

KONA GRILL INC
Form 10-Q
November 02, 2006

Table of Contents

**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, 2006

or

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

Commission File Number 000-51491

Kona Grill, Inc.

(Exact Name of Registrant as Specified in Its Charter)

Delaware

(State of Incorporation)

20-0216690

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

7150 East Camelback Road, Suite 220

Scottsdale, Arizona 85251

(480) 922-8100

(Address, including zip code, and telephone number, including area code, of principal executive offices)

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

As of November 1, 2006, there were outstanding 5,822,194 shares of the registrant's common stock, par value \$.01 per share.

TABLE OF CONTENTS
PART I
FINANCIAL INFORMATION

| | Page |
|--|-------------|
| <u>Item 1.</u> | |
| <u>Unaudited Consolidated Financial Statements</u> | |
| <u>Consolidated Balance Sheets as of September 30, 2006 and December 31, 2005</u> | 2 |
| <u>Consolidated Statements of Operations for the Three and Nine Months Ended September 30, 2006 and 2005</u> | 3 |
| <u>Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2006 and 2005</u> | 4 |
| <u>Notes to Consolidated Financial Statements</u> | 5 |
| <u>Item 2.</u> | |
| <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 10 |
| <u>Item 3.</u> | |
| <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 19 |
| <u>Item 4.</u> | |
| <u>Controls and Procedures</u> | 19 |

PART II
OTHER INFORMATION

| | | |
|---------------------|--|----|
| <u>Item 1.</u> | <u>Legal Proceedings</u> | 20 |
| <u>Item 1A.</u> | <u>Risk Factors</u> | 20 |
| <u>Item 2.</u> | <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 20 |
| <u>Item 3.</u> | <u>Defaults Upon Senior Securities</u> | 20 |
| <u>Item 4.</u> | <u>Submission of Matters to a Vote of Security Holders</u> | 20 |
| <u>Item 5.</u> | <u>Other Information</u> | 20 |
| <u>Item 6.</u> | <u>Exhibits</u> | 20 |
| <u>Exhibit 31.1</u> | | |
| <u>Exhibit 31.2</u> | | |
| <u>Exhibit 32.1</u> | | |
| <u>Exhibit 32.2</u> | | |

Table of Contents**PART I FINANCIAL INFORMATION****Item 1. Unaudited Consolidated Financial Statements**

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

| | September 30, 2006 | December 31, 2005 |
|--|-------------------------------|------------------------------|
| | (Unaudited) | (Note 1) |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 1,444 | \$ 4,466 |
| Investments | 17,894 | 24,200 |
| Receivables | 1,436 | 97 |
| Inventories | 469 | 403 |
| Prepays and other | 718 | 161 |
| Total current assets | 21,961 | 29,327 |
| Other assets | 454 | 474 |
| Property and equipment, net | 36,534 | 22,617 |
| Total assets | \$ 58,949 | \$ 52,418 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 5,268 | \$ 1,599 |
| Accrued expenses | 3,388 | 2,327 |
| Current portion of equipment notes | 616 | 729 |
| Total current liabilities | 9,272 | 4,655 |
| Equipment notes | 2,858 | 3,313 |
| Deferred rent | 10,362 | 7,139 |
| Total liabilities | 22,492 | 15,107 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Preferred stock, \$0.01 par value, 2,000,000 shares authorized, none issued at September 30, 2006 and 20,000,000 shares authorized, none issued at December 31, 2005 | | |
| Common stock, \$0.01 par value, 15,000,000 shares authorized, 5,822,194 shares issued and outstanding at September 30, 2006 and 40,000,000 shares authorized, 5,706,420 shares issued and outstanding at December 31, 2005 | 58 | 57 |
| Additional paid-in capital | 41,278 | 40,467 |
| Accumulated deficit | (4,872) | (3,213) |
| Accumulated other comprehensive loss | (7) | |
| Total stockholders' equity | 36,457 | 37,311 |

| | | | | |
|--|----|--------|----|--------|
| Total liabilities and stockholders' equity | \$ | 58,949 | \$ | 52,418 |
|--|----|--------|----|--------|

See accompanying notes to the consolidated financial statements.

Table of Contents

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

| | Three Months Ended | | Nine Months Ended | |
|--|--------------------|-----------|-------------------|-----------|
| | September 30, | | September 30, | |
| | 2006 | 2005 | 2006 | 2005 |
| | (Unaudited) | | | |
| Restaurant sales | \$ 13,812 | \$ 9,455 | \$ 35,883 | \$ 26,385 |
| Costs and expenses: | | | | |
| Cost of sales | 3,962 | 2,699 | 10,156 | 7,588 |
| Labor | 4,311 | 2,873 | 11,042 | 7,940 |
| Occupancy | 905 | 600 | 2,423 | 1,773 |
| Restaurant operating expenses | 1,909 | 1,195 | 4,835 | 3,202 |
| General and administrative | 1,713 | 1,019 | 5,352 | 3,410 |
| Preopening expense | 491 | 462 | 1,471 | 569 |
| Depreciation and amortization | 1,157 | 602 | 2,710 | 1,651 |
| Total costs and expenses | 14,448 | 9,450 | 37,989 | 26,133 |
| (Loss) income from operations | (636) | 5 | (2,106) | 252 |
| Nonoperating income (expense): | | | | |
| Interest income | 240 | 91 | 723 | 96 |
| Interest expense | (72) | (396) | (226) | (759) |
| Loss before provision for income taxes | (468) | (300) | (1,609) | (411) |
| Provision for income taxes | | 6 | 50 | 24 |
| Net loss | \$ (468) | \$ (306) | \$ (1,659) | \$ (435) |
| Net loss per share : | | | | |
| Basic | \$ (0.08) | \$ (0.09) | \$ (0.29) | \$ (0.20) |
| Diluted | \$ (0.08) | \$ (0.09) | \$ (0.29) | \$ (0.20) |
| Weighted average shares used in computation: | | | | |
| Basic | 5,805 | 3,570 | 5,776 | 2,165 |
| Diluted | 5,805 | 3,570 | 5,776 | 2,165 |

See accompanying notes to the consolidated financial statements.

Table of Contents

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

| | Nine Months Ended September 30, | |
|---|--|-------------|
| | 2006 | 2005 |
| | (Unaudited) | |
| Operating activities | | |
| Net loss | \$ (1,659) | \$ (435) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | |
| Depreciation and amortization | 2,710 | 1,651 |
| Compensation expense for issuance of stock options and accelerated vesting of stock options | 665 | 197 |
| Amortization of debt discount | | 343 |
| Change in operating assets and liabilities: | | |
| Receivables | (1,339) | 491 |
| Inventories | (66) | (61) |
| Prepays and other current assets | (557) | (222) |
| Accounts payable | 1,698 | (819) |
| Accrued expenses | 1,061 | 441 |
| Deferred rent | 3,223 | 1,757 |
| Net cash provided by operating activities | 5,736 | 3,343 |
| Investing activities | | |
| Purchase of property and equipment | (14,656) | (7,835) |
| Decrease in other assets | 20 | 15 |
| Net proceeds on purchase and sale of short-term investments | 6,299 | (23,900) |
| Net cash used in investing activities | (8,337) | (31,720) |
| Financing activities | | |
| Proceeds from issuance of notes payable | | 1,094 |
| Repayments of notes payable | (568) | (449) |
| Proceeds from stock options exercised and employee stock purchases | 147 | 38 |
| Proceeds from the issuance of common stock, net of issuance costs | | 28,090 |
| Net cash (used in) provided by financing activities | (421) | 28,773 |
| Net (decrease) increase in cash and cash equivalents | (3,022) | 396 |
| Cash and cash equivalents at the beginning of the period | 4,466 | 3,098 |
| Cash and cash equivalents at the end of the period | \$ 1,444 | \$ 3,494 |
| Supplemental disclosures of cash flow information | | |
| Cash paid for interest | \$ 226 | \$ 416 |
| Noncash investing and financing activities | | |
| Increase (decrease) in accounts payable related to property and equipment additions | \$ 1,971 | \$ (1,169) |
| Conversion of convertible promissory note to preferred stock | \$ | \$ 3,000 |

See accompanying notes to the consolidated financial statements.

Table of Contents

KONA GRILL, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation

Kona Grill, Inc. (referred to herein as the Company or we, us, and our) owns and operates upscale casual dining restaurants under the name Kona Grill. We completed our initial public offering during August 2005, issuing 2,875,000 common shares at an offering price of \$11.00. As part of the offering, all outstanding preferred stock was converted into shares of common stock. Our common stock trades on the NASDAQ National Market under the symbol KONA.

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with the rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. In our opinion, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and nine month periods ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006.

The consolidated balance sheet at December 31, 2005 has been derived from the audited consolidated financial statements at that date, but does not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. Accordingly, these financial statements should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2005.

Reclassifications

Certain amounts shown in prior periods consolidated financial statements have been reclassified to conform to the current quarter consolidated financial statement presentation.

2. Summary of Significant Accounting Policies

Cash

Cash and cash equivalents consist of cash, money market funds, and highly liquid short-term fixed income securities with a remaining maturity of 90 days or less when acquired. Amounts receivable from credit card processors are also considered cash equivalents because they are both short-term and highly liquid in nature and are typically converted to cash within one day of the sales transaction. Under the Company s asset classification practices, when there is no legal right of offset against cash balances in a specific financial institution, uncleared checks are classified as accounts payable. Uncleared checks totaling approximately \$495,000 were included in accounts payable as of September 30, 2006.

Deferred Rent

We lease our restaurant locations under operating lease agreements with initial terms of approximately 10 to 15 years. Most of these agreements require minimum annual rent payments plus contingent rent payments based on a percentage of restaurant sales which exceed the minimum base rent. Contingent rent payments, to the extent they exceed minimum payments, are accrued over the periods in which the liability is incurred. Rent expense associated with these contingent payments is recorded prior to the achievement of specified sales levels if exceeding such amount is considered probable and is estimable. The lease agreements typically also require scheduled increases to minimum annual rent payments. For leases that contain rent escalations, we record the total rent payable over the initial lease term (including the construction period) on a straight-line basis over the life of the initial lease term. Any difference between minimum rent and straight-line rent is recorded as deferred rent. Deferred rent also includes tenant improvement allowances which are amortized as a reduction of rent expense on a straight-line basis over the initial term of the lease.

Table of Contents

KONA GRILL, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

For leases that commenced subsequent to January 1, 2006, straight-line rent expense incurred from the date of possession to the restaurant opening date is recorded as preopening expense in accordance with Financial Accounting Standards Board (FASB) Staff Position No. 13-1, *Accounting for Rental Costs Incurred During a Construction Period* (FSP FAS No. 13-1). For leases that commenced prior to January 1, 2006, rent expense incurred from the date of possession through the completion of construction was capitalized and included in property and equipment and amortized over the initial life of the lease.

Preopening Expense

Preopening expense, consisting primarily of manager salaries, advertising, travel, food and beverage, employee payroll and related training costs incurred prior to the opening of a restaurant, are expensed as incurred. Also, as a result of the adoption of FSP FAS No. 13-1 on January 1, 2006, straight-line rent recorded for the period between the date of possession and the restaurant opening date, which generally approximates five months, is included in preopening expense. As a result of the adoption of FSP FAS No. 13-1, our preopening costs were increased by approximately \$95,000 and \$320,000 during the three and nine months ended September 30, 2006, respectively.

Net Income (Loss) Per Share

In accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 128, *Earnings Per Share*, basic net income (loss) is computed by dividing net income (loss) by the weighted average number of common shares outstanding during the period. Diluted net income per share includes the dilutive effect of potential warrant and stock option exercises calculated using the treasury stock method.

| | Three Months Ended | | Nine Months Ended | |
|---------------------------------|---------------------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2006 | 2005 | 2006 | 2005 |
| | (In thousands, except per share data) | | | |
| Numerator: | | | | |
| Net loss | \$ (468) | \$ (306) | \$ (1,659) | \$ (435) |
| Denominator: | | | | |
| Weighted average shares Basic | 5,805 | 3,570 | 5,776 | 2,165 |
| Effect of dilutive securities: | | | | |
| Stock options and warrants | | | | |
| Convertible shares | | | | |
| Weighted average shares Diluted | 5,805 | 3,570 | 5,776 | 2,165 |
| Net loss per share: | | | | |
| Basic | \$ (0.08) | \$ (0.09) | \$ (0.29) | \$ (0.20) |
| Diluted | \$ (0.08) | \$ (0.09) | \$ (0.29) | \$ (0.20) |

At September 30, 2006 and 2005, there were 580,339 and 488,479 stock options outstanding, respectively, and 250,000 warrants outstanding for which the effect of issuing these options and warrants were excluded from the calculation of diluted net loss per share because they were anti-dilutive.

Recent Accounting Pronouncements

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 is an interpretation of FASB Statement No. 109, *Accounting for Income Taxes*, and it seeks to reduce the diversity in practice associated with certain aspects of measurement and recognition in accounting for income taxes. In

addition, FIN 48 requires expanded disclosure with respect to the uncertainty in income taxes and is effective for our 2007 fiscal year. We are currently evaluating the impact, if any, that FIN 48 will have on our financial statements.

Table of Contents

KONA GRILL, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 clarifies the principle that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. Under the standard, fair value measurements would be separately disclosed by level within the fair value hierarchy. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years, with early adoption permitted. We have not yet determined the impact, if any, that the implementation of SFAS No. 157 will have on our results of operations or financial condition.

3. Investments

The following is a summary of available-for-sale securities at September 30, 2006 (in thousands):

| | Adjusted Cost | Gross Unrealized Losses | Estimated Fair Value |
|-----------------------------------|--------------------------|--|-------------------------------------|
| Auction rate municipal securities | \$ 14,250 | \$ | \$ 14,250 |
| Government bonds | 3,000 | (6) | 2,994 |
| Corporate securities | 651 | (1) | 650 |
| | \$ 17,901 | \$ (7) | \$ 17,894 |

The original maturity date for our government bonds and corporate securities is one year or less. Although original maturities of our auction rate securities are generally longer than one year, we have the right to sell these securities each auction date subject to the availability of buyers. The original maturity dates for these investments ranged from 2029 to 2044 at September 30, 2006. At December 31, 2005, there were no unrealized gains or losses on our available-for-sale securities.

4. Accrued Expenses

Accrued expenses consisted of the following (in thousands):

| | September 30, 2006 | December 31, 2005 |
|---------------------------|-------------------------------|------------------------------|
| Accrued payroll | \$ 1,494 | \$ 798 |
| Sales tax | 384 | 299 |
| Accrued rent | 279 | 126 |
| Gift cards | 270 | 395 |
| Business and income taxes | 259 | 284 |
| Other | 702 | 425 |
| | \$ 3,388 | \$ 2,327 |

5. Stock-Based Compensation

We maintain stock option plans which provide for discretionary grants of incentive stock options and non-qualified stock options to our employees, consultants, and non-employee directors. These plans authorize the granting of stock options, restricted stock, and other types of awards consistent with the purpose of the plans. The number of shares authorized for issuance under our plans as of September 30, 2006 totals 763,024 of which 182,685 shares were available for future issuance. Stock options granted under these plans are granted with an exercise price at or above

the fair market value of the underlying common stock at the date of grant and generally expire five or ten years from the date of grant. Employee and consultant stock options generally vest 25 percent on the date of grant and 25 percent on each annual anniversary date thereafter. Non-employee director options vest 100 percent on the date of grant. Prior to January 1, 2006, we accounted for our stock-based compensation in accordance with APB No. 25, *Accounting for Stock Issued to Employees*, and related interpretations and adopted the disclosure-only provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*. In accordance with APB No. 25, no stock-based

Table of Contents

KONA GRILL, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

compensation expense was recognized in our prior year net loss for grants of stock options to employees because we granted stock options with an exercise price equal to the fair market value of the stock on the date of grant. However, share-based compensation expense of \$151,000 was recognized for the nine months ended September 30, 2005, as a result of the accelerated vesting of all outstanding unvested employee stock options.

Had we used the fair value method required by SFAS No. 123 for the three and nine months ended September 30, 2005, our net loss and net loss per share would have been increased to the pro-forma amounts illustrated as follows (in thousands, except per share data):

| | Three Months Ended September 30, 2005 | Nine Months Ended September 30, 2005 |
|---|--|---|
| Net loss, as reported | \$ (306) | \$ (435) |
| Add: Stock-based compensation expense included in reported earnings, net of related tax effect ^(a) | | 151 |
| Deduct: Total stock-based compensation income (expense) determined under fair value based method for all awards, net of related tax effect ^(a) | 6 | (341) |
| Pro forma net loss | \$ (300) | \$ (625) |
| Net loss per share: | | |
| Basic, as reported | \$ (0.09) | \$ (0.20) |
| Basic, pro forma | \$ (0.08) | \$ (0.29) |
| Diluted, as reported | \$ (0.09) | \$ (0.20) |
| Diluted, pro forma | \$ (0.08) | \$ (0.29) |

^(a) Income taxes have been offset by a valuation allowance. See Note 7 of Notes to Consolidated Financial Statements.

Effective January 1, 2006, we adopted the fair value recognition provisions of SFAS 123R, *Share-Based Payment*, using the modified prospective transition method. Under this transition method, compensation cost recognized in the three and nine months ended September 30, 2006 includes compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with SFAS 123R. All options granted prior to January 1, 2006 were fully vested. The adoption of SFAS 123R increased our three and nine months ended September 30, 2006 reported operating loss, loss before income taxes and net loss by \$263,000 and \$665,000, respectively, and increased basic and diluted net loss per share by \$0.05 per share and \$0.12 per share,

respectively.

Results of prior periods do not reflect any restated amounts and we had no cumulative effect adjustment upon adoption of SFAS 123R under the modified prospective method. Our policy is to recognize compensation cost for awards with only service conditions using a graded vesting schedule on a straight line basis over the requisite service period for the entire award.

The fair value of each option award is estimated on the date of grant using the Black-Scholes option pricing model and is affected by assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to the actual and projected employee stock option exercise behavior. The use of an option pricing model also requires the use of a number of complex assumptions including expected volatility, risk-free interest rate, expected dividends, and expected term. Expected volatility is based on the historical volatility of a peer group of companies over the expected life of the option as we do not have enough history trading as a public company to calculate our own stock price volatility. We utilize historical data to estimate option exercise and employee termination behavior within the valuation model. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant for the expected term of the option. SFAS 123R also requires us to estimate forfeitures at the time of grant and revise these estimates, if necessary, in subsequent periods if actual forfeitures differ from those estimates. We estimate forfeitures based on historical experience. The weighted-average grant

Table of Contents

KONA GRILL, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

date fair value of employee stock options granted during the three and nine months ended September 30, 2006 was \$5.48 and \$4.61 per share, respectively, and was determined using the following weighted-average assumptions:

| | Three Months Ended September 30, 2006 | Nine Months Ended September 30, 2006 |
|--------------------------|--|---|
| Dividend yield | 0.0% | 0.0% |
| Expected volatility | 37.1% | 39.3% |
| Risk-free interest rate | 4.6% | 4.8% |
| Expected life (in years) | 5.0 | 4.5 |

A summary of our stock option activity as of September 30, 2006, and changes during the nine months then ended is presented in the following table:

| | Shares Under Option | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value |
|---|------------------------------------|--|--|--|
| Outstanding options at December 31, 2005 | 475,879 | \$ 5.56 | | |
| Granted | 328,000 | 12.64 | | |
| Forfeited | (98,764) | 5.09 | | |
| Exercised | (124,776) | 5.60 | | |
| Outstanding options at September 30, 2006 | 580,339 | \$ 9.63 | 5.84 years | \$ 3,110,000 |
| Exercisable | 383,839 | \$ 7.79 | 6.42 years | \$ 2,763,000 |

As of September 30, 2006, there was approximately \$794,000 of total unrecognized compensation cost related to unvested share-based compensation arrangements that is expected to be recognized over a weighted average period of 2.11 years. The intrinsic value of options exercised during the nine months ended September 30, 2006 was \$660,000.

6. Comprehensive Income (Loss)

Comprehensive income (loss) is defined as the aggregate change in stockholders' equity, excluding changes in ownership interests. It is the sum of net income (loss) and changes in unrealized gains or losses on available-for-sale securities. The components of comprehensive income (loss), net of related tax, for the three and nine months ended September 30, 2006 and 2005 were as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|---|-------------|--|-------------|
| | 2006 | 2005 | 2006 | 2005 |
| Net loss | \$ (468) | \$ (306) | \$ (1,659) | \$ (435) |
| Net unrealized gains (losses) on available-for-sale securities | 9 | | (7) | |
| Total comprehensive loss | \$ (459) | \$ (306) | \$ (1,666) | \$ (435) |

7. Income Taxes

For the three months ended September 30, 2006 and 2005, we recorded income tax expense of \$0 and \$6,000, respectively. For the nine months ended September 30, 2006 and 2005, income tax expense of \$50,000 and \$24,000, respectively, was recorded. Tax expense results from state income taxes due to our operations in states where no state net operating loss carryforwards are available. We have recorded valuation allowances for the full amount of our net deferred tax assets (including net operating loss and tax credit carryforwards) given that the more likely than not recoverability criteria has not been met in management's opinion.

8. Commitments and Contingencies

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

Table of Contents**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

This information should be read in conjunction with the unaudited consolidated financial statements and notes thereto included in Item 1 of Part I of this Quarterly Report and the audited consolidated financial statements and notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations for the year ended December 31, 2005 contained in our 2005 Annual Report on Form 10-K. The following discussion contains forward-looking statements that involve risks, uncertainties, and assumptions. Forward-looking statements include statements regarding our expectations, anticipation, intentions, beliefs, or strategies regarding the future. Forward-looking statements relating to our future economic performance, plans and objectives for future operations, and projections of revenue and other financial items that are based on our beliefs as well as assumptions made by and information currently available to us. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of a variety of factors, including those set forth under Item 1A, Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2005 and other reports filed from time to time with the Securities and Exchange Commission.

Overview

We currently own and operate thirteen restaurants located in eight states, including our most recent restaurant in Oak Brook, Illinois which opened after the end of the third quarter. We offer freshly prepared food, personalized service, and a warm, contemporary ambiance that creates an exceptional, yet affordable dining experience that we believe exceeds many traditional casual dining restaurants with whom we compete. Our high-volume upscale casual restaurants feature a diverse selection of mainstream American dishes and award-winning sushi as well as a variety of flavorful appetizers and entrees. Our menu items are freshly prepared and incorporate over 40 signature sauces and dressings that we make from scratch, creating broad-based appeal for the lifestyle and taste trends of a diverse group of guests. Our menu is standardized for all of our restaurants allowing us to deliver consistent high-quality meals. We believe that our offerings and generous portions offer our guests an attractive price-value proposition.

We continue to follow a disciplined growth plan focused largely on expanding our presence in new markets. To date, we have funded our restaurant development, working capital, and general corporate needs with cash flows from operations, loans from affiliates, the sale of common and preferred stock, receipt of landlord tenant improvement allowances, and borrowings under equipment term loans. During 2006, we opened four restaurants in Dallas, Texas; Houston, Texas; Lincolnshire, Illinois and Oak Brook, Illinois. We plan to open a restaurant in Naples, Florida in December 2006, which will complete our scheduled 2006 openings with five new restaurants. We plan to open six restaurants during 2007, which will expand our presence in both new and existing markets. Our goal is for our new restaurants to generate annual unit volumes of \$4.5 million within 24 months of opening. We believe our typical new restaurants experience gradually increasing unit volumes as guests begin to discover our concept and we begin to generate market awareness. Our restaurants are also subject to seasonal fluctuations. Despite our limited operating history, we have identified that sales in most of our restaurants typically are higher during the spring and summer months and winter holiday season.

We experience various trends in our operating cost structure. Cost of sales, labor, occupancy, and other operating expenses for our restaurants open at least 12 months generally trend consistent with restaurant sales, and we analyze those costs as a percentage of restaurant sales. We anticipate that our new restaurants will generally take several months to achieve operating efficiencies and planned sales levels due to challenges typically associated with new restaurants, including lack of market recognition and the need to hire and sufficiently train employees, as well as other factors. We expect cost of sales and labor expenses as a percentage of restaurant sales to be higher when we open a new restaurant, but decrease as a percentage of restaurant sales as the restaurant matures and as the restaurant management and employees become more efficient operating that unit. The majority of our general and administrative costs are fixed costs. We expect our general and administrative spending to increase as we add executive management, corporate personnel, and infrastructure to support our growth and the requirements associated with being a public company. Thereafter, we expect our general and administrative costs to decrease as a percentage of restaurant sales as we begin to realize economies of scale.

Table of Contents

Key Measures We Use to Evaluate Our Company

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

Number of Restaurant Openings. Number of restaurant openings reflects the number of restaurants opened during a particular reporting period.

Same-store Sales Growth. Same-store sales growth reflects the periodic change in restaurant sales for the comparable restaurant base. In calculating same-store sales growth, we include a restaurant in the comparable restaurant base after it has been in operation for more than 18 months. Same-store sales growth can be generated by an increase in guest traffic counts or by increases in the per person average check amount. Menu price changes and the mix of menu items sold can affect the per person average check amount.

Average Unit Volume. Average unit volume represents the average restaurant sales for all of our restaurants open for at least 12 months before the beginning of the period measured.

Restaurant Operating Profit. Restaurant operating profit is defined as restaurant sales minus cost of sales, labor, occupancy, and restaurant operating expenses. Restaurant operating profit does not include general and administrative expenses, depreciation and amortization, and preopening expenses. We believe restaurant operating profit is an important component of financial results because it is a widely used metric within the restaurant industry to evaluate restaurant-level productivity, efficiency, and performance. We use restaurant operating profit as a key metric to evaluate our restaurants' financial performance compared with our competitors.

Sales Per Square Foot. Sales per square foot represents the restaurant sales for our restaurants open for at least 12 months, divided by the total square feet for such restaurants.

Key Financial Definitions

Restaurant Sales. Restaurant sales includes gross food and beverage sales, net of promotions and discounts.

Cost of Sales. Cost of sales consists of food and beverage costs.

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

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

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

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

Preopening Expense. Preopening expense consists of costs incurred prior to opening a new restaurant and is comprised principally of manager salaries and relocation, payroll and related training costs for new employees, including practice and rehearsal of service activities, and rent expense incurred during construction. We expense restaurant preopening expenses as incurred, and we expect preopening expenses to be similar for each new restaurant opening, which typically commences five months prior to a restaurant opening.

Table of Contents

Depreciation and Amortization. Depreciation and amortization expense consists of the depreciation of property and equipment and gains and losses on disposal of assets. We currently have no intangible assets or goodwill recorded on our consolidated balance sheet.

Interest Income. Interest income consists of interest earned on our cash and investments.

Interest Expense. Interest expense includes the cost of servicing our debt obligations, including the amortization of debt discounts.

Financial Performance Overview

The following table sets forth certain information regarding our financial performance for the three and nine months ended September 30, 2006 and 2005.

| | Three Months Ended | | Nine Months Ended | |
|--|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2006 | 2005 | 2006 | 2005 |
| Restaurant sales growth | 46.1% | 44.0% | 36.0% | 51.4% |
| Same-store sales growth (1) | 4.0% | 3.4% | 5.1% | 4.6% |
| Average unit volume (in thousands) (2) | \$ 1,328 | \$ 1,335 | \$ 3,873 | \$ 3,917 |
| Sales per square foot (2) | \$ 190 | \$ 196 | \$ 554 | \$ 574 |
| Restaurant operating profit (in thousands) (3) | \$ 2,725 | \$ 2,088 | \$ 7,427 | \$ 5,882 |
| Restaurant operating profit as a percentage of sales (3) | 19.7% | 22.2% | 20.7% | 22.3% |

(1) Same-store sales growth reflects the periodic change in restaurant sales for the comparable restaurant base. In calculating same-store sales growth, we include a restaurant in the comparable restaurant base after it has been in operation for more than 18 months.

(2) Includes only those restaurants open for at least 12 months before the beginning of the period measured.

(3) Restaurant operating profit is not a financial measurement determined in accordance with generally accepted accounting principles and should not be considered in isolation or as an alternative to (loss) income from operations. Restaurant operating profit may not be comparable to the same or similarly titled measures computed by other companies. The table below sets forth our calculation of restaurant operating profit and a reconciliation to (loss) income from operations, the most comparable GAAP measure.

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-------------------------------|---|-------------|--|-------------|
| | 2006 | 2005 | 2006 | 2005 |
| | (In thousands) | | | |
| Restaurant sales | \$ 13,812 | \$ 9,455 | \$ 35,883 | \$ 26,385 |
| Costs and expenses: | | | | |
| Cost of sales | 3,962 | 2,699 | 10,156 | 7,588 |
| Labor | 4,311 | 2,873 | 11,042 | 7,940 |
| Occupancy | 905 | 600 | 2,423 | 1,773 |
| Restaurant operating expenses | 1,909 | 1,195 | 4,835 | 3,202 |

Edgar Filing: KONA GRILL INC - Form 10-Q

| | | | | |
|---------------------------------|----------|-------|------------|--------|
| Restaurant operating profit | 2,725 | 2,088 | 7,427 | 5,882 |
| Deduct other costs and expenses | | | | |
| General and administrative | 1,713 | 1,019 | 5,352 | 3,410 |
| Preopening expense | 491 | 462 | 1,471 | 569 |
| Depreciation and amortization | 1,157 | 602 | 2,710 | 1,651 |
| (Loss) income from operations | \$ (636) | \$ 5 | \$ (2,106) | \$ 252 |

Table of Contents

| | Percentage of Restaurant Sales Three Months Ended September 30, | | Percentage of Restaurant Sales Nine Months Ended September 30, | |
|---------------------------------|--|--------|---|--------|
| | 2006 | 2005 | 2006 | 2005 |
| Restaurant sales | 100.0% | 100.0% | 100.0% | 100.0% |
| Costs and expenses: | | | | |
| Cost of sales | 28.7 | 28.5 | 28.3 | 28.8 |
| Labor | 31.2 | 30.4 | 30.8 | 30.1 |
| Occupancy | 6.6 | 6.3 | 6.7 | 6.7 |
| Restaurant operating expenses | 13.8 | 12.6 | 13.5 | 12.1 |
| Restaurant operating profit | 19.7 | 22.2 | 20.7 | 22.3 |
| Deduct other costs and expenses | | | | |
| General and administrative | 12.4 | 10.8 | 14.9 | 12.9 |
| Preopening expense | 3.5 | 4.9 | 4.1 | 2.1 |
| Depreciation and amortization | 8.4 | 6.4 | 7.6 | 6.3 |
| (Loss) income from operations | (4.6)% | 0.1% | (5.9)% | 1.0% |

| | Nine Months Ended September 30, 2006 | Year Ended December 31, 2005 |
|------------------------------|---|------------------------------------|
| Store Growth Activity | | |
| Beginning Restaurants | 9 | 7 |
| Openings | 3 | 2 |
| Closings | | |
| Total | 12 | 9 |

Critical Accounting Policies and Estimates

There have been no material changes to our critical accounting policies and estimates from the information provided in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, included in our Annual Report on Form 10-K for the year ended December 31, 2005, except as follows:

Accounting for Stock Options

Effective January 1, 2006, we adopted the fair value recognition provisions of Statement of Financial Accounting Standards 123-revised 2004 (SFAS 123R), *Share-Based Payment*, using the modified prospective transition method. Under this transition method, compensation cost recognized in the three and nine months ended September 30, 2006 includes compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with SFAS 123R. All options granted prior to January 1, 2006 were fully vested. The adoption of SFAS 123R increased our three and nine months ended September 30, 2006 reported operating loss, loss before income taxes and net loss by \$263,000 and \$665,000, respectively, and increased basic and diluted net loss per share by \$0.05 per share and \$0.12 per share, respectively.

The fair value of each option award is estimated on the date of grant using the Black-Scholes option pricing model and is affected by assumptions regarding a number of highly complex and subjective variables. These variables

include, but are not limited to the actual and projected employee stock option exercise behavior. The use of an option pricing model also requires the use of a number of complex assumptions including expected volatility, risk-free interest rate, expected dividends, and expected term. Expected volatility is based on the historical volatility of a peer group of companies over the expected life of the option as we do not have enough history trading as a public company to calculate our own stock price volatility. We utilize historical data to estimate option exercise and employee termination behavior within the valuation model. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant for the expected term of the option. SFAS 123R also requires us to estimate

Table of Contents

forfeitures at the time of grant and revise these estimates, if necessary, in subsequent periods if actual forfeitures differ from those estimates. We estimate forfeitures based on historical experience. The weighted-average estimated value of employee stock options granted during the three and nine months ended September 30, 2006 was \$5.48 and \$4.61 per share, respectively.

See Note 5 to the consolidated financial statements, Stock-Based Compensation, for a more detailed discussion of the effects of SFAS 123R on our results of operations and financial condition. If factors change and we employ different assumptions in the application of SFAS 123R in future periods, the compensation expense that we record under SFAS 123R may differ significantly from what we have recorded in the current period.

Results of Operations

The following table sets forth, for the periods indicated, the percentage of restaurant sales of certain items in our financial statements.

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|--------|------------------------------------|--------|
| | 2006 | 2005 | 2006 | 2005 |
| Restaurant sales | 100.0% | 100.0% | 100.0% | 100.0% |
| Costs and expenses: | | | | |
| Cost of sales | 28.7 | 28.5 | 28.3 | 28.8 |
| Labor | 31.2 | 30.4 | 30.8 | 30.1 |
| Occupancy | 6.6 | 6.3 | 6.7 | 6.7 |
| Restaurant operating expenses | 13.8 | 12.6 | 13.5 | 12.1 |
| General and administrative | 12.4 | 10.8 | 14.9 | 12.9 |
| Preopening expense | 3.5 | 4.9 | 4.1 | 2.1 |
| Depreciation and amortization | 8.4 | 6.4 | 7.6 | 6.3 |
| Total costs and expenses | 104.6 | 99.9 | 105.9 | 99.0 |
| (Loss) income from operations | (4.6) | 0.1 | (5.9) | 1.0 |
| Nonoperating income (expense): | | | | |
| Interest income | 1.7 | 1.0 | 2.0 | 0.4 |
| Interest expense | (0.5) | (4.2) | (0.6) | (2.9) |
| Loss before provision for income taxes | (3.4) | (3.1) | (4.5) | (1.5) |
| Provision for income taxes | | 0.1 | 0.1 | 0.1 |
| Net loss | (3.4)% | (3.2)% | (4.6)% | (1.6)% |

Three Months Ended September 30, 2006 Compared with Three Months Ended September 30, 2005

Restaurant Sales. Restaurant sales increased \$4.3 million, or 46.1%, to \$13.8 million during the third quarter of 2006 compared to \$9.5 million during the third quarter of 2005. The sales increase is primarily a result of a \$4.0 million increase associated with the opening of three new restaurants during 2006 and two restaurants opened during the third quarter of 2005, and a \$0.3 million increase related to a 4.0% increase in same-store sales. The increase in same-store sales benefited from an effective menu price increase of approximately 2.3%.

Cost of Sales. Cost of sales as a percentage of restaurant sales increased to 28.7% during the third quarter of 2006 from 28.5% during the prior year period. Cost of sales for the third quarter of 2006 were negatively impacted by higher produce costs, as well as the impact of our recently opened restaurants which historically have lower sales volume and higher cost of sales than our more mature restaurants as it generally takes several months for our new restaurants to achieve operating efficiencies and planned sales levels.

Labor. Labor expenses as a percentage of restaurant sales increased to 31.2% during the third quarter of 2006 from 30.4% during the third quarter of 2005. This increase was primarily due to the impact of our recently opened

Table of Contents

restaurants which historically have lower sales and higher labor costs than our more mature restaurants as a result of operating inefficiencies typically associated with opening a new restaurant. In addition, we are paying higher average wages to attract qualified restaurant managers in 2006 as compared to 2005.

Occupancy. Occupancy expenses as a percentage of restaurant sales increased 0.3% to 6.6% during the third quarter of 2006 from 6.3% during the prior year period. The increase as a percentage of restaurant sales was primarily due to less leveraging of the fixed portion of occupancy expenses, due in part to lower sales volume at our Sugar Land restaurant.

Restaurant Operating Expenses. Restaurant operating expenses as a percentage of restaurant sales increased 1.2% to 13.8% during the third quarter of 2006 from 12.6% during the third quarter of 2005. The increase is primarily the result of increased expenditures for advertising and promotion, higher utilities and increased staff training costs.

General and Administrative. General and administrative expenses increased by \$0.7 million to \$1.7 million during the third quarter of 2006 from \$1.0 million during the prior year period. The \$0.7 million increase was primarily attributable to \$0.3 million, or 1.9% of restaurant sales, for stock-based compensation attributed to the expensing of stock options under SFAS 123R and \$0.4 million related to the addition of personnel and infrastructure to support our growth strategy and the reporting and compliance requirements of being a public company.

Preopening Expense. Preopening expense was \$0.5 million during both the third quarter of 2006 and 2005.

Preopening expense incurred during the third quarter of 2006 primarily relates to the opening of our Houston, Texas restaurant in August 2006, the opening of our Oak Brook, Illinois restaurant in October 2006 and the planned opening of our Naples, Florida restaurant in December 2006. Preopening expense during the prior year period was related to the openings of our Sugar Land, Texas and San Antonio, Texas restaurants during the third quarter of 2005.

Preopening expense for the 2006 periods also includes approximately \$0.1 million of rent required to be expensed under Financial Accounting Standards Board Staff Position No. 13-1, *Accounting for Rental Costs Incurred During a Construction Period*. Prior to 2006, rental costs incurred during a construction period were capitalized and amortized over the initial term of the lease agreement.

Depreciation and Amortization. Depreciation and amortization expense increased \$0.6 million to \$1.2 million during the third quarter of 2006 from \$0.6 million during the prior year period. The increase was principally the result of the additional depreciation and amortization of three restaurants opened in 2006 and depreciation of the two restaurants opened during the third quarter of 2005. Depreciation and amortization expense also includes \$0.1 million, or 1.0% of restaurant sales, of accelerated depreciation related to our decision earlier this year to retrofit our existing restaurants with a new point of sale system. Depreciation and amortization expense as a percentage of restaurant sales increased 2.0% to 8.4% during the third quarter of 2006 from 6.4% during the third quarter of 2005. The increase consisted of 1.0% for accelerated depreciation on our point of sale system discussed above and 1.0% due to the impact of higher average capital expenditures for our newer restaurants and lower sales volume at our Sugar Land location.

Interest Income. Interest income of \$0.2 million during the third quarter of 2006 increased \$0.1 million from the third quarter of 2005 primarily due to interest income earned from the investment of proceeds from our initial public offering completed in August 2005.

Interest Expense. Interest expense of \$0.1 million during the third quarter of 2006 decreased \$0.3 million from \$0.4 million during the prior year period. The decrease is primarily the result of a \$0.3 million one-time, non-cash charge to interest expense from the conversion of our convertible subordinated promissory note into common stock prior to our initial public offering.

Provision for Income Taxes. During both the third quarter of 2006 and 2005, we did not incur a federal income tax liability and did not record a provision for state income taxes during the third quarter of 2006. We recorded state income taxes of \$6,000 during the third quarter of 2005 for states in which no state net operating loss carryforwards exist.

Table of Contents***Nine Months Ended September 30, 2006 Compared with Nine Months Ended September 30, 2005***

Restaurant Sales. Restaurant sales increased by \$9.5 million, or 36.0%, to \$35.9 million during the first nine months of 2006 from \$26.4 million during the first nine months of 2005 primarily as a result of an \$8.3 million increase related to two restaurants opened during the third quarter of 2005 and the opening of three new restaurants in 2006, and a \$1.2 million increase related to a 5.1% increase in same-store sales. The increase in same-store sales also benefited from a price increase of approximately 1.5% implemented during March of 2006 and price increases of approximately 0.7% and 1.3% taken in April and September of 2005, respectively.

Cost of Sales. Cost of sales as a percentage of restaurant sales decreased to 28.3% during the first nine months of 2006 from 28.8% during the prior year period. The reduction in cost of sales as a percentage of restaurant sales was primarily the result of continued focus on efficient operations and purchasing leverage as well as more favorable seafood and meat pricing, partially offset by higher produce costs.

Labor. Labor expenses as a percentage of restaurant sales increased to 30.8% during the first nine months of 2006 from 30.1% during the prior year period. This increase was primarily due to the fact that our new restaurants experience higher labor cost for several months after opening as the restaurant management and employees become more efficient operating that unit. The increase in labor expenses as a percentage of sales is also attributed to our Sugar Land restaurant which currently has lower sales and higher labor costs than our other restaurants. In addition, we are paying higher average wages to attract qualified restaurant managers in 2006 as compared to 2005.

Occupancy. Occupancy expense as a percentage of restaurant sales remained consistent at 6.7% during the first nine months of 2006 and 2005.

Restaurant Operating Expenses. Restaurant operating expenses as a percentage of restaurant sales increased 1.4% to 13.5% during the first nine months of 2006 from 12.1% during the prior year period. The increase is primarily the result of higher utilities cost, increased advertising and promotion costs, additional staff training costs, and higher repair and maintenance and supplies costs.

General and Administrative. General and administrative expenses increased by \$1.9 million to \$5.3 million during the first nine months of 2006 from \$3.4 million during the prior year period. The \$1.9 million increase is primarily attributable to \$1.0 million related to the planned addition of corporate personnel and infrastructure to support our growth strategy and the reporting and compliance requirements of being a public company. In addition, during the first nine months of 2006, we incurred a net increase of \$0.5 million for stock-based compensation attributed to the expensing of stock options. Also, the first nine months of 2006 includes approximately \$0.4 million of separation costs related to the retirement of our former president and chief executive officer.

Preopening Expense. Preopening expense was \$1.5 million during the first nine months of 2006 compared to \$0.6 million during the prior year period. The increase in preopening expense primarily relates to the opening of three restaurants during the first nine months of 2006 as compared to two restaurants in the prior year period, in addition to \$0.3 million in preopening expense for restaurants scheduled to open in the fourth quarter of 2006. Preopening expense also includes approximately \$0.3 million of rent expense required to be expensed under FSP FAS No. 13-1, as discussed previously.

Depreciation and Amortization. Depreciation and amortization expense increased \$1.0 million to \$2.7 million during the first nine months of 2006 from \$1.7 million during the prior year period. The increase was primarily the result of the additional depreciation and amortization on three restaurants opened in 2006 and two restaurants opened since the third quarter of 2005, as well as accelerated depreciation related to the retrofit of our existing restaurants with a new point of sale system. Depreciation and amortization expense as a percentage of restaurant sales increased 1.3% to 7.6% during the first nine months of 2006 from 6.3% during the first nine months of 2005. The percentage increase was primarily the result of the impact of our Sugar Land restaurant which is experiencing lower sales volumes than our other restaurants, in addition to higher average capital expenditures for our recently opened restaurants and accelerated depreciation related to the point of sale system discussed above.

Table of Contents

Interest Income. Interest income of \$0.7 million during the first nine months of 2006 increased \$0.6 million from the first nine months of 2005 primarily due to interest income earned from the investment of proceeds from our initial public offering completed in August 2005.

Interest Expense. Interest expense was \$0.2 million during the first nine months of 2006 compared to \$0.8 million during the prior year period. The decrease is primarily due to a \$0.3 million one-time, non-cash charge to interest expense recorded during the third quarter of 2005 from the conversion of our convertible subordinated promissory note, in addition to a reduction of interest expense on this note that was converted into common stock prior to our initial public offering.

Provision for Income Taxes. During both the first nine months of 2006 and 2005, we did not incur a federal income tax liability; however, we recorded state income taxes of \$50,000 during the first nine months of 2006 and \$24,000 during the first nine months of 2005 for states in which no state net operating loss carryforwards exist.

Potential Fluctuations in Quarterly Results and Seasonality

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

- timing of new restaurant openings and related expenses;

- restaurant operating costs and preopening costs for our newly-opened restaurants, which are often materially greater during the first several months of operation than thereafter;

- labor availability and costs for hourly and management personnel;

- profitability of our restaurants, especially in new markets;

- increases and decreases in comparable restaurant sales;

- impairment of long-lived assets and any loss on restaurant closures;

- changes in borrowings and interest rates;

- general economic conditions;

- weather conditions or natural disasters;

- timing of certain holidays;

- new or revised regulatory requirements and accounting pronouncements;

- changes in consumer preferences and competitive conditions; and

- fluctuations in commodity prices.

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

Table of Contents**Liquidity and Capital Resources**

Our primary liquidity and capital requirements have been for new restaurant development, working capital, and general corporate needs. We believe the proceeds from our initial public offering in August 2005 and cash generated from operations will be sufficient to meet our capital requirements through 2006. Beyond 2006, additional financing may be needed to fund working capital and restaurant development. Changes in our operating plans, acceleration of our expansion plans, lower than anticipated sales, increased expenses and costs of construction, or other events, including those described in Item 1A, Risk Factors of our Annual Report on Form 10-K for the year ended December 31, 2005 may require us to seek additional debt or equity financing on an accelerated basis. Financing may not be available on acceptable terms, or at all, and our failure to raise capital when needed could impact negatively our growth plans, financial condition, and results of operations. Additional equity financing may be dilutive to the holders of our common stock and debt financing, if available, may involve significant cash payment obligations or financial covenants and ratios that restrict our ability to operate our business.

Equipment Loans

As of September 30, 2006, we had six equipment term loans with lenders; each collateralized by restaurant equipment. The outstanding principal balance under these loans aggregated \$3.5 million. The loans bear interest at rates ranging from 7.0% to 8.5% and require monthly principal and interest payments aggregating approximately \$88,000. The loans mature between October 2006 and June 2012. The loans also require us to maintain certain financial covenants calculated at the end of each calendar year, and we were in compliance with all such financial covenants as of December 31, 2005.

Cash Flows

The following table summarizes our primary sources of cash during the periods presented (in thousands).

| | Nine Months Ended September 30, | |
|--|--|-------------|
| | 2006 | 2005 |
| Net cash provided by (used in): | | |
| Operating activities | \$ 5,736 | \$ 3,343 |
| Investing activities | (8,337) | (31,720) |
| Financing activities | (421) | 28,773 |
| Net (decrease) increase in cash and cash equivalents | \$ (3,022) | \$ 396 |

Operating Activities. During the first nine months of 2006, net cash provided by operating activities was \$5.7 million due principally to the effect of amortization of deferred rent, depreciation and amortization, an increase in accounts payable and accrued expenses, and non-cash stock-based compensation, partially offset by an increase in tenant improvement allowance receivables and prepaids and other current assets. During the first nine months of 2005, net cash provided by operating activities was \$3.3 million consisting primarily of depreciation and amortization, the amortization of deferred rent, collection of tenant improvement allowances, and non-cash compensation expenses, partially offset by payments of accounts payable and an increase in prepaids and other current assets.

Investing activities. We fund the development and construction of our new restaurants primarily with cash and short-term investments. Net cash used for investing activities was \$8.3 million for the first nine months of 2006, reflecting \$14.6 million for the funding of construction in progress and the purchase of property and equipment, the majority of which related to new restaurant openings and planned restaurant openings. Investing activities also include proceeds of \$6.3 million from the sale of investments to fund this construction. Net cash used for investing activities was \$31.7 million for the first nine months of 2005, of which \$23.9 million was used to purchase short-term investments and \$7.8 million relates to funding construction in progress and the purchase of property and equipment for the Sugar Land and San Antonio restaurants. We expect the cash investment cost of our prototype restaurant to range from \$3.2 million to \$3.8 million, excluding landlord tenant improvement allowances and excluding preopening expenses of approximately \$0.4 million.

Table of Contents

Financing Activities. Net cash used in financing activities was \$0.4 million for the nine months ended September 30, 2006 principally consisting of \$0.6 million of principal payments on our equipment loans, partially offset by proceeds from the issuance of common stock from the exercise of stock options and stock issued under our employee stock purchase plan. Net cash provided by financing activities was \$28.8 million during the nine months ended September 30, 2005 consisting primarily of \$28.1 million of net proceeds from our initial public offering and \$0.6 million in proceeds from equipment loans less related principal payments.

Off-Balance Sheet Arrangements

In September 2003, we sold the assets of Saki's Pacific Rim Café. We continue to be financially responsible for the lease payments in the event the purchaser defaults on the lease. The lessor has obtained certain personal guarantees of the lease payments from the purchaser's owners should they fail to perform under the lease. The total remaining lease payments due under the lease approximated \$50,000 at September 30, 2006. The lease expires in January 2007.

Item 3. Quantitative and Qualitative Disclosures about Market Risk**Investments**

A change in market price exposes us to market risk related to our short-term investments. We held approximately \$17.9 million in available-for-sale securities as of September 30, 2006. A hypothetical 10% decline in the market value of those securities would result in a \$1.8 million unrealized loss and a corresponding decline in their fair value. The hypothetical decline would not affect our cash flows unless the securities were disposed of.

Primary Market Risk Exposures

Our primary market risk exposures are in the areas of commodity costs, labor costs, and construction costs. Many of the food products purchased by us are affected by changes in weather, production, availability, seasonality, and other factors outside our control. In addition, we believe that almost all of our food and supplies are available from several sources, which helps to control food commodity risks. Our labor costs may be impacted by proposed legislation to increase the minimum wage rate as many of our employees are paid labor rates related to federal and state minimum wage laws. We have exposure to rising construction costs, which may impact our actual cost to develop new restaurants. Although the cost of restaurant construction will not impact significantly the operating results of the restaurant, it would impact the return on investment for such restaurant.

Inflation

The primary inflationary factors affecting our operations are food, labor, and construction costs. A large number of our restaurant personnel are paid at rates based on the applicable minimum wage, and increases in the minimum wage directly affect our labor costs. Many of our leases require us to pay taxes, maintenance, repairs, insurance, and utilities, all of which are generally subject to inflationary increases. We believe inflation has not had a material impact on our results of operations in recent years.

Item 4. Controls and Procedures

We have evaluated, with the participation of our Chief Executive Officer and Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of September 30, 2006. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer have each concluded that our disclosure controls and procedures are effective to ensure that we record, process, summarize, and report information required to be disclosed by us in our quarterly reports filed under the Securities Exchange Act within the time periods specified by the Securities and Exchange Commission's rules and forms. During the quarterly period covered by this report, there have not been any changes in our internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II OTHER INFORMATION

Item 1. Legal Proceedings

Not applicable

Item 1A. Risk Factors

Not applicable

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Not applicable

Item 3. Defaults Upon Senior Securities

Not applicable

Item 4. Submission of Matters to a Vote of Security Holders

Not applicable.

Item 5. Other Information

Not applicable

Item 6. Exhibits

(a) Exhibits

- 31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), promulgated under the Securities Exchange Act of 1934, as amended.
- 31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), promulgated under the Securities Exchange Act of 1934, as amended.
- 32.1 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Table of Contents

SIGNATURES

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

Kona Grill, Inc.

/s/ Marcus E. Jundt
Marcus E. Jundt
*Chairman of the Board, President, and
Chief Executive Officer*

/s/ Mark S. Robinow
Mark S. Robinow
*Executive Vice President, Chief Financial
Officer, and Secretary (Principal
Accounting and Financial Officer)*

Date: November 2, 2006