MusclePharm Corp
Form 10-Q
August 14, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

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

OR

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

For the transition period from ______________to ______________

Commission File Number: **000-53166**

MUSCLEPHARM CORPORATION

(Exact name of registrant as specified in its charter)

Nevada	**77-0664193**
(State or other jurisdiction of	(I.R.S. Employer

incorporation or organization) Identification No.)

4721 Ironton Street, Building A

Denver, Colorado 80239

(Address of principal executive offices and zip code)

(303) 396-6100

(Registrant's telephone number, including area code)

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

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

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

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

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

As of August 13, 2013, there were 10,127,124 shares outstanding of the registrant's common stock.

TABLE OF CONTENTS

Part I – FINANCIAL INFORMATION

Item 1. Financial Statements

MusclePharm Corporation and Subsidiary

Consolidated Balance Sheets

	June 30, 2013 (unaudited)	December 31, 2012 (audited)
Assets		
Current Assets:		
Cash	$8,655,761	$ -
Cash – restricted	-	9,148
Accounts receivable – net	9,235,094	3,302,344
Inventory	1,168,348	257,975
Prepaid giveaways	101,680	358,800
Prepaid stock compensation	1,109,313	44,748
Prepaid sponsorship fees	581,877	6,249
Deferred equity costs	-	698,500
Other assets	896,671	272,117
Total current assets	21,748,744	4,949,881
Property and equipment – net	1,329,047	1,356,364
Debt issue costs – net	-	335,433
Other assets	172,994	125,049
Total Assets	$23,250,785	$ 6,766,727
Liabilities and Stockholders' Equity		
Current Liabilities:		
Accounts payable and accrued liabilities	$8,173,356	$ 11,721,205
Customer deposits	24,773	336,211
Debt – net	74,329	4,463,040
Derivative liabilities	2,369,032	-
Total current liabilities	10,641,490	16,520,456
Long Term Liabilities:		
Debt – net	-	4,523
Total Liabilities	10,641,490	16,524,979
Commitments and Contingencies		
Stockholders' Equity:		
Series A, Convertible Preferred Stock, $0.001 par value; 5,000,000 shares authorized, none issued and outstanding	-	-

Series B, Preferred Stock, $0.001 par value; 51 shares authorized, issued and outstanding	-	-
Series C, Convertible Preferred Stock, $0.001 par value; 500 shares authorized, 190 and zero issued and outstanding	-	-
Series D, Convertible Preferred Stock, $0.001 par value; 1,600,000 shares authorized, 1,500,000 and none issued and 145,000 and none outstanding	145	-
Common Stock, $0.001 par value; 100,000,000 shares authorized, 7,766,759 and 2,778,404 issued and 7,716,838 and 2,747,308 outstanding	7,767	2,778
Treasury Stock, at cost; 49,921 and 31,096 shares	(564,515)	(460,978)
Additional paid-in capital	87,061,004	54,817,341
Accumulated deficit	(73,893,265)	(64,109,476)
Accumulated other comprehensive loss	(1,841)	(7,917)
Total Stockholders’ Equity	12,609,295	(9,758,252)
Total Liabilities and Stockholders’ Equity	$23,250,785	$ 6,766,727

See accompanying notes to unaudited financial statements.

3

MusclePharm Corporation and Subsidiary

<u>Consolidated Statements of Operations</u>

(unaudited)

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2013	2012	2013	2012
Sales – gross	$ 28,515,483	$ 18,869,103	$ 53,439,519	$ 38,171,872
Discounts and sales allowances	(3,035,424)	(3,439,763)	(5,398,293)	(6,181,852)
Sales – net	25,480,059	15,429,340	48,041,226	31,990,020
Cost of sales	17,566,718	12,942,605	31,963,124	25,837,767
Gross profit	7,913,341	2,486,735	16,078,102	6,152,253
General and administrative expenses	10,654,272	4,151,076	19,540,512	8,543,887
Income (loss) from operations	(2,740,931)	(1,664,341)	(3,462,410)	(2,391,634)
Other income (expense)				
Derivative expense	-	(1,029,541)	(96,913)	(2,486,451)
Change in fair value of derivative liabilities	272,681	9,854,045	(5,771,963)	1,496,874
Gain (loss) on settlement of accounts payable and debt	47,671	-	324,656	(2,941,826)
Interest expense	(1,125)	(976,686)	(781,445)	(3,547,202)
Foreign currency transaction loss	(104)	(1,573)	(5,714)	(1,573)
Other income	-	-	10,000	18,423
Total other income (expense) - net	319,123	7,846,245	(6,321,379)	(7,461,755)
Net income (loss)	(2,421,808)	6,181,904	(9,783,789)	(9,853,389)
Other comprehensive income				
Net change in Foreign currency translation	4,228	40,719	(1,841)	40,719
Total other comprehensive income (loss)	4,228	40,719	(1,841)	40,719
Total comprehensive income (loss)	$ (2,417,580)	$ 6,222,623	$ (9,785,630)	$ (9,812,670)
Net income (loss) per share available to common stockholders – basic and diluted	$ (0.34)	$ 3.78	$ (1.72)	$ (6.44)
Weighted average number of common shares outstanding during the period – basic and diluted	7,226,849	1,633,676	5,686,323	1,530,850

See accompanying notes to unaudited financial statements.

MusclePharm Corporation and Subsidiary

Consolidated Statements of Cash Flows

(unaudited)

	Six Months Ended June 30, 2013	2012
Cash Flows From Operating Activities:		
Net loss	$(9,783,789)	$(9,853,389)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:		
Depreciation	333,383	199,750
Bad debt	105,271	9,490
Amortization of prepaid stock and deferred compensation	3,419,698	456,903
Amortization of debt discount	-	3,083,437
Amortization of debt issue costs	335,433	184,031
(Gain) loss on settlement of accounts payable, debt and conversion of Series C preferred stock	(324,656)	2,941,826
Derivative expense	96,913	2,486,451
Change in fair value of derivative liabilities	5,771,963	(1,496,874)
Changes in operating assets and liabilities:		
(Increase) decrease in:		
Restricted cash balance	9,148	(52,744)
Accounts receivable	(5,713,366)	502,193
Prepaid and other	(1,242,246)	186,725
Inventory	86,866	(219,276)
Increase (decrease) in:		
Accounts payable and accrued liabilities	2,052,010	867,058
Customer deposits	(311,438)	1,142,426
Net Cash (Used In) Provided by Operating Activities	(5,164,810)	438,007
Cash Flows From Investing Activities:		
Purchase of property and equipment	(307,760)	(544,859)
Proceeds from disposal of property and equipment	1,694	-
Purchase of trademark	(47,500)	(35,000)
Net Cash Used In Investing Activities	(353,566)	(579,859)
Cash Flows From Financing Activities:		
Proceeds from issuance of debt	-	4,073,950
Debt issue costs	-	(106,950)
Repayment of debt	(4,393,234)	(4,058,442)
Repurchase of common stock (treasury stock)	(103,537)	(460,978)
Proceeds from issuance of preferred stock	12,000,000	-
Proceeds from issuance of common stock and warrants	8,327,499	285,760
Stock issuance costs	(1,662,667)	-

Net Cash Provided by (Used In) Financing Activities	14,168,061	(266,660)
Cash Flows From Equity Activities:		
Effect of exchange rates on cash and cash equivalents	6,076	40,719
Net Cash Provided by Equity Activities	6,076	40,719
Net increase (decrease) in cash	8,655,761	(367,793)
Cash at beginning of period	-	659,764
Cash at end of period	$8,655,761	$291,971
Supplemental disclosures of cash flow information:		
Cash paid for interest	$410,502	$265,078
Cash paid for taxes	$-	$-
Supplemental disclosure of non-cash investing and financing activities:		
Stock issued for future services - third parties	$4,409,897	$200,000
Warrants issued in conjunction with equity issuances	$8,175,459	$427,759
Debt discount recorded on convertible and unsecured debt accounted for as a derivative liability	$-	$3,554,672
Stock issued to settle accounts payable and accrued expenses– third parties	$5,484,947	$4,667,764
Conversion of convertible debt and accrued interest for common stock	$-	$1,069,402
Stock issued for executive and board compensation	$114,912	$-
Reclassification of derivative liability to additional paid in capital	$-	$4,124,387
Stock issued to settle accrued liabilities	$-	$135,000
Stock issued to settle contracts	$-	$3,932

See accompanying notes to unaudited financial statements.

5

MusclePharm Corporation and Subsidiary

Notes to Consolidated Financial Statements

(June 30, 2013)

(Unaudited)

Note 1: Nature of Operations and Basis of Presentation

Nature of Operations

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

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

Basis of Presentation

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

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

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

Note 2: Summary of Significant Accounting Policies

Principles of Consolidation

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

Use of Estimates

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

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

Risks and Uncertainties

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

6

MusclePharm Corporation and Subsidiary

Notes to Consolidated Financial Statements

(June 30, 2013)

(Unaudited)

Cash and Cash Equivalents

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

Accounts Receivable and Allowance for Doubtful Accounts

Accounts receivable represents trade obligations from customers that are subject to normal trade collection terms. Prior to July 1, the accounts receivable were sent directly to the Company's third party manufacturer and netted with any outstanding liabilities to the manufacturer (see Note 11). Liabilities to the manufacturer totaled $4,213,394 at June 30, 2013 and are included in accounts payable and accrued liabilities. The Company periodically evaluates the collectability of its accounts receivable and considers the need to establish an allowance for doubtful accounts based upon historical collection experience and specific customer information. Accordingly, the actual amounts could vary from the recorded allowances. There is also a review of customer discounts at the period end and an accrual made for discounts earned but not yet received by quarter end.

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

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

	As of June 30, 2013	As of December 31, 2012

Accounts receivable	$ 10,492,646	$ 4,416,193
Less: allowance for discounts	(1,004,000)	(1,088,720)
Less: allowance for doubtful accounts	(253,552)	(25,129)
Accounts receivable – net	$ 9,235,094	$ 3,302,344

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

Customer	As of June 30, 2013	As of December 31, 2012
A	14 %	19 %
B	8 %	6 %
C	7 %	0 %

Inventory

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

Prepaid Giveaways

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

Prepaid Sponsorship Fees

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

Property and Equipment

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

7

MusclePharm Corporation and Subsidiary

Notes to Consolidated Financial Statements

(June 30, 2013)

(Unaudited)

Website Development Costs

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

Long-Lived Assets

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

Fair Value of Financial Instruments

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

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

- Level 1: Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2: Inputs reflect quoted prices for identical assets or liabilities in markets that are not active; quoted prices for similar assets or liabilities in active markets; inputs other than quoted prices that are observable for the assets or liabilities; or inputs that are derived principally from or corroborated by observable market data by correlation or other means.
- Level 3: Unobservable inputs reflecting the Company's assumptions incorporated in valuation techniques used to determine fair value. These assumptions are required to be consistent with market participant assumptions that are reasonably available.

The following are the major categories of liabilities measured at fair value on a recurring basis as of June 30, 2013 and December 31, 2012, using quoted prices in active markets for identical liabilities (Level 1); significant other observable inputs (Level 2); and significant unobservable inputs (Level 3):

	As of June 30, 2013	As of December 31, 2012
Derivative liabilities (Level 2)	$ 2,369,032	$ -

The Company's financial instruments consisted primarily of accounts receivable, accounts payable and accrued liabilities, and debt. The Company's debt approximates fair value based upon current borrowing rates available to the Company for debt with similar maturities. The carrying amounts of the Company's financial instruments generally approximated their fair values as of June 30, 2013 and December 31, 2012, respectively, due to the short-term nature of these instruments.

Revenue Recognition

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

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

MusclePharm Corporation and Subsidiary

Notes to Consolidated Financial Statements

(June 30, 2013)

(Unaudited)

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

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

Sales for the three and six months ended June 30, 2013 and 2012 were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Sales	$ 28,515,483	$ 18,869,103	$ 53,439,519	$ 38,171,872
Discounts	(3,035,424)	(3,439,763)	(5,398,293)	(6,181,852)
Sales - Net	$ 25,480,059	$ 15,429,340	$ 48,041,226	$ 31,990,020

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

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

	Six Months Ended June 30,	
Customer	2013	2012
A	31 %	40 %
B	12 %	11 %

C	6 %	17 %

Licensing Income and Royalty Revenue

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

Cost of Sales

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

Shipping and Handling

Until March 1, 2013 MusclePharm used a manufacturer from Tennessee to ship directly to our customers, and after that date MusclePharm took control of the shipping and began shipping product to our customers from a previously leased 152,000 square foot distribution center in Franklin, Tennessee in close proximity of our manufacturer. Our products are transported from our manufacturer to the MusclePharm distribution center, but title does not pass from the manufacturer until loaded on the truck for shipment. Through June 30, 2013, MusclePharm does not take title to our products (see Note 11). The facility in Franklin, Tennessee is operated with the Company's equipment and employees. This transition away from having our Tennessee manufacturer ship product for us is an effort to reduce our costs and improve gross margins.

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

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

MusclePharm Corporation and Subsidiary

Notes to Consolidated Financial Statements

(June 30, 2013)

(Unaudited)

Advertising

The Company expenses advertising costs when incurred.

Advertising expense for the three and six months ended June 30, 2013 and 2012 were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Advertising	$ 3,275,200	$ 2,044,005	$ 5,592,577	$ 3,976,840

Beneficial Conversion Feature

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

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

Accounts payable and accrued liabilities

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

Debt

The Company defines short term debt as any debt payment due less than one year from the date of the financial statements. Long term debt is defined as any debt payment due more than one year from the date of the financial statements. Refer to Note 4 for further disclosure of debt liabilities.

Derivative Liabilities

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

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

Deferred Equity Costs

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

Debt Issue Costs and Debt Discount

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

10

MusclePharm Corporation and Subsidiary

Notes to Consolidated Financial Statements

(June 30, 2013)

(Unaudited)

Original Issue Discount

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

Share-Based Payments

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

Earnings (loss) Per Share

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

The Company uses an "if converted" method to determine whether there is a dilutive effect of outstanding option and warrant contracts. For the three months ended June 30, 2012, all of the Company's convertible debt options and 625,028 warrants had exercise prices below of the Company's period end market price of the common stock into which they convert. The adjusted dilutive net loss reflects the add back of approximately $349 of interest expense related to the convertible debt and the reduction of $9,449,050 of gains on derivative contracts for the three months ended June

30, 2012. For the three months ended June 30, 2013 and six months ended June 30, 2013 and 2012, and the three months ended June 30, 2012 the Company reflected net loss and a dilutive net loss, respectively, and the effect of considering any common stock equivalents would have been anti-dilutive for these periods. Therefore, separate computation of diluted earnings (loss) per share is not presented.

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

	Six Months Ended June 30,	
	2013	2012
Stock options (exercise price - $425/share)	670	1,903
Warrants (exercise price $4 – $1,275/share)	330,089	84,820
Convertible debt (exercise price $17/share)	-	2,471
Total common stock equivalents	330,759	89,194

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

Foreign Currency

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

MusclePharm Corporation and Subsidiary

Notes to Consolidated Financial Statements

(June 30, 2013)

(Unaudited)

Reclassification

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

Note 3: Property and Equipment

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

	As of June 30, 2013	As of December 31, 2012	Estimated Useful Life
Furniture, fixtures and gym equipment	$ 1,591,642	$ 1,323,998	From 36 to 60 months
Leasehold improvements	601,625	563,204	From 42 to 66 months
Vehicles	100,584	100,584	5 years
Displays	32,057	32,057	5 years
Website	11,462	11,462	3 years
Total	2,337,370	2,031,305	
Less: Accumulated depreciation and amortization	(1,008,323)	(674,941)	
	$ 1,329,047	$ 1,356,364	

Note 4: Debt

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

	As of June 30, 2013	As of December 31, 2012

Auto loan - secured	$	9,729		15,380
Unsecured debt		64,600		4,452,183
Less: debt discount		-		-
Unsecured debt - net		64,600		4,452,183
Total debt		74,329		4,467,563
Less: current portion		(74,329)		(4,463,040)
Long term debt	$	-	$	4,523

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

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

Years Ending December 31,	
2013 (6 months)	$70,840
2014	3,489
Total annual principal payments	$74,329

12

MusclePharm Corporation and Subsidiary

Notes to Consolidated Financial Statements

(June 30, 2013)

(Unaudited)

Convertible Debt – Secured - Derivative Liabilities

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

		Year Ended December 31, 2012 Amount of Principal Raised
Interest Rate		8% - 10%
Default interest rate		0% - 20%
Maturity		January 3, 2012 to October 11, 2014
Conversion terms 1	62% of lowest trade price for the last 7 trading days	100,000
Conversion terms 2	65% of the lowest trade price in the 30 trading days previous to the conversion	19,950
Conversion terms 3	35% multiplied by the average of the lowest three (3) trading prices (as defined below) for the common stock during the ten (10) trading day period ending on the latest complete trading day prior to the conversion date.	400,000
		$ 519,950

The debt holders are entitled, at their option, to convert all or part of the principal and accrued interest into shares of the Company’s common stock at the conversion prices and terms discussed above. The Company classifies embedded conversion features in these notes as a derivative liability due to management’s assessment that the Company may not have sufficient authorized number of shares of common stock required to net-share settle or due to the existence of a ratchet due to an anti-dilution provision. See Note 5 regarding accounting for derivative liabilities.

(A) Unsecured Debt

Unsecured debt consisted of the following activity and terms:

Balance - December 31, 2012	$4,452,183
Repayments	(4,387,583)
Balance – June 30, 2013	$64,600

(B) Vehicle Loan

Vehicle loan account consisted of the following activity and terms:

		Interest Rate	Maturity
Balance - December 31, 2012	$15,380	6.99 %	26 payments of $1,008
Repayments	(5,651)		
Balance – June 30, 2013	$9,729		

(C) Debt Issue Costs

During the six months ended June 30, 2012, the Company paid debt issue costs totaling $106,950.

For the year ended December 31, 2012, the Company issued 22,633 warrants as cost associated with a debt raise. The initial derivative liability value of $427,759 was recorded as debt issue costs and derivative liability.

The following is a summary of the Company's debt issue costs for the six months ended June 30, 2013 and year ended December 31, 2012 as follows:

	2013	2012
Debt issue costs	$335,433	$851,923
Accumulated amortization of debt issue costs	(335,433)	(516,490)
Debt issue costs – net	$-	$335,433

13

MusclePharm Corporation and Subsidiary

Notes to Consolidated Financial Statements

(June 30, 2013)

(Unaudited)

During the six months ended June 30, 2013 and 2012, the Company amortized $335,433 and $184,031, respectively in debt issue costs.

Note 5: Derivative Liabilities

The Company identified conversion features embedded within consulting agreements and Series D Preferred Stock issued in 2013. The Company has determined that the features associated with the embedded conversion option should be accounted for at fair value as a derivative liability as the Company could not determine if a sufficient number of shares would be available to settle all transactions.

The fair value of the conversion feature is summarized as follows:

Derivative liability - December 31, 2012	$-
Fair value at the commitment date for equity instruments	8,175,459
Fair value at the commitment date for warrants issued	96,913
Fair value mark to market adjustment for equity instruments	5,716,688
Fair value mark to market adjustment for warrants	55,275
Conversion instruments exercised	(11,675,303)
Derivative liability – June 30, 2013	$2,369,032

The Company recorded the day 1 value of derivative contracts associated with the Series D preferred stock issuance against gross proceeds raised, and expensed immediately the remaining value of the derivative as it exceeded the gross proceeds of the offering. The Company recorded a derivative expense of $96,913 and $2,486,451 for the six months ended June 30, 2013 and 2012, respectively.

The fair value at the commitment and re-measurement dates for the Company’s derivative liabilities were based upon the following management assumptions:

	Commitment Date		Re-measurement Date	
Expected dividends	0	%	0	%
Expected volatility	118% - 123%		107	%
Expected term:	1 year		17 months – 1 year	
Risk free interest rate	0.14% - 0.15%		0.15	%

Note 6: Restricted Stock Units

In November 2012, the Company granted the Executive Vice President and Co-Chairman, Mr. John H. Bluher, 70,589 restricted stock units through a restricted stock unit agreement. Each restricted stock unit represents a contingent right to receive one share of the Company's common stock upon vesting. The value of this award at the grant date was $245,400 and will be amortized over the vesting periods such that each tranche of restricted stock units will be fully amortized at the date of vesting. The restricted stock units vest in one tranche of 23,529 on January 1, 2013 and two tranches of 23,530 shares on January 1, 2014 and December 1, 2014. As of June 30, 2013, 23,529 restricted stock units have vested and the unamortized portion of this award is $123,036.

In November 2012, the Company granted the Chief Financial Officer, Mr. L. Gary Davis, 58,824 restricted stock units through a restricted stock unit agreement. Each restricted stock unit represents a contingent right to receive one share of the Company's common stock upon vesting. The value of this award at the grant date was $204,500 and will be amortized over the vesting periods such that each tranche of restricted stock units will be fully amortized at the date of vesting. The restricted stock units vest in three tranches of 19,608 shares each on January 1, 2013 and 2014, and December 1, 2014. As of June 30, 2013, 19,608 restricted stock units have vested and the unamortized portion of this award is $102,530.

MusclePharm Corporation and Subsidiary

Notes to Consolidated Financial Statements

(June 30, 2013)

(Unaudited)

Note 7: Stockholders' Equity

The Company has four separate series of authorized preferred stock:

On November 26, 2012, the Company (i) effected a 1-for-850 reverse stock split of our common stock, including a proportionate reduction in the number of authorized shares of our common stock from 2.36 billion shares to 2.8 million shares of common stock, and (ii) amended our articles of incorporation to increase the number of authorized shares of common stock (post reverse stock split) from 2,941,177 to 100 million effective November 27, 2012. All share and per share amounts in this document have been changed to give effect to the reverse stock split.

(A) Series A Convertible Preferred Stock

This class of stock has the following provisions:

- Non-voting,
- No rights to dividends,
- No liquidation value, and
- Convertible into 200 shares of common stock.

(B) Series B Preferred Stock (Related Parties)

In August 2011, the Company issued an aggregate of 51 shares of Series B Preferred Stock to two of its officers. The Company accounted for the share issuance at par value as there was no future economic value that could be associated with the issuance.

This class of stock has the following provisions:

- Voting rights entitling the holders to an aggregate 51% voting control,
- No rights to dividends,
- Stated value of $0.001 per share,
- Liquidation rights entitle the receipt of net assets on a pro-rata basis with the holders of our common stock; and
- Non-convertible.

(C) Series C Convertible Preferred Stock

In October 2011, the Company issued 190 shares of Series C Convertible Preferred Stock, having a fair value of $190,000. Of the total shares issued, 100 shares were issued for $100,000 ($1,000 /share). The remaining 90 shares were issued for services rendered having a fair value of $90,000 ($1,000 /share), based upon the stated value per share. In March 2012, all 190 shares were converted into 22,353 shares of the Company's common stock at a conversion price of $0.0085 per share and a loss of $614,984.

This class of stock has the following provisions:

- Stated Value - $1,000 per share,
- Non-voting,
- Liquidation rights entitle an amount equal to the stated value, plus any accrued and unpaid dividends,
- As long as any Series C, Convertible Preferred Stock is outstanding, the Company is prohibited from executing various corporate actions without the majority consent of the holders of Series C, Convertible Preferred Stockholders authorization; and
- Convertible at the higher of (a) $0.01 or (b) such price that is a 50% discount to market using the average of the low two closing bid prices, five days preceding conversion.

Due to the existence of an option to convert at a variable amount, the Company treated this series of preferred stock as a derivative liability due to the potential for settlement in a variable quantity of shares. Additionally, the Company computed the fair value of the derivative liability at the commitment date and re-measurement date, which was $293 and $175, respectively, using the Black-Scholes assumptions below. This transaction is analogous to a dividend with a direct charge to retained earnings.

MusclePharm Corporation and Subsidiary

Notes to Consolidated Financial Statements

(June 30, 2013)

(Unaudited)

(D) Series D Convertible Preferred Stock

In January 2013 the board of directors authorized 1,600,000 shares of Series D convertible preferred stock. Between January 16, 2013 and February 4, 2013, the Company entered into separate subscription agreements with certain investors in connection with the offering, pursuant to which the Company sold an aggregate of 1,500,000 shares of Preferred Stock for aggregate gross proceeds of approximately $12 million. Pursuant to the Certificate of Designation of the Series D Convertible Preferred Stock filed with the Nevada Secretary of State on January 11, 2013 (the "Certificate of Designation"), each share of Preferred Stock is convertible into two shares of common stock, subject to adjustment as set forth in the Certificate of Designation.

The shares of Series D have the following provisions:

· Voting rights based on number of common shares of conversion option;
· Initially no rights to dividends;
· Liquidation rights entitle an amount equal to the stated value, plus any accrued and unpaid dividends,
· Convertible into 2 shares of common stock, subject to adjustment.

(E) Common Stock

During the six months ended June 30, 2013, the Company issued the following common stock:

Transaction Type	Quantity (#)	Valuation ($)	Range of Value per Share ($)
Conversion of Series D preferred stock to common stock	2,710,000	11,675,481	2.80 – 7.54
Cash and warrants	953,236	8,059,330	8.26 – 9.32
Executive/Board of Director compensation	62,289	264,879	3.48 – 6.00

Stock issued for services and to settle liabilities	1,262,830	9,894,844	4.02 – 12.99
Total	4,988,355	29,894,534	2.80 – 12.99

The fair value of all stock issuances above is based upon either the quoted closing trading price on the date of issuance, the value of derivative instrument at the date of conversion, contract value where the fair value was stated by the contract, or net proceeds from capital raised after giving effect to the cost of capital raised.

(F) Stock Options

The Company applied fair value accounting for all shares based payments awards. The fair value of each option granted is estimated on the date of grant using the Black-Scholes option-pricing model. The Black-Scholes assumptions used when the options were issued in the year ended December 31, 2010 are as follows:

Exercise price	$425	
Expected dividends	0	%
Expected volatility	74.8	%
Risk fee interest rate	1.4	%
Expected life of option	5 years	
Expected forfeiture	0	%

16

MusclePharm Corporation and Subsidiary

Notes to Consolidated Financial Statements

(June 30, 2013)

(Unaudited)

The following is a summary of the Company's stock option activity:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
Balance – December 31, 2012	1,847	$ 425.00	2.25 years	-
Granted	-			
Exercised	-			
Forfeited/Cancelled	(1,177)	$ 425.00		
Balance – June 30, 2013 – outstanding	670	$ 425.00	1.75 years	-
Balance – June 30, 2013 – exercisable	670	$ 425.00	1.75 years	-
Outstanding options held by related parties – 2013	-			
Exercisable options held by related parties – 2013	-			

(G) Stock Warrants

All warrants issued during the six months ended June 30, 2013 were accounted for as derivative liabilities. See Note 5.

During the six months ended June 30, 2013, the Company entered into convertible equity agreements. As part of these agreements, the Company issued warrants to convert 1,500,000 shares of Series D preferred stock into 3,000,000 shares of common stock.

A summary of warrant activity for the Company for the six months ended June 30, 2013 is as follows:

	Number of Warrants	Weighted Average Exercise Price
Outstanding – December 31, 2012	89	$ 1,275

Granted	3,040,000		4.09
Exercised	(2,710,000	)	4.00
Balance as June 30, 2013	330,089	$	5.13