KONA GRILL INC
Form 10-Q
August 14, 2008

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

FORM 10-Q

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

For the quarterly period ended June 30, 2008

or

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

For the transition period from __________ to __________

Commission File Number 001-34082

Kona Grill, Inc.
(Exact Name of Registrant as Specified in Its Charter)

Delaware	**20-0216690**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*

7150 East Camelback Road, Suite 220
Scottsdale, Arizona 85251
(480) 922-8100
(Address, including zip code, and telephone number, including area code, of principal executive offices)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

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

Large accelerated filer o	Accelerated filer o	Non-accelerated filer þ	Smaller reporting company o
		(Do not check if a smaller reporting company)	

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

As of July 31, 2008, there were 6,498,158 shares of the registrant s common stock outstanding.

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PART I FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements

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

	June 30, 2008 (Unaudited)	December 31, 2007 (Note 1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 7,956	$ 4,991
Investments	366	14,188
Receivables	1,865	1,096
Other current assets	1,497	1,393
Total current assets	11,684	21,668
Long-term investments	6,142	
Other assets	542	495
Property and equipment, net	49,856	47,311
Total assets	$ 68,224	$ 69,474
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 3,453	$ 3,324
Accrued expenses	4,215	4,025
Current portion of notes payable	689	663
Total current liabilities	8,357	8,012
Notes payable	1,685	2,037
Deferred rent	14,106	12,994
Total liabilities	24,148	23,043
Commitments and contingencies (Note 9)		
Stockholders equity:		
Preferred stock, $0.01 par value, 2,000,000 shares authorized, none issued		
Series A junior participating preferred stock, $0.01 par value, 10,000 shares and zero shares authorized at June 30, 2008 and December 31, 2007, respectively, none issued		
Common stock, $0.01 par value, 15,000,000 shares authorized, 6,614,358 and 6,608,078 shares issued and outstanding at June 30, 2008 and December 31, 2007, respectively	66	66
Additional paid-in capital	53,382	53,071
	(1,000)	

Treasury stock, at cost, 116,200 shares and zero shares at June 30, 2008 and December 31, 2007, respectively				
Accumulated deficit		(7,914)		(6,706)
Accumulated other comprehensive loss		(458)		
Total stockholders equity		44,076		46,431
Total liabilities and stockholders equity	$	68,224	$	69,474

See accompanying notes to the unaudited consolidated financial statements.

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KONA GRILL, INC.
UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Restaurant sales	$ 20,183	$ 19,322	$ 38,979	$ 34,988
Costs and expenses:				
Cost of sales	5,517	5,487	10,924	10,033
Labor	6,656	5,970	13,115	11,045
Occupancy	1,296	1,205	2,604	2,263
Restaurant operating expenses	3,045	2,742	5,772	4,876
General and administrative	2,026	1,832	3,878	3,601
Preopening expense	541	350	719	838
Depreciation and amortization	1,675	1,477	3,333	2,766
Total costs and expenses	20,756	19,063	40,345	35,422
(Loss) income from operations	(573)	259	(1,366)	(434)
Nonoperating income (expense):				
Interest income	105	131	309	291
Interest expense	(17)	(42)	(51)	(42)
(Loss) income before provision for income taxes	(485)	348	(1,108)	(185)
Provision for income taxes	50	35	100	45
Net (loss) income	$ (535)	$ 313	$ (1,208)	$ (230)
Net (loss) income per share:				
Basic	$ (0.08)	$ 0.05	$ (0.18)	$ (0.04)
Diluted	$ (0.08)	$ 0.05	$ (0.18)	$ (0.04)
Weighted average shares used in computation:				
Basic	6,565	5,866	6,587	5,860
Diluted	6,565	6,233	6,587	5,860

See accompanying notes to the unaudited consolidated financial statements.

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KONA GRILL, INC.
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Six Months Ended June 30, 2008	2007
Operating activities		
Net loss	$ (1,208)	$ (230)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	3,333	2,766
Stock-based compensation expense	265	341
Tax benefit on exercise of stock options		5
Change in operating assets and liabilities:		
Receivables	(769)	602
Other current assets	(104)	(648)
Accounts payable	790	(901)
Accrued expenses	190	107
Deferred rent	1,112	107
Net cash provided by operating activities	3,609	2,149
Investing activities		
Purchase of property and equipment	(6,539)	(6,516)
Increase in other assets	(47)	(35)
Net proceeds on purchase and sale of investments	7,222	5,821
Net cash provided by (used in) investing activities	636	(730)
Financing activities		
Repayments of notes payable	(326)	(301)
Purchase of treasury stock	(1,000)	
Proceeds from issuance of common stock under the Employee Stock Purchase Plan and exercise of stock options	46	157
Net cash used in financing activities	(1,280)	(144)
Net increase in cash and cash equivalents	2,965	1,275
Cash and cash equivalents at the beginning of the period	4,991	1,934
Cash and cash equivalents at the end of the period	$ 7,956	$ 3,209
Supplemental disclosure of cash flow information		
Cash paid for interest, net of capitalization	$ 51	$ 42
Noncash investing activities		
Decrease in accounts payable related to property and equipment additions	$ (661)	$ (1,613)

See accompanying notes to the unaudited consolidated financial statements.

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KONA GRILL, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation and Significant Accounting Policies

Kona Grill, Inc. (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 mainstream American dishes and award-winning sushi that are prepared fresh daily. We currently own and operate 19 restaurants in 12 states throughout the United States.

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with the rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. In our opinion, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and six month periods ended June 30, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008.

The consolidated balance sheet at December 31, 2007 has been derived from the audited consolidated financial statements at that date, but does not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. Accordingly, these financial statements should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2007.

Cash and Cash Equivalents

Cash and cash equivalents consist of cash, money market funds, and highly liquid short-term fixed income securities with a maturity of 90 days or less when acquired. 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 one business day of the sales transaction. Under the Company s asset classification practices, when there is no legal right of offset against cash balances in a specific financial institution, uncleared checks are classified as accounts payable. Uncleared checks totaling approximately $1,683,000 and $1,013,000 were included in accounts payable as of June 30, 2008 and December 31, 2007, respectively.

Recent Accounting Pronouncements

Effective January 1, 2008, we adopted Statement of Financial Accounting Standard No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. See Note 3 for further discussion of fair value measurements.

In February 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position No. FAS 157-2, *Effective Date of FASB Statement No. 157* (SFAS 157-2), which provides a one year deferral of the effective date of SFAS 157 for non-financial assets and non-financial liabilities. We do not expect that the provisions of SFAS 157-2 will have a material impact on our consolidated financial statements.

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KONA GRILL, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

2. Investments

The following is a summary of available-for-sale securities (in thousands):

	Adjusted Cost	Gross Unrealized Losses	Fair Value
June 30, 2008			
Short-term investments:			
Certificates of deposit	$ 366	$	$ 366
Long-term investments:			
Auction rate securities	6,600	(458)	6,142
Total investments	$ 6,966	$ (458)	$ 6,508
December 31, 2007			
Short-term investments:			
Auction rate securities	$ 8,650	$	$ 8,650
Corporate debt securities	5,538		5,538
Total investments	$ 14,188	$	$ 14,188

As of June 30, 2008, our investment portfolio included auction rate securities with a par value of $6.6 million. These securities are primarily AAA rated long term debt obligations secured by student loans, of which approximately $6.0 million or 90% of the par value is guaranteed by the federal government under the Federal Family Education Loan Program. In addition, one of the securities not fully comprised of federal government guaranteed loans is AA rated, but has an insurance policy guaranteeing both the principal and accrued interest. While the maturity dates of our auction rate securities range from 2029 to 2046, the liquidity for these securities has historically been provided by an auction process that resets the applicable interest rate at pre-determined calendar intervals, generally every 28 days. The recent uncertainties in the credit markets have adversely affected the auction market for these types of securities and auctions for these securities have failed to settle on their respective settlement dates. Consequently, our investments in auction rate securities are not currently liquid and we will not be able to access these funds until a future auction of these investments is successful, the issuer refinances the underlying debt, or a buyer is found outside of the auction process. We currently have the intent to hold our auction rate securities until the recovery of the auction process. As of June 30, 2008, we classified our auction rate securities as long-term investments on our consolidated balance sheet because of the uncertainty in when the auction markets will recover and the timing of when these securities can be settled at par value.

Typically the fair value of auction rate securities approximated par value due to the frequent resets through the auction process. We continue to earn interest on our auction rate securities investments with current yields of approximately 2.5% and maximum contractual default rates of approximately 3.6% as of June 30, 2008. As a result of the liquidity issues experienced in the credit markets, all of our auction rate securities have experienced failed auctions since February 2008 and therefore do not currently have a readily determinable market value. We estimated the fair value of our auction rate securities using valuation models provided by third parties. The assumptions used in the models included assessments of the following: (i) collateralization underlying each security; (ii) the present value of future principal and interest payments discounted at rates considered to reflect current market conditions; (iii) consideration of the probabilities of default, passing a future auction, or repurchase at par for each period; and (iv) estimates of the recovery rates in the event of default for each security. Based on these valuation models, we estimated the fair value of our auction rate securities to be $6.1 million as of June 30, 2008. As a result, we recorded an unrealized loss of $0.5 million for the six months ended June 30, 2008.

We review our investments in accordance with FASB Staff Position SFAS No. 115-1 and 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments,* to determine the classification of the impairment as temporary or other-than-temporary. A temporary impairment charge results in an unrealized loss being recorded in the other comprehensive loss component of stockholders equity. Such an unrealized loss does not affect net loss for the applicable accounting period. An other-than-temporary impairment charge is recorded as a realized loss in the consolidated statement of operations and increases net loss for the applicable accounting period. The determination of whether the impairment is temporary or other-than-temporary requires significant judgment. The differentiating factors between temporary and other-than-temporary impairment are primarily the length of time and the extent to which the market value has been less than cost, the financial condition and near-term prospects of the issuer and our intent and ability to retain our investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value. We do not consider our investments in auction rate securities to be other-than-temporarily impaired at June 30, 2008.

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KONA GRILL, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

3. Fair Value Measurements

Effective January 1, 2008, we adopted SFAS 157 for our financial instruments. SFAS 157 defines fair value 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 should be determined based on assumptions that market participants would use in pricing an asset or a liability. As a basis for considering such assumptions, SFAS 157 establishes a three-tier value hierarchy, 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 Company 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.

Our short-term investments represent fixed income securities that are valued primarily using quoted market prices or alternative pricing sources and models utilizing market observable inputs. Our investments in auction rate securities are classified within Level 3 because they are valued using a discounted cash flow model (see Note 2). The following table presents information about our assets measured at fair value on a recurring basis at June 30, 2008, and indicates the fair value hierarchy of the valuation techniques utilized by us to determine such fair value (in thousands).

	Fair Value Measurements at Reporting Date Using			
Description	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**	**June 30, 2008**
Certificates of deposit	$ 366	$	$	$ 366
Auction rate securities			6,142	6,142
	$ 366	$	$ 6,142	$ 6,508

The following table summarizes the changes in fair value of our Level 3 assets (in thousands):

	Fair Value Measurements of Assets Using Level 3 Inputs Long-term Investments
Balance at December 31, 2007	$
Transfer to Level 3	8,650
Total gains or losses (realized and unrealized)	
Included in earnings	
Included in other comprehensive loss	(458)
Net settlements	(2,050)

Balance at June 30, 2008	$	6,142

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KONA GRILL, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

4. Net (Loss) Income Per Share

Basic net (loss) income is computed by dividing net (loss) income by the weighted average number of common shares outstanding during the period. Diluted net loss per share excludes the dilutive effect of potential stock option and warrant exercises, which are calculated using the treasury stock method.

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
	(In thousands, except per share data)			
Numerator:				
Net (loss) income	$ (535)	$ 313	$ (1,208)	$ (230)
Denominator:				
Weighted average shares Basic	6,565	5,866	6,587	5,860
Effect of dilutive stock options and warrants		367		
Weighted average shares Diluted	6,565	6,233	6,587	5,860
Net (loss) income per share:				
Basic	$ (0.08)	$ 0.05	$ (0.18)	$ (0.04)
Diluted	$ (0.08)	$ 0.05	$ (0.18)	$ (0.04)

For the three and six months ended June 30, 2008, there were approximately 1,020,000 stock options and warrants outstanding that were not included in the dilutive earnings per share calculation because the effect would have been anti-dilutive. For the three and six months ended June 30, 2007, there were approximately 117,000 and 918,000 stock options and warrants outstanding, respectively, that were excluded from the dilutive earnings per share calculation for the same reason.

5. Accrued Expenses

Accrued expenses consisted of the following (in thousands):

	June 30, 2008	December 31, 2007
Accrued payroll	$ 1,542	$ 1,358
Business and income taxes	593	629
Sales taxes	605	517
Gift cards	393	533
Accrued occupancy	223	227
Other	859	761
	$ 4,215	$ 4,025

6. Stock Repurchase Plan

During April 2008, our Board of Directors approved a stock repurchase program under which we are authorized to repurchase up to 600,000 shares of our common stock. We repurchased 116,200 shares at a total cost of $1,000,000 during the three months ended June 30, 2008 under a section 10b5-1 purchase program. The authorization does not have an expiration date and it does not require us to purchase a specific number of shares. This authorization may be modified, suspended or terminated at any time. The timing and number of shares repurchased pursuant to the share repurchase authorization are subject to a number of factors, including current market conditions, legal constraints and available cash or other sources of funding.

KONA GRILL, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

7. Stock-Based Compensation

We maintain stock award plans which provide for discretionary grants of incentive and nonstatutory stock options, restricted stock, and other types of awards to our employees, consultants, and non-employee directors. A total of 1,075,000 shares of common stock have been reserved for issuance under our plans of which 26,071 shares were available for grant as of June 30, 2008. 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 generally expire five or ten years from the date of grant. Employee stock options generally vest 25 percent each year over a four-year period, while annual recurring awards for non-employee director options vest 25 percent each quarter over a one-year period.

There were no stock options granted during the three months ended June 30, 2008 and 2007. The fair value of stock options granted during the six month periods ended June 30, 2008 and 2007 were estimated at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Expected volatility	35.7%	34.4%
Risk-free interest rate	2.5%	4.9%
Expected life (in years)	3.7	3.8
Dividend yield	0.0%	0.0%
Weighted average fair value per option granted	$ 3.53	$ 6.45

The following table summarizes activity under our stock award plans for the six months ended June 30, 2008:

	Shares Under Option	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding options at December				