

# SECURITIES & EXCHANGE COMMISSION EDGAR FILING

**CV Sciences, Inc.**

**Form: 10-Q**

**Date Filed: 2018-11-07**

Corporate Issuer CIK: 1510964

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

FORM 10-Q

- ☒ **Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
**For the quarterly period ended September 30, 2018**
- ☐ **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: 000-54677

**CV Sciences, Inc.**

(Exact name of registrant as specified in its charter)

**DELAWARE**

(State or other jurisdiction of incorporation or organization)

**80-0944870**

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

**2688 South Rainbow Boulevard, Suite B, Las Vegas, NV 89146**

(Address number of principal executive offices) (Zip Code)

**(866) 290-2157**

(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 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 ☒ No ☐

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes ☐ No ☒

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

Large accelerated filer

☐

Accelerated filer

☐

Non-accelerated filer

☐

Smaller reporting company

☒

Emerging growth company

☐

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ☐

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

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date. As of November 7, 2018, the issuer had 94,585,313 shares of issued and outstanding common stock, par value \$0.0001.

**DOCUMENTS INCORPORATED BY REFERENCE.** None

---

---

CV SCIENCES, INC.  
FORM 10-Q  
TABLE OF CONTENTS

|   | <u>PAGE</u> |
|---|-------------|
| <br><u><b>PART I – FINANCIAL INFORMATION</b></u>  |             |
| Item 1. <a href="#"><u>Financial Statements (unaudited)</u></a>   | 1           |
| <a href="#"><u>Condensed Consolidated Balance Sheets as of September 30, 2018 (unaudited) and December 31, 2017 (audited)</u></a>                   | 1           |
| <a href="#"><u>Condensed Consolidated Statements of Operations (unaudited) for the three and nine months ended September 30, 2018 and 2017</u></a>  | 2           |
| <a href="#"><u>Condensed Consolidated Statement of Changes in Stockholders' Equity (unaudited) for the nine months ended September 30, 2018</u></a> | 3           |
| <a href="#"><u>Condensed Consolidated Statements of Cash Flows (unaudited) for the nine months ended September 30, 2018 and 2017</u></a>            | 4           |
| <a href="#"><u>Notes to Condensed Consolidated Financial Statements (unaudited)</u></a>   | 5           |
| Item 2. <a href="#"><u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u></a>                                | 23          |
| Item 3. <a href="#"><u>Quantitative and Qualitative Disclosure About Market Risk</u></a>  | 27          |
| Item 4. <a href="#"><u>Controls and Procedures</u></a>  | 27          |
| <br><u><b>PART II – OTHER INFORMATION</b></u>   |             |
| Item 1. <a href="#"><u>Legal Proceedings</u></a>  | 28          |
| Item 1A. <a href="#"><u>Risk Factors</u></a>  | 29          |
| Item 2. <a href="#"><u>Unregistered Sales of Equity Securities and Use of Proceeds</u></a>  | 29          |
| Item 3. <a href="#"><u>Defaults Upon Senior Securities</u></a>  | 29          |
| Item 4. <a href="#"><u>Mine Safety Disclosure</u></a>   | 29          |
| Item 5. <a href="#"><u>Other Information</u></a>  | 29          |
| Item 6. <a href="#"><u>Exhibits</u></a>   | 30          |
| <br><a href="#"><u>SIGNATURES</u></a>   | <br>31      |

## WHERE YOU CAN FIND MORE INFORMATION

We file annual, quarterly and current reports, proxy statements and other information required by the Securities Exchange Act of 1934, as amended (the “Exchange Act”), with the Securities and Exchange Commission (the “SEC”). You may read and copy any document we file with the SEC at the SEC’s public reference room located at 100 F Street, N.E., Washington, D.C. 20549, U.S.A. Please call the SEC at 1-800-SEC-0330 for further information on the public reference room. Our SEC filings are also available to the public from the SEC’s internet site at <http://www.sec.gov>.

On our Internet website, <http://www.cvsciences.com>, we post the following recent filings as soon as reasonably practicable after they are electronically filed with or furnished to the SEC: our annual reports on Form 10-K; our quarterly reports on Form 10-Q; our current reports on Form 8-K; and any amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act.

*When we use the terms “CV Sciences”, “Company”, “we”, “our” and “us” we mean CV Sciences, Inc., a Delaware corporation, and its consolidated subsidiaries, taken as a whole, as well as any predecessor entities, unless the context otherwise indicates.*

## FORWARD LOOKING STATEMENTS

This Quarterly Report on Form 10-Q, the other reports, statements, and information that the Company has previously filed with or furnished to, or that we may subsequently file with or furnish to, the SEC and public announcements that we have previously made or may subsequently make include, may include, or may incorporate by reference certain statements that may be deemed to be “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995, as amended, and that are intended to enjoy the protection of the safe harbor for forward-looking statements provided by that Act. To the extent that any statements made in this report contain information that is not historical, these statements are essentially forward-looking. Forward-looking statements can be identified by the use of words such as “anticipate”, “estimate”, “plan”, “project”, “continuing”, “ongoing”, “expect”, “believe”, “intend”, “may”, “will”, “should”, “could”, and other words of similar meaning. These statements are subject to risks and uncertainties that cannot be predicted or quantified and, consequently, actual results may differ materially from those expressed or implied by such forward-looking statements. Such risks and uncertainties include, without limitation: marketability of our products; legal and regulatory risks associated with the OTC: QB; our ability to raise additional capital to finance our activities; the future trading of our common stock; our ability to operate as a public company; our ability to protect our proprietary information; general economic and business conditions; the volatility of our operating results and financial condition; our ability to attract or retain qualified senior management personnel and research and development staff; and other risks detailed from time to time in our filings with the SEC, or otherwise.

Information regarding market and industry statistics contained in this report is included based on information available to us that we believe is accurate. It is generally based on industry and other publications that are not produced for purposes of securities offerings or economic analysis. Forecasts and other forward-looking information obtained from these sources are subject to the same qualifications and the additional uncertainties accompanying any estimates of future market size, revenue and market acceptance of products and services. We do not undertake any obligation to publicly update any forward-looking statements. As a result, investors should not place undue reliance on these forward-looking statements.

**PART I – FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**CV SCIENCES, INC. AND SUBSIDIARIES**  
CONDENSED CONSOLIDATED BALANCE SHEETS

|   | (Unaudited)<br>September 30,<br>2018 | (Audited)<br>December 31,<br>2017 |
|---|--------------------------------------|-----------------------------------|
| <b>Assets</b>   |                                      |                                   |
| Current assets  |                                      |                                   |
| Cash (Note 2)   | \$ 10,271,599                        | \$ 2,012,965                      |
| Restricted cash (Note 2)  | 738,356                              | 778,579                           |
| Accounts receivable, net (Note 2)   | 2,493,091                            | 1,507,824                         |
| Inventory (Note 3)  | 5,727,569                            | 2,822,585                         |
| Prepaid expenses and other current assets   | 1,847,048                            | 813,218                           |
|   | <u>21,077,663</u>                    | <u>7,935,171</u>                  |
| Inventory, net (Note 3)   | 803,100                              | 5,667,101                         |
| Other assets  | 400,000                              | 400,000                           |
| Property & equipment, net (Note 2)  | 2,158,666                            | 2,083,433                         |
| Intangibles, net (Note 5)   | 3,809,650                            | 3,836,200                         |
| Goodwill (Note 5)   | 2,788,300                            | 2,788,300                         |
|   | <u>31,037,379</u>                    | <u>22,710,205</u>                 |
| <b>Total assets</b>   | <u>\$ 31,037,379</u>                 | <u>\$ 22,710,205</u>              |
| <b>Liabilities and stockholders' equity</b>   |                                      |                                   |
| Current liabilities   |                                      |                                   |
| Accounts payable  | \$ 1,165,014                         | \$ 678,271                        |
| Accrued expenses (Note 4)   | 1,808,734                            | 1,931,920                         |
| Secured convertible promissory notes payable, net (Note 7)  | –                                    | 609,926                           |
| Unsecured notes payable (Note 7)  | –                                    | 116,370                           |
| <b>Total current liabilities</b>  | <u>2,973,748</u>                     | <u>3,336,487</u>                  |
| Non-current liabilities   |                                      |                                   |
| Unsecured note payable, net (Note 7)  | –                                    | 850,000                           |
| Deferred rent   | 1,234,329                            | 1,067,459                         |
| Deferred tax liability  | 1,074,800                            | 1,074,800                         |
| <b>Total liabilities</b>  | <u>5,282,877</u>                     | <u>6,328,746</u>                  |
| Commitments and contingencies (Note 11)   |                                      |                                   |
| <b>Stockholders' equity (Notes 8 and 9)</b>   |                                      |                                   |
| Preferred stock, par value \$0.0001; 10,000,000 shares authorized; no shares issued and outstanding   | –                                    | –                                 |
| Common stock, par value \$0.0001; 190,000,000 shares authorized; 94,355,178 and 90,512,563 shares issued and outstanding as of September 30, 2018 and December 31, 2017, respectively | 9,435                                | 9,051                             |
| Additional paid-in capital  | 53,672,778                           | 51,400,336                        |
| Accumulated deficit   | (27,927,711)                         | (35,027,928)                      |
| <b>Total stockholders' equity</b>   | <u>25,754,502</u>                    | <u>16,381,459</u>                 |
| <b>Total liabilities and stockholders' equity</b>   | <u>\$ 31,037,379</u>                 | <u>\$ 22,710,205</u>              |

See accompanying notes to the condensed consolidated financial statements.

**CV SCIENCES, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**UNAUDITED**

|   | For the three months ended September 30, |                     | For the nine months ended September 30, |                       |
|---|--|---------------------|---|-----------------------|
|   | 2018                                     | 2017                | 2018                                    | 2017                  |
| Product sales, net                              | \$ 13,600,881                            | \$ 5,591,210        | \$ 34,020,341                           | \$ 13,437,233         |
| Cost of goods sold                              | 3,655,458                                | 1,593,561           | 9,452,939                               | 4,162,122             |
| <b>Gross Profit</b>                             | <u>9,945,423</u>                         | <u>3,997,649</u>    | <u>24,567,402</u>                       | <u>9,275,111</u>      |
| Operating Expenses:                             |  |                     |   |                       |
| Selling, general and administrative             | (5,890,332)                              | (4,311,078)         | (15,951,529)                            | (11,513,560)          |
| Research and development                        | (529,562)                                | (179,338)           | (1,125,270)                             | (573,701)             |
|   | <u>(6,419,894)</u>                       | <u>(4,490,416)</u>  | <u>(17,076,799)</u>                     | <u>(12,087,261)</u>   |
| Gain on changes in derivative liabilities       | —  | 10,987              | —                                       | 248,875               |
| Royalty buy-out                                 | —  | —                   | —                                       | (2,432,000)           |
|   | <u>(6,419,894)</u>                       | <u>(4,479,429)</u>  | <u>(17,076,799)</u>                     | <u>(14,270,386)</u>   |
| <b>Operating Income (Loss)</b>                  | 3,525,529                                | (481,780)           | 7,490,603                               | (4,995,275)           |
| Other (expense) income:                         |  |                     |   |                       |
| Interest income                                 | —  | —                   | —                                       | 7                     |
| Interest expense                                | (30,556)                                 | (108,203)           | (150,386)                               | (371,678)             |
| <b>Total Other Expense</b>                      | <u>(30,556)</u>                          | <u>(108,203)</u>    | <u>(150,386)</u>                        | <u>(371,671)</u>      |
| Income (loss) before provision for income taxes | 3,474,973                                | (589,983)           | 7,340,217                               | (5,366,946)           |
| Provision for income taxes                      | 200,000                                  | —                   | 240,000                                 | —                     |
| <b>Net Income (Loss)</b>                        | <u>\$ 3,294,973</u>                      | <u>\$ (589,983)</u> | <u>\$ 7,100,217</u>                     | <u>\$ (5,366,946)</u> |
| Weighted average common shares outstanding      |  |                     |   |                       |
| Basic   | 91,639,488                               | 88,114,604          | 90,959,121                              | 77,126,737            |
| Diluted   | 115,888,788                              | 88,114,604          | 110,601,488                             | 77,126,737            |
| Net income (loss) per common share              |  |                     |   |                       |
| Basic   | \$ 0.04                                  | \$ (0.01)           | \$ 0.08                                 | \$ (0.07)             |
| Diluted   | \$ 0.03                                  | \$ (0.01)           | \$ 0.06                                 | \$ (0.07)             |

See accompanying notes to the condensed consolidated financial statements.

**CV SCIENCES, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**  
**FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2018**  
**UNAUDITED**

|   | <b>Common Stock</b> |                 | <b>Additional</b>          | <b>Accumulated</b>     | <b>Total</b>         |
|---|---------------------|-----------------|----------------------------|------------------------|----------------------|
|   | <b>Shares</b>       | <b>Amount</b>   | <b>Paid-In<br/>Capital</b> | <b>Deficit</b>         |                      |
| Balance - December 31, 2017   | 90,512,563          | \$ 9,051        | \$ 51,400,336              | \$ (35,027,928)        | \$ 16,381,459        |
| Issuance of common stock for professional services                            | 225,000             | 23              | 295,303                    | —                      | 295,326              |
| Issuance of common stock from exercise of stock options                       | 994,433             | 99              | 343,217                    | —                      | 343,316              |
| Issuance of common stock from exercise of warrants on a net<br>issuance basis | 2,623,182           | 262             | (262)                      | —                      | —                    |
| Stock based compensation  | —                   | —               | 1,634,184                  | —                      | 1,634,184            |
| Net Income  | —                   | —               | —                          | 7,100,217              | 7,100,217            |
| Balance - September 30, 2018  | <u>94,355,178</u>   | <u>\$ 9,435</u> | <u>\$ 53,672,778</u>       | <u>\$ (27,927,711)</u> | <u>\$ 25,754,502</u> |

See accompanying notes to the condensed consolidated financial statements.

**CV SCIENCES, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**UNAUDITED**

|  | <b>For the nine months ended September 30,</b> |                     |
|--|--|---------------------|
|  | <b>2018</b>                                    | <b>2017</b>         |
| <b>OPERATING ACTIVITIES</b>  |  |                     |
| Net income (loss)  | \$ 7,100,217                                   | \$ (5,366,946)      |
| Adjustments to reconcile net income (loss) to net cash flows provided by (used in) operating activities: |  |                     |
| Depreciation and amortization  | 375,671  | 144,294             |
| Amortization of debt issuance costs and accrued interest   | 50,074   | 163,599             |
| Amortization of beneficial conversion feature of convertible debts                                       | —  | 26,076              |
| Common stock issued for professional services  | 295,326  | —                   |
| Stock-based compensation   | 1,634,184                                      | 3,072,224           |
| Royalty buy-out  | —  | 2,432,000           |
| Bad debt expense   | 46,779   | 400,435             |
| Accrued interest payable   | —  | 103,603             |
| Gain on changes in derivative liabilities  | —  | (248,875)           |
| Change in operating assets and liabilities:  |  |                     |
| Accounts receivable  | (1,029,546)                                    | (774,473)           |
| Inventory  | 1,959,017                                      | 856,229             |
| Prepaid expenses and other current assets  | (1,036,330)                                    | (971,567)           |
| Accounts payable and accrued expenses  | 363,557  | 810,617             |
| Deferred rent  | 166,870  | —                   |
| Net cash provided by operating activities  | <u>9,925,819</u>                               | <u>647,216</u>      |
| <b>INVESTING ACTIVITIES</b>  |  |                     |
| Purchase of equipment  | (331,101)                                      | (6,410)             |
| Tenant improvements to leasehold real estate   | (93,253)                                       | —                   |
| Net cash flows used in investing activities  | <u>(424,354)</u>                               | <u>(6,410)</u>      |
| <b>FINANCING ACTIVITIES</b>  |  |                     |
| Borrowings from secured convertible debt, net of costs   | —  | 750,000             |
| Repayment of convertible debt in cash  | (660,000)                                      | —                   |
| Repayment of unsecured debt in cash  | (850,000)                                      | —                   |
| Repayment of unsecured notes payable   | (116,370)                                      | (125,964)           |
| Proceeds from exercise of stock options  | 343,316  | —                   |
| Net cash flows provided by (used in) financing activities  | <u>(1,283,054)</u>                             | <u>624,036</u>      |
| Net increase in cash and restricted cash   | 8,218,411                                      | 1,264,842           |
| Cash and restricted cash, beginning of period  | 2,791,544                                      | 1,057,468           |
| Cash and restricted cash, end of period  | <u>\$ 11,009,955</u>                           | <u>\$ 2,322,310</u> |
| <b>Supplemental disclosures of non-cash transactions:</b>  |  |                     |
| Conversion of convertible promissory notes and accrued interest to common stock                          | \$ —   | \$ 1,655,000        |
| Value of embedded derivative at inception  | —  | 29,300              |
| Issuance of common stock in consideration for royalty buyout   | —  | 1,500               |
| Issuance of common stock to settle restricted stock units  | —  | 200                 |
| Issuance of common stock for prepaid expenses and other current assets                                   | —  | 202,000             |
| Stock Redemptions  | —  | 75,000              |
| <b>Supplemental cash flow disclosures:</b>   |  |                     |
| Interest paid  | \$ 150,386                                     | \$ 78,397           |
| Taxes paid   | 70,380   | 39,584              |

See accompanying notes to the condensed consolidated financial statements.



**CV SCIENCES, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**UNAUDITED**

**1. ORGANIZATION AND BUSINESS**

CV Sciences, Inc. (the "Company," "CV Sciences," "we," "our" or "us") was incorporated under the name Foreclosure Solutions, Inc. in the State of Texas on December 9, 2010. On July 25, 2013, the Company's predecessor, CannaVest Corp., a Texas corporation ("CannaVest Texas"), merged with the Company, a wholly-owned Delaware subsidiary of CannaVest Texas, to effectuate a change in the Company's state of incorporation from Texas to Delaware. On January 4, 2016, the Company filed a Certificate of Amendment of Certificate of Incorporation reflecting its corporate name change to "CV Sciences, Inc.", effective on January 5, 2016. In addition, on January 4, 2016, the Company amended its Bylaws to reflect its corporate name change to "CV Sciences, Inc." The Company previously operated under the corporate name of CannaVest Corp. The change in corporate name was undertaken in connection with the acquisition of CanX Inc., a Florida-based, specialty pharmaceutical corporation (the "CanX Acquisition") as more fully set forth in our Current Report on Form 8-K filed with the U.S. Securities and Exchange Commission (the "SEC") on January 4, 2016. On June 8, 2016, the Company announced that the Financial Industry Regulatory Authority ("FINRA") had approved a change in the trading symbol for the Company's common stock to "CVSL." The Company's common stock formerly traded under the symbol "CANV."

The Company operates two distinct business segments: a consumer product segment in manufacturing, marketing and selling plant-based Cannabidiol ("CBD") products to a range of market sectors; and, a specialty pharmaceutical segment focused on developing and commercializing novel therapeutics utilizing synthetic CBD. The specialty pharmaceutical segment began development activities during the second quarter of 2016.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Basis of Presentation** – The condensed consolidated financial statements include, as applicable, the accounts of CV Sciences, Inc. and its wholly-owned subsidiaries Plus CBD, LLC and CANNAVEST Acquisition, LLC; and the accounts of a 70% interest in CannaVest Europe, GmbH (collectively, as applicable, the "Company"). All intercompany accounts and transactions have been eliminated in consolidation. The Company commenced commercial operations for its current business model on January 29, 2013. On January 20, 2017, the Company filed for dissolution of CannaVest Europe, GmbH, an entity that, prior to dissolution, the Company had a 70% interest in, with the District Court, Dusseldorf Germany, effective December 31, 2016. On April 27, 2018, the Company filed a Certificate of Cancellation for its wholly-owned subsidiary, CANNAVEST Acquisition, LLC, with the Secretary of State of Delaware, effective as of April 27, 2018. Neither CANNAVEST Acquisition, LLC nor CannaVest Europe, GmbH had any material assets or liabilities at the time of their respective dissolutions.

The unaudited condensed consolidated interim financial statements have been prepared by the Company pursuant to the rules and regulations of the SEC. The information furnished herein reflects all adjustments (consisting of normal recurring accruals and adjustments) which are, in the opinion of management, necessary to fairly present the operating results for the respective periods and ensure that the financial statements are not misleading. Certain information and footnote disclosures normally present in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") have been omitted pursuant to such rules and regulations. These unaudited condensed consolidated financial statements should be read in conjunction with the audited financial statements and notes for the year ended December 31, 2017, filed with the SEC on the Company's Annual Report on Form 10-K filed on March 29, 2018. The results for the interim periods ended September 30, 2018, are not necessarily indicative of the results to be expected for the full year ending December 31, 2018.

**Liquidity** – For the three months ended September 30, 2018 and 2017, the Company had net income (losses) of \$3,294,973 and (\$589,983), respectively. For the nine months ended September 30, 2018 and 2017, the Company had net income (losses) of \$7,100,217 and (\$5,366,946), respectively. In addition, for the nine months ended September 30, 2018 and 2017, the Company had positive cash flows from operations of \$9,925,819 and \$647,216, respectively. Management believes the Company has the funds necessary to continue its consumer product and specialty pharmaceutical business segments and meet its other obligations over the next year solely from current revenues and cash flow for the next 12-month period through November 6, 2019.

**Derivative Financial Instruments** – Derivative financial instruments are initially recognized at fair value on the date a derivative contract is entered into and subsequently remeasured at fair value on a quarter-end reporting basis. Changes in the fair value of derivative financial instruments are recognized as a gain or loss in the Company's Condensed Consolidated Statements of Operations.

**Goodwill and Intangible Assets** – The Company evaluates the carrying value of goodwill and intangible assets annually during the fourth quarter in accordance with Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 350, *Intangibles Goodwill and Other* and between annual evaluations if events occur or circumstances change that would more likely than not reduce the fair value of the reporting unit below its carrying amount. Such circumstances could include, but are not limited to (1) a significant adverse change in legal factors or in business climate, (2) unanticipated competition, or (3) an adverse action or assessment by a regulator. When evaluating whether goodwill is impaired, the Company compares the fair value of the reporting unit to which the goodwill is assigned to the reporting unit's carrying amount, including goodwill. The fair value of the reporting unit is estimated using a combination of the income, or discounted cash flows, approach and the market approach, which utilizes comparable companies' data. If the carrying amount of a reporting unit exceeds its fair value, then the amount of the impairment loss must be measured. The impairment loss would be calculated by comparing the implied fair value of a reporting unit's goodwill to its carrying amount. In calculating the implied fair value of a reporting unit's goodwill, the fair value of the reporting unit is allocated to all of the other assets and liabilities of that unit based on their fair values. The excess of the fair value of a reporting unit over the amount assigned to its other assets and liabilities is the implied fair value of goodwill.

We make critical assumptions and estimates in completing impairment assessments of goodwill and other intangible assets. Our cash flow projections look several years into the future and include assumptions on variables such as future sales and operating margin growth rates, economic conditions, market competition, inflation and discount rates.

We classify intangible assets into three categories: (1) intangible assets with definite lives subject to amortization; (2) intangible assets with indefinite lives not subject to amortization; and (3) goodwill. We determine the useful lives of our identifiable intangible assets after considering the specific facts and circumstances related to each intangible asset. Factors we consider when determining useful lives include the contractual term of any agreement related to the asset, the historical performance of the asset, our long-term strategy for using the asset, any laws or regulations which could impact the useful life of the asset and other economic factors, including competition and specific market conditions. Intangible assets that are deemed to have definite lives are amortized, primarily on a straight-line basis, over their useful lives to their estimated residual values, generally five years. In process research and development ("IPR&D") has an indefinite life and is not amortized until completion and development of the project, at which time the IPR&D becomes an amortizable asset. If the related project is not completed in a timely manner or the project is terminated or abandoned, the Company may have an impairment related to the IPR&D, calculated as the excess of the asset's carrying value over its fair value. This method of amortization approximates the expected future cash flow generated from their use. During the three and nine months ended September 30, 2018 and 2017, there were no impairments.

**Use of Estimates** – The Company's condensed consolidated financial statements have been prepared in accordance with GAAP. The preparation of these condensed consolidated financial statements requires us to make significant estimates and judgments that affect the reported amounts of assets, liabilities, revenues, expenses and related disclosures of contingent assets and liabilities. We evaluate our estimates, including those related to contingencies, on an ongoing basis. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Significant estimates include the valuation of intangible assets, the amortization lives of intangible assets, valuation of contingent consideration, inputs for valuing derivative financial instruments, inputs for valuing warrants, inputs for valuing notes payable beneficial conversion features and stock-based compensation, valuation of inventory, classification of current and non-current inventory amounts, the allowance for doubtful accounts and determining whether potential losses from legal actions brought against the Company are probable and estimable.

**Reportable Segments** – The Company has two business segments; consumer products and specialty pharmaceuticals. Our consumer products segment develops, manufactures and markets products based on plant-based CBD, including under the name PlusCBD™ in a variety of market sectors including nutraceutical, beauty care, specialty foods and beverages. Our specialty pharmaceutical segment is developing drug candidates which use synthetic CBD as a primary active ingredient. The specialty pharmaceuticals segment began development activities during the second quarter of 2016.

**Cash and Cash Equivalents** – For purposes of the condensed consolidated statements of cash flows, the Company considers amounts held by financial institutions and short-term investments with an original maturity of three months or less when purchased to be cash and cash equivalents. As of September 30, 2018 and December 31, 2017, the Company had no cash equivalents.

**Restricted Cash** – The Company's current and past arrangements with its credit card processors require that its credit card processors withhold a cash reserve balance from the Company's credit card receipt transactions for a period of time not to exceed 270 days, for which the credit card processors will refund the Company the entire amounts withheld at its sole discretion. The Company had \$738,356 and \$778,579 in restricted cash withheld by former credit card processors as of September 30, 2018 and December 31, 2017, respectively. The following table provides a reconciliation of cash and restricted cash reported within the condensed consolidated balance sheets to the total of the same amounts shown in the statement of cash flows:

|   | September 30,<br>2018 | December 31,<br>2017 |
|---|-----------------------|----------------------|
| Cash  | \$ 10,271,599         | \$ 2,012,965         |
| Restricted cash   | 738,356               | 778,579              |
| Total cash and restricted cash shown in the statement of cash flows | <u>\$ 11,009,955</u>  | <u>\$ 2,791,544</u>  |

On October 22, 2018, the Company received un-restricted control of \$450,000 of restricted cash held at September 30, 2018 in connection with the settlement of a complaint filed by the Company against a former credit card processor of the Company (Note 11). The Company recognized bad debt expense of \$40,223 in connection with this settlement during the three months ended September 30, 2018.

**Concentrations of Credit Risk** – As of September 30, 2018, the Federal Deposit Insurance Corporation ("FDIC") provided insurance coverage of up to \$250,000 per depositor per bank. The Company has not experienced any losses in such accounts and does not believe that the Company is exposed to significant risks from excess deposits. The Company's cash balance in excess of FDIC limits totaled \$10,027,090 as of September 30, 2018.

There was no concentration of accounts receivable, revenue and purchases as of, and for the period and year ended September 30, 2018 and December 31, 2017.

**Accounts Receivable** – Generally, the Company requires payment prior to shipment. However, in certain circumstances, the Company extends credit to companies located throughout the U.S. Accounts receivable consists of trade accounts arising in the normal course of business. Accounts for which no payments have been received after 30 days are considered delinquent and customary collection efforts are initiated. Accounts receivable are carried at original invoice amount less a reserve made for doubtful receivables based on a review of all outstanding amounts on a quarterly basis.

Management has determined the allowance for doubtful accounts by regularly evaluating individual customer receivables and considering a customer's financial condition and credit history, and current economic conditions. As of September 30, 2018 and December 31, 2017, the Company maintained an allowance for doubtful accounts related to accounts receivable in the amount of \$200,000.

**Revenue Recognition** - Our revenue is generated from the sale of products consisting primarily of nutritional supplements and beauty products. We recognize revenue when control of our products is transferred to our customers in an amount that reflects the consideration we expect to receive from our customers in exchange for those products. This process involves identifying the contract with a customer, determining the performance obligations in the contract, determining the contract price, allocating the contract price to the distinct performance obligations in the contract, and recognizing revenue when the performance obligations have been satisfied. We consider a performance obligation satisfied once we have transferred control of a product to the customer or distributor, meaning the customer has the ability to use and obtain the benefit of the product. We recognize revenue for satisfied performance obligations only when we determine there are no uncertainties regarding payment terms or transfer of control. Revenue from product sales is generally recognized upon shipment to the end customer, which is when control of the product is deemed to be transferred. Payment or invoicing typically occurs upon shipment and the term between invoicing and when payment is due is not significant. Revenue is recorded net of discounts and promotions.

**Sales Tax** – The Company is responsible for collecting tax on sales made directly to end customers without a valid sales tax exemption certificate, and remitting these taxes to applicable jurisdictions. These taxes are assessed based on the location of the end customer and the laws of the jurisdiction in which they reside. Such taxes are accounted for on a net basis, and not included in revenues.

**Shipping and Handling** – Shipping and handling expenses are recorded in cost of goods sold and totaled \$490,881 and \$265,685 for the three months ended September 30, 2018 and 2017, respectively, and for the nine months ended September 30, 2018 and 2017 totaled \$1,297,844 and \$589,687, respectively.

**Returns – Finished Products** – Within ten (10) days of a customer's receipt of the Company's finished products, the customer may return (i) finished products that do not conform to the Company's product specifications or, (ii) finished products which are defective, provided that notice of condition is given within five (5) days of the customer's receipt of the finished products. The failure to comply with the foregoing time requirements shall be deemed a waiver of customer's claim for incorrect or defective shipments. In the event of the existence of one or more material defects in any finished product upon delivery to the customer, the Company shall, at its sole option and cost, either (a) take such measures as are required to cure the defect(s) designated in the customer's notice, or (b) replace such defective finished product(s). The Company may, at its sole option, require the return or destruction of the defective finished products. The customer shall afford the Company the opportunity to verify that such defects existed prior to shipment and were not, for purposes of example and not limitation, the result of improper transport, handling, storage, product rotation or misuse by the customer.

**Bulk Oil Products** – Sales of bulk oil products are final and the Company does not accept returns under any circumstances.

There was no allowance for customer returns as of September 30, 2018 or December 31, 2017 due to insignificant return amounts experienced during the nine months ended September 30, 2018 and the year ended December 31, 2017.

**Compensation and Benefits** – The Company records compensation and benefits expense for all cash and deferred compensation, benefits, and related taxes as earned by its employees. Compensation and benefits expense also includes compensation earned by temporary employees and contractors who perform similar services to those performed by the Company's employees, primarily information technology and project management activities.

**Stock-Based Compensation** – Certain employees, officers, directors, and consultants of the Company participate in various long-term incentive plans that provide for granting stock options, restricted stock awards, restricted stock units, stock bonus awards and performance-based awards. Stock options generally vest in equal increments over a two- to four-year period and expire on the tenth anniversary following the date of grant. Performance-based stock options vest once the applicable performance condition is satisfied. Restricted stock awards generally vest 100% at the grant date.

The Company recognizes stock-based compensation for equity awards granted to employees, officers, directors, consultants and former directors as compensation and benefits expense in the consolidated statements of operations. The fair value of stock options is estimated using a Black-Scholes valuation model on the date of grant. The fair value of restricted stock awards is equal to the closing price of the Company's stock on the date of grant. Stock-based compensation is recognized over the requisite service period of the individual awards, which generally equals the vesting period. For performance-based stock options, compensation is recognized once the applicable performance condition is satisfied. Forfeited stock options are accounted for as they occur.

**Inventory** – Inventory is stated at lower of cost or net realizable value, with cost being determined on an average cost basis. As of September 30, 2018, the Company had \$312,626 of inventory in Germany and The Netherlands.

**Property & Equipment** – Equipment is stated at cost less accumulated depreciation. Cost represents the purchase price of the asset and other costs incurred to bring the asset into its existing use. Depreciation is provided on a straight-line basis over the assets' estimated useful lives. Tenant improvements are amortized on a straight-line basis over the remaining life of the related lease. Maintenance or repairs are charged to expense as incurred. Upon sale or disposition, the historically-recorded asset cost and accumulated depreciation are removed from the accounts and the net amount less proceeds from disposal is charged or credited to other income (expense).

Property and equipment, net, as of September 30, 2018 and December 31, 2017 were as follows:

|                                | Useful Lives    | September 30,<br>2018 | December 31,<br>2017 |
|--------------------------------|-----------------|-----------------------|----------------------|
| Office furniture and equipment | 3 years         | \$ 731,135            | \$ 537,607           |
| Laboratory and other equipment | 5 years         | 536,570               | 398,997              |
| Tenant improvements            | 14 to 39 months | 1,639,138             | 1,545,885            |
|                                |                 | 2,906,843             | 2,482,489            |
| Less: accumulated depreciation |                 | (748,177)             | (399,056)            |
|                                |                 | <u>\$ 2,158,666</u>   | <u>\$ 2,083,433</u>  |

Depreciation expense for the three months ended September 30, 2018 and 2017 was \$121,911 and \$30,897, respectively, and for the nine months ended September 30, 2018 and 2017 was \$349,121 and \$117,744, respectively.

**Fair Value of Financial Instruments** – In accordance with ASC Topic 825, *Financial Instruments*, the Company calculates the fair value of its assets and liabilities which qualify as financial instruments and includes this additional information in the notes to its financial statements when the fair value is different than the carrying value of those financial instruments. The estimated fair value of the Company's current assets and current liabilities approximates their carrying amount due to their readily available nature and short maturity.

**Long-Lived Assets** – In accordance with ASC Topic 360, *Accounting for the Impairment or Disposal of Long-Lived Assets*, the Company reviews property and equipment for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of property and equipment is measured by comparing its carrying value to the undiscounted projected future cash flows that the asset(s) are expected to generate. If the carrying amount of an asset is not recoverable, we recognize an impairment loss based on the excess of the carrying amount of the long-lived asset over its respective fair value, which is generally determined as the present value of estimated future cash flows or at the appraised value. The impairment analysis is based on significant assumptions of future results made by management, including revenue and cash flow projections. Circumstances that may lead to impairment of property and equipment include a significant decrease in the market price of a long-lived asset, a significant adverse change in the extent or manner in which a long-lived asset is being used or in its physical condition and a significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset including an adverse action or assessment by a regulator.

**Debt Issuance Costs** – Debt issuance costs, when incurred, are capitalized as a discount to the related debt and are amortized to interest expense using the interest method over the expected terms of the related debt agreements.

**Earnings (net loss) per Share** – The Company calculates earnings or loss per share ("EPS") in accordance with ASC Topic 260, *Earnings per Share*, which requires the computation and disclosure of two EPS amounts, basic and diluted. Basic EPS is computed based on the weighted average number of shares of common stock outstanding during the period. Diluted EPS is computed based on the weighted average number of shares of common stock outstanding plus all potentially dilutive shares of common stock outstanding during the period. Potentially dilutive common shares from equity awards are determined using the average share price for each period under the treasury stock method. The Company had 19,562,475 stock options and 79,891 warrants outstanding that were potentially dilutive as of September 30, 2018. In addition, the Company may be required to issue 10,750,000 additional shares of common stock related to certain performance-based stock options outstanding.

**Research and Development Expense** – Research and development costs are charged to expense as incurred and include, but are not limited to, employee salaries and benefits, cost of inventory used in product development, consulting service fees, the cost of renting and maintaining our laboratory facility and depreciation of laboratory equipment. Research and development expense for the consumer products segment was \$170,466 and \$76,520 for the three months ended September 30, 2018 and 2017, respectively, and for the nine months ended September 30, 2018 and 2017 was \$362,933 and \$181,509, respectively. Research and development expense for the specialty pharmaceutical segment was \$359,096 and \$102,818 for the three months ended September 30, 2018 and 2017, respectively, and for the nine months ended September 30, 2018 and 2017 was \$762,337 and \$392,192, respectively.

**Advertising** – The Company supports its products with advertising to build brand awareness of the Company's various products in addition to other marketing programs executed by the Company's marketing team. The Company believes the continual investment in advertising is critical to the development and sale of its *PlusCBD™* brand products. Advertising costs of \$231,715 and \$152,687 were expensed as incurred during the three months ended September 30, 2018 and 2017, respectively, and for the nine months ended September 30, 2018 and 2017 were \$634,274 and \$261,462, respectively.

**Income Taxes** – Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which the related temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized when the rate change is enacted. Valuation allowances are recorded to reduce deferred tax assets to the amount that will more likely than not be realized. In accordance with ASC Topic 740, *Income Taxes*, the Company recognizes the effect of uncertain income tax positions only if the positions are more likely than not of being sustained in an audit, based on the technical merits of the position. Recognized uncertain income tax positions are measured at the largest amount that is greater than 50% likely of being realized. Changes in recognition or measurement are reflected in the period in which those changes in judgment occur. The Company recognizes both interest and penalties related to uncertain tax positions as part of the income tax provision. As of September 30, 2018, and December 31, 2017, the Company did not have a liability for unrecognized tax uncertainties. The Company is subject to routine audits by taxing jurisdictions. Management believes the Company is no longer subject to tax examinations for the years prior to 2014.

#### **Recently Issued and Newly Adopted Accounting Pronouncements**

In May 2014, the FASB issued Accounting Standards Update ("ASU") 2014-09, *Revenue from Contracts with Customers (Topic 606)* ("ASU 2014-09"), as amended by ASU 2015-14, *Revenue from Contracts with Customers (Topic 606)*, ASU 2016-08, *Revenue from Contracts with Customers (Topic 606)*, ASU 2016-10, *Revenue from Contracts with Customers (Topic 606)*, ASU 2016-12, *Revenue from Contracts with Customers (Topic 606)* and ASU 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers*, which completes the joint effort by the FASB and the International Accounting Standards Board to improve financial reporting by creating common revenue recognition guidance for GAAP and the International Financial Reporting Standards. ASU 2014-09 became effective for the Company beginning on January 1, 2018. The Company implemented ASU 2014-09 for the interim and annual reporting periods of 2018, which resulted in no changes to how we recognize revenue.

In July 2015, the FASB issued ASU 2015-11, *Inventory: Simplifying the Measurement of Inventory* ("ASU 2015-11"), which requires inventory measured using any method other than last-in, first out or the retail inventory method to be subsequently measured at the lower of cost or net realizable value, rather than at the lower of cost or market. ASU 2015-11 is effective for annual reporting periods beginning after December 15, 2016 and for interim periods within such annual periods. Early application is permitted. The Company implemented ASU 2015-11 during the annual reporting period of 2017.

In February 2016, the FASB issued ASU 2016-02, *Leases* ("ASU 2016-02"), which, for operating leases, requires a lessee to recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in its balance sheet. ASU 2016-02 also requires a lessee to recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term, on a generally straight-line basis. ASU 2016-02 is effective for public companies for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted. The Company is evaluating the potential impact of ASU 2016-02 on the Company's consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, *Compensation – Stock Compensation* ("ASU 2016-09"), which involves multiple aspects of the accounting for share-based transactions, including income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. ASU 2016-09 is effective for public companies for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. Early adoption is permitted. The Company implemented ASU 2016-09 during the annual reporting period of 2017.

In August 2016, the FASB issued ASU 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments (A Consensus of the FASB Emerging Issues Task Force)* ("ASU 2016-15"), which provides amendments to specific statement of cash flows classification issues. ASU 2016-15 is effective for public companies for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company implemented ASU 2016-15 for the interim and annual reporting periods of 2018.

In January 2017, the FASB issued ASU 2017-01, *Business Combinations (Topic 805): Clarifying the Definition of a Business* ("ASU 2017-01"), which revises the definition of a business. ASU 2017-01 requires that for an acquisition to be considered a business, the business would have to include an input and a substantive process that together significantly contribute to the ability to create outputs. ASU 2017-01 also narrows the definition of the term "outputs," which are now considered the result of inputs and substantive processes that provide goods and services to customers, other revenue, or investment income, such as dividends and interest. ASU 2017-01 is effective for public companies for annual periods beginning after December 15, 2017. Early adoption is permitted. The Company adopted ASU 2017-01 for the interim and annual reporting periods of 2018.

In January 2017, the FASB issued ASU 2017-04, *Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment* ("ASU 2017-04"), which eliminates Step 2 from the goodwill impairment test. Instead, an entity should perform its annual or interim goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should then recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. Additionally, an entity should consider income tax effects from any tax deductible goodwill on the carrying amount of the reporting unit when measuring the goodwill impairment loss, if applicable. ASU 2017-04 requires the entity to apply these amendments on a prospective basis for which it is required to disclose the nature of and reason for the change in accounting upon transition. This disclosure shall be provided in the first annual period and in the interim period within the first annual period when the entity initially adopts the amendments. The Company plans to adopt these amendments for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Company is currently evaluating the potential impact of ASU 2017-04 on the Company's consolidated financial statements.

In June 2018, the FASB issued ASU 2018-07, *Compensation – Stock Compensation (Topic 718): Improvement to Nonemployee Share-Based Payment Accounting* ("ASU 2018-07"), which is intended to reduce cost and complexity and to improve financial reporting for share-based payments to nonemployees. Under ASU 2018-07, most of the guidance on share-based payments to nonemployees would be aligned with the requirements for share-based payments granted to employees. ASU 2018-07 is effective for interim and annual reporting periods beginning after December 15, 2018. The Company is currently evaluating the potential impact of ASU 2018-07 on the Company's consolidated financial statements.

Other recent accounting pronouncements issued by the FASB (including its Emerging Issues Task Force), the American Institute of Certified Public Accountants, and the SEC did not, or are not believed by management to have, a material impact on the Company's present or future financial statements.

### 3. INVENTORY

Inventory as of September 30, 2018 and December 31, 2017 was comprised of the following:

|                | September 30,<br>2018 | December 31,<br>2017 |
|----------------|-----------------------|----------------------|
| Raw materials  | \$ 4,202,493          | \$ 6,648,144         |
| Finished goods | 2,328,176             | 1,841,542            |
|                | <u>\$ 6,530,669</u>   | <u>\$ 8,489,686</u>  |

### 4. ACCRUED EXPENSES

Accrued expenses as of September 30, 2018 and December 31, 2017 were as follows:

|                           | September 30,<br>2018 | December 31,<br>2017 |
|---------------------------|-----------------------|----------------------|
| Accrued payroll expenses  | \$ 908,179            | \$ 1,037,122         |
| Other accrued liabilities | 900,555               | 894,798              |
|                           | <u>\$ 1,808,734</u>   | <u>\$ 1,931,920</u>  |

## 5. INTANGIBLE ASSETS, NET

Intangible assets consisted of the following at September 30, 2018 and December 31, 2017:

|                                     | <u>Original Fair<br/>Market Value</u> | <u>Accumulated<br/>Amortization</u> | <u>Net</u>          | <u>Useful Life<br/>(Years)</u> |
|-------------------------------------|---------------------------------------|-------------------------------------|---------------------|--------------------------------|
| Balance - September 30, 2018:       |                                       |                                     |                     |                                |
| In-process research and development | \$ 3,730,000                          | \$ —                                | \$ 3,730,000        | —                              |
| Trade names                         | 100,000                               | 55,000                              | 45,000              | 5                              |
| Non-compete agreements              | 77,000                                | 42,350                              | 34,650              | 5                              |
|                                     | <u>\$ 3,907,000</u>                   | <u>\$ 97,350</u>                    | <u>\$ 3,809,650</u> |                                |
| Balance - December 31, 2017:        |                                       |                                     |                     |                                |
| In-process research and development | \$ 3,730,000                          | \$ —                                | \$ 3,730,000        | —                              |
| Trade names                         | 100,000                               | 40,000                              | 60,000              | 5                              |
| Non-compete agreements              | 77,000                                | 30,800                              | 46,200              | 5                              |
|                                     | <u>\$ 3,907,000</u>                   | <u>\$ 70,800</u>                    | <u>\$ 3,836,200</u> |                                |

Amortization expense for the three months ended September 30, 2018 and 2017 totaled \$8,850 and \$8,850, respectively and for the nine months ended September 30, 2018 and 2017 totaled \$26,550 and \$26,550, respectively.

## 6. RELATED PARTIES

During the nine months ended September 30, 2018 and 2017, the Company paid a Company stockholder who is a supplier of raw material inventory to the Company \$0 and \$9,060, respectively.

During the three months ended September 30, 2018 and 2017, the Company paid \$0 and \$5,250, respectively, to a company partially owned by a Company director that provides quality control and quality assurance consulting to the Company. During the nine months ended September 30, 2018 and 2017, the Company paid the same company \$10,500 and \$15,750, respectively.



## 7. NOTES PAYABLE

### Iliad Secured Convertible Promissory Notes Payable

On May 25, 2016 (the "Purchase Price Date"), the Company entered into a Securities Purchase Agreement ("Iliad SPA") with Iliad Research and Trading, L.P. (the "Lender" or "Iliad") pursuant to which the Lender loaned the Company \$2,000,000. On the Purchase Price Date, the Company issued to Lender a Secured Convertible Promissory Note (the "Iliad Note") in the principal amount of \$2,055,000 in exchange for payment by Lender of \$2,000,000. The principal sum of the Iliad Note reflected the amount invested, plus a 2.25% "Original Issue Discount" ("OID") and a \$10,000 reimbursement of Lender's legal fees. Out of the proceeds from the Iliad Note, the Company paid the sum of \$25,000 to its placement agent, Myers & Associates, L.P., which is a registered broker-dealer. The Company received net proceeds of \$1,975,000 in exchange for the Iliad Note. The Iliad Note required the repayment of all principal and any interest, fees, charges and late fees on the date that was thirteen months after the Purchase Price Date (the "Maturity Date"). Interest was to be paid on the outstanding balance at a rate of ten percent (10%) per annum from the Purchase Price Date until the Iliad Note was paid in full. Interest was accrued during the term of the Iliad Note and all interest calculations were computed on the basis of a 360-day year comprised of twelve (12) thirty (30)-day months and compounded daily. Subject to adjustment as set forth in the Iliad Note, the conversion price for each Lender conversion was \$0.50 (the "Lender Conversion Price"), convertible into shares of fully paid and non-assessable common stock. Beginning on the date that was six months after the Purchase Price Date and continuing until the Maturity Date, Iliad had the right to redeem a portion of the Iliad Note in any amount up to the "Maximum Monthly Redemption Amount" (\$275,000, which was the maximum aggregate redemption amount that could be redeemed in any calendar month), for which payments could be made in cash or by converting the redemption amount into shares of Company common stock at a conversion price which was the lesser of (a) the Lender Conversion Price of \$0.50 and (b) the Market Price, defined as 70% ("the Conversion Factor"), subject to adjustment as follows: if at any time (1) the average of the three lowest closing bid prices in the previous twenty (20) trading days was below \$0.25 per share then the Conversion Factor would have been reduced by 10%, (2) the Company was not Deposit/Withdrawal At Custodian eligible, then the Conversion Factor would have been reduced by an additional 5%, or (3) there occurred a "Major Default" then the Conversion Factor would have been reduced by an additional 5%. The Company was permitted to prepay the Iliad Note at any time by payment to Lender of 125% of the principal, interest and other amounts then due under the Note. The Company was permitted to prepay the Iliad Note notwithstanding an earlier notice of conversion from the Lender, provided that in such event the Lender could convert an amount not to exceed \$300,000 under the Iliad Note. In connection with the Iliad Note, as set forth above, the Company incurred an original issue discount of \$45,000 and \$35,000 of other debt issuance costs, which were amortized over the Iliad Note term. The Iliad Note was securitized by the Company's accounts receivable, inventory and equipment.

In November 2016, the Company entered into an Amendment to the Iliad Note (the "Iliad Amendment"), whereby the Lender and the Company agreed that the Maximum Monthly Redemption Amount for the period from November 2016 to January 2017 (the "Reduction Period") be reduced from \$275,000 to \$166,667 (the "Reduced Maximum Monthly Redemption Amount"). In addition, if the Lender failed to convert the full Reduced Maximum Monthly Redemption Amount during any month in the Reduction Period, then any such unconverted amount would increase the Reduced Maximum Monthly Redemption Amount in the following month or months. Furthermore, the Company was not allowed to pay any of the Reduced Maximum Monthly Redemption Amounts in cash. As such, all amounts converted would be converted into "Redemption Conversion Shares" of the Company's common stock. Also, as part of the Iliad Amendment, the Lender agreed that, with respect to any Redemption Conversion Shares received during the Reduction Period, in any given calendar week its Net Sales of such Redemption Conversion Shares would not exceed the greater of (a) 10% of the Company's weekly dollar trading volume in such week or (b) \$50,000 (the "Volume Limitation"). However, if the Lender's Net Sales were less than the Volume Limitation for any given week, then in the following week or weeks, the Lender would be allowed to sell an additional amount of Redemption Conversion Shares equal to the difference between the amount the Lender was allowed to sell and the amount the Lender actually sold. For the purpose of the Iliad Amendment, Net Sales was defined as the gross proceeds from sales of the Redemption Conversion Shares sold in a calendar week during the Reduction Period minus any trading commissions or costs associated with clearing and selling such Redemption Conversion Shares minus the purchase price paid for any shares of the Company's common stock purchased in the open market during such week. The Lender and the Company both agreed that in the event the Lender breached the Volume Limitation where its Net Sales of Redemption Conversion Shares during any week during the Reduction Period exceeded the dollar volume the Lender was permitted to sell during such week pursuant to the Volume Limitation (the "Excess Sales"), then the Company's sole and exclusive remedy for such breach was the reduction of the outstanding balance of the Iliad Note by an amount equal to 200% of the Excess Sales upon delivery of written notice to the Lender setting forth its basis for such reduction.

In January 2017, the Company entered into Amendment #2 to the Iliad Note (the "Iliad Amendment 2"). In accordance with the Iliad Amendment 2, during the period between January 27, 2017 and February 24, 2017, the Company agreed to allow the Lender to convert up to \$500,000 (the "Additional Redemption Amount") in "Redemption Conversions" under the Note, provided that the Lender not effectuate a Redemption Conversion of any Maximum Monthly Redemption Amount between January 27, 2017 and March 1, 2017. During this time period, the Company was not allowed to pay any of the Additional Redemption Amount in cash and all such amounts had to be converted into Redemption Conversion Shares of the Company's common stock. In addition, the Lender agreed that the sale of any Redemption Conversion Shares between January 27, 2017 and April 30, 2017 (the "Limitation Period") was subject to the Volume Limitation. Immediately following the expiration of the Limitation Period, the Volume Limitation was cancelled.

In March 2017, the Company entered into Amendment #3 to the Iliad Note (the "Iliad Amendment 3"). In accordance with the Iliad Amendment 3, during the period from March 1, 2017 to March 31, 2017, the Company agreed to allow the Lender to convert up to \$500,000 (the "Additional Redemption Amount 2") in Redemption Conversions under the Note, provided that the Lender not effectuate a Redemption Conversion of any Maximum Monthly Redemption Amount from March 1, 2017 until April 1, 2017. During this time period, the Company was not allowed to pay any of the Additional Redemption Amount 2 in cash and all such amounts had to be converted into Redemption Conversion Shares of the Company's common stock. In addition, the Lender agreed that the sale of any Redemption Conversion Shares between March 1, 2017 and May 31, 2017 (the "Limitation Period 2") was subject to the Volume Limitation. Immediately following the expiration of the Limitation Period 2, the Volume Limitation was cancelled.

In August 2017, the Company entered into Amendment #4 to the Iliad Note (the "Iliad Amendment 4"), whereby the Lender and the Company agreed to extend the Maturity Date of the Iliad Note to April 1, 2018. In addition, the parties agreed to amend the Volume Limitation in the Iliad Note, with respect to any "Conversion Shares", such that in any given calendar week the Lender's Net Sales of such Conversion Shares would not exceed the greater of (a) 15% of the Company's weekly dollar trading volume in such week or (b) \$50,000 (the "New Volume Limitation"). However, if the Lender's Net Sales were less than the New Volume Limitation for any given week, then in the following week or weeks, the Lender would be allowed to sell an additional amount of Conversion Shares equal to the difference between the amount the Lender was allowed to sell and the amount the Lender actually sold. For the purpose of the Iliad Amendment 4, Net Sales was defined as the gross proceeds from sales of the Conversion Shares sold in a calendar week minus any trading commissions or costs associated with clearing and selling such Conversion Shares minus the purchase price paid for any shares of the Company's common stock purchased in the open market during such week. The Lender and the Company both agreed that in the event the Lender breached the New Volume Limitation where its Net Sales of Conversion Shares during any week exceeded the dollar volume the Lender was permitted to sell during such week pursuant to the New Volume Limitation (the "Excess Sales"), then the Company's sole and exclusive remedy for such breach was the reduction of the outstanding balance of the Iliad Note by an amount equal to 200% of the Excess Sales upon delivery of written notice to the Lender setting forth its basis for such reduction. In connection with the Iliad Amendment 4, Lender confirmed that no Events of Default or other material breaches existed under the Iliad Note and related Transaction Documents (as defined in the Iliad SPA).

During the nine months ended September 30, 2017, the Company issued 5,793,791 shares of its common stock to Iliad in connection with the conversions of the Iliad Note in the aggregate principal amount of \$1,344,359 and \$55,641 of accrued interest. The total of \$1,400,000 was allocated to common stock and additional paid-in capital.

The Company's borrowings and conversions under the Iliad SPA for the nine months ended September 30, 2018 and for the year ended December 31, 2017 are summarized in the table below:

|  | <u>Maturity</u> | <u>September 30,<br/>2018</u> | <u>December 31,<br/>2017</u> | <u>Interest<br/>Rate</u> |
|--|-----------------|-------------------------------|------------------------------|--------------------------|
| Secured promissory note payable  | April 1, 2018   | \$ —                          | \$ 1,897,976                 | 10%                      |
| Interest accrued   |                 | —                             | 137,334                      |                          |
| Unamortized original issue discount and debt issuance costs                            |                 | —                             | 35,335                       |                          |
| Conversion of convertible promissory notes and accrued interest to common stock        |                 | —                             | (1,805,000)                  |                          |
| Conversion of convertible promissory notes and accrued interest to accrued liabilities |                 | —                             | 75,000                       |                          |
| Cash repayment of promissory notes and accrued interest                                |                 | —                             | (340,645)                    |                          |
| Net carrying amount of debt  |                 | —                             | —                            |                          |
| Less current portion   |                 | —                             | —                            |                          |
| Long-term borrowings - net of current portion  |                 | <u>\$ —</u>                   | <u>\$ —</u>                  |                          |

On the Purchase Price Date, the Company recorded a beneficial conversion feature of \$370,000 (the "Iliad Instrument"), which was originally recorded in additional paid-in capital ("APIC") and was scheduled for amortization over six months. The Company determined in 2016 that the Iliad Instrument qualified for derivative accounting treatment. The \$370,000 fair value of the Iliad Instrument at the Purchase Price Date is unchanged as a result of the change in derivative accounting treatment, however, in 2016 we reclassified the Iliad Instrument from APIC to a liability in accordance with derivative accounting treatment. During the three and nine months ended September 30, 2017, the Company recorded a gain of \$0 and \$222,800, respectively, for the change in fair value of the Iliad Instrument as part of a separate line item in the Company's Condensed Consolidated Statement of Operations. The assumptions used by the Company for calculating the fair value of the Iliad Instrument at the Purchase Price Date using the Binomial Lattice valuation model were: (i) Volatility of 74.0%; (ii) Risk-Free Interest Rate of 0.44%; and (iii) Expected Term of five months; and at September 30, 2017 were (i) Volatility of 61%, (ii) Risk-Free Interest Rate of 0.74%; and (iii) Expected Term of zero months.

In March 2017, the Company entered into another Securities Purchase Agreement ("Iliad SPA 2") with Iliad pursuant to which the Lender loaned the Company \$750,000. On March 1, 2017 (the "Subsequent Purchase Price Date"), the Company issued to Lender a Secured Convertible Promissory Note (the "Iliad Note 2") in the principal amount of \$770,000 in exchange for payment by Lender of \$750,000. The principal sum of the Iliad Note 2 reflected the amount invested, plus a \$15,000 OID and a \$5,000 reimbursement of Lender's legal fees. The Company received net proceeds of \$750,000 in exchange for the Iliad Note 2. The Iliad Note 2 required the repayment of all principal and any interest, fees, charges and late fees on the date that was fourteen months after the Subsequent Purchase Price Date (the "Maturity Date"). Interest was to be paid on the outstanding balance at a rate of eight percent (8%) per annum from the Subsequent Purchase Price Date until the Iliad Note 2 was paid in full. Interest accrued during the term of the Iliad Note 2 and all interest calculations were computed on the basis of a 360-day year comprised of twelve (12) thirty (30)-day months and compounded daily. Subject to adjustment as set forth in the Iliad Note 2, the conversion price for each Lender conversion was the Lender Conversion Price, convertible into shares of fully paid and non-assessable common stock. Beginning on the date that was six months after the Subsequent Purchase Price Date and continuing until the Maturity Date, Iliad had the right to redeem a portion of the Iliad Note 2 in an amount not to exceed \$100,000. Provided the Company had not suffered an "Event of Default" and was in compliance with certain "Equity Conditions" (unless waived by Iliad, in either case), the Company was permitted to make payments on such redemptions in cash or by converting the redemption amount into shares of Company common stock at a conversion price which was the lesser of (a) \$0.50 per share and (b) 70% ("the Conversion Factor") of the average of the three (3) lowest closing bid prices in the previous 20 trading days, subject to adjustment as follows: if at any time (1) the average of the three lowest closing bid prices in the previous twenty (20) trading days was below \$0.25 per share then the Conversion Factor would have been reduced by 10%, (2) the Company was not Deposit/Withdrawal At Custodian eligible, then the Conversion Factor would have been reduced by 5%, (3) the Company was not DTC eligible, then the Conversion Factor would have been reduced by an additional 5% or (4) there occurred a "Major Default" then the Conversion Factor would have been reduced by an additional 5% for each of the first three Major Defaults that occurred after the effective date. The Company was permitted to prepay the Iliad Note 2 at any time by payment to Lender of 125% of the principal, interest and other amounts then due under the Note. The Company was permitted to prepay the Iliad Note notwithstanding an earlier notice of conversion from the Lender, provided that in such event the Lender could have converted an amount not to exceed \$200,000 under the Iliad Note 2. In connection with the Iliad Note 2, as set forth above, the Company incurred an original issue discount of \$15,000 and \$5,000 of other debt issuance costs, which was amortized over the Iliad Note 2 term. The Iliad Note 2 was securitized by the Company's accounts receivable, inventory and equipment.

The Company's borrowings under the Iliad SPA 2 for the nine months ended September 30, 2018 and for the year ended December 31, 2017 is summarized in the table below:

|  | <b>Maturity</b> | <b>September 30,<br/>2018</b> | <b>December 31,<br/>2017</b> | <b>Interest<br/>Rate</b> |
|--|-----------------|-------------------------------|------------------------------|--------------------------|
| Secured promissory note payable  | April 30, 2018  | \$ 609,926                    | \$ 770,000                   | 8%                       |
| Interest accrued   |                 | 44,360                        | 51,890                       |                          |
| Unamortized original issue discount and debt issuance costs, net                       |                 | 5,714                         | (5,714)                      |                          |
| Conversion of convertible promissory notes and accrued interest to accrued liabilities |                 | —                             | (75,000)                     |                          |
| Cash repayment of promissory notes and accrued interest                                |                 | (660,000)                     | (131,250)                    |                          |
| Net carrying amount of debt  |                 | —                             | 609,926                      |                          |
| Less current portion   |                 | —                             | (609,926)                    |                          |
| Long-term borrowings - net of current portion  |                 | \$ —                          | \$ —                         |                          |

On the Subsequent Purchase Price Date, the Company recorded a derivative liability of \$29,300 which was scheduled for amortization over 8 months. During the three and nine months ended September 30, 2017, the Company recorded a gain of \$10,987 and \$26,075, respectively, for the change in fair value of the derivative liability as part of a separate line item in the Company's Condensed Consolidated Statement of Operations. The assumptions used by the Company for calculating the fair value of the derivative liability at the Subsequent Purchase Price Date and at September 30, 2017 using the Binomial Lattice valuation model were: (i) Volatility of 85.0%; (ii) Risk-Free Interest Rate of 0.84%; and (iii) Expected Term of 8 months; and at September 30, 2017 were (i) Volatility of 84.0%, (ii) Risk-Free Interest Rate of 0.93%; and (iii) Expected Term of 4 months. On April 24, 2018, the Company repaid all amounts outstanding under the Iliad Note 2.

#### **Current Unsecured Note Payable**

In November 2017, the Company entered into a new loan agreement with First Insurance Funding to fund a portion of the Company's insurance policies. The amount financed was \$149,044 and bears interest at a rate of 4.65%. The Company was required to make nine monthly payments of \$16,883 to satisfy this current unsecured note payable. As of September 30, 2018 and December 31, 2017, the outstanding balance was \$0 and \$116,370, respectively.

#### **Unsecured Note Payable**

On January 29, 2016, the Company issued an unsecured promissory note to Wiltshire, LLC ("Wiltshire") in the principal amount of \$850,000 (the "Promissory Note") in consideration of a loan provided to the Company by Wiltshire. The Promissory Note accrued interest at 12% per annum, and the Company was obligated to make monthly interest-only payments in the amount of \$8,500, for which the interest-only payments obligation commenced on March 1, 2016. All principal and accrued and unpaid interest was due under the Promissory Note on February 1, 2018. The Company had the right to prepay the Promissory Note without penalty or premium. In connection with the Promissory Note, the Company incurred an original issue discount of \$30,000 and \$18,570 of other debt issuance costs, which were amortized over the Promissory Note term.

On November 9, 2017, the Company extinguished and replaced the Promissory Note with a new note to Wiltshire in the principal amount of \$850,000 (the "Wiltshire Note 2") in consideration of a new loan to the Company by Wiltshire. The Wiltshire Note 2 bears interest at 16% per annum, the Company is obligated to make monthly interest-only payments of \$11,333, for which the interest-only payments obligation commenced on November 9, 2017. All principal and accrued interest is due under the Wiltshire Note 2 on May 9, 2019. In connection with the Wiltshire Note 2, the Company incurred legal expenses of \$12,500.

The Company's borrowing under the Promissory Note for the nine months ended September 30, 2018 and for the year ended December 31, 2017 is summarized in the table below:

|   | September 30,<br>2018 | December 31,<br>2017 |
|---|-----------------------|----------------------|
| Unsecured promissory note payable                               | \$ 850,000            | \$ 850,000           |
| Debt extinguishment (Promissory Note)                           | —                     | (850,000)            |
| Cash repayment of Wiltshire Note 2                              | (850,000)             | —                    |
| Unsecured promissory note – principal amount (Wiltshire Note 2) | —                     | 850,000              |
| Net carrying amount of debt                                     | —                     | 850,000              |
| Less current portion  | —                     | —                    |
| Long-term borrowings - net of current portion                   | \$ —                  | \$ 850,000           |

Pursuant to the terms of the Promissory Note, the Company issued to Wiltshire a warrant with the right to purchase up to 2,000,000 shares of the Company's common stock (the "Warrant"). The Warrant is exercisable, subject to certain limitations, subsequent to July 1, 2017 and before the date that is five years from the date of issuance at an exercise price of \$0.20 per share, subject to adjustment upon the occurrence of certain events such as stock splits and dividends. The Company recorded the fair value of the Warrant of \$266,800 as a debt discount associated with the Promissory Note. During the three months ended each of September 30, 2018 and 2017, the Company recorded interest expense of \$30,491 and \$33,350, respectively, for the amortization of the Warrant fair value. During the nine months ended each of September 30, 2018 and 2017, the Company recorded interest expense of \$98,491 and \$100,500, respectively. The assumptions used by the Company for calculating the fair value of the Warrant at inception using the Black-Scholes valuation model were: (i) Volatility of 83.3%; (ii) Risk-Free Interest Rate of 2.12%; and (iii) Expected Term of five years.

Pursuant to the terms of the Wiltshire Note 2, the Company issued to Wiltshire a warrant with the right to purchase up to 750,000 shares of the Company's common stock (the "Warrant 2"). The Warrant 2 is exercisable at any time subsequent to the date of issuance on November 9, 2017, and before the date that is five years from the date of issuance at an exercise price of \$0.248 per share, subject to adjustment upon the occurrence of certain events such as stock splits and dividends. The Company used extinguishment accounting to record the repayment of the Promissory Note and issuance of the Wiltshire Note 2. As a result, the fair value of the Warrant 2 of \$136,650 was included in the loss on extinguishment of debt amount totaling \$188,822 that was included in the Company's Consolidated Statement of Operations for the year ended December 31, 2017. The assumptions used by the Company for calculating the fair value of the Warrant 2 at inception using the Black-Scholes valuation model were: (i) Volatility of 95.9%; (ii) Risk-Free Interest Rate of 2.59%; and (iii) Expected Term of five years. On August 22, 2018, the Company repaid all amounts outstanding under the Wiltshire Note 2.

## 8. STOCKHOLDERS' EQUITY

### *Common Stock*

The Company is authorized to issue up to 190,000,000 shares of common stock (par value \$0.0001). As of September 30, 2018 and December 31, 2017, the Company had 94,355,178 and 90,512,563 shares of common stock issued and outstanding.

### *Preferred Stock*

The Company is authorized to issue up to 10,000,000 shares of \$0.0001 par value preferred stock with designations, rights and preferences to be determined from time to time by the Board of Directors of the Company. Each such series or class shall have voting powers, if any, and such preferences and/or other special rights, with such qualifications, limitations or restrictions of such preferences and/or rights as shall be stated in the resolution or resolutions providing for the issuance of such series or class of shares of preferred stock. As of September 30, 2018 and December 31, 2017, there was no preferred stock issued and outstanding.

**Options/Warrants/RSU's**

On July 23, 2014, Company stockholders approved the CV Sciences, Inc. Amended and Restated 2013 Equity Incentive Plan (the "Amended 2013 Plan"), which provides for the granting of stock options, restricted stock awards, restricted stock units (RSU's), stock bonus awards and performance-based awards. On each of December 21, 2015, October 24, 2016, July 14, 2017 and August 4, 2018, the Company's stockholders approved an amendment to the Amended 2013 Plan to increase the number of shares that may be issued under the Amended 2013 Plan. There are currently 28,000,000 shares of common stock authorized for issuance under the Amended 2013 Plan. This plan serves as the successor to the 2013 Equity Incentive Plan. There were no option awards under the 2013 Equity Incentive Plan prior to it being amended and restated.

During the three months ended September 30, 2018, warrants to purchase 2,750,000 were exercised on a net issuance basis, resulting in the issuance of 2,632,182 shares of common stock.

**9. STOCK-BASED COMPENSATION**

The Company's Amended 2013 Plan provides for the granting of stock options, restricted stock awards, RSU's, stock bonus awards and performance-based awards. As of September 30, 2018, the Company had 7,237,433 of authorized unissued shares reserved and available for issuance upon exercise and conversion of outstanding awards under the Amended 2013 Plan.

The stock options are exercisable at no less than the fair market value of the underlying shares on the date of grant, and restricted stock and restricted stock units are issued at a value not less than the fair market value of the common stock on the date of the grant. Generally, stock options awarded are vested in equal increments ranging from two to four years on the annual anniversary date on which such equity grants were awarded. The stock options generally have a maximum term of 10 years.

The Company recognized Selling, General and Administrative ("SG&A") expenses of \$237,882 and \$1,328,096, relating to stock options and RSU's issued to employees, officers, directors and consultants for the three months ended September 30, 2018 and 2017, respectively. The Company recognized SG&A expenses of \$1,634,184 and \$3,072,224, relating to stock options and RSU's issued to employees, officer, directors and consultants for the nine months ended September 30, 2018 and 2017, respectively. As of September 30, 2018, total unrecognized compensation cost related to non-vested stock-based compensation arrangements granted to employees, officers, directors and consultants was \$2,286,415 which is expected to be recognized over a weighted-average period of 1.87 years.

The following table summarizes stock option and RSU activity for the Amended 2013 Plan during the nine months ended September 30, 2018:

|   | Number of<br>Shares | Weighted Average<br>Exercise Price | Weighted<br>Average<br>Remaining<br>Contract Term<br>(Years) | Aggregate<br>Intrinsic Value |
|---|---------------------|------------------------------------|--|------------------------------|
| Outstanding - December 31, 2017                       | 15,823,277          | \$ 0.48                            | 8.54   | \$ 5,406,499                 |
| Granted   | 6,969,000           | 0.52                               | —  | —                            |
| Exercised   | (994,432)           | 0.35                               | —  | —                            |
| Cancelled/Forfeited                                   | (1,035,278)         | 0.36                               | —  | —                            |
| Outstanding - September 30, 2018                      | <u>20,762,567</u>   | 0.50                               | 7.78   | 89,820,535                   |
| Total exercisable - September 30, 2018                | <u>15,654,682</u>   | 0.49                               | 7.36   | 67,957,693                   |
| Total unvested - September 30, 2018                   | <u>5,107,885</u>    | 0.55                               | 9.05   | 21,862,842                   |
| Total vested or expected to vest - September 30, 2018 | <u>20,762,567</u>   | 0.50                               | 7.78   | 89,820,535                   |

The following table summarizes unvested stock options as of September 30, 2018:

|   | <b>Number of<br/>Shares</b> | <b>Weighted<br/>Average<br/>Fair Value<br/>Per Share on<br/>Grant Date</b> |
|---|-----------------------------|--|
| Unvested stock options - December 31, 2017  | 3,738,615                   | 0.35   |
| Granted                                     | 6,969,000                   | 0.52   |
| Vested                                      | (4,564,452)                 | 0.36   |
| Cancellations                               | (1,035,278)                 | 0.31   |
| Unvested stock options - September 30, 2018 | 5,107,885                   | 0.55   |

The following table summarizes stock option activity outside of the Amended 2013 Plan during the nine months ended September 30, 2018:

|   | <b>Number of<br/>Shares</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price</b> | <b>Weighted<br/>Average<br/>Remaining<br/>Contract<br/>Term<br/>(Years)</b> | <b>Aggregate<br/>Intrinsic<br/>Value</b> |
|---|-----------------------------|--|---|--|
| Outstanding - December 31, 2017                       | 7,250,000                   | \$ 0.37  | 8.03  | \$ 32,336,000                            |
| Granted   | —                           | —  | —   | —  |
| Exercised   | —                           | —  | —   | —  |
| Forfeited   | —                           | —  | —   | —  |
| Expired   | —                           | —  | —   | —  |
| Outstanding - September 30, 2018                      | 7,250,000                   | 0.37   | 8.03  | 32,336,000                               |
| Total exercisable - September 30, 2018                | 7,250,000                   | 0.37   | 8.03  | 32,336,000                               |
| Total unvested - September 30, 2018                   | —                           | —  | —   | —  |
| Total vested or expected to vest - September 30, 2018 | 7,250,000                   | 0.37   | 8.03  | 32,336,000                               |

As of September 30, 2018, there were 10,750,000 remaining unvested stock options granted outside of the Amended 2013 Plan which vest upon the completion of future performance conditions.

## 10. INCOME TAXES

On December 22, 2017, tax reform legislation known as the Tax Cuts and Jobs Act (the "Tax Legislation") was enacted in the United States (the "U.S."). The Tax Legislation significantly revises the U.S. corporate income tax by lowering the statutory corporate tax rate to 21%, among other changes.

The Company has preliminarily accounted for the effects of the Tax Legislation and estimate that our effective tax rate exclusive of discrete items is 9.5% for 2018 because taxable income exclusive of discrete items should be mostly offset by net operating loss carry forwards. Tax expense based on the estimated annual effective tax rate was \$710,000 for the nine months ended September 30, 2018, however, this amount is partially offset by a tax benefit on discrete items of \$470,000 for the nine months ended September 30, 2018 which is related to excess tax deductions for non-qualified stock options exercised. Due to uncertainties in estimating our taxable income after 2018, we cannot determine that it is more likely than not that net operating loss carry forwards and other deferred tax assets will be utilized after 2018.

Our income tax provision for the three and nine months ended September 30, 2018 was \$200,000 and \$240,000, respectively, and was \$0 and \$0 for the three and nine months ended September 30, 2017, respectively.

## 11. COMMITMENTS AND CONTINGENCIES

### *Commitments*

The Company entered an 8-year lease agreement (the “Lease”) consolidating its operations of approximately 24,000 square feet in San Diego, California that commenced on February 1, 2018. The Company is required to pay monthly base rent, utilities and common area maintenance expenses. The Company received a landlord rent incentive of \$1,067,459 for tenant improvements. The Lease rent incentive is recorded as a deferred liability and is amortized over the Lease term to rent expense.

The Company entered a 3-year lease agreement for additional warehouse space of approximately 5,000 square feet in San Diego, California that commenced on April 1, 2018. In August 2018, the Company entered a lease agreement for additional office space of approximately 6,600 in San Diego, California that commenced on October 15, 2018.

The following table provides the Company’s future minimum payments under all Company lease commitments as of September 30, 2018:

|  | <b>Operating Lease<br/>Commitment</b> |
|--|---------------------------------------|
| 2018 – for the three months ending December 31, 2018 | \$ 178,232                            |
| 2019   | 923,889                               |
| 2020   | 955,048                               |
| 2021   | 917,415                               |
| 2022   | 922,638                               |
| Thereafter   | 3,024,659                             |
|  | <b>\$ 6,921,881</b>                   |

The Company incurred rent expense of \$164,397 and \$110,938 for the three months ended September 30, 2018 and 2017, respectively, and incurred rent expense of \$500,214 and \$353,555 for the nine months ended September 30, 2018 and 2017, respectively.

### *Contingencies*

On April 23, 2014, Tanya Sallustro filed a purported class action complaint (the “Complaint”) in the Southern District of New York (the “Court”) alleging securities fraud and related claims against the Company and certain of its officers and directors and seeking compensatory damages including litigation costs. Ms. Sallustro alleges that between March 18-31, 2014, she purchased 325 shares of the Company’s common stock for a total investment of \$15,791. The Complaint refers to Current Reports on Form 8-K and Current Reports on Form 8-K/A filings made by the Company on April 3, 2014 and April 14, 2014, in which the Company amended previously disclosed sales (sales originally stated at \$1,275,000 were restated to \$1,082,375 - a reduction of \$192,625) and restated goodwill as \$1,855,512 (previously reported at net zero). On March 19, 2015, the Court issued a ruling appointing Steve Schuck as lead plaintiff. Counsel for Mr. Schuck filed a “consolidated complaint” on September 14, 2015, asserting two claims: (1) for violation of Section 10(b) of the Exchange Act and SEC Rule 10B-5 promulgated thereunder against all defendants, and (2) for violation of Section 20(a) of the Exchange Act against the individual defendants. Plaintiffs sued the Company, Michael Mona, Jr., Bart Mackay, Theodore Sobieski, Edward Wilson, Stuart Titus, and Michael Llamas.



On December 11, 2015, the Company and the individuals (except for Messrs. Titus and Llamas) filed a motion to dismiss the consolidated complaint. On April 2, 2018, the Court issued an order granting in part and denying in part the motion to dismiss. With respect to the First Claim for violation of Section 10(b) of the Exchange Act, the court ruled that plaintiffs failed to allege misstatements or omissions attributable to Messrs. Mackay, Sobieski, or Titus, and so granted the motion on that claim as to those parties. The court found the allegations sufficient as to the Company and Messrs. Wilson, and Mona Jr., and so denied the motion as to those parties. Under plaintiffs' separate theory of "market manipulation," the Court granted the motion in favor of all defendants. The parties are currently awaiting entry of a case scheduling order by the Court. Management intends to vigorously defend the allegations and an estimate of possible loss cannot be made at this time.

On March 17, 2015, stockholder Michael Ruth filed a shareholder derivative suit in Nevada District Court alleging two causes of action: 1) Breach of Fiduciary Duty, and 2) "Gross Mismanagement." The claims are premised on the same events as the already-pending securities class action case in New York discussed above – it is alleged that the Form 8-K filings misstated goodwill and sales of the Company, which when corrected, lead to a significant drop in stock price. The Company filed a motion to dismiss the suit on June 29, 2015. Instead of opposing the Company's motion, Mr. Ruth filed an amended complaint on July 20, 2015. Thereafter, Mr. Ruth and the Company agreed to stay the action pending the outcome of the securities class action case in New York discussed above. Mr. Ruth and the Company filed a stipulation and proposed order on June 20, 2018 asking the Nevada District Court to continue the stay in the action pending a resolution on the securities class action case. Since no discovery has been conducted and the case has been stayed for nearly three years, an estimate of the possible loss or recovery cannot be made at this time.

On June 15, 2017, the SEC filed an enforcement action against the Company and its then-Chief Executive Officer, Michael Mona, Jr. In the complaint, filed in the United States District Court of Nevada (Case No. 2:17-cv-01681), the SEC alleged that the Company and Mr. Mona violated federal securities laws, including Section 10(b) of the Securities Exchange Act of 1934, as amended, and SEC Rule 10b-5(b), through alleged misrepresentations made in certain SEC reports regarding the value of the Company's assets acquired by the Company from PhytoSphere Systems, LLC. On May 31, 2018, the Company and Mr. Mona settled all claims. Pursuant to the terms of the settlement, without admitting or denying the allegations made by the SEC, the Company agreed to a consent judgment pursuant to which (a) the Company agreed to pay a penalty in the amount of \$150,000, and (b) the Company is permanently enjoined from violations of federal securities laws. The Company has made this payment in full. Mr. Mona, without admitting or denying any allegations, agreed to an order (a) prohibiting him from serving as an officer or director of a publicly held company for five (5) years, (b) providing for payment in the aggregate amount of \$50,000, payable in 12 installments commencing 30 days after entry of final judgment, and (c) permanently enjoining him from violations of federal securities laws. Effective concurrent with the settlement, Mr. Mona resigned as the Company's President and Chief Executive Officer, and resigned his position on the Company's Board of Directors.

On October 21, 2016, Dun Agro B.V. ("Dun Agro") filed a complaint against the Company in the District Court of the North Netherlands, location Groningen, The Netherlands, alleging non-performance under a contract, seeking compensatory damages of approximately 2,050,000 euros, excluding interest and costs. The plaintiff alleges that the Company was obligated to perform under that certain Supply Agreement between the Company and Dun Agro dated December 19, 2013, and to purchase 1,000,000 kilograms of harvested raw material related to the 2016 crop. The Company settled this matter on August 31, 2018 with no compensatory damages.

The Company is a plaintiff in a litigation matter involving a former credit card processor of the Company and recently settled another matter involving a former credit card processor of the Company. On September 10, 2017, the Company filed a complaint against one such credit card processor, PayToo Merchant Services, Corporation ("Pay Too"), a Florida corporation, in the Circuit Court in Broward County, Florida, asserting breach of contract claims for PayToo's failure to remit approximately \$250,000 to the Company for credit card sales processed by PayToo from January 2017 to February 2017. On December 11, 2017, the Company filed a complaint against the other credit card processor, T1 Payments, LLC ("T1"), a Nevada corporation, in District Court, Clark County, Nevada, asserting breach of contract claims for T1's failure to remit approximately \$500,000 to the Company for credit card sales processed by T1 from February 2017 to October 2017. The T1 matter was resolved on October 22, 2018 with \$450,000 of previously restricted cash being released to the Company by T1 in full settlement of the Company's complaint.

The Company has been made aware of a series of complaints and one derivative suit filed by various plaintiffs alleging violations of securities law related to the Company's disclosures regarding patent prosecution of its various drug development assets. On August 24, 2018, David Smith filed a purported class action complaint against the Company in the United States District Court District of Nevada. This complaint and the other complaints that the Company has been made aware of were filed directly after Citron Research published on Twitter on August 20, 2018 its belief that the Company misled investors by failing to disclose that the Company's efforts to secure patent protection had been "finally rejected" by the United States Patent and Trademark Office (USPTO). The Company believes these claims are without merit, and intends to vigorously defend any claims in the event it is served with a complaint.

In the normal course of business, the Company is a party to a variety of agreements pursuant to which we may be obligated to indemnify the other party. It is not possible to predict the maximum potential amount of future payments under these types of agreements due to the conditional nature of our obligations and the unique facts and circumstances involved in each particular agreement. Historically, payments made by us under these types of agreements have not had a material effect on our business, consolidated results of operations or financial condition.

## 12. SEGMENT INFORMATION

The Company operates in two distinct business segments: a consumer product segment in manufacturing, marketing and selling plant-based CBD products to a range of market sectors; and, a specialty pharmaceutical segment focused on developing and commercializing novel therapeutics utilizing synthetic CBD. The Company's segments maintain separate financial information for which operating results are evaluated on a regular basis by the Company's senior management in deciding how to allocate resources and in assessing performance. The Company evaluates its consumer product segment based on net product sales, gross profit and operating income or loss. The Company currently evaluates its specialty pharmaceutical segment based on the progress of its clinical development programs.

The following table presents information by reportable operating segment for the three and nine months ended September 30, 2018 and 2017:

|   | Consumer<br>Products<br>Segment | Specialty<br>Pharmaceutical<br>Segment | Consolidated<br>Totals |
|---|---------------------------------|--|------------------------|
| <b>Three Months Ended</b>                   |                                 |  |                        |
| September 30, 2018:                         |                                 |  |                        |
| Product sales, net                          | \$ 13,600,881                   | \$ —                                   | \$ 13,600,881          |
| Gross profit                                | 9,945,423                       | —                                      | 9,945,423              |
| Selling, general and administrative expense | (5,869,762)                     | (20,570)                               | (5,890,332)            |
| Research and development expense            | (170,466)                       | (359,096)                              | (529,562)              |
| Operating income (loss)                     | <u>\$ 3,905,195</u>             | <u>\$ (379,666)</u>                    | <u>\$ 3,525,529</u>    |
| <b>Three Months Ended</b>                   |                                 |  |                        |
| September 30, 2017:                         |                                 |  |                        |
| Product sales, net                          | \$ 5,591,210                    | \$ —                                   | \$ 5,591,210           |
| Gross profit                                | 3,997,649                       | —                                      | 3,997,649              |
| Gain on change in derivative liabilities    | 10,987                          | —                                      | 10,987                 |
| Selling, general and administrative expense | (4,259,725)                     | (51,353)                               | (4,311,078)            |
| Research and development expense            | (76,520)                        | (102,818)                              | (179,338)              |
| Operating loss                              | <u>\$ (327,609)</u>             | <u>\$ (154,171)</u>                    | <u>\$ (481,780)</u>    |
| <b>Nine Months Ended</b>                    |                                 |  |                        |
| September 30, 2018:                         |                                 |  |                        |
| Product sales, net                          | \$ 34,020,341                   | \$ —                                   | \$ 34,020,341          |
| Gross profit                                | 24,567,402                      | —                                      | 24,567,402             |
| Selling, general and administrative expense | (15,915,882)                    | (35,647)                               | (15,951,529)           |
| Research and development expense            | (362,933)                       | (762,337)                              | (1,125,270)            |
| Operating income (loss)                     | <u>\$ 8,289,587</u>             | <u>\$ (797,984)</u>                    | <u>\$ 7,490,603</u>    |
| <b>Nine Months Ended</b>                    |                                 |  |                        |
| September 30, 2017:                         |                                 |  |                        |
| Product sales, net                          | \$ 13,437,233                   | \$ —                                   | \$ 13,437,233          |
| Gross profit                                | 9,275,111                       | —                                      | 9,275,111              |
| Gain on change in derivative liabilities    | 248,875                         | —                                      | 248,875                |
| Royalty buy-out                             | —                               | (2,432,000)                            | (2,432,000)            |
| Selling, general and administrative expense | (11,312,687)                    | (200,873)                              | (11,513,560)           |
| Research and development expense            | (181,509)                       | (392,192)                              | (573,701)              |
| Operating loss                              | <u>\$ (1,970,210)</u>           | <u>\$ (3,025,065)</u>                  | <u>\$ (4,995,275)</u>  |

## 13. SUBSEQUENT EVENT

On October 22, 2018, the Company received un-restricted control of \$450,000 of restricted cash held at September 30, 2018 in connection with the settlement of a complaint filed by the Company against a former credit card processor of the Company (Note 11). The Company recognized bad debt expense of \$40,223 in connection with this settlement.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of our financial condition and results of operations for the three and nine months ended September 30, 2018 and 2017, respectively, should be read in conjunction with the financial statements and the notes to those statements that are included elsewhere in this Quarterly Report on Form 10-Q. Our discussion includes forward-looking statements based upon current expectations that involve risks and uncertainties, such as our plans, objectives, expectations and intentions. Actual results and the timing of events could differ materially from those anticipated in these forward-looking statements as a result of a number of factors. We use words such as "anticipate", "estimate", "plan", "project", "continuing", "ongoing", "expect", "believe", "intend", "may", "will", "should", "could", and similar expressions to identify forward-looking statements.

### OVERVIEW

We are a life science company with two distinct business segments. Our specialty pharmaceutical segment is focused on developing and commercializing novel therapeutics utilizing synthetic Cannabidiol ("CBD"). Our consumer product segment is focused on manufacturing, marketing and selling plant-based CBD products to a range of market sectors. On June 8, 2016, the Company changed its trading symbol from "CANV" to "CVSI", and continues to be traded on the OTC: QB.

Our specialty pharmaceutical business segment is developing synthetic cannabinoids to treat a range of medical conditions. The Company's product candidates are based on proprietary formulations, processes and technology that we believe are patent-protectable, and we plan to vigorously pursue patent protection on the Company's two drug candidates.

Our consumer product business segment manufactures, markets and sells consumer products containing plant-based CBD under our *PlusCBD™* brand in a range of market sectors including nutraceutical, beauty care, specialty foods and vape.

We expect to realize revenue from our consumer products business segment to fund our working capital needs during 2018. However, the Company's pharmaceutical business segment may require additional capital over the next 12 months. Management believes that it will be able to fund our drug development efforts in 2018 solely through current cash flow, however, there can be no assurances that the Company will be successful. If the Company is unable to generate sufficient cash flow or, alternatively, raise additional capital, the Company would likely be forced to curtail pharmaceutical development.

### Non-GAAP Financial Measures

We currently focus on Adjusted EBITDA to evaluate our operating performance and financial position. Adjusted EBITDA is defined by us as EBITDA (net income (loss) minus interest income, plus interest expense, income tax expense, depreciation and amortization), further adjusted to exclude certain non-cash expenses and other adjustments as set forth below. We present Adjusted EBITDA because we consider it an important measure of our performance and it is a meaningful financial metric in assessing our operating performance from period to period by excluding certain items that we believe are not representative of our core business, such as certain non-cash items and other adjustments. The Company believes that Adjusted EBITDA, viewed in addition to, and not in lieu of, our reported results in accordance with accounting principles generally accepted in the United States ("GAAP"), provides useful information to investors regarding the Company's performance.

Adjusted EBITDA is a non-GAAP measure and does not purport to be an alternative to net income (loss) as a measure of operating performance or to cash flows from operating activities as a measure of liquidity. The term "Adjusted EBITDA" is not defined under GAAP, and Adjusted EBITDA is not a measure of net income (loss), operating income or any other performance measure derived in accordance with GAAP. Adjusted EBITDA has limitations as an analytical tool and should not be considered in isolation or as a substitute for analysis of the Company's results as reported under GAAP. CV Sciences' management compensates for these limitations by relying primarily on GAAP results and using Adjusted EBITDA as supplemental information.

A reconciliation from our net income (loss) to Adjusted EBITDA, a non-GAAP measure, for the three and nine months ended September 30, 2018 and 2017 is detailed below:

|   | For the three months ended<br>September 30, |                   | For the nine months ended<br>September 30, |                    |
|---|---|-------------------|--|--------------------|
|   | 2018  | 2017              | 2018                                       | 2017               |
| Net income (loss)                                 | \$ 3,294,973                                | \$ (589,983)      | \$ 7,100,217                               | \$ (5,366,946)     |
| Interest income                                   | —   | —                 | —  | 7                  |
| Interest expense                                  | 30,556                                      | 108,203           | 150,386                                    | 371,678            |
| Provision for income taxes                        | 200,000                                     | —                 | 240,000                                    | —                  |
| Amortization of purchased intangible assets       | 8,850                                       | 8,850             | 26,550                                     | 26,550             |
| Depreciation of property & equipment              | 121,911                                     | 30,897            | 349,121                                    | 117,744            |
| EBITDA  | <u>3,656,290</u>                            | <u>(442,033)</u>  | <u>7,866,274</u>                           | <u>(4,850,967)</u> |
| EBITDA Adjustments:                               |   |                   |  |                    |
| Stock-based compensation expense (1)              | 237,882                                     | 1,328,096         | 1,634,184                                  | 3,072,224          |
| Common stock issued for professional services (2) | 233,751                                     | —                 | 295,326                                    | —                  |
| Gain on changes in derivative liabilities (3)     | —   | (10,987)          | —  | (248,875)          |
| Royalty buy-out (4)                               | —   | —                 | —  | 2,432,000          |
| Total EBITDA Adjustments                          | <u>471,633</u>                              | <u>1,317,109</u>  | <u>1,929,510</u>                           | <u>5,255,349</u>   |
| Adjusted EBITDA                                   | <u>\$ 4,127,923</u>                         | <u>\$ 875,076</u> | <u>\$ 9,795,784</u>                        | <u>\$ 404,382</u>  |

- (1) Represents stock-based compensation expense related to stock options and RSU's awarded to employees, consultants and non-executive directors based on the grant date fair value under the Black-Scholes valuation model (See Note 9 of the Company's condensed consolidated financial statements)
- (2) Represents common stock issued for professional services
- (3) Represents the gain on changes in derivative liabilities associated with the Iliad Notes (See Note 7 of the Company's condensed consolidated financial statements)
- (4) Represents the share-based royalty buy-out associated with the CanX acquisition

As illustrated above, Adjusted EBITDA improved by \$3.25 million and \$9.39 million for the three and nine months ended September 30, 2018 compared with the same period in 2017. This improvement is primarily due to the Company's increase in sales.

#### Critical Accounting Policies

We have disclosed in the notes to our consolidated financial statements and in "Item 7 – Management's Discussion and Analysis of Financial Condition and Results of Operations" included in our 2017 Annual Report on Form 10-K, those accounting policies that we consider to be significant in determining our results of operation and financial condition. There have been no material changes to those policies that we consider to be significant since the filing of our 2017 Annual Report on Form 10-K. The accounting principles used in preparing our unaudited condensed consolidated financial statements conform in all material respects to GAAP.

## Recent Accounting Pronouncements

See Note 2 in the accompanying notes to condensed consolidated financial statements.

## Results of Operations

### Comparison of the three and nine months ended September 30, 2018 and 2017

**Revenues and gross profit** - We had sales of \$13.60 million and gross profit of \$9.95 million representing a gross profit percentage of 73.1% for the three months ended September 30, 2018 compared to sales of \$5.59 million and gross profit of \$4.00 million, representing a gross profit percentage of 71.5% for the three months ended September 30, 2017. The Company increased sales by \$8.01 million, or a 143.2% increase, for the three months ended September 30, 2018, when compared to results for three months ended September 30, 2017.

For the nine months ended September 30, 2018, we had sales of \$34.02 million and gross profit of \$24.57 million, representing a gross profit percentage of 72.2% compared with sales of \$13.49 million and gross profit of \$9.28 million, representing a gross profit percentage of 68.8% for the nine months ended September 30, 2017. The Company increased sales by \$20.53 million, or a 152% increase, for the nine months ended September 30, 2018 when compared to results for nine months ended September 30, 2017.

The sales increase for the three and nine months ended September 30, 2018 compared with the three and nine months ended September 30, 2017 is primarily due to an increase in distribution, customer awareness and demand for our branded *PlusCBD™* products, as we continued to expand and maintain our core customer base which further supports our decision to focus our sales strategy primarily on branded consumer products.

The gross profit increase for the three and nine months ended September 30, 2018 compared with the three and nine months ended September 30, 2017 is the result of our change in sales mix and increased sales.

**Selling, general and administrative expenses** – Selling, general and administrative (“SG&A”) expenses increased to \$5.89 million for the three months ended September 30, 2018, compared with \$4.31 million for the three months ended September 30, 2017. SG&A expenses include non-cash expenses of \$0.41 million and \$1.37 million for the three months ended September 30, 2018 and 2017, respectively, which consisted primarily of stock-based compensation, amortization of intangible assets, depreciation of fixed assets and bad debt expense. After adjusting for these non-cash expenses, SG&A expenses increased by \$2.46 million for the three months ended September 30, 2018 compared to three months ended September 30, 2017, an approximate 83% increase. This increase relates primarily to increased employee headcount and higher commissions, both directly related to our 143.2% increase in sales for the three months ended September 30, 2018, as compared to three months ended September 30, 2017.

For the nine months ended September 30, 2018 and 2017, we incurred SG&A expenses in the amount of \$15.97 million and \$11.51 million, respectively. SG&A expenses include non-cash expenses of \$2.14 million and \$3.22 million for the nine months ended September 30, 2018 and 2017, respectively, which consisted primarily of stock-based compensation, amortization of intangible assets, depreciation of fixed assets and bad debt expense. After adjusting for these non-cash expenses, SG&A expenses increased by \$6.34 million for the nine months ended September 30, 2018 compared to nine months ended September 30, 2017, an approximate 75% increase. This increase relates primarily to increased employee headcount and higher commissions, both directly related to our 152% increase in sales for the nine months ended September 30, 2018, as compared to nine months ended September 30, 2017.

**Research and development expenses** - For the three months ended September 30, 2018 and 2017, the Company incurred research and development (“R&D”) expenses of \$0.53 million and \$0.18 million, respectively. These expenses are related to our cost of process development, rental of our laboratory facility, payroll expenses, laboratory supplies, product development and testing, outsourced research personnel, and R&D expenses related to our specialty pharmaceutical segment.

During the three months ended September 30, 2018, we incurred \$0.36 million of R&D expenses related to our specialty pharmaceutical segment compared with \$0.18 million for the three months ended September 30, 2017. We expect R&D expense related to our pharmaceutical segment to increase each quarter over the next 12 months.

For the nine months ended September 30, 2018 and 2017, the Company incurred R&D expenses of \$1.13 million and \$0.57 million, respectively. These costs are related to the same costs incurred during the three months ended September 30, 2018 and 2017, respectively. During the nine months ended September 30, 2018, we incurred \$0.76 million of R&D expenses related to our specialty pharmaceutical segment compared with \$0.39 million in the nine months ended September 30, 2017.

**Gain on changes in derivative liabilities** - Gain on changes in derivative liabilities of \$0 and \$0.01 million during the three months ended September 30, 2018 and 2017, respectively, relates to the change in the derivative liability from the Iliad Note and the change in the derivative liability from inception for the Iliad Note 2 (See Note 7 of the Company's condensed consolidated financial statements). The gain results primarily from the reduction in the expected term of the derivative liabilities.

Gain on changes in derivative liabilities of \$0 and \$0.25 million during the nine months ended September 30, 2018 and 2017, respectively, relates to the change in the derivative liability from December 31, 2016 on the Iliad Notes (See Note 7 of the Company's condensed consolidated financial statements). The gain results primarily from the reduction in the expected term of the derivative liabilities.

**Royalty buy-out** - Royalty buy-out of \$0 and \$2.43 million during the nine months ended September 30, 2018 and 2017, respectively relates to the Company's share-based royalty buy-out associated with the Company's acquisition of CanX, Inc., Florida-based, specialty pharmaceutical corporation, as disclosed by the Company in that certain Current Report on Form 8-K filed by the Company with the SEC on March 22, 2017.

## Liquidity and Capital Resources

A summary of our changes in cash flows for the nine months ended September 30, 2018 and 2017 is provided below:

|   | For the nine months ended September 30, |              |
|---|---|--------------|
|   | 2018                                    | 2017         |
| Net cash flows provided by (used in):         |   |              |
| Operating activities                          | \$ 9,925,819                            | \$ 647,216   |
| Investing activities                          | (424,354)                               | (6,410)      |
| Financing activities                          | (1,283,054)                             | 624,036      |
| Net increase in cash and restricted cash      | 8,218,411                               | 1,264,842    |
| Cash and restricted cash, beginning of period | 2,791,544                               | 1,057,468    |
| Cash and restricted cash, end of period       | \$ 11,009,955                           | \$ 2,322,310 |

## Operating Activities

Net cash provided by or used in operating activities includes our net income (loss) adjusted for non-cash expenses such as depreciation and amortization, bad debt expense, amortizations of debt issuance costs, gains or losses on our derivative liabilities, expenses related to issuance of common stock for professional services, stock-based compensation and accrued interest expense. Operating assets and liabilities primarily include balances related to funding of inventory purchases and customer accounts receivable. Operating assets and liabilities that arise from the funding of inventory purchases and customer accounts receivable can fluctuate significantly from day to day and period to period depending on the timing of inventory purchases and customer behavior.

Net cash provided by operating activities increased to \$9.92 million for the nine months ended September 30, 2018 compared to \$0.65 million for the nine months ended September 30, 2017, an improvement of \$9.27 million. The primary reasons for this improvement include our increased sales, gross margins, and ability to convert our inventory investment into cash, as well as the Company's transition from a net loss to net income position during the first nine months of 2018.

### ***Investing Activities***

The Company had \$0.42 million and \$0.01 million used in investing activities for the nine months ended September 30, 2018 and 2017, respectively. The investing activities for the first nine months of 2018 included purchase of equipment and leasehold improvements.

### ***Financing Activities***

Net cash (used in) provided by financing activities for the nine months ended September 30, 2018 and 2017 totaled (\$1.28) million and \$0.62 million, respectively. Cash flows used by financing activities for the nine months ended September 30, 2018 consisted of \$0.66 million of cash repayments on convertible debt, \$0.85 million of repayment of unsecured debt, \$0.12 million of repayments on an unsecured note payable, and proceeds from exercise of stock options of \$0.34 million. Cash flows provided by financing activities for the nine months ended September 30, 2017 consisted of \$0.75 million in borrowing net proceeds from the issuance of secured convertible debt and \$0.13 million of repayments on an unsecured note payable. (See Note 7 of the Condensed Consolidated Financial Statements).

### ***Liquidity***

For the three months ended September 30, 2018 and 2017, the Company had net income (loss) of \$3.29 million and (\$0.59) million, respectively, and for the nine months ended September 30, 2018 and 2017, the Company had net income (loss) of \$7.10 million and (\$5.37) million, respectively. In addition, for the nine months ended September 30, 2018 and 2017, the Company had positive cash flows from operations of \$9.92 million and \$0.65 million. Management believes the Company has the funds needed to continue its consumer product business segment and meet its other obligations over the next year solely from current revenues and cash flow due to increased sales. However, the Company's pharmaceutical business segment may require additional capital over the next 12 months. Management believes that it will be able to fund our drug development efforts solely from current revenue and cash flow for the next 12-month period through November 6, 2019. If the Company is unable to generate sufficient cash flow or raise additional capital, the Company would likely be forced to curtail pharmaceutical development.

### ***Off-Balance Sheet Arrangements***

The Company previously had two supply arrangements with European farmers to supply raw inventory material through October 2018. Both agreements have been terminated. A new agreement with a European farmer to supply raw inventory material from the 2018 crop was completed in August 2018.

## **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Not applicable to a "smaller reporting company" as defined in Item 10(f)(1) of Regulation S-K.

## **ITEM 4. CONTROLS AND PROCEDURES**

### **DISCLOSURE CONTROLS AND PROCEDURES**

Our management, which is comprised of one person holding the offices of Chief Executive Officer, Chief Financial Officer and Secretary, evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) promulgated under the Exchange Act) as of the end of the period covered by this report (the "Evaluation Date"). Based on such evaluation, our management concluded that our disclosure controls and procedures were effective, at a reasonable assurance level, as of the Evaluation Date, to ensure that information required to be disclosed in reports that we file or submit under that Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms and to ensure that information required to be disclosed in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management in a manner that allows timely decisions regarding required disclosures.

An evaluation was performed under the supervision and with the participation of the Company's management of the effectiveness of the design and operation of the Company's procedures and internal control over financial reporting as of September 30, 2018. In making this assessment, the Company used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") in its Internal Control-Integrated Framework (2013).

### **CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING**

There was no change in our internal control over financial reporting identified with our evaluation that occurred during the fiscal quarter ended September 30, 2018, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. LEGAL PROCEEDINGS

On April 23, 2014, Tanya Sallustro filed a purported class action complaint (the "Complaint") in the Southern District of New York (the "Court") alleging securities fraud and related claims against the Company and certain of its officers and directors and seeking compensatory damages including litigation costs. Ms. Sallustro alleges that between March 18-31, 2014, she purchased 325 shares of the Company's common stock for a total investment of \$15,791. The Complaint refers to Current Reports on Form 8-K and Current Reports on Form 8-K/A filings made by the Company on April 3, 2014 and April 14, 2014, in which the Company amended previously disclosed sales (sales originally stated at \$1,275,000 were restated to \$1,082,375 - a reduction of \$192,625) and restated goodwill as \$1,855,512 (previously reported at net zero). On March 19, 2015, the Court issued a ruling appointing Steve Schuck as lead plaintiff. Counsel for Mr. Schuck filed a "consolidated complaint" on September 14, 2015, asserting two claims: (1) for violation of Section 10(b) of the Exchange Act and SEC Rule 10B-5 promulgated thereunder against all defendants, and (2) for violation of Section 20(a) of the Exchange Act against the individual defendants. Plaintiffs sued the Company, Michael Moná, Jr., Bart Mackay, Theodore Sobieski, Edward Wilson, Stuart Titus, and Michael Llamas.

On December 11, 2015, the Company and the individuals (except for Messrs. Titus and Llamas) filed a motion to dismiss the consolidated complaint. On April 2, 2018, the Court issued an order granting in part and denying in part the motion to dismiss. With respect to the First Claim for violation of Section 10(b) of the Exchange Act, the court ruled that plaintiffs failed to allege misstatements or omissions attributable to Messrs. Mackay, Sobieski, or Titus, and so granted the motion on that claim as to those parties. The court found the allegations sufficient as to the Company and Messrs. Wilson, and Moná Jr., and so denied the motion as to those parties. Under plaintiffs' separate theory of "market manipulation," the Court granted the motion in favor of all defendants. The parties are currently awaiting entry of a case scheduling order by the Court. Management intends to vigorously defend the allegations and an estimate of possible loss cannot be made at this time.

On March 17, 2015, stockholder Michael Ruth filed a shareholder derivative suit in Nevada District Court alleging two causes of action: 1) Breach of Fiduciary Duty, and 2) "Gross Mismanagement." The claims are premised on the same events as the already-pending securities class action case in New York discussed above – it is alleged that the Form 8-K filings misstated goodwill and sales of the Company, which when corrected, lead to a significant drop in stock price. The Company filed a motion to dismiss the suit on June 29, 2015. Instead of opposing the Company's motion, Mr. Ruth filed an amended complaint on July 20, 2015. Thereafter, Mr. Ruth and the Company agreed to stay the action pending the outcome of the securities class action case in New York discussed above. Mr. Ruth and the Company filed a stipulation and proposed order on June 20, 2018 asking the Nevada District Court to continue the stay in the action pending a resolution on the securities class action case. Since no discovery has been conducted and the case has been stayed for nearly three years, an estimate of the possible loss or recovery cannot be made at this time.

On June 15, 2017, the Securities and Exchange Commission (SEC) filed an enforcement action against the Company and its then-Chief Executive Officer, Michael Moná, Jr. In the complaint, filed in the United States District Court of Nevada (Case No. 2:17-cv-01681), the SEC alleged that the Company and Mr. Moná violated federal securities laws, including Section 10(b) of the Securities Exchange Act of 1934, as amended, and SEC Rule 10b-5(b), through alleged misrepresentations made in certain SEC reports regarding the value of the Company's assets acquired by the Company from PhytoSphere Systems, LLC. On May 31, 2018, the Company and Mr. Moná settled all claims. Pursuant to the terms of the settlement, without admitting or denying the allegations made by the SEC, the Company agreed to a consent judgment pursuant to which (a) the Company agreed to pay a penalty in the amount of \$150,000, and (b) the Company is permanently enjoined from violations of federal securities laws. The Company has made this payment in full. Mr. Moná, without admitting or denying any allegations, agreed to an order (a) prohibiting him from serving as an officer or director of a publicly held company for five (5) years, (b) providing for payment in the aggregate amount of \$50,000, payable in 12 installments commencing 30 days after entry of final judgment, and (c) permanently enjoining him from violations of federal securities laws. Effective concurrent with the settlement, Mr. Moná resigned as the Company's President and Chief Executive Officer, and resigned his position on the Company's Board of Directors.



On October 21, 2016, Dun Agro B.V. ("Dun Agro") filed a complaint against the Company in the District Court of the North Netherlands, location Groningen, The Netherlands, alleging non-performance under a contract, seeking compensatory damages of approximately 2,050,000 euros, excluding interest and costs. The plaintiff alleges that the Company was obligated to perform under that certain Supply Agreement between the Company and Dun Agro dated December 19, 2013, and to purchase 1,000,000 kilograms of harvested raw material related to the 2016 crop. The Company settled this matter on August 31, 2018 with no compensatory damages.

The Company is a plaintiff in a litigation matter involving a former credit card processor of the Company and recently settled another matter involving a former credit card processor of the Company. On September 10, 2017, the Company filed a complaint against one such credit card processor, PayToo Merchant Services Corporation ("Pay Too"), a Florida corporation, in the Circuit Court in Broward County, Florida, asserting breach of contract claims for PayToo's failure to remit approximately \$250,000 to the Company for credit card sales processed by PayToo from January 2017 to February 2017. On December 11, 2017, the Company filed a complaint against the other credit card processor, T1 Payments, LLC ("T1"), a Nevada corporation, in District Court, Clark County, Nevada, asserting breach of contract claims for T1's failure to remit approximately \$500,000 to the Company for credit card sales processed by T1 from February 2017 to October 2017. The T1 matter was resolved on October 22, 2018 with \$450,000 of previously restricted cash being released to the Company by T1 in full settlement of the Company's complaint.

The Company has been made aware of a series of complaints and one derivative suit filed by various plaintiffs alleging violations of securities law related to the Company's disclosures regarding patent prosecution of its various drug development assets. On August 24, 2018, David Smith filed a purported class action complaint against the Company in the United States District Court District of Nevada. This complaint and the other complaints that the Company has been made aware of were filed directly after Citron Research published on Twitter on August 20, 2018 its belief that the Company misled investors by failing to disclose that the Company's efforts to secure patent protection had been "finally rejected" by the United States Patent and Trademark Office (USPTO). The Company believes these claims are without merit, and intends to vigorously defend any claims in the event it is served with a complaint.

#### **Item 1a. RISK FACTORS**

Not applicable to a "smaller reporting company" as defined in Item 10(f)(1) of Regulation S-K.

#### **Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

In August 2018, the Company issued 50,000 shares of common stock to IRT Communications LLC, the Company's investor relations consultant, and 25,000 shares of common stock to Larry Raskin, both for compensation related to professional services provided. The total value of the shares issued was \$153,500 and \$80,251, respectively, which represents the fair market value of the Company's common stock as of the issuance dates. The issuance of these shares of common stock was exempt from registration under the Securities Act of 1933, as amended (the "Act"), in reliance on exemptions from the registration requirement of the Act in transactions not involved in a public offering pursuant to Section 4(a)(2) under the Act.

#### **Item 3. DEFAULTS UNDER SENIOR SECURITIES**

None.

#### **Item 4. MINE SAFETY DISCLOSURE**

Not applicable.

#### **Item 5. OTHER INFORMATION**

None.

## Item 6. EXHIBITS

| Exhibit No. | Description of Exhibit   |
|-------------|--|
| 2.1 (1)     | <a href="#"><u>Agreement and Plan of Merger, dated as of July 25, 2013, by and between CannaVEST Corp., a Texas corporation, and CannaVEST Corp., a Delaware corporation.</u></a>                                      |
| 2.1 (2)     | <a href="#"><u>Agreement and Plan of Reorganization by and among CannaVEST Corp., CannaVEST Merger Sub, Inc., CANNAVEST Acquisition LLC, CanX, Inc. and the Starwood Trust, as the Shareholder Representative.</u></a> |
| 3.1 (1)     | <a href="#"><u>Certificate of Incorporation of CannaVEST Corp., as filed on January 26, 2013.</u></a>  |
| 3.2 (1)     | <a href="#"><u>Bylaws of CannaVEST Corp., dated as of January 26, 2013.</u></a>  |
| 3.3 (3)     | <a href="#"><u>Certificate of Amendment to Certificate of Incorporation of CannaVest Corp., as filed on January 4, 2016.</u></a>   |
| 3.4 (4)     | <a href="#"><u>Certificate of Incorporation of the Company, as amended.</u></a>  |
| 3.5 (5)     | <a href="#"><u>Amendment to the Bylaws of the Company, as amended.</u></a>   |
| 3.6 (6)     | <a href="#"><u>Bylaws of the Company, as amended.</u></a>  |
| 4.1 (7)     | <a href="#"><u>CannaVEST Corp. Specimen Stock Certificate</u></a>  |
| 10.1(8)     | <a href="#"><u>Amended and Restated 2013 Equity Incentive Plan, as amended.</u></a>  |
| 31.1*       | <a href="#"><u>Certification of the Chief Executive Officer and Chief Financial Officer pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.</u></a>  |
| 32.1*       | <a href="#"><u>Certification of the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u></a>              |
| 101 INS     | XBRL Instance Document**   |
| 101 SCH     | XBRL Schema Document**   |
| 101 CAL     | XBRL Calculation Linkbase Document**   |
| 101 LAB     | XBRL Labels Linkbase Document**  |
| 101 PRE     | XBRL Presentation Linkbase Document**  |
| 101 DEF     | XBRL Definition Linkbase Document**  |

\* Filed herewith.

\*\* The XBRL related information in Exhibit 101 shall not be deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to liability of that section and shall not be incorporated by reference into any filing or other document pursuant to the Securities Act of 1933, as amended, except as shall be expressly set forth by specific reference in such filing or document.

- (1) Incorporated by reference from an exhibit to our Quarterly Report on Form 10-Q filed on August 13, 2013.
- (2) Incorporated by reference from an exhibit to our Current Report on Form 8-K filed on January 4, 2016.
- (3) Incorporated by reference from an exhibit to our Annual Report on Form 10-K filed on April 14, 2016.
- (4) Incorporated by reference from an exhibit to our Quarterly Report on Form 10-Q filed on May 16, 2016.
- (5) Incorporated by reference from an exhibit to our Current Report on Form 8-K filed on March 22, 2017.
- (6) Incorporated by reference from an exhibit to our Quarterly Report on Form 10-Q filed on May 9, 2017.
- (7) Incorporated by reference from an exhibit to our Current Report on Form 8-K filed on July 31, 2013.
- (8) Incorporated by reference from an exhibit to our Current Report on Form 8-K filed on August 9, 2018.

## 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.

CV SCIENCES, INC.  
(Registrant)

By /s/ Joseph D. Dowling  
Joseph D. Dowling  
Chief Executive Officer and Chief Financial Officer  
(Principal Executive Officer)  
(Principal Financial Officer)  
Dated November 7, 2018

**CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER AND PRINCIPAL FINANCIAL OFFICER PURSUANT TO  
SECURITIES EXCHANGE ACT RULES 13a-14(a) AND 15(d)-14(a), AS ADOPTED PURSUANT TO  
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Joseph D. Dowling, Chief Executive Officer and Chief Financial Officer of CV Sciences, Inc. (the "Company") certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of the Company;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. I am responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under my supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to me by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under my supervision, 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;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report my conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. I have disclosed, based on my most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: November 7, 2018

By: /s/ Joseph D. Dowling  
**Joseph D. Dowling**  
**Chief Executive Officer and Chief Financial Officer**  
**(Principal Executive Officer)**  
**(Principal Financial Officer)**

**CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER AND PRINCIPAL FINANCIAL OFFICER  
PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED  
PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of CV Sciences, Inc. (the "Registrant") on Form 10-Q for the interim period ended September 30, 2018 (the "Report"), I, Joseph D. Dowling, Chief Executive Officer and Chief Financial Officer of the Registrant, do hereby certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

(1) the Report, as filed with the Securities and Exchange Commission, fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Registrant.

Dated: November 7, 2018

By: /s/ Joseph D. Dowling

**Joseph D. Dowling**

**Chief Executive Officer and Chief Financial Officer**

**(Principal Executive Officer)**

**(Principal Financial Officer)**