a percentage of revenue, cost of sales was 26.7% compared to 27.1% in the prior year, primarily reflecting improved kitchen efficiencies and favorable commodity pricing for poultry, produce and dairy products compared to 2015.

Labor. Labor expense for our restaurants increased to \$62.0 million from \$50.2 million in 2015, an increase of 23.6%, primarily due to the twelve new restaurants opened since the beginning of the fourth quarter of 2015. Labor expenses as a percentage of revenue increased to 36.6% compared to 35.1% in the prior year, reflecting labor inefficiencies from our newly opened locations, increased wage costs due to certain state or local mandated minimum wage increases and a competitive labor market, and higher benefit costs. We expect labor cost as a percentage of sales to typically trend higher upon opening and gradually improve as our new restaurant management and employees become more efficient in operating their restaurants.

Occupancy. Occupancy expenses increased \$3.2 million or 30.6% to \$13.8 million year over year, primarily associated with base rent and common area maintenance charges for twelve new locations opened since the beginning of the fourth quarter of 2015. Occupancy expenses as a percentage of revenue were 8.1% in 2016 compared to 7.4% in 2015.

Restaurant Operating Expenses. Restaurant operating expenses increased \$4.4 million, or 21.9%, to \$24.7 million in 2016, primarily due to the additional operating expenses for twelve new restaurants opened since the beginning of the fourth quarter of 2015. Restaurant operating expenses as a percentage of revenue were 14.6% and 14.2% in 2016 and 2015, respectively. The year over year increase was driven in part by higher repair and maintenance costs, marketing expenses, professional services and training-related travel costs.

General and Administrative. General and administrative expenses increased in absolute dollars by \$0.7 million, or 5.2% to \$13.3 million from \$12.6 million year over year; however, these expenses decreased as a percentage of sales to 7.8% in 2016 compared to 8.8% in the prior year. Increased payroll, benefit costs and recruiting fees associated with additional headcount to support our unit growth expansion, higher audit fees and increased legal and professional fees contributed to the year over year increase in absolute dollars, partially offset by lower incentive compensation.

Preopening Expense. Preopening expense was \$4.5 million in 2016 compared to \$4.7 million in 2015, including non-cash rent of \$1.1 million and \$1.2 million, respectively. Preopening expense in 2016 primarily related to eight restaurants opened during the year. Preopening expense in 2015 related to seven restaurant openings and preparations for openings in the first half of 2016.

Depreciation and Amortization. Depreciation and amortization expense increased \$4.4 million or 44.7% to \$14.4 million year over year, primarily attributable to the incremental depreciation expense for eight restaurants opened during 2016 and a full year of depreciation expense for seven restaurants that opened during 2015 as well as depreciation expense associated with two restaurant remodels. Depreciation and amortization expense as a percentage of revenue was 8.5% and 7.0% of revenue in 2016 and 2015, respectively.

Asset Impairment Charge. During 2016, we recorded a non-cash asset impairment charge of \$12.5 million related to the write-down of certain long-lived assets associated with five underperforming restaurants. The asset impairment charges were based upon an assessment of each restaurant's historical operating performance combined with expected cash flows for that restaurants over the respective remaining lease term.

Other Expenses. Other expenses of \$0.2 million in 2015 primarily related to an expected settlement of a state use tax audit.

Interest Expense, Net. Interest expense increased to \$0.6 million year-over-year due to borrowings under the credit facility. We used the majority of the borrowings to fund new restaurant construction and remodel activities in 2016. We did not borrow from the credit facility during 2015.

Income Tax Expense. We recorded income tax expense of \$66,000 and \$43,000 for 2016 and 2015, respectively. Income tax expense for 2016 and 2015 relate to state income tax expense for which no net operating loss carryforwards or other credits exist partially offset by refunds primarily associated with previous year state income tax. We did not recognize any federal income tax benefit in 2016 or 2015 due to projected net operating loss carryforwards expected to be generated from tax planning strategies and available credits to offset taxable income.

Potential Fluctuations in Quarterly Results and Seasonality

Our quarterly operating results may fluctuate significantly as a result of a variety of factors, including the following:

- profitability of our restaurants, especially in new markets;
- increases and decreases in comparable restaurant sales;
- labor availability and wages and benefits for hourly and management personnel;
- timing of new restaurant openings and related expenses;
- preopening costs for our newly-opened restaurants and operating costs for those locations, which are often materially greater during the first several months of operation than thereafter;
- timing of restaurant remodels and potential lost sales associated with remodel closure;
- impairment of long-lived assets and any loss on restaurant closures;

costs related to any lease terminations, which could be significant, or fluctuations due to renegotiation of leases;

fluctuations in commodity and food protein prices;

changes in borrowings and interest rates;

general economic conditions;

weather conditions or natural disasters;

timing of certain holidays;

changes in government regulations;

settlements, damages and legal costs associated with litigation;

new or revised regulatory requirements and accounting pronouncements; and

changes in consumer preferences and competitive conditions.

Our business is also subject to seasonal fluctuations. Historically, sales in most of our restaurants have been higher during the spring and summer months and winter holiday season. Consequently, our quarterly and annual operating results and comparable restaurant sales may fluctuate significantly as a result of seasonality and the factors discussed above. Accordingly, results for any one quarter are not necessarily indicative of results to be expected for any other quarter or for any year and comparable restaurant sales for any particular future period may decrease. In the future, operating results may fall below the expectations of our investors. In that event, the price of our common stock would likely be impacted.

Liquidity and Capital Resources

During our high growth phase, we required significant capital resources to construct and equip each restaurant. As we are significantly slowing the pace of growth of new restaurant development in 2018, capital resources are required to maintain our existing base of restaurants and to further strengthen the capabilities of our corporate and information technology infrastructures. Similar to many restaurant companies, we utilize operating lease arrangements for all of our restaurant locations. We believe that our operating lease arrangements provide appropriate leverage for our capital structure in a financially efficient manner.

The following tables set forth, as of the dates and for the periods indicated, a summary of our key liquidity measurements (amounts in thousands):

	December 31,	
	2017	2016
Cash and short-term investments	\$5,100	\$3,654
Net working capital (deficit)	(7,559)	(10,545)

	Year Ended	
	December 31,	
	2017	2016
Cash provided by operating activities	\$5,900	\$20,887
Capital expenditures	11,840	41,900

Future Capital Requirements

Our capital requirements, including development costs related to the opening of new restaurants, have historically been significant. Over the past two years, we funded development of new restaurants and maintenance capital expenditure primarily from borrowings under our credit facility and cash flows from operations. Our future cash

requirements and the adequacy of available funds will depend on many factors, including the operating performance of our current restaurants, the pace of expansion and remodels, real estate markets, site locations, the nature of the arrangements negotiated with landlords and capital market accessibility and availability under our credit line.

We opened one restaurant at the Scottsdale Quarter in 2017 compared to eight restaurants in 2016 and seven restaurants in 2015. Our current plans are for modest new restaurant growth over the next few years. We are focused on building sales, improving margins and generating cash flow to repay debt. We spent \$11.8 million on capital expenditures during the year ended December 31, 2017, primarily associated with the opening of the Scottsdale Quarter restaurant, residual payments for restaurants opened during the second half of 2016, the relocation of our corporate office and maintenance capital expenditures. Additionally, we received \$4.1 million in tenant improvement allowances during the year. Net capital expenditures was \$7.7 million for the year ended December 31, 2017. We expect to spend significantly less in capital expenditures in 2018, as we have slowed down our growth of new units. Our current plans for unit growth are through the franchising of our brand outside the United States which require significantly less capital investment.

As of December 31, 2017, we had a working capital deficit of \$7.6 million and outstanding borrowings under our credit facility of \$37.8 million. We believe existing cash and cash equivalents and short-term investments of \$5.1 million, cash flow from operations, and the ability to draw additional borrowings under our credit facility, subject to compliance with certain covenants and to the extent such borrowings are permitted under our debt arrangements, will be sufficient to fund working capital requirements over the next 12 months.

During the first quarter of 2017, we repurchased \$3.6 million or 395,586 shares of common stock and completed our \$5.0 million stock repurchase program.

Any reduction of our cash flow from operations or an inability to draw on our credit facility may cause us to take appropriate measures to generate cash. Our failure to raise capital when needed could impact our financial condition and results of operations and ability to continue as a going concern. Additional equity financing, to the extent available, may result in dilution to current stockholders and additional debt financing, if available, may involve significant cash payment obligations or financial covenants and ratios that may restrict our ability to operate our business and remain a going concern.

Debt and Credit Agreements

On October 12, 2016, we entered into the Second Amended and Restated Credit Agreement (the “Second Amended Credit Agreement”) with KeyBank National Association (“KeyBank”) and Zions First National Bank to (i) increase the combined revolving and term credit facilities (the “credit facility”) from \$35 million to \$60 million, comprised of a \$45 million revolver (“Revolver”) and \$15 million term loan (“Term Loan”), and (ii) extend the maturity date of the credit facility to October 12, 2021. The credit facility is secured by our personal property and assets. Certain of our wholly owned subsidiaries have also guaranteed the credit facility. On March 29, 2017, we entered into Amendment No. 1 to the Second Amended and Restated Credit Agreement, which amended certain financial covenants in the Second Amended Credit Agreement.

On July 7, 2017, we entered into Amendment No. 2 to the Second Amended and Restated Credit Agreement (“Amendment No.2”). Amendment No. 2 amended the Second Amended Credit Agreement to, among other things, decrease the total available credit from the revolving credit facility from \$45 million to \$30 million, which including the \$15 million term loan, resulted in an overall reduction of the credit facility from \$60 million to \$45 million. Additionally, (a) the maturity date was amended from October 12, 2021 to October 12, 2019, provided that if the Company’s *pro forma* leverage ratio is less than 4.25 to 1.00 at any time prior to the maturity date, the Company may request a one year extension of the maturity date until October 12, 2020; (b) the applicable margins for base rate loans and the applicable margins for LIBOR rate loans were increased by 25 bps to 75 bps depending on the Company’s leverage ratio; and (c) the maximum leverage ratio was increased and the minimum fixed charge coverage ratio was decreased to provide increased flexibility as further described below. The terms of Amendment No. 2 were effective as of June 30, 2017.

Amendment No. 2 requires us to comply with certain covenants on a quarterly basis, including (a) a minimum fixed charge coverage ratio of (i) 1.25 to 1.00 for the fiscal quarter ended June 30, 2017; (ii) 1.20 to 1.00 for the fiscal quarters ended September 30, 2017, December 31, 2017, March 31, 2018, June 30, 2018, September 30, 2018, and December 31, 2018; and (iii) 1.30 to 1.00 for the fiscal quarter ended March 31, 2019 and each fiscal quarter thereafter; and (b) a maximum leverage ratio of (i) 5.50 to 1.00 for the fiscal quarters ended June 30, 2017, September 30, 2017, and December 31, 2017; (ii) 5.25 to 1.00 for the fiscal quarters ended March 31, 2018, June 30, 2018, September 30, 2018 and December 31, 2018; and (iii) 5.00 to 1.00 for the fiscal quarter ended March 31, 2019 and each fiscal quarter thereafter.

On October 30, 2017, we entered into Amendment No. 3 to the Second Amended and Restated Credit Agreement (“Amendment No. 3”). Amendment No. 3 amends the Second Amended Credit Agreement to, among other things, (a) implement a monthly reporting requirement; (b) restrict certain restricted payments as defined in the Second Amended Credit Agreement; and (c) implement a limitation on capital expenditures subject to approval by the Lenders in their sole discretion.

On March 9, 2018, we entered into Amendment No. 4 to the Second Amended and Restated Credit Agreement (“Amendment No. 4”). Amendment No. 4 amends the Second Amended Credit Agreement to, among other things, reduces the available credit on the Revolver from \$30 million to \$25 million as of the effective date of Amendment No. 4 and further reduces the available credit on the Revolver to \$22.5 million at June 30, 2018 and \$20 million at December 31, 2018. Additionally, (a) the maturity date was amended from October 12, 2019 to January 13, 2020 with no option to extend the maturity; (b) the applicable margins for base rate loans and the applicable margins for LIBOR rate loans were increased by 50 bps to 100 bps depending on the Company’s leverage ratio; and (c) the maximum leverage ratio was increased and the minimum fixed charge coverage ratio was decreased to provide increased flexibility as further described below. The terms of Amendment No. 4 were effective as of March 9, 2018.

Amendment No. 4 requires us to comply with certain covenants on a quarterly basis, including (a) a minimum fixed charge coverage ratio of (i) 1.10 to 1.00 for the fiscal quarters ended March 31, 2018, June 30, 2018 and September 30, 2018; (ii) 1.15 to 1.00 for the fiscal quarters ended December 31, 2018 and March 31, 2019 and (iii) 1.20 to 1.00 for the fiscal quarter ended June 30, 2019 and each fiscal quarter thereafter; and (b) a maximum leverage ratio of (i) 6.25 to 1.00 for the fiscal quarter ended March 31, 2018; (ii) 6.00 to 1.00 for the fiscal quarter ended June 30, 2018; (iii) 5.50 to 1.00 for the fiscal quarter ended September 30, 2018; (iv) 5.00 to 1.00 for the fiscal quarters ended December 31, 2018, March 31, 2019 and June 30, 2019; and (v) 4.25 for the fiscal quarter ended September 30, 2019 and each fiscal quarter thereafter.

The Company was not in compliance with the fixed charge coverage ratio and the leverage ratio at December 31, 2017. A waiver was received on March 9, 2018 for the quarter ended December 31, 2017. The Company believes that it is probable that it will be in compliance at future covenant compliance dates.

At December 31, 2017, we had \$37.8 million in outstanding borrowings, consisting of \$23.7 million under the Revolver and \$14.1 million under the Term Loan. As of December 31, 2017, net availability under the credit facility was \$6.25 million, subject to compliance with certain covenants.

Cash Flows

The following table summarizes our primary sources and uses of cash during the past three years:

	2017	2016	2015
	(In thousands)		
Net cash provided by (used in):			
Operating activities	\$5,900	\$20,887	\$10,294
Investing activities	(11,715)	(42,033)	(38,215)

Financing activities	7,381	15,567	398
Net increase (decrease) in cash and cash equivalents	\$ 1,566	\$(5,579)	\$(27,523)

Operating Activities. We generated \$5.9 million, \$20.9 million and \$10.3 million of operating cash flows in 2017, 2016 and 2015, respectively. The year over year change in cash from operating activities is primarily due to lower net income, the amount and timing of receipt of tenant allowance reimbursements and timing of payments for accrued expenses and accounts payable.

Investing activities. Capital expenditures for 2017 were \$11.8 million, primarily associated with our Scottsdale Quarter restaurant, which opened in June 2017, residual payments from restaurants opened during the fourth quarter of 2016, the relocation of our corporate office, and maintenance capital expenditures. Capital expenditures for 2016 were \$41.9 million, primarily attributed to costs associated with eight new restaurant openings, costs for our Boca Park restaurant remodel, and residual payments from restaurants opened during the fourth quarter of 2015. Capital expenditures in 2015 were \$38.1 million, primarily associated with seven new restaurant openings and our Denver restaurant remodel.

Financing Activities. Net cash provided by financing activities for 2017 was \$7.4 million and consisted primarily of \$11.0 million in net borrowings under the credit facility and \$0.3 million of proceeds from stock option exercises and employee stock purchases, partially offset by \$3.6 million for the repurchase of common stock under the October 2016 stock repurchase program and \$0.3 million for debt issuance costs associated with amendments to our credit facility. Net cash provided by financing activities for 2016 consisted of \$26.8 million in net borrowings under the credit facility and \$0.7 million in proceeds from stock option exercises and employee stock purchases, partially offset by \$11.2 million in cash outflow associated with stock repurchase programs, \$0.5 million in fees paid for the amended credit facility and \$0.2 million in payment for withholding tax from net settled option exercise. Net cash provided by financing activities during 2015 consisted of \$0.6 million of proceeds from stock option exercises partially offsetting a \$0.2 million purchase and retirement of our common stock under the November 2015 authorization.

Off-Balance Sheet Arrangements

As of December 31, 2017, we had no off-balance sheet arrangements or obligations, other than operating leases, which are not classified as debt..

Critical Accounting Policies

Critical accounting policies are those that we believe are most important to the portrayal of our financial condition and results of operations and also require our most difficult, subjective or complex judgments. Judgments or uncertainties regarding the application of these policies may result in materially different amounts being reported under various conditions or using different assumptions. We consider the following policies to be the most critical in understanding the judgment that is involved in preparing our consolidated financial statements.

Property and Equipment

We record property and equipment at cost less accumulated depreciation, and we select useful lives that reflect the estimated economic lives of the underlying assets. We amortize leasehold improvements over the shorter of the useful life of the asset or the related lease term. We calculate depreciation using the straight-line method for financial statement purposes. We capitalize improvements and expense repairs and maintenance costs as incurred. We are often required to exercise judgment in our decision whether to capitalize an asset or expense an expenditure that is for maintenance and repairs. The useful life of property and equipment and the determination as to what constitutes a capitalized cost versus a repair and maintenance expense involves judgment by management, which may produce different amounts of repair and maintenance or depreciation expense if different assumptions were used.

We evaluate property and equipment for impairment whenever events or changes in restaurant operating results indicate that the carrying value of those assets may not be recoverable. Factors considered include, but are not limited to, significant underperformance relative to expected historical or projected future operating results; significant negative industry or economic trends; and significant changes in laws and regulations, legal factors or in the business climate. The assessment of impairment is performed on a restaurant-by-restaurant basis. Recoverability is assessed by comparing the carrying value of the asset to the undiscounted cash flows expected to be generated by the asset. This assessment process requires the use of estimates and assumptions regarding future cash flows and estimated useful lives, which are subject to a significant degree of judgment. If indicators of impairment are present and if we determine that the carrying value of the asset exceeds the fair value of the restaurant assets, an impairment charge is recorded to reduce the carrying value of the asset to its fair value. Calculation of fair value requires significant estimates and judgments which could vary significantly based on our assumptions.

We recorded long-lived asset impairment charges of \$9.3 million and \$12.5 million, for the years ended December 31, 2017 and 2016, respectively. Such amounts are included in "Asset impairment charge" in the Consolidated Statements of Comprehensive Loss. See Note 2 in the Notes to the Consolidated Financial Statements for further details on the impairment charges. We continue to monitor the operating performance of each individual restaurant. We may be required to record impairment charges in the future if certain restaurants perform below expectations.

Leasing Activities

We lease all of our restaurant properties. At the inception of the lease, we evaluate each property and classify the lease as an operating or capital lease in accordance with applicable accounting standards. We exercise significant judgment in determining the estimated fair value of the restaurant as well as the discount rate used to discount the future minimum lease payments. The term used for this evaluation includes renewal option periods only in instances in which the exercise of the renewal option can reasonably be assured and failure to exercise such option would result in an economic penalty. All of our restaurant leases are classified as operating leases.

Our lease term used for straight-line rent expense is calculated from the date we take possession of the leased premises through the lease termination date. There is potential for variability in our "rent holiday" period which typically begins on the possession date and ends on the store open date. Factors that may affect the length of the rent holiday period generally include construction related delays or situations where we take possession of the leased premises upon execution of the lease. Extension of the rent holiday period due to delays in restaurant opening will result in greater rent expensed during the rent holiday period.

We record contingent rent expense based on a percentage of revenue amounts that exceed a specified sales threshold over the periods the liability is incurred. Contingent rent expense is recorded prior to achievement of specified sales levels if achievement of such amounts is considered probable and estimable.

Leasehold improvements financed by the landlord through tenant improvement allowances are capitalized as leasehold improvements with the tenant improvement allowances recorded as deferred lease incentives. Deferred lease incentives are amortized on a straight-line basis over the lesser of the life of the asset or the lease term, including option periods which in the judgment of management are reasonably assured of renewal (same term that is used for related leasehold improvements) and are recorded as a reduction of occupancy expense. As part of the initial lease terms, we negotiate with our landlords to secure these tenant improvement allowances. There is no guarantee that we will receive tenant improvement allowances for any of our future locations, which would result in additional occupancy expenses.

In February 2016, ASC Topic 842, *Leases*, was issued to increase the transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. In order to meet that objective, the new standard requires recognition of the assets and liabilities that arise from leases. Accordingly, a lessee will recognize a right-of-use (ROU) asset for its right to use the underlying asset and a lease liability for the corresponding lease obligation. Both the ROU asset and lease liability will initially be measured at the present value of the future minimum lease payments over the lease term. Subsequent measurement, including the presentation of expenses and cash flows, will depend on the classification of the lease as either a finance or an operating lease. Initial costs directly attributable to negotiating and arranging the lease will be included in the ROU asset. Lessees can make an accounting policy election by class of underlying asset not to recognize a ROU asset and corresponding lease liability for leases with a term of 12 months or less. All of our restaurant leases are accounted for as operating leases, with no related assets and liabilities on our balance sheet. The new standard is effective for public companies for fiscal years beginning after December 15, 2018, and interim periods within those years, with early adoption permitted. The expected adoption method is being evaluated by us. We expect the adoption of this guidance to have a material impact on our consolidated financial statements.

Income Taxes

We provide for income taxes based on our estimate of federal and state tax liabilities. These estimates consider, among other items, effective rates for state and local income taxes, allowable tax credits for items such as taxes paid on reported tip income, estimates related to depreciation and amortization expense allowable for tax purposes, and the tax deductibility of certain other items. Our estimates are based on information available to us at the time we prepare the income tax provision. Income tax returns are subject to audit by federal, state, and local governments, generally years after the returns are filed. These returns could be subject to material adjustments or differing interpretations of the tax laws.

Deferred income tax assets and liabilities are recognized for the expected future income tax consequences of carryforwards and temporary differences between the book and tax basis of assets and liabilities. Deferred tax assets and liabilities are measured using the income tax rate in effect during the year in which the differences are expected to reverse. The realization of tax benefits of deductible temporary differences and operating loss or tax credit carryforwards will depend on whether we have sufficient taxable income within the carryback and carryforward periods permitted by tax law to allow for utilization of the deductible amounts and carryforwards. We record net deferred tax assets to the extent we believe these assets will more likely than not be realized. In making this determination, we consider all available positive and negative evidence, including scheduled reversals of deferred tax liabilities, projected future taxable income, tax planning strategies and recent financial operations. In the event we determine that we would be able to realize our deferred income tax assets in the future in excess of their net recorded amount, we will make an adjustment to the valuation allowance which would likely result in an income tax benefit.

The Tax Cuts and Jobs Act (“the Tax Act”) was enacted on December 22, 2017. As of December 31, 2017, we have not finalized our accounting for the tax effects of the enactment of the Tax Act; however, as described in Note 5 in the Notes to the Consolidated Financial Statements, we have made a reasonable estimate of the effects on our existing deferred tax balances and uncertain tax positions. We anticipate that the completion of our 2017 income tax returns, future guidance and additional information and interpretations with the respect to the Tax Act will cause us to further review a need for provisional amounts to be recorded as of December 31, 2017. If necessary, and in accordance with SAB 118, we will record such adjustments in the period that relevant guidance and/or additional information becomes available and our analysis is completed.

Stock-Based Compensation

We apply the Black-Scholes valuation model in determining the fair value of stock option awards, which requires the use of a number of highly complex and subjective variables. These variables include, but are not limited to the actual and projected employee and director stock option exercise behavior, expected volatility, risk-free interest rate, expected dividends, and expected term. Expected volatility is based on the historical volatility of our stock. We utilize historical data to estimate option exercise and employee termination behavior within the valuation model. The

risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant for the expected term of the option. We also estimate forfeitures at the time of grant and revise these estimates, if necessary, in subsequent periods if actual forfeitures differ from those estimates. We estimate forfeitures based on our expectation of future experience while considering our historical experience. Changes in the subjective assumptions can materially affect the estimate of fair value of stock-based compensation and consequently, the related amount recognized in the Consolidated Statements of Comprehensive Loss. We are also required to establish deferred tax assets for expense relating to options that would be expected to generate a tax deduction under their original terms. The recoverability of such assets are dependent upon the actual deduction that may be available at exercise and can further be impaired by either the expiration of the option or an overall valuation allowance on deferred tax assets.

We believe the estimates and assumptions related to these critical accounting policies are appropriate under the circumstances; however, should future events result in unanticipated consequences, there could be a material impact on our future financial condition or results of operations.

Recent Accounting Pronouncements

See Note 1 Recently Issued Accounting Standards to our Consolidated Financial Statements. As described therein, in May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2014-09, *Revenue from Contracts with Customers (Topic 606)*. We adopted the new standard effective January 1, 2018. The guidance may be applied retrospectively for all periods presented or retrospectively with the cumulative effect of initially applying the guidance recognized at the date of initial application. We adopted the standard retrospectively with the cumulative effect of initially applying the amended guidance recognized at January 1, 2018. Consequently, we will apply the guidance to the most current period presented in the financial statements issued subsequent to the adoption date. However, had we adopted the standard as of January 1, 2017, our revenue and operating income for 2017 would have been reduced by \$0.3 million.

Item 7A. *Quantitative and Qualitative Disclosures About Market Risk*

The following discussion of market risks contains forward-looking statements. Actual results may differ materially from the following discussion based on general conditions in the commodity and capital markets.

Primary Market Risk Exposures

Our primary market risk exposure is commodity costs. Many of the food products purchased by us can be subject to volatility due to changes in weather, production, availability, seasonality, international demand, and other factors outside our control. Substantially all of our food and supplies are available from several sources, which help to diversify our overall commodity cost risk. We also believe that we have the ability to increase certain menu prices in response to food commodity price increases.

We also face market risk exposure due to the variable interest rates on our credit facility. Interest on the loans is subject to adjustment based on changes to the prime or LIBOR rate. Interest rate fluctuations may adversely impact our financial condition or results of operations.

Item 8. *Financial Statements and Supplementary Data*

Reference is made to the consolidated financial statements, the notes thereto, and the report thereon, commencing on page F-1 of this report, which financial statements, notes, and report are incorporated herein by reference.

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

Not applicable.

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) are our controls and other procedures that are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. We have evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of December 31, 2017. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective.

Changes in Internal Control Over Financial Reporting

There has not been any change in our internal control over financial reporting during our fourth fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Management's Report on Internal Control Over Financial Reporting

We are responsible for establishing and maintaining adequate internal control over financial reporting. As defined in the securities laws, internal control over financial reporting is a process designed by, or under the supervision of, our principal executive and principal financial officer and effected by our Board of Directors, management, and other personnel, 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 and includes those policies and procedures that (i) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the acquisitions and dispositions of our assets; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of management and directors; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the 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 our internal control over financial reporting as of December 31, 2017, based on the framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control—Integrated Framework (the “2013 framework”). Based on that assessment, management concluded that, as of December 31, 2017, our internal control over financial reporting was effective.

Item 9B. Other Information

Not applicable.

PART III

Item 10. Directors, Executive Officers and Corporate Governance

The information required by this Item relating to our directors, executive officers and corporate governance is incorporated herein by reference to the definitive Proxy Statement to be filed pursuant to Regulation 14A of the Exchange Act for our 2018 Annual Meeting of Stockholders.

Item 11. *Executive Compensation*

The information required by this Item is incorporated herein by reference to the information contained in the definitive Proxy Statement to be filed pursuant to Regulation 14A of the Exchange Act for our 2018 Annual Meeting of Stockholders.

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

The information required by this Item is incorporated herein by reference to the information contained in the definitive Proxy Statement to be filed pursuant to Regulation 14A of the Exchange Act for our 2018 Annual Meeting of Stockholders.

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

The information required by this Item is incorporated herein by reference to the information contained in the definitive Proxy Statement to be filed pursuant to Regulation 14A of the Exchange Act for our 2018 Annual Meeting of Stockholders.

Item 14. ***Principal Accountant Fees and
Services***

The information required by this Item is incorporated herein by reference to the information contained in the definitive Proxy Statement to be filed pursuant to Regulation 14A of the Exchange Act for our 2018 Annual Meeting of Stockholders.

PART IV

Item 15. *Exhibits and Financial Statement Schedules*

(a) The following documents are filed as a part of the report:

(1) Financial Statements

Financial Statements are listed in the Index to Consolidated Financial Statements on page F-1 of this report.

(2) Financial Statement Schedules

No financial statement schedules are included because such schedules are not applicable, are not required, or because required information is included in the consolidated financial statements or notes thereto.

(3) Exhibits

Exhibit Number	<u>Exhibit</u>
3.1	<u>Amended and Restated Certificate of Incorporation of the Registrant. Incorporated by reference to Amendment No. 1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2015, as filed with the Commission on August 4, 2015</u>
3.2	<u>Certificate of Designations.</u>

- Preferences, and Rights of Series A Junior Participating Preferred Stock of Kona Grill, Inc. Incorporated by reference to the Registrant's Form 8-K filed on May 28, 2008. Certificate of Designation, Preferences, and Rights of Series B Junior Participating Preferred Stock of Kona Grill, Inc. filed with the Secretary of State of the State of Delaware on September 7, 2016 (incorporated by reference from Form 8-K filed September 7, 2016) Second Amended and Restated Bylaws of Kona Grill, Inc., as of March 1, 2018.
- 3.3
- 3.4
- Incorporated by reference to the Registrant's Form 8-K filed on March 6, 2018. Form of Common Stock Certificate. Incorporated by reference to Amendment No. 2 to the Registrant's Registration Statement on Form S-1 (Registration No. 333-125506), as filed on July 21, 2005. Rights Agreement dated September 6, 2016 by and between Kona Grill, Inc. and Continental Stock Transfer & Trust Company (incorporated by reference from Form 8-K filed September 7, 2016)
- 4.1
- 4.2
- 10.12* Kona Grill, Inc. 2005 Employee Stock Purchase Plan (amended as of August 15,

2005). Incorporated by
reference to the
Registrant's Registration
Statement on Form S-8
(Registration No.
333-127593), as filed
with the Commission on
August 16, 2005.
Form of Stock Option
Agreement (2005 Stock
Award
Plan). Incorporated by
reference to the
Registrant's Quarterly
Report on Form 10-Q for
the quarter ended March
31, 2006, as filed with
the Commission on May
8, 2006.

10.15*

<u>Exhibit Number</u>	<u>Exhibit</u>
10.16*	<u>Kona Grill, Inc.</u> <u>Amended and</u> <u>Restated 2012</u> <u>Stock Award Plan,</u> <u>as amended</u> <u>Incorporated by</u> <u>reference to the</u> <u>Registrant's Annual</u> <u>Report on Form</u> <u>10-K for the year</u> <u>ended December</u> <u>31, 2017, as filed</u> <u>with the</u> <u>Commission on</u> <u>March 6, 2018.</u> <u>Employment</u> <u>Agreement, dated</u> <u>as of March 1,</u> <u>2018, between the</u> <u>Company and</u>
10.30*	<u>Berke Bakay.</u> <u>Incorporated by</u> <u>reference to the</u> <u>Registrant's Form</u> <u>8-K filed on March</u> <u>6, 2018.</u> <u>Form of Stock</u> <u>Option Agreement</u> <u>(2012 Stock Award</u> <u>Plan) Incorporated</u> <u>by reference to the</u> <u>Registrant's Annual</u>
10.33	<u>Report on Form</u> <u>10-K for the year</u> <u>ended December</u> <u>31, 2012, as filed</u> <u>with the</u> <u>Commission on</u> <u>March 15, 2013.</u>
10.34	<u>Amendment No. 1</u> <u>to Second</u> <u>Amended and</u> <u>Restated Credit</u> <u>Agreement dated as</u> <u>of March 29, 2017</u> <u>(incorporated by</u>

- 10.35 reference to Form
8-K filed April 3,
2017).
Amendment No. 2
to Second
Amended and
Restated Credit
Agreement dated as
of July 7, 2017
(incorporated by
reference to Form
8-K filed July 11,
2017).
Amendment No. 3
to Second
Amended and
Restated Credit
Agreement dated as
- 10.36 of October 30,
2017 (incorporated
by reference to
Form 8-K filed
November 3,
2017).
Amendment No. 4
to Second
Amended and
Restated Credit
Agreement dated as
- 10.37 of March 9, 2018
(incorporated by
reference to Form
8-K filed March
15, 2018).
Second Amended
and Restated Credit
Agreement dated as
- 10.38 of October 12,
2016 (incorporated
by reference from
Form 8-K filed
October 18, 2016)
Amended and
Restated Subsidiary
Guaranty dated as
- 10.39 of October 12,
2016 (incorporated
by reference from
Form 8-K filed
October 18, 2016)
- 10.40

	<u>Amendment No. 1</u>
	<u>to Amended and</u>
	<u>Restated Pledge</u>
	<u>and Security</u>
	<u>Agreement dated as</u>
	<u>of March 9, 2018</u>
	<u>(incorporated by</u>
	<u>reference from</u>
	<u>Form 8-K filed</u>
	<u>March 15, 2018)</u>
21	<u>List of Subsidiaries</u>
	<u>Consent of</u>
23	<u>Independent</u>
	<u>Registered Public</u>
	<u>Accounting Firm</u>
	<u>Certification of</u>
	<u>Chief Executive</u>
	<u>Officer pursuant to</u>
31.1	<u>Rule 13a-14(a) and</u>
	<u>Rule 15d-14(a),</u>
	<u>promulgated under</u>
	<u>the Securities</u>
	<u>Exchange Act of</u>
	<u>1934, as amended</u>
	<u>Certification of</u>
	<u>Chief Financial</u>
	<u>Officer pursuant to</u>
31.2	<u>Rule 13a-14(a) and</u>
	<u>Rule 15d-14(a),</u>
	<u>promulgated under</u>
	<u>the Securities</u>
	<u>Exchange Act of</u>
	<u>1934, as amended</u>
	<u>Certification</u>
	<u>pursuant to 18</u>
	<u>U.S.C. Section</u>
32.1	<u>1350, as adopted</u>
	<u>pursuant to Section</u>
	<u>906 of the</u>
	<u>Sarbanes-Oxley</u>
	<u>Act of 2002</u>
	<u>Certification</u>
	<u>pursuant to 18</u>
	<u>U.S.C. Section</u>
32.2	<u>1350, as adopted</u>
	<u>pursuant to Section</u>
	<u>906 of the</u>
	<u>Sarbanes-Oxley</u>
	<u>Act of 2002</u>
101	The following
	materials from

Kona Grill Inc.'s
Annual Report on
Form 10-K for the
year ended
December 31,
2017, formatted in
Extensible
Business Reporting
Language (XBRL),
(i) Consolidated
Balance Sheets, (ii)
Consolidated
Statements of
Comprehensive
Loss, (iii)
Consolidated
Statements of
Stockholders'
Equity, (iv)
Consolidated
Statements of Cash
Flows, and (v) the
Notes to the
Consolidated
Financial
Statements

* Management contract or compensatory plan or arrangement in which directors or executive officers are eligible to participate.

Signatures

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

Kona Grill, Inc.

/s/ Berke Bakay
Berke Bakay
President and Chief Executive Officer

Date: March 22, 2018

Pursuant to the requirement of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<u>Signature</u>	<u>Capacity</u>	<u>Date</u>
/s/ Berke Bakay Berke Bakay	President, Chief Executive Officer and Director (Principal Executive Officer)	March 22, 2018
/s/ Christi Hing Christi Hing	Chief Financial Officer (Principal Financial and Accounting Officer)	March 22, 2018
/s/ Richard J. Hauser Richard J. Hauser	Director	March 22, 2018
/s/ James R. Jundt James R. Jundt	Director	March 22, 2018
/s/ Marcus E. Jundt Marcus E. Jundt	Director	March 22, 2018

/s/ Leonard Newman	Director	March 22, 2018
Leonard Newman		
/s/ Steven W. Schussler	Director	March 22, 2018
Steven W. Schussler		
/s/ Anthony L. Winczewski	Director	March 22, 2018
Anthony L. Winczewski		

KONA GRILL, INC.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders and the Board of Directors of Kona Grill, Inc.

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of Kona Grill, Inc. (the Company) as of December 31, 2017 and 2016, the related consolidated statements of comprehensive loss, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2017, and the related notes (collectively referred to as the "consolidated financial statements"). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company at December 31, 2017 and 2016, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2017, in conformity with U.S. generally accepted accounting principles.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (PCAOB) and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. As part of our audits we are required to obtain an understanding of internal control over financial reporting 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.

Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also

included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ Ernst & Young LLP

We have served as the Company's auditor since 2001.

Phoenix, Arizona

March 22, 2018

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KONA GRILL, INC.**CONSOLIDATED BALANCE SHEETS****(In thousands, except share data)**

	December 31,	
	2017	2016
ASSETS		
Current assets:		
Cash and cash equivalents	\$5,042	\$3,476
Investments	58	178
Receivables	1,371	1,850
Inventory	1,706	2,176
Prepaid expenses and other current assets	867	1,052
Total current assets	9,044	8,732
Other assets	1,116	1,383
Property and equipment, net	81,639	98,268
Total assets	\$91,799	\$108,383
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$2,890	\$4,115
Accrued expenses	12,934	14,450
Current portion of long-term debt	779	712
Total current liabilities	16,603	19,277
Long-term debt	36,921	25,921
Deferred rent and other long-term liabilities	32,612	31,610
Total liabilities	86,136	76,808
Commitments and contingencies (Note 9)		
Stockholders' equity:		
Preferred stock, \$0.01 par value, 2,000,000 shares authorized; none issued	—	—
Common stock, \$0.01 par value, 30,000,000 shares authorized, 10,225,915 shares issued and 10,109,715 shares outstanding at December 31, 2017 and 10,568,230 shares issued and 10,452,030 shares outstanding at December 31, 2016	102	106
Additional paid-in capital	86,227	88,703
Accumulated deficit	(79,666)	(56,234)
Treasury stock, at cost, 116,200 shares at December 31, 2017 and 2016	(1,000)	(1,000)
Total stockholders' equity	5,663	31,575
Total liabilities and stockholders' equity	\$91,799	\$108,383

See accompanying notes to the consolidated financial statements.

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KONA GRILL, INC.**CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS****(In thousands, except per share data)**

	Year Ended December 31,		
	2017	2016	2015
Revenue	\$179,081	\$169,523	\$143,023
Costs and expenses:			
Cost of sales	48,673	45,314	38,803
Labor	65,778	62,027	50,187
Occupancy	16,602	13,754	10,528
Restaurant operating expenses	28,929	24,740	20,293
General and administrative	13,453	13,272	12,612
Preopening expense	816	4,533	4,746
Depreciation and amortization	15,183	14,421	9,966
Asset impairment charge	9,341	12,454	—
Lease termination and exit costs	1,392	—	—
Other	—	—	161
Total costs and expenses	200,167	190,515	147,296
Loss from operations	(21,086)	(20,992)	(4,273)
Write off of deferred financing costs	472	—	—
Interest expense, net	1,784	571	180
Loss before income taxes	(23,342)	(21,563)	(4,453)
Income tax expense	90	66	43
Net Loss	\$(23,432)	\$(21,629)	\$(4,496)
Net loss per share (Note 1):			
Basic and diluted	\$(2.32)	\$(2.00)	\$(0.40)
Weighted average shares outstanding (Note 1):			
Basic and diluted	10,121	10,791	11,264
Comprehensive loss	\$(23,432)	\$(21,629)	\$(4,496)

See accompanying notes to the consolidated financial statements.

KONA GRILL, INC.**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**

(In thousands)

	Common Stock		Additional Paid-in Capital	Accumulated Treasury Deficit	Treasury Stock	Stockholders' Equity
	Shares	Amount				
Balances at December 31, 2014	11,209	113	96,422	(30,109)	(1,000)	65,426
Stock-based compensation	—	—	1,363	—	—	1,363
Issuance of common stock under the Employee Stock Purchase Plan and exercise of stock options	81	1	624	—	—	625
Purchase and retirement of common stock	(18)	—	(227)	—	—	(227)
Net loss and comprehensive loss	—	—	—	(4,496)	—	(4,496)
Balances at December 31, 2015	11,272	114	98,182	(34,605)	(1,000)	62,691
Stock-based compensation	—	—	1,262	—	—	1,262
Issuance of common stock under the Employee Stock Purchase Plan and exercise of stock options net of share repurchase for minimum tax withholdings	132	1	450	—	—	451
Purchase and retirement of common stock	(952)	(9)	(11,191)	—	—	(11,200)
Net loss and comprehensive loss	—	—	—	(21,629)	—	(21,629)
Balances at December 31, 2016	10,452	106	88,703	(56,234)	(1,000)	31,575
Stock-based compensation	—	—	831	—	—	831
Issuance of common stock under the Employee Stock Purchase Plan and exercise of stock options	53	—	261	—	—	261
Purchase and retirement of common stock	(395)	(4)	(3,568)	—	—	(3,572)
Net loss and comprehensive loss	—	—	—	(23,432)	—	(23,432)
Balances at December 31, 2017	10,110	\$ 102	\$ 86,227	\$ (79,666)	\$ (1,000)	\$ 5,663

See accompanying notes to the consolidated financial statements.

KONA GRILL, INC.**CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands)**

	Year Ended December 31,		
	2017	2016	2015
Operating activities			
Net loss	\$(23,432)	\$(21,629)	\$(4,496)
Adjustments to reconcile net loss to net cash provided by operating activities:			
Depreciation and amortization	15,155	14,421	9,781
Stock-based compensation	831	1,262	1,363
Loss on disposal of assets	28	—	185
Amortization of deferred financing costs	185	99	81
Write off of deferred financing costs	472	—	—
Asset impairment charge	9,341	12,454	—
Lease termination and exit costs	1,392	—	—
Change in operating assets and liabilities:			
Receivables	478	(275)	(1,187)
Inventory	470	(311)	(366)
Prepaid expenses and other current assets	164	(164)	(69)
Accounts payable	4	564	86
Accrued expenses	(701)	4,044	1,290
Deferred rent and other long term liabilities	1,513	10,422	3,626
Net cash provided by operating activities	5,900	20,887	10,294
Investing activities			
Purchase of property and equipment	(11,840)	(41,900)	(38,077)
Change in other assets	125	(133)	(138)
Net cash used in investing activities	(11,715)	(42,033)	(38,215)
Financing activities			
Borrowings from revolving credit facility	13,500	14,500	—
Repayments on revolving credit facility	(1,750)	(2,500)	—
Borrowings from term loan	—	15,000	—
Repayments on term loan	(750)	(188)	—
Fees paid for credit facility	(308)	(496)	—
Proceeds from issuance of common stock under the Employee Stock Purchase Plan and exercise of stock options	261	674	625
Payment for withholding tax from net settled stock option exercise	—	(223)	—

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Purchase and retirement of common stock	(3,572)	(11,200)	(227)
Net cash provided by financing activities	7,381	15,567	398
Net increase (decrease) in cash and cash equivalents	1,566	(5,579)	(27,523)
Cash and cash equivalents at the beginning of the year	3,476	9,055	36,578
Cash and cash equivalents at the end of the year	\$5,042	\$3,476	\$9,055

Supplemental disclosures of cash flow information

Cash paid for interest (net of capitalized interest)	\$1,571	\$323	\$99
Cash paid for income taxes, net of refunds	\$58	\$2	\$12

Noncash investing activities

Accounts payable and accrued expenses related to property and equipment purchases	\$233	\$3,258	\$7,266
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See accompanying notes to the consolidated financial statements.

KONA GRILL, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1. The Company and Summary of Significant Accounting Policies

Description of Business

Kona Grill, Inc., including its wholly-owned subsidiaries, (referred to herein as the “Company” or “we,” “us,” and “our”) owns and operates upscale casual dining restaurants under the name “Kona Grill.” Our restaurants feature a diverse selection of contemporary American favorites and award-winning sushi items that are prepared fresh daily at each restaurant location. As of *December 31, 2017*, we owned and operated 46 restaurants in 23 states throughout the United States and Puerto Rico. Our *three* international franchise partners opened Kona Grill locations in Monterrey, Mexico; Dubai, United Arab Emirates; and Vaughan (Toronto), Canada in 2017. Our chief operating decision maker function is comprised of our Chief Executive Officer, Chief Operating Officer, and Chief Financial Officer who manage our restaurant operation base that aggregates into *one* reportable segment. Accordingly, we have a single operating segment and reporting unit structure.

Basis of Presentation

The consolidated financial statements include the accounts and operations of the Company and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

Ability to Continue as a Going Concern

The accompanying consolidated financial statements have been prepared assuming the Company will continue as a going concern. The Company has incurred losses resulting in an accumulated deficit of \$79.7 million, has a net working capital deficit of \$7.6 million and outstanding debt of \$37.8 million as of *December 31, 2017*. These conditions together with recent debt covenant violations and subsequent debt covenant waivers and debt amendments, raise substantial doubt about the Company’s ability to continue as a going concern. The ability to continue as a going concern is dependent upon the Company generating profitable operations, improving liquidity and reducing costs to meet its obligations and repay its liabilities arising from normal business operations when they become due. The Company has evaluated its plans to alleviate this doubt, which will include slowing new restaurant development,

implementing cost-savings initiatives and evaluating potential closure of underperforming restaurants. While the Company believes that its existing cash and cash equivalents as of *December 31, 2017*, coupled with its anticipated cash flow generated from operations, will be sufficient to meet its anticipated cash requirements, there can be *no* assurance that the Company will be successful in its plans to increase profitability or to obtain alternative financing on acceptable terms, when required or if at all. These consolidated financial statements do *not* include any adjustments to the recoverability and classification of recorded asset amounts and classification of liabilities that might be necessary should the Company be unable to continue as a going concern.

Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

Cash and Cash Equivalents

We consider all highly liquid investments that are readily convertible into cash and have an original maturity of *three* months or less at the time of purchase to be cash equivalents. Amounts receivable from credit card processors are also considered cash equivalents because they are both short-term and highly liquid in nature and are typically converted to cash within *three* business days of the sales transaction.

Investments

Investments consist primarily of certificates of deposit that are generally highly liquid in nature. We classify our investments based on the intended holding period.

KONA GRILL, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Inventory

Inventory consists of food and beverage products that are valued at the lower of cost or market using the *first-in, first-out* method.

Concentration of Credit Risk

Financial instruments that potentially subject us to a concentration of credit risk principally consist of cash and cash equivalents, investments and accounts receivable. We maintain our day-to-day operating cash balances in non-interest-bearing transaction accounts, which are insured by the Federal Deposit Insurance Corporation ("FDIC") up to \$250,000. Although we maintain balances that exceed the federally insured limit, we have *not* experienced any losses related to our accounts, and we believe credit risk to be minimal.

Property and Equipment

Property and equipment are recorded at cost. We capitalize all direct costs on the construction of leasehold improvements and interest incurred during the construction and development period. Leasehold improvements are amortized over the shorter of the useful life of the asset or the related lease term that includes reasonably assured lease renewals as determined on the date of acquisition of the leasehold improvement. Improvements that materially extend the life of an asset are capitalized while repair and maintenance costs are expensed as incurred.

Depreciation and amortization are recorded on a straight-line basis over the following estimated useful lives:

Furniture and fixtures (years)	5 - 7
Equipment (years)	2 - 7
Computer software and electronic equipment (years)	3
Leasehold improvements	Shorter of the

useful
life or
the
lease
term

Impairment of Long-Lived Assets

We evaluate long-lived assets, such as property and equipment, for impairment whenever events or changes in restaurant operating results indicate that the carrying value of those assets *may not* be recoverable. Factors considered include, but are *not* limited to, significant underperformance relative to expected historical or projected future operating results; significant negative industry or economic trends; and significant changes in legal factors or in the business climate. The assessment of impairment is performed on a restaurant-by-restaurant basis. Recoverability is assessed by comparing the carrying value of the asset to the undiscounted cash flows expected to be generated by the asset. This assessment process requires the use of estimates and assumptions regarding future cash flows and estimated useful lives, which are subject to a significant degree of judgment. If indicators of impairment are present and if we determine that the carrying value of the asset exceeds the fair value of the restaurant assets, an impairment charge is recorded to reduce the carrying value of the asset to its fair value.

As a result of the process described above, we recorded long-lived asset impairment charges of \$9.3 million and \$12.5 million, for 2017 and 2016, respectively. Such amounts are included in "Asset impairment charge" in the consolidated statements of comprehensive loss (Note 2).

KONA GRILL, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Fair Value Measurements

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. As such, fair value is a market-based measurement that is determined based on assumptions that market participants would use in pricing an asset or a liability. As a basis for considering such assumptions, a *three*-tier value hierarchy was established, which prioritizes the inputs used in the valuation methodologies in measuring fair value.

Level 1: Fair values determined by quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access.

Level 2: Fair values utilize inputs other than quoted prices that are observable for the asset or liability, and *may* include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability.

Level 3: Fair values determined by unobservable inputs that are *not* corroborated by market data and *may* reflect the reporting entity's own assumptions market participants would use in pricing the asset or liability.

The carrying value for certain of our financial instruments, including cash and cash equivalents, accounts receivable and accounts payable approximates fair value because of their short-term nature. Our investments represent certificates of deposit and are considered available-for-sale securities that are valued using market observable inputs (Level 2). Our long-term debt is valued using primarily Level 2 inputs including current applicable rates for similar instruments and approximates the carrying value of such obligations.

In addition to our assets and liabilities that are measured at fair value on a recurring basis, we are required by GAAP to measure certain assets and liabilities at fair value on a nonrecurring basis after initial recognition. Generally, assets, liabilities and reporting units are measured at fair value on a nonrecurring basis as a result of impairment reviews and any resulting impairment charge. In connection with our impairment review of long-lived assets described in Note 2, we measured the fair value of our asset groups that were *not* deemed recoverable, based on Level 2 and Level 3 inputs consisting of the fair market value or discounted future cash flows associated with the use and eventual disposition of the asset group. The discounted cash flow method is based on Level 3 inputs consisting primarily of our restaurant forecasts and utilizes forward-looking assumptions and projections, as well as factors impacting long-range plans such as pricing, discount rates and commodity prices.

Leases

We lease our restaurant locations under operating lease agreements with initial terms ranging from *10* to *20* years. Most of these agreements require minimum annual rent payments plus contingent rent payments based on a percentage of revenue which exceed the minimum base sales threshold. Contingent rent payments, to the extent they exceed minimum payments, are accrued over the periods in which the liability is incurred. Rent expense associated with these contingent payments is recorded prior to the achievement of specified sales levels if exceeding such amount is considered probable and is estimable. The lease agreements typically also require scheduled increases to minimum annual rent payments. For leases that contain rent escalations, we record the total rent payable over the initial lease term, starting on the date we gain possession of the property (including the construction period), on a straight-line basis. Any difference between minimum rent and straight-line rent is recorded as deferred rent. Deferred rent also includes tenant improvement allowances which are amortized as a reduction of rent expense on a straight-line basis over the term of the lease. As part of the initial lease terms, we negotiate with our landlords to secure these tenant improvement allowances and record such allowances as lease incentive receivables when determined to be collectible. These amounts are included in receivables on the consolidated balance sheets.

KONA GRILL, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Revenue Recognition

Revenues from food, beverage, and alcohol sales are recognized when payment is tendered at the point of sale. Revenue are recorded net of promotions and discounts. Revenues from gift card sales are recognized upon redemption. Prior to redemption, the outstanding balances of all gift cards are included in accrued expenses in the accompanying consolidated balance sheets. We recognize gift card breakage income when the likelihood of the redemption of the gift cards becomes remote. Gift card breakage income is recorded in "Revenue" on the consolidated statements of comprehensive loss and amounted to \$0.2 million for the year ended *December 31, 2017*. We did *not* record any breakage income related to our gift card liability for the years ended *December 31, 2016* and *2015*, respectively.

We execute franchise agreements for units operated by *third* parties. Our franchise agreements typically provide for payment of development and initial franchise fees in addition to subsequent royalty fees based on the gross sales of each restaurant. Royalties are based on a percentage of gross sales at franchise restaurants and are recognized when earned and collectability is reasonably assured. We recognize initial fees received from a franchisee as revenue when we have performed substantially all initial services required by the franchise agreement, which is generally upon the opening of a store. Fees collected in advance are deferred until earned. Upfront fees paid by franchisees in connection with development agreements are deferred when the development agreement includes a minimum number of restaurants to be opened by the franchisee. Initial franchise and development fees are recorded as deferred revenue and included in "Deferred rent and other long-term liabilities" in our consolidated balance sheets. The deferred amounts are recognized as revenue on a pro rata basis as the franchisee opens each respective restaurant.

Sales Taxes

Revenues are presented net of sales taxes. The sales tax obligation is included in accrued expenses until the taxes are remitted to the appropriate taxing authorities.

Advertising and Marketing Costs

Advertising and marketing costs are expensed as incurred. Advertising and marketing expense for 2017, 2016 and 2015 was \$1.7 million, \$0.9 million and \$0.7 million, respectively, and is included in restaurant operating expenses in the accompanying consolidated statements of comprehensive loss. We maintain a customer loyalty club (the Konavore™ program), an email-based marketing program designed to communicate new menu offerings, restaurant specific events, and other marketing messages to keep Kona Grill top of mind for consumers. The Konavore™ loyalty program offers members a discount coupon upon enrolling in the program and a discount coupon for a member's birthday. These coupons are recognized upon redemption and recorded in the financial statements as a sales discount. Costs associated with the redemption of a promotion in the form of a coupon for discounted product are recorded in cost of sales as these coupons are typically redeemed with the purchase of additional food and beverage items. Costs associated with promotional giveaways of food and beverages to local businesses and sponsorship of events are viewed as advertising in nature and recorded in restaurant operating expenses.

Preopening Expense

Costs directly related to the opening of new restaurants, including employee relocation, travel, employee payroll and related training costs, and rent expense subsequent to the date we take possession of the property through the restaurant opening are expensed as incurred.

Stock-Based Compensation

We maintain stock award plans under which we *may* issue incentive stock options, non-qualified stock options, restricted stock, and other types of awards to employees, directors, and consultants. Stock options issued under these plans are granted with an exercise price at or above the fair market value of the underlying common stock on the date of grant and expire *five* years from the date of grant. Employee stock options generally vest 25% each year over a *four*-year period, while annual recurring awards for non-employee director options vest 25% each quarter over a *one*-year period. Certain stock option awards for executive officers *may* vest earlier in the event of a change of control or termination, as defined in the executive officer's employment agreement. We apply the Black-Scholes valuation model in determining the fair value of stock option grants. We recognize compensation cost for our stock awards using a graded vesting schedule on a straight line basis over the requisite service period.

KONA GRILL, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Income Taxes

We utilize the liability method of accounting for income taxes. Under the liability method, deferred tax assets and liabilities are computed at each balance sheet date for temporary differences between the consolidated financial statements and tax basis of assets and liabilities that will result in taxable or deductible amounts in the future based on tax rates in effect in the years in which the temporary differences are expected to affect taxable income. Valuation allowances are established when necessary to reduce deferred tax assets to the amounts that will more likely than *not* be realized.

We recognize the impact of a tax position in our financial statements if that position more likely than *not* will be sustained upon examination by a tax authority. We recognize accrued interest and penalties related to uncertain tax positions as income tax expense.

Net Loss Per Share

Basic and diluted loss per common share is computed by dividing loss by the weighted average number of common shares outstanding during the period. For 2017, 2016 and 2015, there were 0.9 million, 0.8 million and 0.6 million stock options outstanding, respectively, that were *not* included in the dilutive earnings per share calculation because the effect would have been anti-dilutive.

The following table sets forth the computation of basic and diluted net loss per share:

	Year Ended December 31,		
	2017	2016	2015
	(In thousands, except per share data)		
Numerator:			
Net loss	\$ (23,432)	\$ (21,629)	\$ (4,496)

Denominator:

Weighted average shares — basic	10,121	10,791	11,264
Effect of dilutive stock options	—	—	—
Weighted average shares — diluted	10,121	10,791	11,264

Net loss per share:

Basic and diluted	\$(2.32)	\$(2.00)	\$(0.40)
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Recently Issued Accounting Standards

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2014-09, *Revenue from Contracts with Customers (Topic 606)*. The pronouncement was issued to clarify the principles for recognizing revenue and is effective for reporting periods beginning after December 15, 2017. We have completed our assessment of the revised standard and impacts on the Company’s consolidated financial statements and disclosures. We have reviewed a sample of contracts that are representative of the current types of revenue generating streams, including our assessment of the impacts, on initial franchise fees and breakage income recognized on our unredeemed gift cards. Additionally, this ASU requires enhanced disclosures, including significant judgments in measurement and recognition.

While we do *not* anticipate a significant change as a result of adopting the new standard, we have identified the most significant impact associated with the adoption of the new standard relates to accounting for development and franchise fees received in connection with our current and future franchise related activity. We currently believe that the services we provide related to upfront fees we receive from franchisees such as territory or initial fees do *not* contain separate and distinct performance obligations from the franchise right and thus those upfront fees will be recognized as revenue on a straight-line basis over the term of each respective franchise agreement. The standard requires the unearned portion of fees received to be presented in our consolidated balance sheets as a contract liability. Additionally, we have evaluated the impact that ASU 2014-09 will have on our recognition of breakage income related to our unredeemed gift cards. Based upon the above review, we have determined the adoption of ASU 2014-09 in fiscal year 2018 will *not* have a material effect on our consolidated financial statements and related disclosures.

KONA GRILL, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

We will adopt the new standard effective *January 1, 2018*. The guidance *may* be applied retrospectively for all periods presented or retrospectively with the cumulative effect of initially applying the guidance recognized at the date of initial application. We will adopt the standard retrospectively with the cumulative effect of initially applying the amended guidance recognized at *January 1, 2018*. Consequently, we will apply the guidance to the most current period presented in the financial statements issued subsequent to the adoption date. However, had we adopted the standard as of *January 1, 2017*, our revenue and operating loss for the year would have been reduced by approximately \$0.3 million.

In addition to the changes presented above, we have historically recognized sales commissions as a component of labor expenses as they are incurred. Under the new standard, certain sales commissions will be capitalized and amortized to general and administrative expense over the expected life of the customer relationship. We do *not* expect a material change to the amount we recognize as general and administrative expense on an annual basis, nor do we expect to recognize a material cumulative effective adjustment to Accumulated Deficit as of *January 1, 2018*.

Lastly, we assessed the disclosure requirements under ASU 2014-09, and we anticipate disclosing additional information, as necessary, to comply with the requirements of the new standard.

In *March 2016*, the FASB issued ASU 2016-09, Compensation - Stock Compensation (Topic 718) which simplifies the accounting for employee share-based payment transactions, including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows. The standard is effective for fiscal years beginning after *December 15, 2016*. The Company has adopted this standard effective *January 1, 2017*. Under the new standard, income tax benefits and deficiencies are to be recognized as income tax expense or benefit in the income statement and the tax effects of exercised or vested awards should be treated as discrete items in the reporting period in which they occur. The Company should also recognize excess tax benefits regardless of whether the benefit reduces taxes payable in the current period. Excess tax benefits should be classified along with other income tax cash flows as an operating activity. In regards to forfeitures, the Company has elected to *not* change its accounting policy and continue to estimate the number of awards that are expected to vest. The adoption of this standard created an additional \$2.1 million in deferred tax assets, which was offset by the Company's full valuation allowance. As such, we determined the adoption of this standard did *not* have a material impact on our consolidated financial position and results of operations. See Note 5 for further discussion.

In *February 2016*, ASC Topic 842, Leases, was issued to increase the transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. In order to meet that objective, the new standard requires recognition of the assets and

liabilities that arise from leases. Accordingly, a lessee will recognize a right-of-use (ROU) asset for its right to use the underlying asset and a lease liability for the corresponding lease obligation. Both the ROU asset and lease liability will initially be measured at the present value of the future minimum lease payments over the lease term. Subsequent measurement, including the presentation of expenses and cash flows, will depend on the classification of the lease as either finance or an operating lease. Initial costs directly attributable to negotiating and arranging the lease will be included in the ROU asset. Lessees can make an accounting policy election by class of underlying asset *not* to recognize a ROU asset and corresponding lease liability for leases with a term of 12 months or less. Accounting by lessors will remain largely unchanged from current U.S. GAAP. The leasing standard is applicable for most entities starting in 2019. Public business entities are required to apply the leasing standard for annual reporting periods (including interim periods therein) beginning after *December 15, 2018*. The leasing standard is required to be applied to leases in existence as of the date of adoption using a modified retrospective transition approach. The modified retrospective approach includes a number of optional practical expedients that companies *may* elect to apply. These practical expedients relate to the identification and classification of leases that commenced before the effective date, initial direct costs for leases that commenced before the effective date, and the ability to use hindsight in evaluating lessee options to extend or terminate a lease or to purchase the underlying asset. The transition guidance also provides specific guidance for sale and leaseback transactions, build-to-suit leases, leveraged leases, and amounts previously recognized in accordance with the business combinations guidance for leases. We are currently performing an assessment of the revised standard, including optional practical expedients, and assessing our existing lease portfolio in order to determine the impact to our accounting systems, processes and internal control over financial reporting. To date, we have reviewed a sample of contracts that are representative of our current lease environment. We expect the adoption of this guidance to have a material impact on our consolidated financial statements; however the effect is *not* currently estimable.

KONA GRILL, INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****2. Property and Equipment**

Property and equipment consisted of the following (in thousands):

	December 31,	
	2017	2016
Leasehold improvements	\$114,346	\$115,902
Equipment	29,596	29,900
Furniture and fixtures	11,798	12,196
	155,740	157,998
Less accumulated depreciation and amortization	(75,429)	(62,921)
	80,311	95,077
Construction in progress	1,328	3,191
Total property and equipment, net	\$81,639	\$98,268

We capitalize direct internal payroll and travel costs on the construction of leasehold improvements incurred during the construction and development period. Capitalized costs were \$0.6 million and \$1.3 million in 2017 and 2016, respectively.

We review the carrying value of our long-lived assets on a restaurant-by-restaurant basis when indicators of potential impairment exist. Such indicators include, but are *not* limited to, significant underperformance relative to expected, historical or projected future operating results; significant negative industry or economic trends; and significant changes in laws and regulations. Given the continued underperformance of certain restaurants we determined impairment indicators were present as of *December 31, 2017*. As such, we conducted additional impairment analyses and performed a recoverability test which ultimately concluded the property and equipment of *three* restaurants were impaired.

During the year ended *December 31, 2017* and *2016*, we recorded non-cash asset impairment charges of \$9.3 million and \$12.5 million for certain underperforming restaurants based upon an assessment of each restaurant's historical operating performance combined with expected cash flows for these restaurants over the respective remaining lease term. We reduced the carrying value of these assets to their estimated fair value which was determined using a discounted cash flow model or the market value of each restaurant's assets. The fair values of each of the reporting

units as well as the related assets and liabilities utilized to determine the impairment were measured using Level 2 and Level 3 inputs as described in Note 1. This impairment charge was recorded to asset impairment charge in the consolidated statement of comprehensive loss.

We have *not* closed any of these underperforming restaurants at this time, however, we will continue to evaluate each of these restaurants on a case-by-case basis. Additionally, while we believe that our estimates of fair value are appropriate, we will continue to monitor these asset values of each individual restaurant, and should actual values differ materially from our estimates, we *may* be required to record impairment charges in the future.

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KONA GRILL, INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

Additionally, during 2017, we wrote-off \$0.9 million of long-lived assets associated with our decision *not* to open a restaurant in El Segundo. This asset impairment charge is reflected within “Lease termination and exit costs” in the accompanying consolidated statements of comprehensive loss. See Note 10 for further discussion.

3. Accrued Expenses

Accrued expenses consisted of the following (in thousands):

	December 31,	
	2017	2016
Accrued payroll and benefits	\$4,290	\$4,549
Gift cards	3,995	4,311
Sales and use taxes	1,275	1,776
Lease termination ⁽¹⁾	1,048	—
Business and income taxes	514	563
Accrued occupancy	249	240
Accrued construction and remodel	209	2,005
Other	1,354	1,006
Total accrued expenses	\$12,934	\$14,450

(1) Balance is attributable to lease termination costs associated with the decision *not* to open a restaurant in El Segundo, California. See Note 10.

4. Debt and Credit Agreements

On *October 12, 2016*, we entered into the Second Amended and Restated Credit Agreement (the “Second Amended Credit Agreement”) with KeyBank National Association (“KeyBank”) and Zions First National Bank to (i) increase the combined revolving and term credit facilities (the “credit facility”) from \$35 million to \$60 million, comprised of a \$45 million revolver (“Revolver”) and \$15 million term loan (“Term Loan”), and (ii) extend the maturity date of the credit facility to *October 12, 2021*. The credit facility is secured by our personal property and assets. Certain of our wholly

owned subsidiaries have also guaranteed the credit facility. On *March 29, 2017*, we entered into Amendment *No. 1* to the Second Amended and Restated Credit Agreement, which amended certain financial covenants in the Second Amended Credit Agreement.

On *July 7, 2017*, we entered into Amendment *No. 2* to the Second Amended and Restated Credit Agreement (“Amendment *No.2*”). Amendment *No. 2* amended the Second Amended Credit Agreement to, among other things, decrease the total available credit from the revolving credit facility from \$45 million to \$30 million, which including the \$15 million term loan, resulted in an overall reduction of the credit facility from \$60 million to \$45 million. Additionally, (a) the maturity date was amended from *October 12, 2021* to *October 12, 2019*, provided that if the Company’s *pro forma* leverage ratio is less than 4.25 to 1.00 at any time prior to the maturity date, the Company *may* request a *one* year extension of the maturity date until *October 12, 2020*; (b) the applicable margins for base rate loans and the applicable margins for LIBOR rate loans were increased by 25 bps to 75 bps depending on the Company’s leverage ratio; and (c) the maximum leverage ratio was increased and the minimum fixed charge coverage ratio was decreased to provide increased flexibility as further described below. The terms of Amendment *No. 2* were effective as of *June 30, 2017*.

Amendment *No. 2* requires us to comply with certain covenants on a quarterly basis, including (a) a minimum fixed charge coverage ratio of (i) 1.25 to 1.00 for the fiscal quarter ended *June 30, 2017*; (ii) 1.20 to 1.00 for the fiscal quarters ended *September 30, 2017, December 31, 2017, March 31, 2018, June 30, 2018, September 30, 2018*, and *December 31, 2018*; and (iii) 1.30 to 1.00 for the fiscal quarter ended *March 31, 2019* and each fiscal quarter thereafter; and (b) a maximum leverage ratio of (i) 5.50 to 1.00 for the fiscal quarters ended *June 30, 2017, September 30, 2017, and December 31, 2017*; (ii) 5.25 to 1.00 for the fiscal quarters ended *March 31, 2018, June 30, 2018, September 30, 2018 and December 31, 2018*; and (iii) 5.00 to 1.00 for the fiscal quarter ended *March 31, 2019* and each fiscal quarter thereafter.

KONA GRILL, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

On *October 30, 2017*, we entered into Amendment *No. 3* to the Second Amended and Restated Credit Agreement (“Amendment *No. 3*”). Amendment *No. 3* amends the Second Amended Credit Agreement to, among other things, (a) implement a monthly reporting requirement; (b) restrict certain restricted payments as defined in the Second Amended Credit Agreement; and (c) implement a limitation on capital expenditures subject to approval by the Lenders in their sole discretion.

On *March 9, 2018*, we entered into Amendment *No. 4* to the Second Amended and Restated Credit Agreement (“Amendment *No. 4*”). Amendment *No. 4* amends the Second Amended Credit Agreement to, among other things, reduces the available credit on the Revolver from \$30 million to \$25 million as of the effective date of Amendment *No. 4* and further reduces the available credit on the Revolver to \$22.5 million at *June 30, 2018* and \$20 million at *December 31, 2018*. Additionally, (a) the maturity date was amended from *October 12, 2019* to *January 13, 2020* with *no* option to extend the maturity; (b) the applicable margins for base rate loans and the applicable margins for LIBOR rate loans were increased by 50 bps to 100 bps depending on the Company’s leverage ratio; and (c) the maximum leverage ratio was increased and the minimum fixed charge coverage ratio was decreased to provide increased flexibility as further described below. The terms of Amendment *No. 4* were effective as of *March 9, 2018*.

Amendment *No. 4* requires us to comply with certain covenants on a quarterly basis, including (a) a minimum fixed charge coverage ratio of (i) 1.10 to 1.00 for the fiscal quarters ended *March 31, 2018*, *June 30, 2018* and *September 30, 2018*; (ii) 1.15 to 1.00 for the fiscal quarters ended *December 31, 2018* and *March 31, 2019* and (iii) 1.20 to 1.00 for the fiscal quarter ended *June 30, 2019* and each fiscal quarter thereafter; and (b) a maximum leverage ratio of (i) 6.25 to 1.00 for the fiscal quarter ended *March 31, 2018*; (ii) 6.00 to 1.00 for the fiscal quarter ended *June 30, 2018*; (iii) 5.50 to 1.00 for the fiscal quarter ended *September 30, 2018*; (iv) 5.00 to 1.00 for the fiscal quarters ended *December 31, 2018*, *March 31, 2019* and *June 30, 2019*; and (v) 4.25 for the fiscal quarter ended *September 30, 2019* and each fiscal quarter thereafter.

The Company was *not* in compliance with the fixed charge coverage ratio and the leverage ratio at *December 31, 2017*. A waiver was received on *March 9, 2018* for the quarter ended *December 31, 2017*. The Company believes that it is probable that it will be in compliance at future covenant compliance dates.

Debt consists of the following at *December 31, 2017* and *2016*:

December 31, 2017

				December 31, 2016	
		Unamortized			
	Maturity	Deferred	Fair	Carrying	Carrying
	Date	Financing	Value	Value of	Value of
		Costs	of Debt	Debt	Debt
		(a)	(b)		
Revolver	Oct. 2019	\$257	\$23,750	\$ 23,750	\$ 12,000
Term Loan	Oct. 2019	113	14,063	14,063	14,813
Total debt		\$370	\$37,813	37,813	26,813
Debt issuance costs presented with debt (a)				(113)	(180)
Total debt, net				37,700	26,633
Less: current portion				779	712
Long-term debt				\$ 36,921	\$ 25,921

We have presented the deferred financing costs associated with the Term Loan in the balance sheet as a direct deduction from the carrying amount of the debt liability as of *December 31, 2017* and *2016*. The deferred financing costs related to the Revolver continue to be presented as an asset, and are included in both Prepaid (a) expenses and other current assets and Other assets on the consolidated balance sheets as of *December 31, 2017* and *2016*. In connection with Amendment No. 2 the Company wrote-off unamortized deferred financing costs associated with both its amended Revolver and Term Loan of approximately \$0.4 million and \$0.1 million, respectively, for the year ended *December 31, 2017*.

(b) Our Revolver and Term Loan bear interest at rates commensurate with market rates and therefore their respective carrying values approximate fair value.

KONA GRILL, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

The interest rate under Amendment *No. 4* is KeyBank's base rate or LIBOR, at our option, plus an applicable margin depending on our leverage ratio. The LIBOR margins range from 2.00% to 5.00% and the base rate margins range from 1.00% to 4.00%. For such times when the leverage ratio is greater than or equal to 6.0, then the applicable margin for base rate loans and the applicable margin for LIBOR rate loans will be 4.00% and 5.00%, respectively. For such times when the leverage ratio is greater than or equal to 5.5 but less than 6.0, then the applicable margin for base rate loans and the applicable margin for LIBOR rate loans will be 3.50% and 4.50%, respectively. Payments on the Term Loan are due quarterly and are subject to acceleration upon certain events as defined in the Second Amended Credit Agreement, while borrowings on the Revolver are interest only, payable quarterly with respect to each base rate loan and at varying times with respect to LIBOR rate loans, with outstanding principal and interest due at maturity. Prepayment is permitted at any time without penalty, subject to certain restrictions on the order of repayment or prepayment. We are obligated to pay a commitment fee at an annual rate of 0.175% to 0.350%, depending on our leverage ratio, times the unused total revolving commitment of the credit facility based on the average daily amount outstanding under the credit facility for the previous quarter. For such times when the leverage ratio is greater than 4.25, the commitment fee annual rate will be 0.50%. The commitment fee is payable quarterly in arrears. During 2017, 2016 and 2015, we incurred commitment fees of \$0.1 million for each year.

We incurred gross interest expense of \$1.9 million, \$0.6 million and \$0.2 million during the years ended *December 31, 2017, 2016 and 2015*, respectively; which includes approximately \$0.1 million of commitment fees incurred during the years ended *December 31, 2017, 2016 and 2015*, respectively. Additionally, capitalized interest was \$0.1 million and \$0.2 million for the years ended *December 31, 2017 and 2016*, respectively. We did *not* capitalize any interest for the year ended *December 31, 2015*.

At *December 31, 2017*, we had \$37.8 million in outstanding borrowings, consisting of \$23.7 million under the Revolver and \$14.1 million under the Term Loan. As of *December 31, 2017*, net availability under the credit facility was \$6.25 million, subject to compliance with certain covenants.

Our current projections indicate that we will maintain the outstanding borrowings for the next 12 months and, thus, all borrowings under the credit facility are classified as long-term debt, except for amounts payable in the next 12 months which are classified as current.

As of *December 31, 2017*, the required principal payments for all borrowings for each of the *five* years following the balance sheet date are as follows (in thousands):

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2018	\$844
2019	36,969
2020	—
2021	—
2022	—
Thereafter	—
Total	\$37,813

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KONA GRILL, INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

As previously mentioned above, upon execution of Amendment *No. 4*, the maturity date of our credit facility was extended to *January 13, 2020*, and among other things, includes required payments on our Revolver borrowings during *2018*. As such, subsequent to the execution of Amendment *No. 4*, the required principal payments for all borrowings for each of the *five* years following the balance sheet date are as follows:

2018	\$4,594
2019	844
2020	32,375
2021	—
2022	—
Thereafter	—
Total	\$37,813

5. Income Taxes

Income tax expense consisted of the following (in thousands):

	Year Ended December 31, 2017 2016 2015		
Current:			
Federal	\$—	\$ —	\$ —
State	90	66	43
Total current	90	66	43
Deferred:			
Federal	—	—	—
State	—	—	—
Total deferred	—	—	—
Total	\$90	\$ 66	\$ 43

Income tax expense differed from amounts computed by applying the federal statutory rate to loss from operations before provision for income taxes as follows (in thousands):

	Year Ended December 31,		
	2017	2016	2015
Income tax expense at federal statutory rate of 34%	<i>\$(7,936)</i>	<i>\$(7,331)</i>	<i>\$(1,514)</i>
State income taxes, net of federal benefit	<i>(1,109)</i>	<i>(1,382)</i>	<i>46</i>
Nondeductible expenses	<i>702</i>	<i>701</i>	<i>583</i>
Business tax credit	<i>(1,754)</i>	<i>(1,692)</i>	<i>(1,503)</i>
Federal rate change	<i>8,042</i>	<i>—</i>	<i>—</i>
Other	<i>639</i>	<i>108</i>	<i>(273)</i>
Change in valuation allowance	<i>1,506</i>	<i>9,662</i>	<i>2,704</i>
Total	<i>\$90</i>	<i>\$66</i>	<i>\$43</i>

KONA GRILL, INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

The temporary differences that give rise to significant portions of deferred tax assets and liabilities were as follows (in thousands):

	December 31,	
	2017	2016
Deferred tax assets (liabilities):		
Net operating loss carryforward	\$11,944	\$10,694
Deferred rent	8,092	11,570
Business tax credits	14,422	12,558
Organizational and preopening costs	340	558
Stock-based compensation	774	1,033
Accrued expenses	98	157
Property and equipment	(2,452)	(7,338)
Other	660	984
Net deferred tax assets	33,878	30,216
Valuation allowance	(33,878)	(30,216)
Total	\$—	\$—

The Tax Cuts and Jobs Act (“the Tax Act”) was enacted on *December 22, 2017*. The Tax Act reduces the U.S. federal corporate tax rate from 34% to 21%, effective *January 1, 2018*, limits deductions for, among other things, interest expense, executive compensation and meals and entertainment while enhancing deductions for equipment and other fixed assets. The Tax Act provisions regarding foreign reporting do *not* apply to Kona at this time.

The SEC staff issued SAB 118, which provides guidance on accounting for the tax effects of the Tax Act. SAB 118 provides a measurement period that should *not* extend beyond *one* year from the Tax Act’s enactment date for companies to complete its accounting under ASC 740. In accordance with SAB 118, to the extent a company has *not* completed its analysis of the Tax Act but can provide a reasonable estimate, it must record a provisional estimate in its financial statements.

As of *December 31, 2017*, we have *not* finalized our accounting for the tax effects of the enactment of the Tax Act; however, as described below, we have made a reasonable estimate of the effects on our existing deferred tax balances and uncertain tax positions.

We remeasured our deferred tax assets and liabilities based on the rates at which they are expected to reverse in the future. However, we are still analyzing certain aspects of the Tax Act and refining our calculations, which could potentially affect the provisional measurement of these balances. We also anticipate that the completion of our 2017 income tax returns by the *third* quarter of 2018 could also impact any provisional amounts recorded. Based on our current estimates, we do *not* anticipate any net change to our deferred tax balances as we anticipate a full valuation allowance will remain in place. Due to the continued full valuation allowance *no* provisional amounts are recorded at *December 31, 2017*.

We have *no* reserves for uncertain tax positions and *no* adjustment or provisional amounts to record at *December 31, 2017*.

We anticipate that the completion of our 2017 income tax returns, future guidance and additional information and interpretations with the respect to the Tax Act will cause us to further review a need for provisional amounts to be recorded as of *December 31, 2017*. If necessary, and in accordance with SAB 118, we will record such adjustments in the period that relevant guidance and/or additional information becomes available and our analysis is completed but don't expect it to have a material impact on our income taxes.

KONA GRILL, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

The valuation allowance increased \$3.7 million and \$9.7 million at *December 31, 2017* and *2016*. At *December 31, 2017*, we had \$41.1 million in federal net operating loss carryforwards, \$64.2 million in state net operating loss carryforwards and \$15.1 million in federal business tax credit carryforwards, the majority of which is comprised of FICA tip credit carryforwards. These credits and certain state net operating loss carryforwards are also subject to annual limitations due to ownership change rules under the Internal Revenue Code.

The Company recorded the effect of the adoption of ASU 2016-09 as of *January 1, 2017*, which resulted in an increase to deferred tax assets of approximately \$2.1 million. The realization of our deferred tax assets ultimately depends on the existence of sufficient taxable income in future periods. We have analyzed, and will continue to analyze, the positive and negative evidence to support our conclusion regarding the appropriate amount of our valuation allowance. This analysis incorporates our recent earnings history and forecasted future results. We are currently in a *three*-year cumulative loss which points to a full valuation allowance for our net deferred tax assets due to the uncertainty surrounding their future utilization. The valuation allowance could be reduced in a subsequent period if there is sufficient evidence to support a conclusion that it is more likely than *not* that our deferred tax assets will be realized. Future changes in our valuation allowance could have a material effect on our results of operations in the period recorded.

As of *December 31, 2017*, there were *no* accrued interest or penalties recorded in the consolidated financial statements. We are subject to U.S. federal income tax as well as income tax of multiple state jurisdictions. The earliest tax year still subject to examination by a significant taxing jurisdiction is *2013*.

6. Stockholders' Equity

Preferred Stock

We are authorized to issue 2,000,000 shares of preferred stock with a par value of \$0.01. There were *no* shares of preferred stock that were issued or outstanding at *December 31, 2017* or *2016*.

Common Stock

Stock Purchase and Retirement Program

In *November 2015*, our Board of Directors authorized a stock repurchase program of up to *\$10.0* million of our outstanding common stock. We completed the stock repurchase authorization in *June 2016* and repurchased and retired 832,937 shares at a cost of *\$10.0* million.

In *October 2016*, our Board of Directors authorized an additional stock repurchase of up to *\$5.0* million of outstanding common stock. As of *December 31, 2016*, we repurchased and retired *\$1,427,000* or *136,790* shares under the *2016* authorization. We completed the *\$5.0* million stock repurchase program in *February 2017* with the purchase and retirement of *532,376* shares.

Stockholder Rights Plan

On *September 6, 2016*, our Board of Directors approved the declaration of a dividend of *one* purchase right (a “Right”) for each outstanding share of common stock, par value *\$0.01* per share, of the Company (the “Common Stock”). Each Right entitles the registered holder to purchase from the Company *one one-thousandth* of a share of preferred stock of the Company (the “Preferred Stock”) at a price of *\$55.94* per share (the “Purchase Price”), subject to adjustment, under certain conditions specified in the Rights Agreement. Rights will be exercisable only if a person or group acquires *9.9%* or more of the Company’s common stock (subject to certain exceptions), and thus becomes an “Acquiring Person” under the Rights Plan. In the event that any person or group of affiliated or associated persons becomes an Acquiring Person, each holder of a Right, other than Rights beneficially owned by the Acquiring Person, affiliates and associates of the Acquiring Person and certain transferees thereof (which will thereupon become null and void), will thereafter have the right to receive upon exercise of a Right, for the exercise price of the Right, in lieu of preferred stock, shares of Common Stock of the Company having a market value equal to twice such exercise price. The Rights are *not* exercisable until the Distribution Date, as defined in the Rights Agreement filed on Form 8-K on *September 6, 2016*. The Rights will expire on *September 6, 2019*, unless the Rights are earlier redeemed or exchanged by the Company, or upon the occurrence of certain transactions.

KONA GRILL, INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****7. Stock-Based Compensation****Stock Options**

We maintain stock award plans under which we *may* issue incentive stock options, non-qualified stock options, restricted stock, and other types of awards to employees, directors, and consultants. We typically grant non-qualified stock options with an exercise price at the fair market value of the underlying common stock on the date of grant and such options expire *five* years from the date of grant. Employee stock options generally vest 25% each year over a *four*-year period, while annual recurring awards for non-employee director options vest 25% each quarter over a *one*-year period.

We grant stock options under our 2012 Stock Award Plan (the “2012 Plan”). The total shares of common stock reserved for issuance were 3.7 million, of which 1.3 million shares were available for grant as of *December 31, 2017*.

We account for stock-based compensation using the fair value recognition provisions. Compensation expense is recognized ratably over the vesting term of the option and is included in general and administrative expenses. The following table presents information related to stock-based compensation (in thousands):

	Year Ended December 31,		
	2017	2016	2015
Stock-based compensation	\$831	\$1,262	\$1,363

The fair value of each option award is estimated on the date of grant using the Black-Scholes option pricing model and is affected by assumptions regarding a number of highly complex and subjective variables. These variables include, but are *not* limited to, the actual and projected employee stock option exercise behavior, expected volatility, risk-free interest rate, expected dividends, and expected term. Expected volatility is based on the historical volatility of our stock. The expected term of the options represents the estimated period of time until exercise and is based on historical experience of similar awards, giving consideration to the contractual terms, vesting schedules and expectations of future employee behavior. The risk-free interest rate is based on the U.S. Treasury yield curve in effect

at the time of grant for the expected term of the option. We have *not* paid dividends in the past and do *not* plan to pay any dividends in the near future. Compensation expense is recognized only for those options expected to vest, with forfeitures estimated based on our historical experience and future expectations. The fair value of stock options granted was estimated at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

	2017	2016	2015
Expected volatility	54.1%	45.2%	40.7%
Risk-free interest rate	1.7 %	0.9 %	0.9 %
Dividend yield	0.0 %	0.0 %	0.0 %
Expected life (in years)	3.5	3.2	3.0
Weighted average fair value per option granted	\$2.58	\$4.57	\$6.67

KONA GRILL, INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

Activities under our stock award plans during 2017, 2016 and 2015 were as follows:

	Shares Under Option	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value (in thousands)
Outstanding options at December 31, 2014	740,250	\$ 10.66		
Granted	380,268	23.28		
Forfeited	(81,213)	19.73		
Exercised	(77,837)	7.40		
Outstanding options at December 31, 2015	961,468	15.15		
Granted	251,532	14.26		
Forfeited	(111,094)	11.49		
Exercised	(127,706)	6.73		
Outstanding options at December 31, 2016	974,200	16.44		
Granted	294,178	6.62		
Forfeited	(215,507)	15.96		
Exercised	(40,000)	5.41		
Outstanding options at December 31, 2017	1,012,871	\$ 14.12	2.5	\$ —
Exercisable at December 31, 2017	605,728	\$ 15.67	1.9	\$ —

The intrinsic value of options exercised during 2017, 2016 and 2015 was \$0.1 million, \$0.8 million and \$1.2 million, respectively. The total fair value of shares vested during 2017, 2016 and 2015 was \$1.1 million, \$1.1 million and \$1.0 million, respectively. As of *December 31, 2017*, there was approximately \$1.1 million of unrecognized stock-based compensation expense related to unvested share-based compensation arrangements, which is expected to be recognized over a weighted average period of 2.1 years.

Information regarding options outstanding and exercisable at *December 31, 2017* is as follows:

Range of Exercise Prices	Options Outstanding			Options Exercisable		
	Shares	Weighted Average Remaining Contractual	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	
		Life (years)				
\$2.15 - \$8.71	374,725	3.1	\$ 7.11	168,250	\$ 8.52	
\$11.82 - \$18.85	401,150	2.2	\$ 15.14	272,114	\$ 15.34	
\$23.49	236,996	2.1	\$ 23.49	165,364	\$ 23.49	
	1,012,871	2.5	\$ 14.12	605,728	\$ 15.67	

8. Employee Benefit Plans

Defined Contribution Plan

We maintain a voluntary defined contribution plan covering eligible employees as defined in the plan documents. Participating employees *may* elect to defer the receipt of a portion of their pre-tax or post-tax compensation, subject to applicable laws, and contribute such amount to *one* or more investment options. We currently match in cash a certain percentage of the employee contributions to the plan and also pay for related administrative expenses. Matching contributions made during 2017, 2016 and 2015 were \$0.3 million for each year.

KONA GRILL, INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****Employee Stock Purchase Plan**

Our 2005 Employee Stock Purchase Plan (ESPP) reserves 425,000 shares of common stock for issuance. The ESPP permits eligible employees to purchase common stock at a discount through payroll deductions up to 15% of employees' eligible earnings during the offering period. During 2017, 2016 and 2015, the purchase price per share at which shares of common stock were sold in under the ESPP was equal to 85%, 95% and 95%, respectively, of the fair market value of common stock on the last day of the applicable offering period. During 2017, 2016 and 2015, 13,271 shares, 4,333 shares and 2,743 shares, respectively, were purchased under the ESPP.

9. Commitments and Contingencies**Leases**

We lease our restaurant locations under operating leases having terms expiring from 2018 to 2029. The leases typically include renewal clauses of *five* years exercisable at our option and rent escalation clauses stipulating specific rent increases. We record deferred rent to recognize rent evenly over the lease term. These leases typically require the payment of contingent rentals based on a percentage of gross revenues above specified minimum amounts as defined in the respective lease agreement. The leases also typically require us to pay our proportionate share of common area maintenance, property tax, insurance, and other occupancy-related costs. We also lease office space and certain equipment under operating lease agreements.

Rent expense on all operating leases was as follows (in thousands):

	Year Ended December		
	31,		
	2017	2016	2015
Minimum base rent	\$14,898	\$12,203	\$9,618
Contingent rent	137	222	269
Total rent	\$15,035	\$12,425	\$9,887

As of *December 31, 2017*, future minimum lease payments under operating leases, including all signed leases for restaurants to be opened and excluding unexercised renewal options periods, were as follows (in thousands):

2018	\$ 15,734
2019	15,844
2020	15,325
2021	14,945
2022	13,768
Thereafter	42,008
Total minimum lease payments	\$ 117,624

Litigation

We are engaged in various legal actions, which arise in the ordinary course of our business. Although there can be *no* assurance as to the ultimate disposition of these matters, it is the opinion of our management, based upon the information available at this time, that the expected outcome of these matters, individually or in the aggregate, will *not* have a material adverse effect on the results of operations or financial condition of our company.

KONA GRILL, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

On *December 13, 2012*, Frank Neal Goss filed a lawsuit against Kona Grill Macadamia, Inc., a wholly-owned subsidiary of the Company (“Macadamia”) and Anthony DeAngelo in the Circuit Court of Jackson County, Kansas City, Missouri. The claim revolves around a fight that Goss and DeAngelo allegedly had outside of the Company’s Kansas City restaurant on *March 1, 2011*, which is claimed to have resulted in physical injury to the plaintiff. The plaintiff also claims that Macadamia failed to take certain actions that allegedly would have prevented the fight. A default judgment of approximately \$3.5 million was entered on *December 18, 2013* against Macadamia, but was subsequently set aside by order of the Circuit Court on *April 7, 2014*. On *August 17, 2015*, we filed a Motion for Summary Judgment requesting judgment in our favor on all claims asserted against us by the plaintiff. On *August 18, 2015*, the plaintiff filed for a voluntary dismissal of the claim without prejudice; however, on *April 22, 2016*, the plaintiff re-filed the claim in the Circuit Court. A trial date was scheduled for *June 12, 2017*. The plaintiff filed for a motion of continuance on *June 2, 2017* and the motion was granted. In *January 2018*, a confidential general release was signed by the plaintiff. On *January 29, 2018*, the Circuit Court dismissed the case with prejudice.

On *November 29, 2017*, Continental Atrium Corporation filed a complaint for damages in the Superior Court for the State of California for the County of Los Angeles alleging, among other things, that the Company breached its written contract relating to the Company’s decision in *April 2017* to *not* move forward with the construction of a restaurant in El Segundo as discussed in Note 10 below (the “Complaint”). The Complaint alleges that beginning *no later than August 15, 2017*, the Company has failed to pay rent and other amounts owed to the plaintiff. A case management conference is scheduled for *April 30, 2018*. As of *December 31, 2017*, we had \$1.0 million in lease termination and exit costs recorded in accrued expenses in the accompanying consolidated balance sheets associated with this matter.

10. Lease Termination and Exit Costs

As a result of our continued focus on improving sales and margins at our existing restaurants, in addition to slowing growth to provide us with capital allocation flexibility, we made the decision in the *second* quarter of 2017 to *not* open a restaurant in El Segundo, California and stopped construction on this restaurant. We recognized \$1.4 million associated with the estimated costs to terminate the lease, asset impairment charges, write-off of deferred rent liability, and other costs associated with this location during the year ended *December 31, 2017*.

Lease termination and exit costs attributable to the El Segundo restaurant are reflected within “Lease termination and exit costs” in the accompanying consolidated statements of comprehensive loss. Such costs consisted of the following (in thousands):

	Year Ended December 31,		
	2017	2016	2015
Lease termination costs	\$1,048	\$ —	\$ —
Write-off of deferred rent liability	(510)	—	—
Asset impairment charge	854	—	—
Total lease termination and exit costs	\$1,392	\$ —	\$ —

The lease termination and exit cost accrual is included in accrued expenses on the consolidated balance sheets. Activities associated with the lease termination and exit cost accrual are summarized below (in thousands):

	Lease Exit Costs
Lease termination and exit costs accrued at December 31, 2016	\$—
Lease termination and exit-related costs	1,048
Cash payments	—
Lease termination and exits costs accrued at December 31, 2017	\$1,048

KONA GRILL, INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****11. Selected Quarterly Financial Data (Unaudited)**

Summarized quarterly unaudited financial data for 2017 and 2016 is as follows (in thousands, except per share data):

	2017			
	March 31	June 30	September 30	December 31
Revenue	\$45,225	\$46,977	\$ 44,390	\$42,489
Loss from operations ⁽²⁾	(3,042)	(3,422)	(2,802)	(11,820)
Net loss ⁽²⁾	(3,373)	(4,327)	(3,323)	(12,409)
Basic and diluted net loss per share ^{(1) (2)}	\$(0.33)	\$(0.43)	\$ (0.33)	\$(1.23)

	2016			
	March 31	June 30	September 30	December 31
Revenue	\$39,277	\$43,296	\$ 43,358	\$43,592
Loss from operations	(1,578)	(738)	(2,411)	(16,265)
Net loss	(1,656)	(835)	(2,555)	(16,583)
Basic and diluted net loss per share ⁽¹⁾	\$(0.15)	\$(0.08)	\$ (0.24)	\$(1.58)

⁽¹⁾ The per share calculations for each quarter are based on the weighted average basic and diluted shares outstanding for that quarter and *may not* total to the full year amount.

⁽²⁾ During the quarters ended *December 31, 2017* and *2016* we recorded an asset impairment charge of \$9.3 million and \$12.5 million, respectively.